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October 27, 2017

Toni Lee-Andrews
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1211 Avenue of the Americas
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RE: AICPA Professional Ethics Division Proposed Interpretation *State and Local Government Entities*

Dear Ms. Lee-Andrews:

We appreciate the opportunity to comment on the AICPA Professional Ethics Division's (PEEC) Proposed Interpretation to the Code of Professional Conduct, *State and Local Government Entities*. In evaluating the proposed interpretation, we offer the following comments for PEEC's consideration. We have included editorial suggestions and changes for the use of the term 'components' in Appendix 1. Additionally, PEEC specifically requested feedback on a number of questions, which we have included in Appendix 2.

Overall

We have two comments that apply pervasively to the proposed interpretation:

- **Use the term 'components' instead of 'funds and component units'**

We recommend using the term 'components' instead of 'funds and component units' throughout the interpretation. The term 'components' is more closely aligned with AU-C 600, *Group Audits*, and better connotes the broad use of the term throughout the interpretation. We also recommend defining 'components' and deleting the definition for 'fund and component units' in paragraph .04c as follows:

[1.224.020.04c] Components are intended to be broadly defined and can include, but are not limited to, funds, departments, agencies, programs, component units, employee benefit plans, and other fiduciary and custodial activities. ~~Funds and component units are intended to be broadly defined and can include, but are not limited to, departments, agencies, programs, organizational units administered by elected officials, grant reporting, organizational units within component units, employee benefit plans, and other fiduciary and custodial activities. A component unit can also be a primary government in its standalone financial statements.~~

- **Define 'downstream' and 'upstream' for purposes of evaluating independence**

The 'Explanation of the Proposed Revisions' section of the exposure draft includes a description of the terms 'upstream' and 'downstream' that is critical to the understanding and application of the proposed interpretation. Accordingly, we recommend including the following descriptions for downstream and upstream in the interpretation after paragraph .04d:



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The term downstream is used in this interpretation to refer to those entities that are “below” the financial statement attest client in its organizational structure. This would be the case in circumstances in which the financial statement attest client is the primary government, and the components to be evaluated (downstream entities) are those required to be included in the primary government’s financial reporting entity.

The term upstream is used in this interpretation to refer to those entities that are “above” the financial statement attest client in its organizational structure. This would be the case in circumstances in which the financial statement attest client is a component (downstream entity) that is required to be included in a financial reporting entity of a primary government (upstream entity). In this case, the entities to be evaluated are those included in the primary government but not other components included in the financial reporting entity.

There are numerous places in the proposed interpretation with changes for use of ‘component’. We have identified those changes and other editorial suggestions in Appendix 1.

Introduction (ET 1.224.020.01-.03)

- **Clarify that the GASB financial reporting entity is underlying the foundation for evaluation of independence**

The ‘Explanation of the Proposed Revisions’ section of the exposure draft includes a brief discussion of the GASB financial reporting entity that we believe will be helpful to members in understanding the underlying tenants of the proposed interpretation (that is, the scope of the interpretation is based on the financial reporting entity as determined by the notion of financial accountability). Accordingly, we recommend including this guidance in the interpretation after paragraph .03 as follows:

The guidance in this interpretation related to which entities should be evaluated for independence is based on the concept of the financial reporting entity in the financial reporting standards of Governmental Accounting Standards Board (GASB). Specifically, GASB uses the notion of financial accountability to determine when an entity should be included in a state or local government’s financial statements.

Terminology (ET 1.224.020.04)

- **Define ‘financial reporting entity’ and ‘primary government’ to be consistent with GASB**

The terms ‘financial reporting entity’ and ‘primary government’ are not consistently used throughout the document and are inconsistent with the GASB financial reporting framework, which could lead to the inappropriate evaluation of certain entities.

We recommend using the following definition for ‘financial reporting entity’ in paragraph .04a:



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[1.224.020.04a] The financial reporting entity consists of all components of a state or local government that are required to be included in financial statements based on the applicable financial reporting framework. The financial reporting entity can be viewed from the perspectives of 1) the attest client's financial statements (that is, downstream), and 2) the financial statements in which the attest client's financial statements are included (that is, upstream).

We recommend using the following definition for 'primary government' in the interpretation after paragraph .04a:

The primary government of the financial reporting entity consists of all of the organizations that make up the primary government's legal entity. All funds, organizations, institutions, agencies, departments, and offices that are not legally separate are part of the primary government. The primary government does not include legally separate entities that are required to be included in the financial reporting entity as discretely presented component units. The primary government can be viewed from the perspective of 1) the financial statement attest client (that is, downstream), or 2) the financial reporting entity in which the attest client's financial statements are required to be included (that is, upstream).

Downstream Independence (1.224.020.05-1.224.020.08)

- **Include guidance on materiality for downstream entities**

We believe guidance is needed on how to determine materiality for purposes of identifying material components in paragraph .06. Specifically, we recommend including guidance from the 'Explanation of the Proposed Revisions' section of the exposure draft to paragraph .06 as follows:

[1.224.020.06] Members should apply the "Independence Rule" [ET sec. 1.200.001] and related interpretations to all material ~~funds and component units~~ components included in the financial statement attest client's financial reporting entity ~~in for~~ which the covered member makes reference to another auditor's report ~~on the material fund or component unit~~, and the primary government has more than minimal influence over the accounting or financial reporting process ~~over of that fund or component unit~~ component. Materiality should be considered in relation to the financial statement attest client's financial reporting entity as a whole.

- **Include additional guidance on reasonable to conclude exception**

The 'Explanation of the Proposed Revisions' section of the exposure draft includes additional guidance we believe would be helpful to members in determining whether the 'reasonable to conclude' exception for nonaudit services in paragraph .08 can be applied. Accordingly, we recommend including this guidance in the interpretation after paragraph .08 as follows:

When considering if the exception in paragraph .08 can be applied, a member should evaluate whether the otherwise prohibited services provided to a downstream entity are subject to a member's attest procedures for the primary government. For example, a member may be considering whether that member can apply this



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exception to the provision of financial system implementation and design at a component in which this exception might be available. In this example, the member has determined that this service would be prohibited if performed directly for an audit client. The member will need to consider the impact on threats to independence related to the attest procedures at the primary government. The determination of whether the otherwise prohibited service can be performed at the downstream component is a matter of professional judgment after considering the significance of threats to independence in fact and in appearance.

Upstream Independence (ET 1.224.020.09)

- **Include guidance on materiality for upstream entities**

We believe guidance is needed on how to determine materiality for purposes of identifying material components in paragraph .09. Specifically, we recommend including guidance in the interpretation from the 'Explanation of the Proposed Revisions' section of the exposure draft to paragraph .09 as follows:

[1.224.020.09] When ~~the a material fund or component unit is a~~attest client's financial statements ~~financial statement attest client and are~~is material and required to be included in ~~another~~ financial reporting entity that is not a financial statement attest client, members should use the "Conceptual Framework for Independence" interpretation [ET sec. 1.210.010] to evaluate relationships and circumstances that a member has with a primary government that exerts more than minimal influence over the accounting or financial reporting process of the financial statement attest client. Materiality should be considered in relation to the financial statements as a whole of the financial reporting entity for which the attest client's financial statements are included.

- **Provide clarification and examples on how to apply conceptual framework**

We believe paragraph .09 (which requires the use of the "Conceptual Framework for Independence" for evaluation of independence threats at the primary government upstream of the financial statement attest) will be difficult for members to understand and consistently apply without additional clarification and examples. Specifically, we recommend providing additional guidance and examples of how this paragraph may be applied for both financial and employment relationships in the interpretation after paragraph .09. An example of such additional guidance might look like the following:

When evaluating whether significant threats exist with any relationships or circumstances that a member has with a primary government that exerts more than minimal influence over the accounting or financial reporting process of the financial statement attest client, the member should consider threats that may exist as a result of relationships and circumstances that a member has with the primary government. Threats to consider include threats to self-review and self-interest among others. The member can consider relationships and circumstances as result of financial interests with the firm or with members of the firm, employment relationships with members of the firm and their immediate family members as well as provision of non-audit



services to the primary government, in particular those that may be subject to audit procedures.

Examples of how a member might consider threats include:

- a. A member in an office with a large number of professionals may consider that, when auditing a component of a primary government that meets the criteria in paragraph .09, self-interest threats exist related to investments in general obligation bonds issued by the primary government held by covered members. The member could determine that the threats are significant for investments held by members of the engagement team only (and not all other covered members) and therefore prohibit any member of the engagement team from holding such investments. A firm in an office with fewer personnel may determine that threats are significant for all covered members and prohibit all covered members from holding such investments.*
- b. A member may conclude that employment relationships create significant threats to independence when a spouse of the audit partner on the engagement team has a key financial position with a primary government that meets the criteria in paragraph .09. As such, the member could prohibit the audit partner from serving on the engagement. A member may conclude that when the employment relationship is with a partner in the office when that partner provides no services to the audit client, that the threats are not significant and therefore, do not require the member to apply safeguards.*
- c. A member may conclude that when the firm provides otherwise prohibited nonattest services to a primary government that meets the criteria in paragraph .08 that is not subject to the audit of the financial statement attest client, that threats are not significant and therefore, the firm can provide the nonattest services. Alternatively, the member may conclude that the firm should not provide the services if the services were subject to audit.*

Other Components

- **Clarify whether guidance applies to both upstream and downstream entities**

It is unclear whether paragraph .10 applies to both upstream and downstream entities. We recommend including '(Upstream and Downstream)' at the end of the header preceding paragraph .10 in the interpretation as follows:

Other ~~Funds, Components, Units, or Activities~~ (Upstream and Downstream)

Investments (ET 1.224.020.11-13)

- **Clarify whether guidance applies to investments held both upstream and downstream entities**

It is unclear whether the guidance in paragraphs .11-.12 apply to investments held by upstream entities, downstream entities, or both. We believe at a minimum this was intended to apply to downstream entities.



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- **Establish separate guidance for investments held by upstream entities**

We believe the guidance in paragraphs .11 and .12 should not apply to investments held by upstream entities. Specifically, we believe the threats to independence are unlikely to be significant for investments held by upstream entities. Additionally, members may need to apply significant efforts to obtain the information necessary to make the evaluation and the information may not be readily available. Therefore, we recommend the interpretation include a requirement to apply a conceptual framework approach for investments held by upstream entities, considering threats and safeguards based on when the member knows or has reason to believe that significant threats exist.

- **Incorporate clarification on application of the downstream evaluation**

It is not clear whether the independence requirements in paragraphs .11 and .12 apply to all investments held by downstream entities, or whether the independence requirements should be applied differently based first upon whether the component that holds the investments meets the criteria in paragraphs .05, .06, or .07.

These paragraphs cover circumstances in which the component:

- is material and the member does not make reference to another auditor's report (paragraph .05)
- is material and the member makes reference to another auditor's report on the material component and the primary government has more than minimal influence over the accounting and financial reporting process over that component (paragraph .06)
- is material and the component is excluded from the financial reporting entity but is required to be included under the applicable framework when the primary government has more than minimal influence over the accounting or financial reporting process over the component (paragraph .07)

We recommend the requirements in paragraphs .11 and .12 only apply to investments held by components for which the member does not make reference to another auditor's report (paragraph .05). For all other investments held by downstream entities (paragraphs .06, .07, and .10), we believe the threats to independence are unlikely to be significant. Members may need to apply significant efforts to obtain the information necessary to make the evaluation and the information may not be readily available to the member. Therefore, we recommend the interpretation include a requirement to apply a conceptual framework approach for all other investments held by downstream entities, considering threats and safeguards based on when the member knows or has reason to believe that significant threats exist.



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More Than Minimal Influence

- **Delete factors related to determining influence in paragraph .14**

We believe the factors listed in paragraph .14 are duplicative or potentially inconsistent with the examples included in paragraph .15. We recommend deleting the factors listed in paragraph .14 and moving the potential discussion of a rebuttable presumption to paragraph .15 (see comment on the rebuttable presumption below).

- **Limit rebuttable presumption to components that are not legally separate from the primary government**

We believe there should *only* be a rebuttable presumption that the primary government has more than minimal influence over the accounting or financial reporting of a component in circumstances when the component is not legally separate from the primary government (for example, a fund). Anecdotally, we believe a majority of components that are legally separate will not meet the criteria for more than minimal influence over the accounting or financial reporting. We recommend removing paragraph .14 and including the discussion on the rebuttable presumption in paragraph .15 as follows:

[1.224.020.15] There is a rebuttable presumption that the primary government has more than minimal influence over the accounting or financial reporting of a component that is not legally separate from the primary government (for example, a fund). The overall facts and circumstances should be considered ~~when using the factors in paragraph .14~~ to evaluate whether a primary government has more than minimal influence over the accounting or financial reporting process of a ~~fund or component unit~~ component...

If you have questions about our response, please contact Bill Mckeown at (610) 341-4810 or wmckeown@kpmg.com.

Very truly yours,

KPMG LLP

Theresa P. Ahlstrom
Partner in Charge - Independence

TPA:ec:pf

[1.224.020] ~~Entities Included in~~ State and Local Government Entities ~~Financial Statements~~

[1.224.020.02] This interpretation applies to financial statement attest clients that are state and local governmental entities whose basic financial statements include ~~funds and component units components~~ that...

[section header] Independence of ~~Funds and Component Units~~~~Components~~ Required to Be Included in the Financial Reporting Entity (Downstream ~~Entities~~) of the Financial Statement Attest Client

[1.224.020.05] Members should apply the “Independence Rule” [ET sec. 1.200.001] and related interpretations to all ~~funds and component units~~~~components~~ included in the financial statement attest client’s financial reporting entity ~~in for~~ which the covered member does not make reference to another auditor’s report ~~on the fund or component unit~~.

[1.224.020.07] Members should apply the “Independence Rule” [ET sec. 1.200.001] and related interpretations to all material ~~funds and component units~~~~components~~ excluded from the financial statement attest client’s financial reporting entity but required to be included under the applicable framework when the primary government has more than minimal influence over the accounting or financial reporting process ~~over of~~ those ~~funds or component units~~~~components~~.

[section header] Independence When the Financial Statement Attest Client Is Required to Be Included in Another Financial Reporting Entity (Upstream ~~Entity~~)

[1.224.020.10] For ~~funds, component units, or activities~~~~components~~ not specified in paragraphs .05–.09 of this interpretation, members should apply the “Conceptual Framework for Independence” interpretation [ET sec. 1.210.010] if the member knows or has reason to believe that a relationship or circumstance exists with the entity that would create threats to independence.

[1.224.020.15]

Less Influence

More Influence

a. Fund or component unit Component prepares its own financial statements.	A. Primary government prepares the fund or component unit component ’s financial statements.
b. Accounting staff is separate from primary government staff.	B. Accounting staff is part of primary government finance staff.
c. Separate accounting system exists.	C. Same accounting system as primary government exists, with no fund or component unit component subsystems that feed the primary government system.
d. Separate internal control over financial reporting exists.	D. Same internal control over financial reporting as primary government exists.
e. Primary government has no operational control.	E. Primary government has strong operational control.
f. Strong independent governing board exists.	F. Same governing body as primary government exists, with high level of involvement.
g. There is no level of financial dependence on primary government.	G. There is a high level of financial dependence (such as operating loss subsidies and payment for certain costs).
h. Board members are not otherwise associated with the primary government.	H. Board members are associated with the primary government, such as ex-officio members that are employed by the primary government.

<p>i. Fund or component unitComponent financial statements isare incorporated into primary government without modification (that is, either fund-level or government-wide level statements of primary government).</p>	<p>l. Fund component unitComponent financial statements need adjustments or reclassifications (for example, significant adjustments made by primary government are necessary to include balances or notes to statements modified for differing accounting methods or reporting alternatives).</p>
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Appendix 2

Question	Comments
<p>1. Are there any situations in which you believe the framework proposed will not reach the appropriate answer for the general fund? If so, please explain the situation and why you believe the appropriate answer would not be reached.</p>	<p><i>We have not identified any such situations where we believe the framework proposed would not reach the appropriate answer for the general fund.</i></p>
<p>2. Paragraph .03 of the proposed revised interpretation notes that when an interpretation of the “Independence Rule” (ET sec. 1.200.001) is applied in a state or local government environment and the interpretation uses terminology that is not applicable in this environment, the member should use their professional judgement to determine if there is an equivalent term and provides an example of one such situation in which PEEC believes this could occur. Are there any other terms or concepts included in the interpretations to the independence rules that PEEC should highlight as an example or consider providing additional application guidance for?</p>	<p><i>We have provided additional terms and concepts where we felt additional guidance and examples were necessary throughout the proposed interpretation.</i></p>
<p>3. Are the entities that would be included in the proposed definition of a <i>primary government</i> in paragraph .04a the entities that should be evaluated for independence purposes? If not, what entities should be evaluated for independence purposes, and should the term <i>primary government</i> be used to describe these entities?</p>	<p><i>We believe the terms ‘financial reporting entity’ and ‘primary government’ are not consistently used throughout the document and are inconsistent with the GASB financial reporting framework, which could lead to the inappropriate evaluation of certain entities. We have provided comments and proposed language related to this paragraph in our letter under the ‘Terminology (ET 1.224.020.04)’ section.</i></p>

Question	Comments
<p>4. PEEC believes that the criteria necessary to undertake the “more than minimal influence evaluation” in paragraph .14 is already available to the auditor as a result of other audit procedures. Do you believe that there are circumstances in which this information is not readily available to the auditor? If so, provide examples of circumstances in which a member may have difficulty in performing this evaluation.</p>	<p><i>We believe that this information is readily available to the member. However, we do believe the potential exists today for inconsistent evaluation of these factors by the group and component auditors.</i></p>
<p>5. The “more than minimal influence over the accounting or financial reporting process over that fund or component unit” concept would require an analysis that is intended to be different than the analysis required for determining which entities are in a primary government’s financial reporting entity. In the context of the proposed guidance, is that objective clear? If not, how would you better describe the analysis?</p>	<p><i>We believe that the objective is clear and have no further comments.</i></p>
<p>6. Paragraph .13 provides a “best efforts” provision that addresses those situations in which a member is unable to obtain the information necessary to identify investments held by a financial statement attest client. Are there any other situations in which you believe a best efforts provision would be necessary, either upstream or downstream, because the financial statement attest client may have difficulty identifying all the entities required to be included in the financial reporting entity?</p>	<p><i>We are not aware of any other circumstances in which a best efforts provision should be applied.</i></p>
<p>7. Is it clear that the interpretation does not apply to an entity that provides grant funds to the financial statement attest client (or vice versa) unless that entity is a fund or component unit that would otherwise be covered by the interpretation? If not, provide examples of situations in which you believe additional guidance is needed.</p>	<p><i>We do not think this distinction is necessary. It is generally well understood that grant activities do not directly impact the consideration of the financial reporting entity. Accordingly, we do not believe there is a need to make reference to grants in this interpretation.</i></p>