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AICPA Professional Ethics Executive Committee  
Via email: [Ethics-ExposureDraft@aicpa-cima.com](mailto:Ethics-ExposureDraft@aicpa-cima.com)

Re: Exposure Draft – State and Local Government Entities

Baker Tilly Virchow Krause, LLP (“Baker Tilly”) appreciates the opportunity to respond to the State and Local Government Entities Exposure Draft (“ED”).

Baker Tilly is a large accounting firm with approximately 300 partners and 2,700 team members, and is ranked in the top 15 of American CPA firms. Baker Tilly performs approximately 1,000 audits of governmental entities annually. We have drawn on this experience in preparing our response for your consideration.

Thank you to the State and Local Government (“SLG”) Entities Task Force for the significant time and effort committed to this project. We have been following the project over the last year and understand it has gone through numerous revisions. When reviewing our comment letter, you will find that we are going to ask the committee to consider another rewrite effort to simplify the proposed interpretation and better align threats to independence in the government environment.

### **Overall**

We agree with paragraph .05 of the ED that states members should apply the Independence Rule to all funds and component units included in the financial statement attest client’s financial reporting entity in which the covered member does not make reference to another auditor’s report on the fund or component unit. This language is similar to extant guidance and we believe has been appropriately applied in practice.

We also believe that the conceptual framework is being applied when a member identifies a significant threat to independence of a financial statement attest client that originates from entities that have a relationship to the financial statement attest client (such as the upstream and downstream entities described in this ED). We recognize there is a limitation in extant guidance surrounding these relationships.

However, the proposed revision goes far beyond what we believe is necessary to adequately address the risk of an independence impairment in the government environment. While we appreciate the desire for PEEC to study if the affiliate’s guidance could be applied in the government environment, we are not aware of problems in practice with the extant guidance. As a result, we are not fully understanding the need for a revision of this magnitude that will result in firms needing to invest significant time, cost, and tracking mechanisms for circumstances and relationships that are ultimately unlikely to result in different independence conclusions.

The background to the ED states that PEEC tried to be conceptually consistent with the underlying principles of the affiliate’s guidance, unless there was a compelling reason to differ. Throughout that discussion, valid and significant differences are cited between the financial reporting objectives and financial statement presentation of SLG and commercial entities. For the many reasons listed in the ED, we believe the government reporting relationships are not able to be aligned to the affiliate’s guidance.

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## Recommendation

We recommend this proposed interpretation be significantly simplified to promote consistent application in practice while still addressing true threats to independence. We recommend an overall change to a more broadly applied conceptual framework for independence and the elimination of the prescriptive requirements identified in much of this ED. This can be accomplished through expanded application of the language in paragraph .10 of the ED to also apply upstream and downstream. We believe much of this proposed interpretation is imposing requirements to search for circumstances and relationships that are otherwise unknown to the engagement team, and therefore highly unlikely to actually threaten independence.

Paragraph .10 of the ED states *“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. “*

This could be enhanced to cover upstream and downstream relationships through a revision as follows:

*“members should also consider entities that have a reporting relationship to the financial statement attest client that the member does not audit and 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. “*

“Reporting relationship” could then be defined in the standard to include upstream, downstream, and brother-sister entities.

## Downstream

We believe that the downstream paragraphs .05 through .08 are understandable and would be consistently interpreted by members. However, we fundamentally disagree with the rebuttable presumption that a primary government has more than minimal influence over a fund or component unit, and we also believe the prescriptive application of the Independence Rule does not achieve the appropriate conclusion. Both of these are discussed through examples provided below.

### More than Minimal Influence

We disagree with the rebuttable presumption that a primary government has more than minimal influence over the accounting or financial reporting process of downstream funds and component units. In fact, our experiences indicate that if another auditor is engaged to audit a fund or component unit of the primary government, more often than not the primary government does not have more than minimal influence over the downstream entity. If enough separation exists that an audit is separately contracted, this should be a first indicator that there is likely not more than minimal influence. The autonomy of downstream entities that are audited by other auditors is commonly evidenced by independently prepared financial statements, separate management and accounting staff, and separate systems and controls. While this is true of many of the funds we see separately audited, the autonomy is taken a step further with component units that also have a separate governance structure.

To illustrate a common example we encounter in our firm, many municipalities and counties we audit have various “authorities” associated with the governments which we do not audit. These include housing authorities, community development authorities, and other authorities that are established by the government and operate under state statutes. Depending on various factors that determine the reporting entity presentation established by GASB, including the governance structure, these organizations are typically reported as funds or component units of the primary government that we audit, and we make reference to other auditors in our auditors report. However, very rarely would we reach a conclusion of more than minimal influence when considering the general autonomy of the entities and factors listed in paragraph .15 of the ED.

### **Application of the Independence Rule**

We also disagree that prescriptive application of the Independence Rule to these downstream entities is appropriate in all situations when more than minimal influence exists. To illustrate this, in the authority example above, let's assume this is a community development authority that has common members of governance and payroll systems with the city. This results in the audit team concluding there is more than minimal influence. The community development authority is also material to the city we are auditing. As a result, under paragraph .06 of the ED, we need to apply the Independence Rule to the authority that we do not audit.

In applying the Independence Rule, we consider the various requirements of ET.1.200, and discover that a partner in the same office as the city audit engagement team has a revolving loan from the authority for rehabilitation of a building that he owns in the city. Under ET 1.260.010, the existence of this loan would impair independence. This evaluation and conclusion does not seem practical or logical for multiple reasons. First, the more than minimal influence conclusion was determined based on factors unrelated to the revolving loan activities of the authority. Second, the city audit engagement team would have to significantly expand their independence procedures to identify the existence of this loan, resulting in time and cost to the firm. Finally, as the auditor of the city, we struggle to understand how our judgment is impaired because of this situation since we are not auditing the authority, and the revolving loan activities of the authority are not administered or overseen by the city. Therefore, we believe the prescriptive requirement to apply the Independence Rule and a resulting conclusion of an independence impairment for the city audit is not the right answer.

### **Alternative Recommendation**

We believe a better solution to address both of these concerns for downstream entities is the application of the language in the ED paragraph .10 revised as noted above and as follows:

*"members should also consider entities that have a reporting relationship to the financial statement attest client that the member does not audit and 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. "*

Looking at the situation described above for the community development authority, if we, as the city auditors, determine there is a threat to our independence because of the existence of this loan with the authority, we could apply the conceptual framework for independence to evaluate the threat. Our considerations may include factors such as the size of the loan and the role of governance in the loan approval. This would allow the auditor an opportunity to identify the threat, determine its significance, and consider if there are safeguards that can be applied to reduce the threat to an acceptable level. This seems like a much more realistic response than the automatic conclusion of an independence impairment for the city audit.

## Upstream

Paragraph .09 of the ED also causes us concern for various reasons, the most significant relate to the lack of clarity in how it should be applied and the extensive efforts this paragraph will require for what will likely be limited or nonexistent changes in conclusions from extant guidance. We appreciate the efforts made to modify the upstream considerations to a conceptual framework instead of the prescriptive application of the Independence Rule as contained within the downstream view. However, we still believe the application of this paragraph will result in significant efforts by members, and significant tracking systems by firms, to search for potential relationships and circumstances at the upstream entity that will rarely result in a significant threat to independence. We have additional concerns related to the application of the paragraph as follows:

- > The reporting entity level to which materiality should be applied is not identified within the ED paragraph .09, but instead identified as the financial reporting entity level only in Exhibit B. If the intent is application at the entity level, we believe this should be brought into the language of the interpretation.
- > It is unclear how far upstream this analysis should be applied. For example, consider a pension plan fund of a school district. This school district is reported as a fund of a county. From the perspective of the pension plan auditor, is this upstream analysis to be applied to the school district only, or does it also apply at the higher level of the county?
- > We anticipate significant variation in practice with the extent to which the conceptual framework analysis is applied, and the level of documentation expected to be maintained. Exhibit B indicates that the member is expected to actively consider threats when applying the conceptual framework. We understand this to be a step beyond the language in paragraph .10 which indicates the member applies the conceptual framework to relationships and circumstances that the member knows or has reason to believe exist. This guidance is not within the ED paragraph itself, and therefore, we understand will not be contained in the final guidance. Even as currently worded in the Exhibit B, we are not sure there will be common understanding of what “actively consider” means.
- > Similar to our comments with downstream, for the reasons and examples stated in that section, we disagree with the rebuttable presumption that a primary government has more than minimal influence over the accounting or financial reporting process of a fund or component unit.

Looking at a common example in our firm, we frequently perform audits of public utilities that are part of the reporting entity of a government that we do not audit. These utilities may be funds or component units of the primary government. When applying paragraph .09 to these situations, we anticipate the following challenges:

- > When the auditor determines if the utility is a material fund or component unit, it is unclear the opinion unit to which the materiality calculation should be considered. The auditor could conclude it should be applied to the business type activities or component unit opinion unit. However, since Exhibit B indicates it should be applied to the financial reporting entity, it suggests the combination of these opinion units, which is not a materiality foundation that currently exists in practice.
- > In determining whether more than minimal influence exists, because the ED paragraph .14 indicates a rebuttable presumption of more than minimal influence, the auditor will need to consider and document the factors in paragraphs .14 and .15 to conclude whether or not more than minimal influence exists. As discussed earlier in this letter, our experience when these separate audit contractual relationships exist indicate that most of the time the auditor will conclude there is not more than minimal influence. As a result, the utility audit team will need to prepare documentation in each engagement that demonstrates how this rebuttable presumption is overcome.

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- > If the rebuttable presumption is not overcome, and the fund is material, the next challenge occurs in how extensively to apply the conceptual framework. The explanation of proposed revisions in the ED indicates the upstream requirements go beyond simply responding when a member knows or has reason to believe that threats exist. Therefore, while not written into paragraph .09 itself, we understand the intent is more substantial consideration of the factors that influence independence. However, this exercise of searching for relationships and circumstances at the primary government which we do not audit will be a significant administrative effort for firms to implement and we struggle to understand how those circumstances which the auditor was otherwise unaware influence their independence.

### **Alternative Recommendation**

Similar to downstream, we believe a better solution for upstream evaluation is the application of the language in the ED paragraph .10 revised as noted above and as follows:

*“members should also consider entities that have a reporting relationship to the financial statement attest client that the member does not audit and 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. “*

### **Investments**

We have been unable to conclude if paragraph .11 in the ED is intended to apply to downstream entities that the member does not audit but are part of the financial statement attest client’s reporting entity. Application of this section to any portion of the entity we do not audit will be highly impractical to operationalize in member firms.

To demonstrate an example that is common in our firm, we audit a city with a single employer pension plan reported as a fiduciary fund of the city. This plan is audited by another firm which we make reference to in our auditor’s report. If this section of the proposed ET is intended to apply to the financial statement attest client’s entire reporting entity, we would need to put systems in place to track and evaluate investments of the pension plan. Since we do not audit the plan and have no contractual relationship with the plan, we would not be able to access this information and the pension plan would have no responsibility to provide it to us.

We recommend the following be added to paragraph .11 so it is clearly applicable only to the portion of the entity that the member audits.

*“Application of the Independence Rule and related interpretations does not apply to investments of funds or component units in which the covered member makes reference to another auditor’s report.”*

### **Other concerns**

The use of the terminology “primary government” for purposes of this proposed interpretation, as defined in paragraph .04, does not align to how the term is used in other standards, which we believe will create confusion and potential misapplication.

We have considered how this proposed interpretation will correlate with the group audit standards, and we anticipate there will be differences of opinion between the primary government auditor and fund or component unit auditor related to materiality and more than minimal influence which could become problematic in practice.

## Responses to Request for Specific Comments

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.***

We are unsure the intent of the question and focus on the general fund. As discussed above, we believe there are some situations where the appropriate answer will not be reached when the Independence Rule is applied to a downstream entity.

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 judgment 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?***

See our comments in the upstream section for various areas where we think there will be inconsistent interpretation.

3. ***Are the entities that would be included in the proposed definition of a *primary government* 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 *primary government* be used to describe these entities?***

See our comments in the other section for complexities with the terminology of primary government.

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.***

We believe that this information is often readily available, but there will certainly be circumstances in which it is not. However, our larger concern in paragraph .14 is that we disagree there is a rebuttable presumption that the primary government has more than minimal influence over the accounting or financial reporting process of a fund or component unit. Our explanation for that is included in earlier sections of this letter.

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?***

The objective is clear, but we disagree with the rebuttable presumption as described in earlier sections of this letter.

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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?

This could also be considered is in paragraph .07 if information is not available from an excluded material fund or component unit.

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.

This is clear.

## Conclusion

As we have reviewed this ED and considered how it will be applied to our many SLG audits, we consistently reached a conclusion that independence impairments could be appropriately considered through application of the extant guidance plus a conceptual framework for threats that a member knows or has reason to believe related to upstream and downstream entities of the financial statement attest client. The significant additional time and expense imposed by this standard related to calculation of materiality, rebutting the presumption of more than minimal influence, applying the Independence Rule to downstream entities, and actively considering threats when applying the conceptual framework upstream are unnecessary steps that do not result in improved professional standards. We respectfully request the committee consider a rewrite to simplify application while still reaching the appropriate independence conclusion as discussed in our recommendation section.

We appreciate the opportunity to provide comments on this exposure draft. Should you wish to discuss any of these comments, please contact Philip Santarelli at [philip.santarelli@bakertilly.com](mailto:philip.santarelli@bakertilly.com) or Heather Acker at [heather.acker@bakertilly.com](mailto:heather.acker@bakertilly.com).

Sincerely,

BAKER TILLY VIRCHOW KRAUSE, LLP

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