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October 13, 2017

Professional Ethics Executive Committee
Professional Ethics Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas, 19th Floor
New York, NY 10036

Via e-mail: Ethics-ExposureDraft@aicpa-cima.com

Re: Comments on Exposure Draft, *Proposed Interpretation and other guidance, State and Local Government Entities*, AICPA Professional Ethics Division dated July 7, 2017

Dear Committee Members:

Crowe Horwath LLP appreciates the opportunity to comment on the American Institute of Certified Public Accountants ("AICPA") Professional Ethics Executive Committee's ("PEEC") July 2017 Exposure Draft, *Proposed Interpretation and other guidance, State and Local Government Entities* (Exposure Draft) which provides a conforming revision to the definition of financial statement attest client and revision to "The Plan Is an Attest Client or Is Sponsored by an Attest Client" interpretation.

We agree the concept of "client affiliates" in the State and Local Government (SLG) sector is different than affiliates for commercial entities because of the fundamental differences between the governmental and commercial sectors. We also agree it is more appropriate to consider financial accountability for identifying SLG affiliates rather than control and influence which is present in the general affiliate definition.

The extant "Client Affiliates" interpretation (ET sec. 1.224.010) makes it clear that SLG entities are excluded from the interpretation and references interpretation 1.224.020. If threats to independence originate from a relationship or circumstance related to an entity excluded from the extant interpretation, we believe most members would apply the conceptual framework to a significant threat identified. However, we recognize the extant guidance may lead members to believe those threats do not need to be evaluated since those entities are excluded.

We understand PEEC's initial project was to consider incorporating the threats and safeguards approach into the SLG interpretation and we are supportive of clarifying the requirement for members to apply the conceptual framework assessment in evaluating threats to independence. However, we have significant concerns about PEEC's recommendation to apply the Proposed Independence Rule for downstream entities such as investments and entities which are excluded from the financial statements or where the member makes references to another auditor's report. In addition, we are concerned about the requirements for members to evaluate relationships and circumstances that the member has with an upstream entity (as defined in paragraph .09).

We believe it is effective for the member to evaluate relationships and circumstances only when the member knows of or has reason to believe that such relationships or circumstances would create a threat to independence. If a threat is identified, then the member would apply the conceptual framework to evaluate the significance of the threat and application of safeguards, if applicable. As a result, we believe

applying the approach laid out in paragraph .10 would be effective for evaluating relationships and circumstances for all SLG entities that are not part of the financial reporting entity.

The Exposure Draft's approach seems to imply there is a concern in the industry that independence has been impaired either in fact or appearance by applying the extant guidance. It is unclear to us whether there are situations where independence has been impaired in fact or appearance as a result of the application of the current guidance for entities included in state and local government financial statements as we believe any significant threats would be identified by applying the conceptual framework. We would encourage PEEC, if it has not already done so, to conduct outreach to identify if the rules need to be amended to prevent situations that would impair independence.

In addition, we are concerned the Exposure Draft will require significant additional effort on the part of auditors and SLG entities to identify, report and track entities that we strongly believe are not likely to impair independence in fact or appearance. As stated above, we believe the conceptual framework as described in paragraph .10 would be more effective for identifying significant threats to independence rather than applying the Independence Rule or requiring the member to seek out threats for other SLG entities.

We also believe the extant Independence Rule (1.224.020) should continue to be applied to the financial reporting entity and the component units and funds disclosed in the financial statements, unless the primary auditor explicitly states reliance on another auditors' report.

Further, we do not believe members should be required to track all circumstances and relationships with other SLG entities, but rather should only evaluate circumstances and relationships the member knows of or has reason to believe would create threats to independence.

In order to effectively monitor investments held by state and local government entities there will need to be an on-going identification and evaluation of these investments, not just at a point in time as of the financial statement date. This will likely require both SLG entities and member firms to implement new, extensive, and possibly costly, reporting processes and systems to provide this information to auditors on a real-time basis. We believe the SLG industry and their tax-payers will see little value for this portion of the proposed rule.

The interpretation requires the member to make judgmental assessments of concepts such as materiality and minimal influence. In situations where there are component and group auditors, different auditors are likely to make different assessments which may result in differing conclusions regarding independence. It is unclear how these situations should be addressed and resolved. This will likely result in additional cost for the SLG industry. We believe PEEC should provide more guidance for materiality and minimal influence in order to reduce the diversity that will result.

Paragraph .14 provides a list of factors for the member to consider in determining whether the primary government has only a minimal influence. In situations where the ultimate primary government is not directly above the financial statement attest client, the information needed to evaluate the factors may not be available to the auditor or client. We have concerns about the difficulty in making this assessment the further removed the primary government is from the financial statement attest client. For example, if the financial statement attest client is a component unit of a state university which is a component unit of the state, the auditor (or management of the component unit of the university) may have difficulty making the assessment of minimal influence.

Other Observations

Notwithstanding our comments above, we provide the following specific comments on the text of the proposed new interpretations for PEEC's consideration.

Proposed Interpretation [1.224.020]: "*State and Local Government Entities*":

- The term "primary government" is defined in paragraph .04 as being solely for use within this interpretation. While we recognize it was intentional to define it differently than how the term is used in the accounting standards, we believe using a different definition will likely cause confusion. We

suggest PEEC create a new term to prevent confusion with the term used in the accounting standards.

- Members are required to apply the Proposed Independence Rule to material funds and component units included in the financial statement attest client's financial reporting entity (paragraphs .06 and .07). We recommend PEEC add clarification to paragraphs .06 and .07 that materiality should be considered in relation to the financial reporting entity and not to materiality as determined at the individual opinion unit since this was PEEC's intention as laid out in the explanation of the proposed revisions. In addition, we believe more guidance may be required for calculating materiality at the financial reporting entity level since auditors do not currently calculate materiality at that level, nor provide an opinion at this level.
- We believe more guidance is necessary for identifying upstream entities as the financial statement attest client may have more than one upstream entity. It is unclear if the evaluation as required by paragraph .14 only applies to the upstream entity directly above the financial statement attest client or if the evaluation must continue upward to all upstream entities. For example, if a member is auditing a component unit of a state university system where the state university system is a component unit of the state, it is unclear whether the upstream evaluation needs to extend up to the ultimate primary government. If that is the intent of the proposal, we suggest the guidance be clarified.
- Paragraph .11 uses the term "de minimis", which is defined in this paragraph as amounts that are clearly inconsequential. We suggest removing the term "de minimis" since this term is not used within the auditing standards and instead just use the term "clearly inconsequential" or "clearly trivial" which is consistent with AU-C 450 paragraph A2.
- We believe the reference to "rebuttable presumption" should be removed from paragraph .14 as we have observed the primary government often does not have more than minimal influence.

Our detailed responses to the questions presented in the Exposure Draft are included in Attachment A.

Crowe Horwath LLP appreciates the PEEC's efforts in providing these new interpretations. We would be pleased to respond to any questions regarding our comments. Should you have any questions please contact Jennifer C. Kary at (574) 239-7886 or Kevin W. Smith (214) 777-5208.

Cordially,

Crowe Horwath LLP

Crowe Horwath LLP

Attachment A

Responses to Request for Specific Comment

- 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 unable to respond to this question since the materiality considerations noted in PEEC's explanation of the proposed revisions makes it unclear as to the intent of the question specific to the general fund. The materiality considerations in the Exposure Draft states, "When materiality is used to determine whether independence is required of an entity in the preceding situations, PEEC believes that materiality should be considered in relation to the financial reporting entity and not to materiality as determined at the individual opinion unit." While we recognize the significance of the general fund to state and local governments, the consideration of material funds and component units in this interpretation is solely in relation to the financial reporting entity as a whole and not the general fund of a financial reporting entity.

We believe the fact that this question is posed in evaluating this interpretation indirectly acknowledges the significance of fund accounting to a user of government financial statements and highlights how governments, their stakeholders, and users of the financial statements are different from their for-profit counterparts. Yet, materiality for purposes of determining independence of SLG entities does not contemplate this unique environment.

- 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?**

As stated in our observations above, paragraph .11 uses the term "de minimis", which is defined in this paragraph as amounts that are clearly inconsequential. We suggest removing the term "de minimis" since this term is not used within the auditing standards and instead just use the term "clearly inconsequential" or "clearly trivial" which is consistent with AU-C 450 paragraph A2.

- 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?**

As stated in our observations above, we believe more guidance is necessary for identifying upstream entities as the financial statement attest client may have more than one upstream affiliate. It is unclear if the evaluation as required by paragraph .14 only applies to the upstream entity directly above the financial statement attest client or if the evaluation must continue upward to all upstream entities. For example, if a member is auditing a component unit of a state university system where the state university system is a component unit of the state, does the upstream evaluation need to extend up to the ultimate primary government. If that is the intent of the proposal, we suggest this be clarified within the guidance.

The Exposure Draft definition of primary government appears to be broader than the generally accepted accounting principles (GAAP) definition which we believe may cause confusion in application. For example, a state government may have a state university as a component unit

and the university may have a campus foundation. The university may issue separate financial statements, but under GAAP if it is not fiscally independent of the state then it is a component unit not a primary government. The primary government of the university and foundation is the state. The Exposure Draft would appear to indicate the university and the state would be the primary government as it relates to the foundation. In GAAP there would only be one primary government. We suggest PEEC create a new term to prevent confusion with the term used in GAAP.

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.**

As stated in our observations above, paragraph .14 provides a list of factors for the member to consider in determining whether the primary government has only a minimal influence. In situations where the ultimate primary government is not directly above the financial statement attest client, the information needed to evaluate the factors may not be available to the auditor or client. We have concerns about the difficulty in making this assessment the further removed the primary government is from the financial statement attest client. For example, if the financial statement attest client is an auxiliary component unit of a state university system which is a component unit of the state, the auditor (or management of the component unit of the university) may not have sufficient information to evaluate “more than minimal influence” related to the accounting systems, internal control over financial reporting, operational control, level of control that the state’s governing body has over the governing body of the system and then in turn over the auxiliary, or funding of debt (i.e. pensions and OPEB). This evaluation becomes even more difficult the further removed a financial statement attest client is from the ultimate upward entity. It also becomes more difficult as the size and complexity of the ultimate upward entity increases.

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?**

Please see our response to question #3.

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?**

We believe there may be confusion in applying the “best efforts” provision as this term is not addressed in the auditing standards. The AICPA Professional Code includes the concept of “best efforts” in the Client Affiliates interpretation [1.224.010] related to the member’s responsibility to obtain information to determine affiliates of a financial statement attest client. If this provision is going to be used in multiple interpretations, we recommend PEEC provide further guidance to assist members in applying the concept of “best efforts”.

It may be beneficial to add the “best efforts” provision to any part of the interpretation which is reliant on the auditor obtaining information from a client or third party. For example, paragraph .14 includes factors to assess when determining more than minimal influence and many of those factors may not be available or accessible to the client.

- 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.**

We believe it is clear the interpretation does not apply to an entity that provides grant funds to the financial statement attest client unless that entity is a fund or component unit that would otherwise be covered by the interpretation.