



EXPOSURE DRAFT

Proposed Interpretation and other guidance

State and Local Government Entities (*formerly*
Entities Included in State and Local Government
Financial Statements)

AICPA Professional Ethics Division
July 7, 2017

Comments are requested by October 16, 2017

Prepared by the AICPA Professional Ethics Executive Committee for comments from those interested in independence, behavioral, and technical standards matters. Comments should be addressed to the Professional Ethics Division, Ethics-ExposureDraft@aicpa-cima.com

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July 7, 2017

This exposure draft contains an important proposal for review and comment by the AICPA's membership and other interested parties regarding a pronouncement for possible adoption by the Professional Ethics Executive Committee (PEEC). The text and an explanation of the proposed pronouncement are included in this exposure draft.

After the exposure period is concluded and PEEC has evaluated the comments, PEEC may decide to publish the proposed pronouncement. Once published, the pronouncement will become effective on the last day of the month in which it is published in the *Journal of Accountancy*, unless otherwise stated in the pronouncement.

Your comments are an important part of the standard-setting process; please take this opportunity to comment. Responses must be received at the AICPA by October 16, 2017. All written replies to this exposure draft will become part of the public record of the AICPA and will be available at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx. PEEC will consider comments at its subsequent meetings.

Please email comments to the Professional Ethics Division (Ethics-ExposureDraft@aicpa-cima.com).

Sincerely,

Samuel L. Burke, Chair
AICPA Professional Ethics Executive Committee

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Explanation of the Proposed Revisions

The Professional Ethics Executive Committee (PEEC) is exposing for comment the interpretation “State and Local Government Entities” (ET sec. 1.224.020),¹ a conforming revision to the definition of a *financial statement attest client* (ET sec. 0.400.16) and revision to “The Plan Is an Attest Client or Is Sponsored by an Attest Client” interpretation (ET sec. 1.250.010).

I. Background

In December 2014, PEEC added a project to its three-year agenda to consider incorporating the threats and safeguards approach into the “Entities Included in State and Local Government Financial Statements” interpretation and to determine if a conceptual framework assessment could be used to determine when a member needs to be independent of state and local governmental (SLG) entities for which he or she is not providing financial statement attest services. PEEC also sought to clarify who at the firm and which immediate family members the interpretation should extend to and if the interpretation should contain any exceptions.

PEEC began its analysis by looking at the “[Client Affiliates](#)” interpretation (ET sec. 1.224.010) and related [affiliate](#) definition (ET sec. 0.400.02) that is applicable to commercial sector entities to determine if this guidance could be extended to the SLG sector. PEEC does not believe the “Client Affiliates” interpretation is effective at identifying relationships requiring independence in the SLG sector because of the fundamental differences in the financial reporting objectives and financial statement presentation of these two sectors. However, PEEC tried to be conceptually consistent with the underlying principles of that affiliate’s guidance, unless there was a compelling reason to differ from those principles.

Financial Reporting Objectives Differ Between SLG and Commercial Sector Entities

The financial reporting objectives in the commercial sector rely heavily on FASB definitions of *control* and *significant influence*, which are not used in the Governmental Accounting Standards Board’s (GASB’s) reporting standards. Instead, GASB uses a concept of financial accountability to identify when an entity should be included in a state or local government’s financial statements. As a result, financial accountability may require inclusion of an entity in the financial reporting entity of a primary government that might not meet the FASB definitions of *control* or *significant influence* by the primary government over the entity. Some of the more significant examples of how GASB standards differ from commercial financial reporting include the following:

- The view that capital assets are primarily used to provide services to citizens, rather than to contribute to future cash flows
- The measurement and recognition of certain types of revenues (for example, taxes and grants)
- The use of fund accounting and budgetary reporting to meet public accountability needs
- The view that governments and their pension plans generally are ongoing entities with the ability to take a career-long view of the employment exchange

In the SLG sector, *entities* included in a set of financial statements are usually referred to as *funds* or *component units*. A fund is a fiscal and accounting entity with a self-balancing set of accounts that are segregated for the purpose of carrying on specific activities or attaining certain objectives. Funds are not legally separate entities.

Component units are legally separate entities. Primary governments may not have control or significant influence over component units in the same way that a commercial sector entity has over its subsidiaries. Component units that are included in a governmental financial reporting entity can operate autonomously from each other, for example, by having separate governing boards, accounting systems, financial reporting systems, operations, and even separate strategic directions. The financial accountability criteria requiring inclusion in the financial reporting entity may merely be due to the appointment of a majority of the otherwise autonomously operating governing board, along with a significant financial benefit or burden relationship in which the governmental

¹ All ET sections can be found in AICPA *Professional Standards*.

financial reporting entity is legally obligated to provide significant operating subsidies or financial support to that entity. Component units may interact with the primary government in an adversarial fashion that is typically foreign in a corporate environment. Officials at a component unit may not report up an organizational structure to someone at the primary government as they would in a corporate environment. Often, there is no communication regarding governance or operations between a component unit and the primary government, which includes the component unit in its financial reporting entity. Affiliate guidance does not effectively identify entities requiring independence in the SLG sector because the assumptions of control and significant influence that underpin the guidance in the FASB *Accounting Standards Codification* in the *affiliates* definition is not the basis for inclusion in a governmental financial reporting entity.

Financial Statement Presentation Differs Between SLG and Commercial Sector Entities

SLG financial statements are not consolidated into a single column, like commercial sector entities. Instead, government-wide financial statements and fund financial statements are presented in columnar formats. Inter-fund activities are not always eliminated as they would be in a consolidated presentation. Different fund categories and, in certain circumstances, different fund types within the same fund category, will not be included on a single set of fund financial statements but will be spread across multiple fund financial statements.

Furthermore, auditors may not necessarily opine solely on the financial statements as a whole. Instead, auditors (often multiple auditors) typically opine separately on the financial statements by auditing individual opinion units. Opinion units may be composed of a single entity, such as a discretely presented component unit, or may include several discretely presented component units or funds. [Exhibit A](#) is a graphic that provides an overview of a typical SLG financial statement presentation.

Terminology—Downstream, Upstream, and Brother-Sister Entities

In this exposure draft, as well as in the proposed interpretation, PEEC makes use of the terms *downstream* and *upstream* entities. PEEC believes that use of this terminology will assist members in appropriately considering which entities are subject to evaluation in determining whether the independence rules and related interpretations should apply. The term *downstream* is used 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 funds and component units to be evaluated are those required to be included in the primary government’s financial reporting entity. In contrast, the term *upstream* is used 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 fund or component unit that is required to be included in a financial reporting entity of a primary government.

The concept of *brother-sister entities* refers to other funds and component units that the member does not provide attest services to but are included in the same upstream financial reporting entity as the financial statement attest client. These entities would be comparable to commercial sector entities covered by item (e) of the [affiliate definition](#) (ET sec. 0.400.02).

II. Applicability

The interpretation addresses independence with respect to entities that are required to be included in a financial reporting entity under the applicable reporting framework.² The extant interpretation refers explicitly to financial statements issued in conformity with generally accepted accounting principles (GAAP). However, given that

² So that the proposed interpretation is clear about when the guidance extends to excluded entities that are required to be included in another financial reporting entity under the applicable framework, the Professional Ethics Executive Committee used the phrase “*is required to be included ...*”

many state and local governments issue financial statements under reporting frameworks other than GAAP (for example, cash basis or regulatory basis), PEEC proposes that the independence evaluation is based on the reporting framework applied by the state and local government entity.

III. Downstream View

Independence of Funds and Component Units Required to Be Included in the Financial Reporting Entity of the Financial Statement Attest Client (Paragraphs .05–.08 of the Proposed Interpretation)

Making Reference to Another Auditor’s Report

Under both the extant interpretation, as well as the proposed interpretation, members must be independent of funds and component units that are 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 provision appears in paragraph .05 of the proposed interpretation and [paragraph .04](#) of the extant interpretation.

Under [paragraph .04](#) of the extant interpretation, members do not need to be independent of funds and component units that are included in the financial reporting entity of the financial statement attest client when the member explicitly states reliance on another auditor’s reports (that is, makes reference to another auditor’s report). After further consideration, PEEC believes that making reference to another auditor’s report will not always reduce threats to an acceptable level when the fund or component unit is material to the financial reporting entity, and the primary government has more than minimal influence over the accounting or financial reporting process of the fund or component unit. As such, PEEC proposes that members be independent of material funds and component units when a primary government has more than minimal influence over the accounting or financial reporting process of such funds or component units even when the member makes reference to another auditor in the auditor’s report. This provision appears in paragraph .06 of the proposed interpretation. See the discussion that follows under “More Than Minimal Influence Over Accounting or Financial Reporting Process” for further clarification.

Funds and Component Units Excluded From the Financial Reporting Entity

The extant interpretation does not provide any independence guidance related to funds and component units that are excluded from the financial reporting entity but are required to be included under the applicable framework (for example, GAAP, regulatory, or cash basis). It is not uncommon for a primary government to exclude a fund or component unit from its financial reporting entity for a variety of reasons, such as unavailability of a component unit’s audited financial statements. PEEC proposes incorporating guidance when a material fund or component unit is excluded from the financial statement attest client’s financial reporting entity but is required under the applicable framework to be included in that financial reporting entity. In this situation, PEEC believes members should apply the “Independence Rule” and related interpretations to the material excluded fund or component unit if the primary government has more than minimal influence over its accounting or financial reporting process. This provision appears in paragraph .07 of the proposed interpretation.

Not Subject to Attest Procedures—Exception

In the commercial sector, the “[Client Affiliates](#)” interpretation (ET sec. 1.224.010) provides an exception that may be applied to all affiliates other than those defined as [type a and b](#). This exception permits the provision of nonattest services that would impair independence to affiliates provided it is reasonable to conclude that the services do not create a self-review threat with respect to the financial statement attest client because the results of the nonattest services will not be subject to the covered member’s financial statement attest procedures. For any other threats that are created by the provision of the nonattest services that are not at an acceptable level (particularly those relating to management participation), the member should apply safeguards to eliminate or reduce the threats to an acceptable level. PEEC is proposing that this exception be applicable to downstream funds and component units, except for those that are included in the financial reporting entity in which the

member does not make reference to another auditor's report. This exception appears in paragraph .08 of the proposed interpretation.

When considering if this exception 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 at the primary government. For example, a member may be considering whether that member can apply this exception to the provision of financial system implementation and design at an entity 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 entity is a matter of professional judgment after considering the significance of threats to independence in fact and in appearance.

Materiality Considerations

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.

Other Downstream Entities

For downstream entities that are not addressed by the guidance referenced previously, members would need to apply only 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 provision appears in paragraph .10 of the proposed interpretation. PEEC believes this is appropriate because these entities are unlikely to create significant threats to the member's independence. See the discussion that follows under "Other Funds, Component Units, or Activities" for further clarification.

Investments Held by State or Local Government Entity

Members may also need to apply the "Independence Rule" and related interpretations to investments held by a state or local governmental entity that is the financial statement attest client as described in paragraphs .11–.13 of the proposed interpretation. See the discussion that follows under "Investments" for further clarification.

Downstream Visual Aid—Table A

Table A provides a visual of how the “Independence Rule” and related interpretations are applied currently and under the proposed interpretation when looking downstream:

Table A					
Auditor of primary government					
Extant and proposed interpretation	Proposed interpretation				
<p>Must apply the Independence Rule to funds and component units included in reporting entity when the auditor does not make reference to another auditor’s report for that fund or component unit.</p>	<p>Must apply the Independence Rule to nontemporary investments held by the primary government that the primary government...</p>				
	<p>Must apply the Independence Rule to material funds and component units that the primary government has more than minimal influence over the accounting and financial reporting process and the funds and component units are...</p>				
	<table border="1"> <tr> <td> <p>... has control over and the investment is not de minimis to the primary government.</p> </td> <td> <p>... has significant influence over and is material to the primary government.</p> </td> </tr> <tr> <td> <p>... included in reporting entity when the auditor makes reference to another auditor’s report for that fund or component unit.</p> </td> <td> <p>... excluded from the reporting entity (but required to be included under the applicable framework).</p> </td> </tr> </table>	<p>... has control over and the investment is not de minimis to the primary government.</p>	<p>... has significant influence over and is material to the primary government.</p>	<p>... included in reporting entity when the auditor makes reference to another auditor’s report for that fund or component unit.</p>	<p>... excluded from the reporting entity (but required to be included under the applicable framework).</p>
<p>... has control over and the investment is not de minimis to the primary government.</p>	<p>... has significant influence over and is material to the primary government.</p>				
<p>... included in reporting entity when the auditor makes reference to another auditor’s report for that fund or component unit.</p>	<p>... excluded from the reporting entity (but required to be included under the applicable framework).</p>				
<hr/> <table> <tr> <td> <p> Independence required</p> </td> <td> <p> Independence required but can provide prohibited nonattest services to the entity if it is reasonable to conclude that the services do not create self-review threats with respect to the financial statement attest client.</p> </td> </tr> </table>		<p> Independence required</p>	<p> Independence required but can provide prohibited nonattest services to the entity if it is reasonable to conclude that the services do not create self-review threats with respect to the financial statement attest client.</p>		
<p> Independence required</p>	<p> Independence required but can provide prohibited nonattest services to the entity if it is reasonable to conclude that the services do not create self-review threats with respect to the financial statement attest client.</p>				

IV. Upstream View

Independence When the Financial Statement Attest Client Is Required to Be Included in Another Financial Reporting Entity as a Fund or Component Unit and the Primary Government of That Financial Reporting Entity Is Not a Financial Statement Attest Client (Paragraph .09 of the Proposed Interpretation)

Financial Statement Attest Client Is a Material Fund or Component Unit

Under [paragraph .07](#) of the extant interpretation, when the member does not audit the primary government, independence is not required of entities included in the financial reporting entity that the member doesn't audit (that is, upstream entity). However, [paragraph .08](#) prohibits covered members and their immediate family and close relatives from having a key position within the primary government.

After further thought, PEEC believes that there could be circumstances in which a member has a relationship that creates threats that are not at an acceptable level. PEEC believes these situations are more likely to occur when a material fund or component unit is a financial statement attest client that is required to be included in another financial reporting entity in which the primary government of that financial reporting entity can exert more than minimal influence over the accounting or financial reporting process of the financial statement attest client. As such, PEEC proposed that in these situations members be required to evaluate these relationships and circumstances that a member has with that primary government using the "[Conceptual Framework for Independence](#)" interpretation. The member will be required to identify those entities that meet the criteria of materiality and have more than minimal influence over the accounting or financial reporting process of the financial statement attest client. Then, the member will be required to consider whether there are any relationships or circumstances that create threats to independence. This requirement goes beyond simply responding when a member knows or has reason to believe that threats exist. Rather, the member must identify those entities that meet the criteria and subsequently evaluate whether significant threats exist that require a response. This provision appears in paragraph .09 of the proposed interpretation.

For example, a member is auditing a transportation capital projects fund that is a material fund of a county government. The fund is required to be included in the county's financial statements. The county has more than minimal influence over the fund's accounting or financial reporting process. In this circumstance, the member would need to identify whether any relationships or circumstances with the county exist that would impair independence with respect to the fund. If so, the member would then need to determine if safeguards can be applied to eliminate or reduce threats to an acceptable level.

Table B provides a visual of this example:

Table B

Financial statement attest client is a material fund and required to be included in the primary government's reporting entity and the primary government has more than minimal influence over fund.

XYZ County (primary government)

Audited by Firm B and Firm B makes reference to Firm A's report on the transportation capital projects fund



Transportation capital projects fund

- Firm A's financial statement attest client.
- Primary government has more than minimal influence over this fund's accounting or financial reporting process.
- This fund is material to the financial reporting entity.
- This fund is required to be included in the primary government's reporting entity.

Conclusions

The member needs to evaluate relationships and circumstances that the member has with the primary government because the fund is material to the financial reporting entity and the primary government has more than minimal influence over the fund's accounting or financial reporting process.

 Firm A's financial statement attest client.

 Firm A Independence required.

 Firm A – Must evaluate relationships and circumstances it has with the primary government using the conceptual framework.

Materiality Considerations

When materiality is used to determine whether independence is required of a primary government when the financial statement attest client is required to be included in the upstream financial reporting entity, 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.

Other Upstream Entities

For all other upstream entities, members would need to apply only the “[Conceptual Framework for Independence](#)” interpretation if the member knows or has reason to believe that a relationship or circumstance exists with the entity that would create threats to independence. PEEC believes that this is appropriate because relationships or circumstances that may exist with these entities are unlikely to create significant threats to the member’s independence. See the discussion that follows under “Other Funds, Component Units, or Activities” for additional clarification. This provision appears in paragraph .10 of the proposed interpretation.

Inclusion in Another Financial Reporting Entity and Investments Held by State or Local Government Entity

PEEC expects that when the financial statement attest client is required to be included in another primary government’s financial reporting entity, the member will need to perform an analysis both upstream of the financial statement attest client (that is, paragraph .09 of the proposed interpretation) as well as downstream (that is, paragraphs .05–.08 of the proposed interpretation), for those entities that are required to be included in the financial reporting entity of the financial statement attest client. Members may also need to apply the “Independence Rule” and related interpretations to investments held by a state or local governmental entity that is the financial statement attest client as described in paragraphs .11–.13 of the proposed interpretation. See the preceding discussion under “Downstream View,” as well as the discussion that follows under “Investments,” for additional clarification.

V. Other Upstream and Downstream Entities

Other Funds, Component Units, or Activities (Paragraph .10 of the Proposed Interpretation)

PEEC believes that it is possible that a member may encounter circumstances or relationships with funds or component units or other activities or entities that are not addressed in paragraphs .05–.09 that could give rise to threats that are not at an acceptable level. However, because threats to independence are unlikely for immaterial funds or component units or when the primary government does not have more than minimal influence over the financial accounting or reporting, PEEC does not believe members should have to track all of these circumstances or relationships. Rather, if the member knows or has reason to believe that a relationship or circumstance would create threats to independence, PEEC believes the member should then evaluate the situation using the “[Conceptual Framework for Independence](#)” interpretation. Some examples of entities in which a member may encounter relationships or circumstances that might create threats to independence could include the following:

- Funds or component units that are included or excluded from the financial reporting entity (but required to be included under the applicable framework) that the primary government has only minimal influence over the financial accounting or reporting process
- Funds or component units that are included or excluded (but required to be included under the applicable framework) from the financial reporting entity that are immaterial to the primary government
- Government employee benefit plans that are not required to be included in the financial reporting entity under the applicable framework
- Fiduciary funds that are not required to be included in the financial reporting entity under the applicable framework

- Joint ventures
- Related organizations
- Guarantees of debt service
- Creative financing
- Public private partnerships
- Equity method investments that do not meet the GASB *investment* definition
- Brother-sister funds or component units of a financial statement attest client included in the primary government's financial reporting entity

PEEC does not intend for members to be required to evaluate customers and vendors under this interpretation, including paragraph .10. For example, when a service provider is used to provide administration services to an employee benefit plan, members would not need to extend the independence rules to the service provider as long as (1) the service provider is not a state or local government entity that would meet the requirements of the "Entities Included in State and Local Government Financial Statements" interpretation, or (2) any investment the plan has in the service provider does not meet criteria outlined in paragraph .11 of the interpretation. Another example would be when an entity provides grant funds to another organization. Ordinarily, a grantor-grantee relationship is that of a customer-vendor relationship and independence is not required of the grantor or grantee in this circumstance.

VI. Defined Terms

Investments (Paragraphs .04d and .11–.13 of the Proposed Interpretation)

The extant interpretation does not provide any guidance on when members should apply the "Independence Rule" and related interpretations to entities in which the financial statement attest client has an investment. Accordingly, members were left to address these situations using the "[Conceptual Framework for Independence](#)" interpretation. PEEC proposes including guidance on how entities in which the financial statement attest client has an investment should be treated. Specifically, PEEC believes that members should apply the independence rules and related interpretations to certain entities that the financial statement attest client invests in. PEEC believes the independence rules should be extended to entities in which the financial statement attest client can control the entity and the investment in that entity is not de minimis to the financial statement attest client's financial reporting entity. PEEC is including a de minimis threshold because of the operational problems associated with determining which entities are controlled by a financial statement attest client when those entities are insignificant. Unlike in the commercial sector, state and local governments may not have systems in place to track this information, nor do they have regulatory requirements that might be applicable to commercial entities to monitor investment relationships. This provision appears in item (a) of paragraph .11 of the proposed interpretation.

The committee considers de minimis to be something less than immaterial. De minimis reflects circumstances in which the investment would be insignificant or clearly inconsequential to the financial statement attest client's financial reporting entity. Determination of when an investment is de minimis is a matter of professional judgment by the member considering independence of mind and in appearance.

PEEC also believes the "Independence Rule" and related interpretations should be extended to include circumstances when a financial statement attest client has significant influence over an entity in which it has a material investment. This provision appears in item (b) of paragraph .11 of the proposed interpretation.

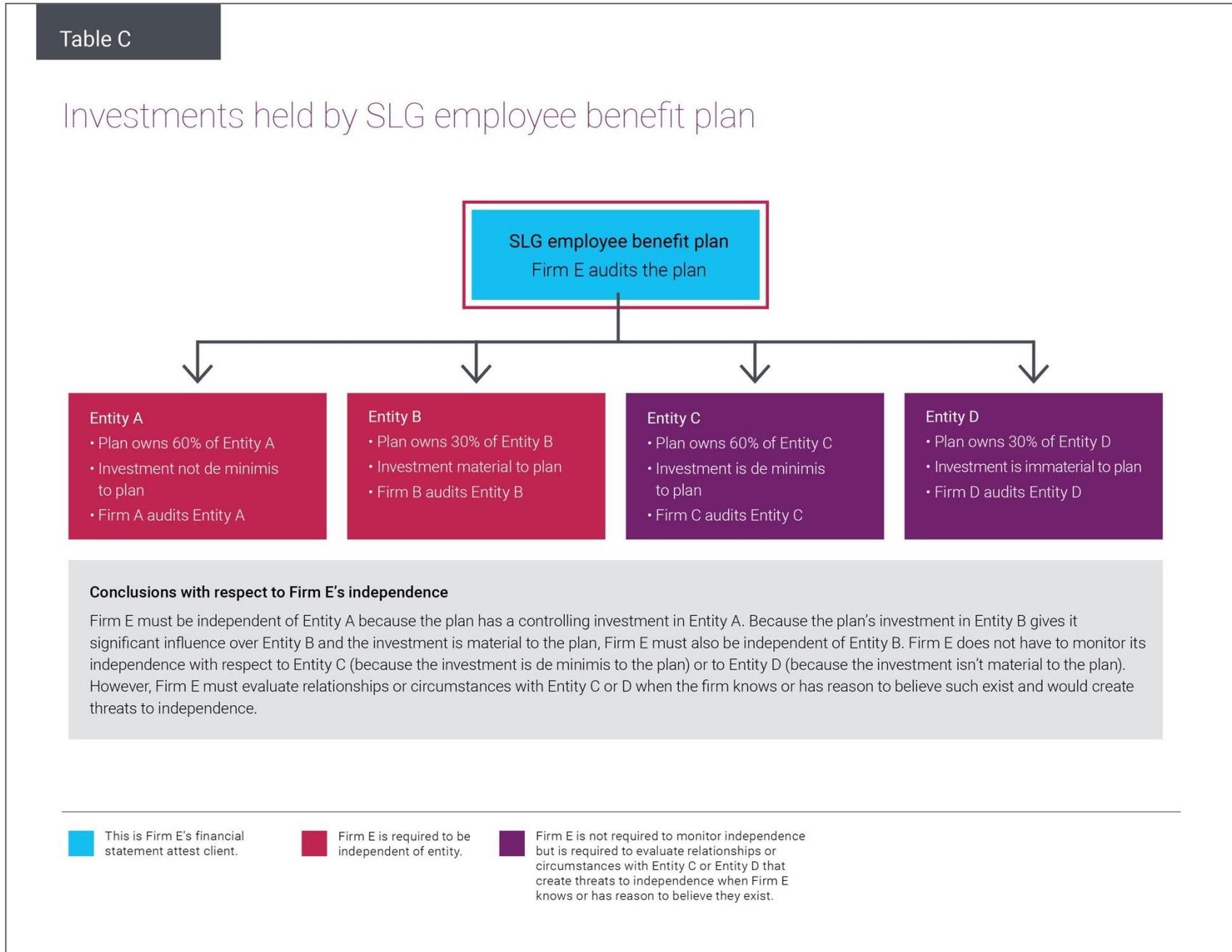
Investments, as defined in the interpretation, exclude entities that would otherwise be considered a fund or component unit. In addition, the investments definition excludes temporary investments for interests obtained by a financial statement attest client as a result of an action by a third party, such as through a bequest or a grant,

and that the entity does not intend to retain. Temporary investments were excluded because PEEC believes SLG entities are more likely to be passive recipients of investments than commercial entities. The definition appears in item (d) of paragraph .04 of the proposed interpretation.

Although investments can be encountered anywhere, often, they can be found in primary governments, component units, and funds, where there is excess cash and long-term investment objectives such as the following:

- a. Business-type activities associated with tribal organizations
- b. Pension and OPEB plans
- c. Endowment funds and foundations related to public colleges and universities
- d. External investment pools
- e. IRS Section 529 plans
- f. Controlling investment in a real estate investment trust
- g. An investment qualifying for the equity method of accounting under applicable GASB standards, such as an investment in what is commonly known as an “alternative investments”

Table C provides a visual of how to apply the investment guidance to an SLG employee benefit plan:



More Than Minimal Influence Over Accounting or Financial Reporting Process (Paragraphs .14–.15 of the Proposed Interpretation)

Although PEEC believes there is a presumption that the primary government has more than minimal influence over its fund's and component unit's accounting or financial reporting process, it also believes that this presumption will often be rebutted depending upon the specific facts and circumstances. For example, a state government financial statement attest client may not have more than minimal influence over the accounting and financial reporting processes of a university component unit that has a separate board, management, accounting system, and accounting personnel. Alternatively, the state government might have more than minimal influence over the university if the state government performs the accounting functions on behalf of the university. To assist members in assessing their unique facts and circumstances, PEEC proposes to include a list of factors that might help members evaluate the level of influence the primary government has over the accounting and financial reporting process of the fund or component unit. This guidance is found in paragraphs .14–.15 of the proposed interpretation.

In the SLG sector, the evaluation regarding whether a fund or component unit should be included in the financial reporting entity's financial statements is determined using a financial accountability concept that is based in the GASB standards. Alternatively, in the commercial sector, the evaluation regarding whether an entity should be included in the client's financial statements is determined by whether the client has control or significant influence over the entity as a whole. Because the determination differs between the two sectors, PEEC believes the control and significant influence concepts are not workable in this proposed interpretation. PEEC believes that the concept of whether the primary government has more than minimal influence over the accounting and financial reporting process of the fund or component unit is the appropriate concept to use to determine whether independence should be applied to funds and component units that are required to be included in the financial reporting entity under the applicable framework. The more than minimal influence criteria are part of a facts and circumstances analysis that is applied solely to the accounting and financial reporting process of the fund or component unit. This is a targeted evaluation of one aspect of the relationship between the primary government and the fund or component units, as opposed to a broad evaluation of relationships between entities using a "significant influence" criteria as used in the "Client Affiliates" interpretation (ET sec. 1.224.010). See the preceding discussion under "Financial Reporting Objectives Differ Between SLG Entities and Commercial Sector Entities" and "Financial Statement Presentation Differs Between SLG and Commercial Sector Entities" for further clarification.

PEEC believes that the impact of this evaluation should not require the member to obtain additional information not already available as a result of other audit procedures. Furthermore, PEEC believes that some entities and engagements are more likely than others to be able to rebut the presumption. Larger governments and component units are more likely to meet criteria that will rebut the presumption. Smaller governments and funds are less likely to meet criteria that could rebut the presumption. However, these are broad generalizations that may not be applicable to a member's specific facts and circumstances.

PEEC believes that members should take a substantive approach to evaluating the criteria. For example, a government may have the ability to exercise influence over the financial accounting and reporting over a fund through an ability to approve financial reports. However, if the primary government does not exercise that ability, the member can consider that as a mitigating factor in the determination of whether more than minimal influence exists.

PEEC does not believe that any one criterion will necessarily cause the more than minimal influence determination to be rebutted (or not). Rather, the member should consider the facts and circumstances for each situation to make the determination regarding whether more than minimal influence exists. In some cases, a single factor may cause the member to believe that factor is determinative for the member's situation. In other cases, a member may consider a number of factors that are indicators of minimal influence and indicators that minimal influence doesn't exist in order to reach a conclusion.

Therefore, the determination of whether more than minimal influence exists is a matter of the member's professional judgment after considering specific facts and circumstances relevant to the attest client.

Conforming Revisions

PEEC is proposing striking the last sentence in the definition of *financial statement attest client* because this term is now being used in the SLG interpretation. PEEC believes that the reference to “public employee retirement plan” in item (a) of paragraph .01 of “The Plan Is an Attest Client or Is Sponsored by an Attest Client” interpretation (ET sec. 1.250.010) is too limiting because there are many other types of plans aside from just public employee retirement plans. As such, PEEC is proposing this phrase be changed to “public employee benefit plan” so that all plans are covered.

Phase 2

Once revisions to the “Entities Included in State and Local Government Financial Statements” interpretation are adopted, PEEC will begin phase 2 of this project, which will include determining whether the guidance should be applied to compliance audits and the federal government.

Visual Aid Examples

Following are some visual aids that demonstrate how the proposed interpretation will be applied if adopted as final.

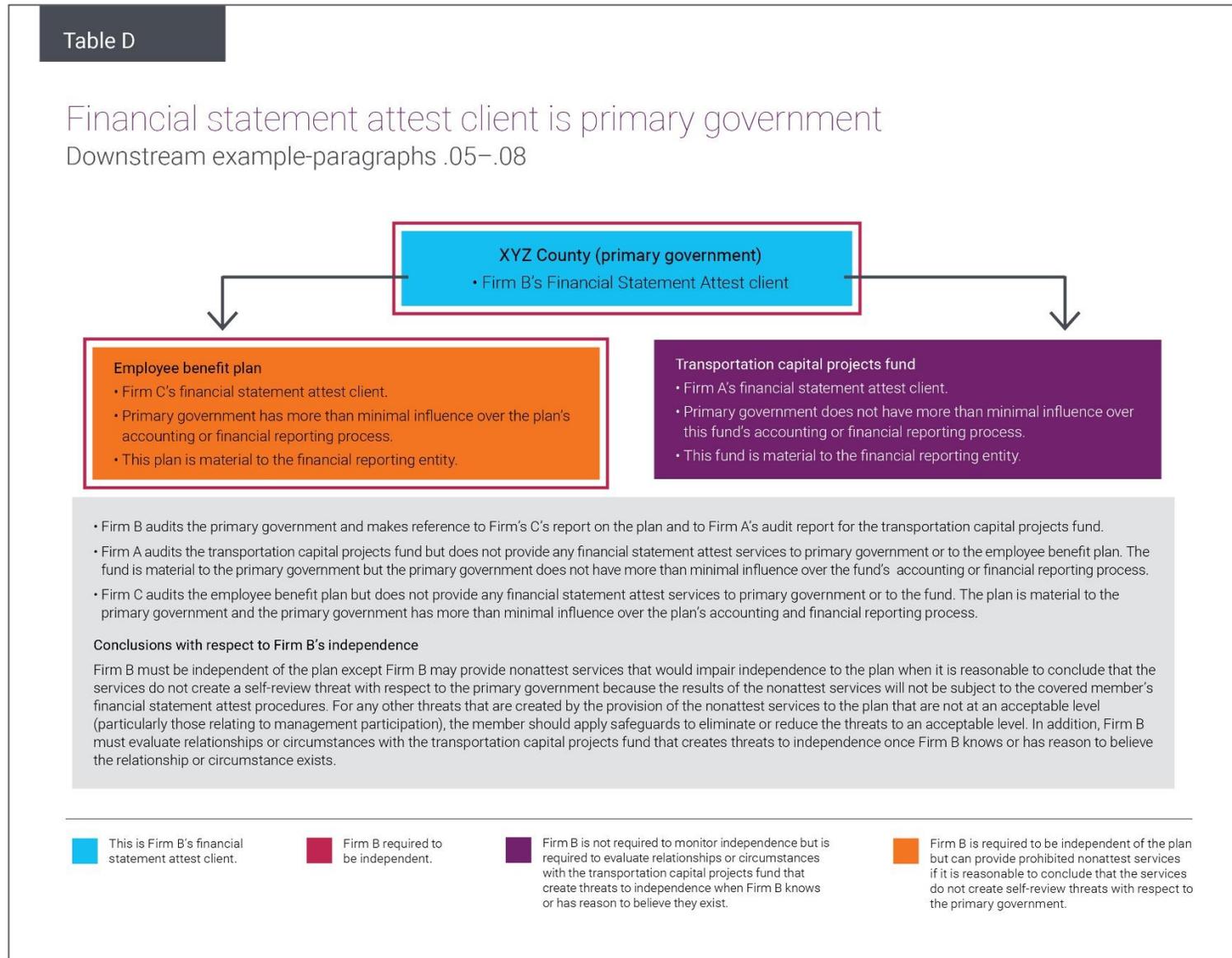
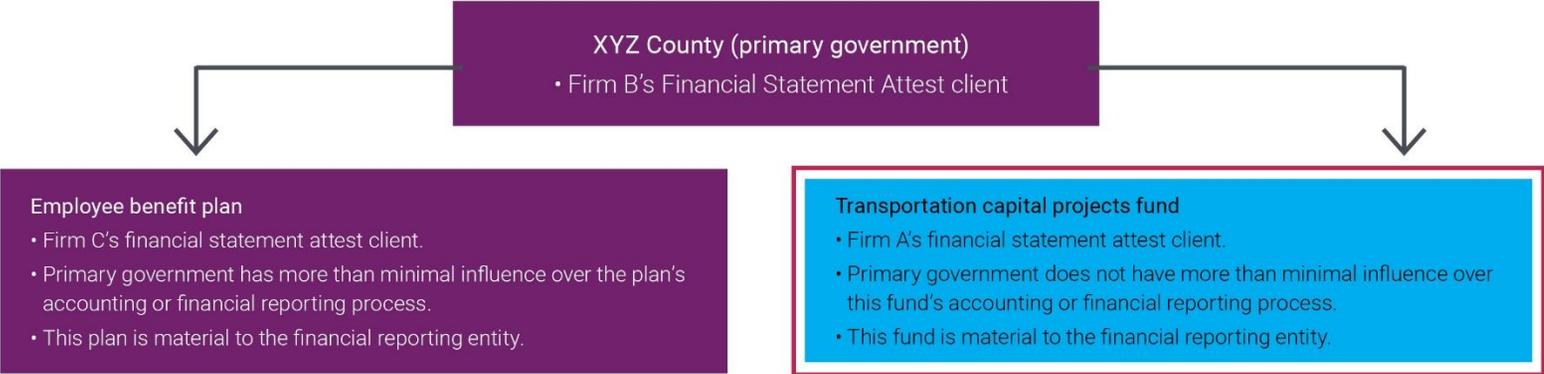


Table E

Financial statement attest client is a material fund

Upstream example-paragraph .09E



- Firm A audits the transportation capital projects fund but does not provide any financial statement attest services to primary government or to the employee benefit plan. The fund is material to the primary government but the primary government does not have more than minimal influence over the fund's accounting or financial reporting process.
- Firm C audits the employee benefit plan. The plan is material to the primary government and the primary government has more than minimal influence over the plan's accounting and financial reporting process.
- Firm B audits the primary government and makes reference to Firm's C's report on the plan and to Firm A's audit report for the transportation capital projects fund.

Conclusions with respect to Firm A's independence

Because the primary government does not have more than minimal influence over the fund, Firm A has to evaluate relationships or circumstances with the primary government or plan that creates threats to independence only when Firm A knows or has reason to believe they exist.

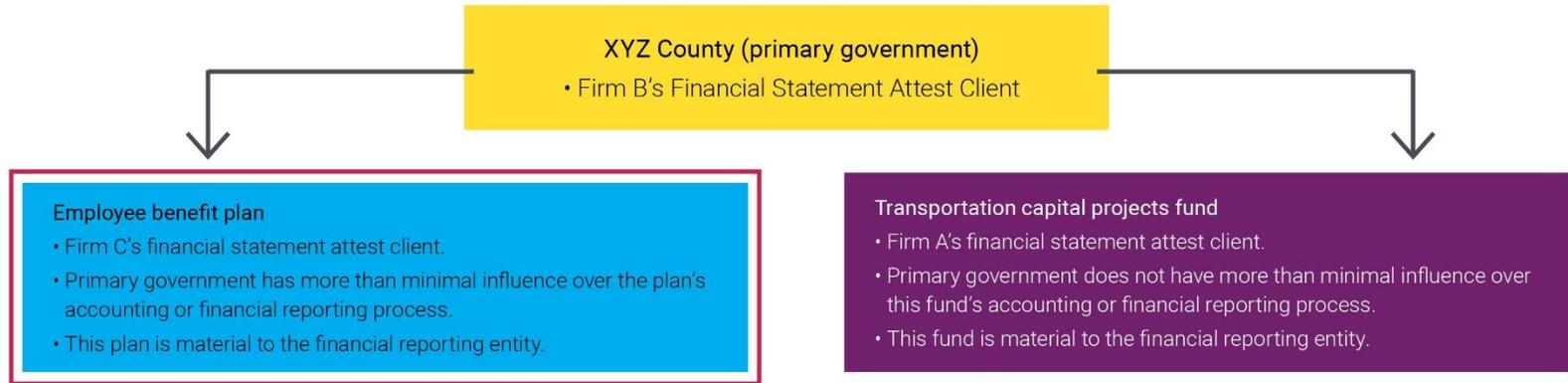
 This is Firm A's financial statement attest client.

 Firm A required to be independent.

 Firm A is not required to monitor independence but is required to evaluate relationships or circumstances with the primary government or plan that create threats to independence when Firm A knows or has reason to believe they exist.

Table F

Financial statement attest client is a material employee benefit plan Upstream example-paragraph .09



- Firm C audits the employee benefit plan but does not provide any financial statement attest services to the primary government or to the fund. The plan is material to the primary government and the primary government has more than minimal influence over the plan's accounting and financial reporting process.
- Firm A audits the transportation capital projects fund but does not provide any financial statement attest services to the primary government or to the employee benefit plan. The fund is material to the primary government but the primary government does not have more than minimal influence over the fund's accounting or financial reporting process.
- Firm B audits the primary government and makes reference to Firm's C's report on the plan and to Firm A's audit report for the transportation capital projects fund.

Conclusions with respect to Firm C's independence

Because the plan is material and the primary government has more than minimal influence over the plan, Firm C must evaluate relationships and circumstances it has with the primary government using the "Conceptual Framework For Independence" interpretation (ET sec. 1.210.010). In addition, Firm C must evaluate relationships or circumstances with the fund that creates threats to independence when Firm C knows or has reason to believe they exist.

■ This is Firm C's financial statement attest client.

■ Firm C required to be Independent.

■ Firm C is not required to monitor independence but is required to evaluate relationships or circumstances with the fund that create threats to independence when Firm C knows or has reason to believe they exist.

■ Firm C required to evaluate relationships and circumstances with the primary government using the conceptual framework.

Impact Analysis

PEEC prepared an impact analysis that summarizes the main differences between the extant interpretation and the proposed interpretation. The impact analysis is found in [exhibit B](#) in this exposure draft.

Request for Specific Comments

Although PEEC welcomes comments on all aspects of these proposed interpretations, it specifically requests feedback on the following:

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.
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?
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?
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.
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?
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?
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.

Effective Date

The committee believes that members who practice in the SLG environment will need significant time to implement the proposed revisions. As such, PEEC recommends that the interpretation be effective for engagements covering periods beginning on or after June 15, 2019, but allow for early implementation.

Text of Proposed Interpretation “State and Local Government Entities”

(Formerly “Entities Included in State and Local Government Financial Statements;” revisions to this title appear in strikethrough.)

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

Introduction

- .01 This interpretation provides guidance on which entities’ members should be independent of because the entities have a relationship to a financial statement attest client that is a state or local government entity.
- .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 that are required to be included in a primary government’s financial reporting entity under the applicable financial reporting framework. For purposes of this interpretation, the applicable financial reporting framework is as defined in the auditing standards (for example, governmental generally accepted accounting principles [GAAP], regulatory basis, cash basis, modified cash basis).
- .03 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 professional judgement to determine if there is an equivalent term. For example, certain interpretations use the phrase “officer, director, or owner of the attest client.” In some state or local government environments, it may be necessary for the member to extend these interpretations to officials of the financial statement attest client when the individual has governance responsibilities or control over financial reporting.

Terminology

- .04 The following terms are defined here solely for use with this interpretation:
 - a. The primary government is a state and local governmental entity that includes the following:
 - i. The financial statement attest client and all entities that are required to be included in the financial statement attest client’s financial reporting entity (that is, downstream entities) under the applicable financial reporting framework
 - ii. The financial reporting entity (that is, upstream entity) in which the attest client’s financial statements are required to be included under the applicable financial reporting framework
 - b. State and local governmental entities are entities whose GAAP standard setter is GASB. Examples of state and local governmental entities include general purpose governments such as states, counties, cities, towns, villages, and special purpose governments that perform limited activities. Examples of special purpose governments include, but are not limited to, cemetery districts, school districts, universities and colleges, utilities, hospitals or other health care organizations, public airports, public housing authorities, financing

authorities, public transportation systems, public utilities, public employee retirement systems (PERSs), post-employment benefit plans, pension plans, public entity risk pools, external investment pools, public colleges and universities, Indian tribes, state tuition programs, and other special districts.

- c. 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](#).
- d. An investment is a security or other asset that the [financial statement attest client](#) holds primarily for the purpose of income or profit and has a present service capacity based solely on its ability to generate cash or to be sold to generate cash. This includes investments and ownership in equity interest in common stock accounted for using the equity method of accounting as provided for in GASB Codification Section I50.

The following interests are not considered investments for purposes of this interpretation:

- i. Interests obtained by a [financial statement attest client](#) as a result of an action by a third party, such as through a bequest or a grant, and that the entity does not intend to retain
- ii. Equity interests in joint ventures partnerships, limited liability companies, or other types of entities in which the intent of the [financial statement attest client](#) is to directly enhance its ability to provide governmental services
- iii. Equity interests in component units in which the intent of the [financial statement attest client](#) is to directly enhance its ability to provide governmental services

Independence of Funds and Component Units Required to Be Included in the Financial Reporting Entity (Downstream Entities) of the Financial Statement Attest Client

- .05 [Members](#) should apply the “[Independence Rule](#)” [ET sec. 1.200.001] and related [interpretations](#) 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.
- .06 [Members](#) should apply the “[Independence Rule](#)” [ET sec. 1.200.001] and related [interpretations](#) to all material funds and component units included in the [financial statement attest client’s](#) financial reporting entity in 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 that fund or component unit.
- .07 [Members](#) should apply the “[Independence Rule](#)” [ET sec. 1.200.001] and related [interpretations](#) to all material funds and component units 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 those funds or component units.
- .08 In the situations identified in paragraphs .06–.07 of this interpretation, the [member](#) and [member’s firm](#) may provide nonattest services that [impair independence](#) during the [period of the professional engagement](#) or during the period covered by the [financial statements](#), provided that it is reasonable to conclude that the services do not create a self-review [threat](#) with respect to the [financial statement attest client](#) because the results of the nonattest

services will not be subject to the [covered member's financial statement](#) attest procedures. For any other [threats](#) that are created by the provision of the nonattest services that are not at an [acceptable level](#) (in particular, those relating to management participation), the [member](#) should apply [safeguards](#) to eliminate or reduce the [threats](#) to an [acceptable level](#).

Independence When the Financial Statement Attest Client Is Required to Be Included in Another Financial Reporting Entity (Upstream Entity)

.09 When a material fund or component unit is a [financial statement attest client](#) and is 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](#).

Other Funds, Component Units, or Activities

.10 For funds, component units, or activities 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](#).

Investments

.11 [Members](#) should apply the "[Independence Rule](#)" [ET sec. 1.200.001] and related [interpretations](#) to an entity in which the [financial statement attest client](#) has the following:

- a. A controlling investment that is not de minimis to the [financial statement attest client](#) as a whole. De minimis amounts are dollar amounts that in the [member's](#) professional judgement are clearly inconsequential to the [financial statement attest client](#) as a whole.
- b. An investment that gives the [financial statement attest client](#) significant influence over the entity and that is material to the [financial statement attest client](#) as a whole.

.12 [Members](#) should use their professional judgement to determine if control or significant influence exists. [Members](#) should consider using the definitions for *control* [ET section 0.400.10] and *significant influence* [ET section 0.400.45], along with any applicable GASB guidance.

.13 A [member](#) must expend best efforts to obtain the information necessary to identify these investments. If, after expending best efforts, a [member](#) is unable to obtain the information to determine the investments of the [financial statement attest client](#), [threats](#) would be at an [acceptable level](#) and [independence](#) would not be [impaired](#) if the [member](#) does all of the following:

- a. Discusses the matter, including the potential impact on [independence](#), with [those charged with governance](#)
- b. Documents the results of that discussion and the efforts taken to obtain the information
- c. Obtains written assurance from the [financial statement attest client](#) that it is unable to provide the [member](#) with the information necessary to identify the investments of the [financial statement attest client](#)

Determination of Whether the Primary Government of the Financial Reporting Entity Has More Than Minimal Influence Over Funds or Component Units

.14 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. To rebut this presumption, members can consider factors, such as the following, that in the member's professional judgment demonstrate that the primary government has only minimal influence:

- a. Primary government does not prepare the financial statements for the fund or component unit.
- b. Accounting or finance staff of the fund or component unit is not the same staff as the primary government.
- c. Fund or component unit does not have the same accounting systems as the primary government.
- d. Fund or component unit does not have the same internal control over financial reporting systems as the primary government.
- e. Primary government does not have a significant level of operational control over the fund or component unit.
- f. Primary government does not direct the behaviors or actions of the governing board of the fund or component unit.
- g. Primary government does not have the ability to add or remove members of the governing board of the fund or component unit.
- h. Primary government does not exert influence that results from the following:
 - i. The primary government's issuance or full or partial payment of the fund's or component unit's debt
 - ii. The primary government's financing of some or all of the fund's or component unit's deficits
 - iii. The primary government's actions to use or take the fund's or component unit's financial resources

.15 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. Whereas some factors may indicate influence, others may indicate little to no influence. Some factors may be weighted differently depending on the circumstances and the subject matter of any potential impairment. Thus, the consideration of these factors runs along a spectrum. The following illustrates one possible spectrum:

Less Influence	More Influence
a. Fund or component unit prepares its own <u>financial statements</u> .	A. Primary government prepares the fund or component unit's <u>financial statements</u> .
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 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.
i. Fund or component unit <i>financial statements</i> is incorporated into primary government without modification (that is, either fund-level or government-wide level statements of primary government).	I. Fund component unit <i>financial statements</i> 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).

Effective Date

.16 This interpretation will be effective for engagements covering periods beginning on or after June 15, 2019. Early implementation is allowed.

Text of Conforming Revision to the Definition of *Financial Statement Attest Client*

(Deletions are stricken)

Financial statement attest client. An entity whose [financial statements](#) are audited, reviewed, or compiled when the [member's](#) compilation report does not disclose a lack of [independence](#). This term is used in the “Client Affiliates” interpretation [1.224.010] of the “Independence Rule” [1.200.001] and in the definition of an affiliate [0.400.02].

Text of Proposed Revision to “The Plan Is an Attest Client or Is Sponsored by an Attest Client” Interpretation

(Additions appear in boldface italic and deletions are stricken)

1.250.010 Plan Is an Attest Client or Is Sponsored by an Attest Client

.01 When a *covered member* participates in an employee benefit plan that is an *attest client* or is sponsored by an *attest client*, during the *period of the professional engagement* or during the period covered by the *financial statements*, the self-interest *threat* to compliance with the “[Independence Rule](#)” [ET sec. 1.200.001] would not be at an *acceptable level*. *Independence* with respect to the employee benefit plan and the sponsor would be *impaired* except in the following specific situations:

- a. *Governmental organization.* When a *covered member* is an employee of a governmental organization that sponsors, co-sponsors, or participates with other governmental organizations in a public employee ***benefit retirement*** plan (the plan) and the *covered member* is required by law, rule, or regulation to audit the plan, *threats to independence* would be at an *acceptable level* if all of the following *safeguards* are met:
 - i. The *covered member* is required to participate in the plan as a condition of employment.
 - ii. The plan is offered to all employees in comparable employment positions.
 - iii. The *covered member* is not associated with the plan in any capacity prohibited by the “[Simultaneous Employment or Association With an Attest Client](#)” interpretation [ET sec. 1.275.005] of the “Independence Rule.”
 - iv. The *covered member* has no influence or control over the investment strategy, benefits, or other management activities associated with the plan.
- b. *Former employment or association with the attest client.* The requirements of [paragraph .04](#) of the “Former Employment or Association With an Attest Client” interpretation [ET sec. 1.277.010] must be met. [Prior reference: paragraphs .214–.215 of ET section 191]

.02 When an *immediate family* member participates as a result of his or her employment in an employee benefit plan that is an *attest client* or is sponsored by an *attest client*, the requirements of the “[Immediate Family Member Participation in an Employee Benefit Plan That Is an Attest Client or Is Sponsored by an Attest Client \(Other Than Certain Share-Based Arrangements or Nonqualified Deferred Compensation Plans\)](#)” interpretation [ET sec. 1.270.030] of the “Independence Rule” [ET sec. 1.200.001] must be met. [Prior reference: paragraph .17 of ET section 101]

Impact Analysis of Proposed Revisions to “Entities Included in State and Local Government Financial Statements” Interpretation

Extant Interpretation	Additional Independence Requirements Under the Exposure Draft	Rationale of Proposed Change
Downstream Entities of the Financial Reporting Entity, Including Benefit Plans		
<p>A. Members need to remain independent of funds and component units that are 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 a fund or component unit. <i>(Refer to paragraph .04 of the extant interpretation.)</i></p>	<p>The requirement is the same under the proposed interpretation.</p>	<p>Not applicable.</p>
<p>B. Members do not need to remain independent of funds and component units that are included in the financial reporting entity of the financial statement attest client when the member makes reference to another auditor’s report. <i>(Refer to paragraph .04 of the extant interpretation.)</i></p>	<p>When making reference to another auditor’s report, members will need to remain independent of material funds and component units that are included in the financial reporting entity of the financial statement attest client when the primary government has more than minimal influence over the accounting or financial reporting process of the fund or component unit. <i>(Refer to provision paragraph .06 of the proposed interpretation.)</i></p>	<p>The Professional Ethics Executive Committee (PEEC) believes that making reference to another auditor’s report will not always reduce threats to an acceptable level when the fund or component unit is material to the financial reporting entity, and the primary government has more than minimal influence over the accounting or financial reporting process of the fund or component unit.</p>
<p>C. The extant interpretation does not provide any independence guidance</p>	<p>Members should apply the independence rule and related interpretations to material</p>	<p>It is not uncommon for a primary government to exclude a fund or component</p>

Extant Interpretation	Additional Independence Requirements Under the Exposure Draft	Rationale of Proposed Change
<p>related to funds and component units that are excluded from the financial reporting entity but are required to be included under the applicable framework (for example, generally accepted accounting principles, regulatory, or cash basis).</p>	<p>funds and component units that are excluded from the financial reporting entity but required to be included under the applicable framework if the primary government has more than minimal influence over its accounting or financial reporting process. <i>(Refer to provision paragraph .07 of the proposed interpretation.)</i></p>	<p>unit from the financial reporting entity for a variety of reasons, such as unavailability of a component unit's audited financial statements; therefore, PEEC incorporated guidance in its proposed interpretation related to a material fund or component unit that is excluded from the financial statement attest client's financial reporting entity but is required under the applicable framework to be included.</p>
<p>D. The extant interpretation does not have any exceptions for nonattest services.</p>	<p>Members may provide nonattest services that would impair independence to funds and component units identified in preceding rows B and C, provided it is reasonable to conclude that the services do not create a self-review threat with respect to the financial statement attest client because the results of the nonattest services will not be subject to the covered member's financial statement attest procedures. For any other threats that are created by the provision of the nonattest services that are not at an acceptable level (particularly those relating to management participation), the member should apply safeguards to eliminate or reduce the threats to an acceptable level. <i>(Refer to paragraph .08 of the proposed interpretation.)</i></p>	<p>The exception was incorporated so that the proposed interpretation would be conceptually consistent with the underlying principles of the "Client Affiliates" interpretation because PEEC did not identify a compelling reason to differ from those principles.</p>

Extant Interpretation	Additional Independence Requirements Under the Exposure Draft	Rationale of Proposed Change
Upstream Entities (For Example, Financial Reporting Entity or Primary Government) of Financial Statement Attest Client, Including Benefit Plans		
<p>E. Under the extant interpretation, when the member does not audit the primary government, members do not need to remain independent of entities that the member does not audit (for example, upstream entity), except covered members and their immediate family, and close relatives may not have a key position within the primary government. (Refer to paragraphs .07–.08 of the extant interpretation.)</p>	<p>Members would be required to evaluate relationships and circumstances that a member has with the primary government using the “Conceptual Framework for Independence” interpretation when the financial statement attest client is material to the financial reporting entity, and the primary government has more than minimal influence over the accounting or financial reporting process of the financial statement attest client. The member is expected to actively consider threats when applying the conceptual framework. (Refer to paragraph .09 of the proposed interpretation.)</p>	<p>PEEC believes that there could be circumstances in which a member could have a relationship that creates a threat(s) that is (are) not at an acceptable level.</p> <p>Furthermore, PEEC believes these situations are more likely to occur when a material fund or component unit is a financial statement attest client and is required to be included in another financial reporting entity and the primary government of that financial reporting entity can exert more than minimal influence over the accounting or financial reporting process of the financial statement attest client.</p>

Other Funds, Component Units, or Activities Not Identified in Rows A–E, Including Benefit Plans		
<p>F. The extant interpretation does not have a requirement to evaluate threats to independence created by relationships or circumstances the member has with funds, component units, or activities that aren’t covered by the interpretation.</p>	<p>If a member knows or becomes aware of relationships or circumstances with a fund, component unit, or activity that is not identified in rows A–E that would create threats to independence, the member would be required to evaluate the matter using the “Conceptual Framework for Independence” interpretation. (Refer to paragraph .10 of the proposed interpretation.)</p>	<p>Member may encounter circumstances or relationships with certain entities that could give rise to threats that are not at an acceptable level.</p>

Extant Interpretation	Additional Independence Requirements Under the Exposure Draft	Rationale of Proposed Change
Investments		
<p>G. Under the extant interpretation, there is no guidance regarding when members should extend the “Independence Rule” and related interpretations to investments held by a state or local entity; therefore, members would use the Conceptual Framework for Independence interpretation when evaluation is required.</p>	<p>Under the proposed interpretation, the independence rules and related interpretations are extended to investments that are not de minimis to the financial statement attest client when the financial statement attest client can do one of the following:</p> <ul style="list-style-type: none"> • Control the investment. <i>(Refer to item (a) of paragraph .11 of the proposed interpretation.)</i> • Has significant influence over an entity in which it has a material investment. <i>(Refer to item (b) of paragraph .11 of the proposed interpretation.)</i> 	<p>PEEC believes that members should apply the independence rules and related interpretations to certain investments of a state and local government entity.</p> <p>Furthermore, a de minimis threshold is applied because of the operational problems associated with determining which entities are controlled by a financial statement attest client when those entities are insignificant. Unlike in the commercial sector, state and local governments may not have systems in place to track this information, nor do they have regulatory requirements that might be applicable to commercial entities to monitor investment relationships.</p>