



OFFICIAL RELEASE

Interpretation

State and Local Government Client Affiliates

**AICPA Professional Ethics
Division**

**Effective for years beginning after
December 15, 2020**

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Ethics interpretations and other guidance are promulgated by the executive committee of the Professional Ethics Division to provide guidelines about the scope and application of the rules but are not intended to limit such scope or application. Publication in the Journal of Accountancy constitutes notice to members. A member who departs from such guidelines shall have the burden of justifying such departure in any disciplinary hearing.

The Professional Ethics Executive Committee adopted the revised interpretation “State and Local Government Client Affiliates,” formerly “Entities Included in State and Local Government Financial Statements,” (ET sec. 1.224.020) under the “Independence Rule” (ET sec. 1.200.001) at its May 2019 meeting.

The revised interpretation is effective for years beginning after December 15, 2020 and will be added to the [AICPA Code of Professional Conduct](#) with the June 2019 update. Notice of the new interpretation will appear in the August 2019 Journal of Accountancy.

Text of Revised Interpretation “State and Local Government Client Affiliates”

Additions in ***bold italic*** and deletions in ~~strike through~~ found in the paragraphs below are to the text of the proposed interpretation that was included in the January 11, 2019, exposure draft.

1.224 Affiliates, Including State and Local Government Affiliates Governmental Units

1.224.020 Entities Included in State and Local Government Client Affiliates Financial Statements

Applicability

- .01 This interpretation applies to state and local government entities (as defined in paragraph .03d of this interpretation) that are [financial statement attest clients](#).
- .02 When an [interpretation](#) of the “[Independence Rule](#)” [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 judgment 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 ***official individual*** has governance responsibilities or control over financial reporting.

Terminology

- .03 The following terms are defined here solely for use with this interpretation:
 - a. An affiliate of a ~~state or local government~~ [financial statement attest client](#) exists in all of the following situations:
 - i. The entity is included in the *financial statement attest client’s* [financial statements](#) and the [member](#) or *member’s* [firm](#) does not make reference to another auditor’s report on the entity.
 - ii. The entity is included in the *financial statement attest client’s* *financial statements*, and the *member* or *member’s* *firm* makes reference to another auditor’s report on the entity, and
 - 1. the entity is material to the *financial statement attest client’s* *financial statements* as a whole and
 - 2. the *financial statement attest client* has more than minimal influence over the entity’s accounting or financial reporting process. There is a rebuttable presumption that the *financial statement attest client* has more than minimal influence over the accounting or financial reporting process of funds and blended component units.
 - iii. The entity is a material excluded entity, and the *financial statement attest client* has more than minimal influence over the entity’s accounting or financial reporting process. A material excluded entity is an entity that is required under the applicable financial reporting framework to be included in the *financial statements* of the *financial statement attest client* but is,

nevertheless, excluded by the *financial statement attest client* and is material to the *financial statement attest client's financial statements* as a whole. There is a rebuttable presumption that the *financial statement attest client* has more than minimal influence over the accounting or financial reporting process of funds and blended component units.

- iv. The **investor, which is either the financial statement attest client** or an affiliate **as defined in** under item (i-) of this definition, (~~investor~~) has an investment **in an investee when the investor** that either
 1. **controls the investee, unless the investment in the investee** is not trivial and clearly inconsequential to the **financial statement attest client's investor's financial statements** as a whole, and gives the investor control over the investment or
 2. **has significant influence over the investee and the investment in the investee** is material to the **financial statement attest client's investor's financial statements** as a whole and gives the investor significant influence over the investment.
- b. An entity is intended to be broadly defined and can include funds, component units, departments, agencies, programs, organizational units, fiduciary activities, custodial activities, employee benefit plans, and suborganizational units of the preceding entities.
- c. An investment is a security or other asset that **an investor, which is either the financial statement attest client** or an affiliate, **as defined in** under item (a.i.) of this paragraph, 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 of an equity interest in common stock accounted for using the equity method of accounting as provided for in GASB Codification Section 150. The following interests are not considered investments for purposes of this interpretation:
 - i. Interests obtained by **an investor** ~~a financial statement attest client or an affiliate under item a.i. of this paragraph~~ as a result of an action by a third party, such as through a bequest or a grant, and that the entity **investor** does not intend to retain (~~temporary investments~~) **and does not retain for more than a reasonable period of time given the temporary nature of the investment**
 - ii. Equity interests in joint ventures, partnerships, LLCs, or other types of entities **where the investor's principal purpose** in which the intent of the ~~financial statement attest client or an affiliate under item a.i. of this paragraph~~ is to directly enhance its ability to provide governmental services
 - iii. Equity interests in component units **where the investor's principal purpose** in which the intent of the ~~financial statement attest client or an affiliate under item a.i. of this paragraph~~ is to directly enhance its ability to provide governmental services
 - iv. Interests that would otherwise be considered an entity as defined in item (b) of this paragraph
- d. State and local government entities are entities whose generally accepted accounting principles standard setter is GASB. Examples of state and local

government entities include general purpose governments **and special purpose governments. Examples of general purpose governments include** such as states, counties, cities, towns, villages, **and Indian tribes**, and special purpose governments that perform limited activities. Examples of special purpose governments include 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 employee retirement systems (PERSs), post-employment benefit plans, pension plans, public-entity risk pools, external investment pools, ~~Indian tribes~~, state tuition programs, and other special districts.

Interpretation

- .04 Financial interests in, and other relationships with, affiliates of a financial statement attest client that is a state or local government entity may create threats to a member's compliance with the "Independence Rule."
- .05 Members should apply the "Independence Rule" and related interpretations applicable to a state or local government financial statement attest client to their affiliates except as provided for in paragraph .07 of this interpretation.
- .06 **However, if the member** ~~Members may encounters~~ circumstances or relationships with nonaffiliates that **may** create threats to independence that could result in, the *member should consulting apply* the "Conceptual Framework for Independence" [1.210.010] **to evaluate whether threats are at an acceptable level**. Examples of such circumstances or relationships **could** include the following:
- a. A covered member's immediate family member is in a key position with a nonaffiliate that includes the financial statement attest client in its financial statements and the nonaffiliate provides accounting staff, shares financial information systems, or establishes internal controls over financial reporting for the *financial statement attest client*.
 - b. The *member or member's firm* is considering providing financial information system design services to a nonaffiliate in which the same financial information system would also be used by the *financial statement attest client*.
 - c. A *covered member* has a *financial interest* in a nonaffiliate that includes the *financial statement attest client* in its *financial statements*, and the nonaffiliate prepares the *financial statements* for the *financial statement attest client*.
 - d. The *financial statement attest client* participates in a public-private partnership or joint venture that does not meet the definition of an *investment* in ~~item c. of~~ paragraph .03c of this interpretation. A *covered member* has a *financial interest* in an organization that is also involved with the public-private partnership or joint venture.
 - e. A *covered member* owns utility bonds issued by a nonaffiliate, and the *financial statement attest client* is responsible for payment of the utility bond debt service.
 - f. ~~A covered member owns defeased debt issued by the financial statement attest client. The defeased debt is not accounted for on the financial statements of the financial statement attest client, and the financial statement attest client has funded the debt service to be paid from a bank trust account. A covered member owns conduit debt issued by the financial statement attest client on behalf of a~~

nonaffiliate. The conduit debt is not accounted for on the *financial statements* of the *financial statement attest client*, and the debt service is paid by the nonaffiliate.

Exception

.07 The member and *member's firm* may provide prohibited nonattest services to entities described under items (a)ii) and (a)iii) of paragraph .03 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.

Best Efforts

.08 A member must expend best efforts to obtain the information necessary to identify affiliates of a financial statement attest client. If, after expending best efforts, a *member* is unable to obtain the information to determine which entities are affiliates of a *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. ~~D~~discusses the matter, including the potential impact on independence, with those charged with governance; at the *financial statement attest client*
- b. ~~D~~documents the results of that discussion and the efforts taken to obtain the information; **and**
- c. ~~O~~btains written assurance from the *financial statement attest client* that it is unable to provide the *member* with the information necessary to identify the affiliates of the *financial statement attest client*.

More Than Minimal Influence Over Accounting and Financial Reporting Process

.09 The overall facts and circumstances should be considered when evaluating the level of influence the financial statement attest client has over the accounting or financial reporting process of an entity in the ***financial statement attest client's financial statements*** financial reporting entity. The targeted analysis is applied solely to the accounting and financial reporting process of the entity as opposed to the analysis of what entities are included in the ***financial statement attest client's financial statements*** financial reporting entity. Factors such as the following may assist members with this evaluation:

- a. The extent of involvement the *financial statement attest client* has in preparing the financial statements of ~~an~~**the** entity-
- b. The extent of operational control the *financial statement attest client* has over ~~an~~**the** entity-
- c. The extent to which both the *financial statement attest client* and ~~an~~**the** entity have the same
 - i. accounting or finance staff;
 - ii. accounting systems; **and**
 - iii. internal control over financial reporting systems

d. The extent to which the *financial statement attest client*

- i. ~~is able to~~**can** direct the behaviors or actions of the governing board of the entity;
- ii. ~~has the ability to~~**can** add or remove members of the governing board of the **entity**~~fund or component unit~~;
- iii. issues or pays for the entity's debt;
- iv. finances the entity's deficits; **and**
- v. uses or takes the entity's financial resources

.10 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. [Members](#) should take a substantive approach to evaluating the factors (for example, the **financial statement attest client** entity exercises a right),⁷ rather than merely considering form (for example, the *financial statement attest client* has a right that is not exercised). The consideration of these factors will require the *member* to exercise professional judgment when reaching the ~~determination of~~ **determining** whether more than minimal influence exists.

Material to the Financial Statement Attest Client's Financial Statements as a Whole

.11 Determination of materiality is a matter of professional judgment. [Members](#) should consider both quantitative and qualitative factors when determining whether an entity or investment is material to a [financial statement attest client's](#) financial **statements as a whole** ~~reporting entity~~. For purposes of this interpretation, materiality is intended to be applied at the **level of the financial statement attest client's** financial **statements** ~~reporting entity~~, rather than individual opinion units in circumstances in which there may be more than one opinion unit.

[See [Revision History Table](#).]