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AICPA New Independence Guidance: State and Local Government Affiliates

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Agenda

- Overview
- Determination of Affiliates
- Examples
- Summary



Overview



Overview

New Independence Affiliates Guidance Applies to State and Local Governments (SLG)

- Supersedes “Entities included in State and Local Governmental Financial Statements”
 - Previous rules required independence only for the entity being audited
- New guidance determines:
 - Which entities are affiliates
 - Independence requirements to be applied to affiliates



Overview

New Independence Affiliates Guidance Applies to State and Local Governments (SLG)

- Not applicable to single audits (future project)
- Conceptually consistent with general affiliate guidance issued by AICPA (ET 1.224.010)
- Downstream concept; eliminated upstream entities as possible affiliates
- Applies to affiliates unless exceptions available



Overview

What does this mean to your SLG organization?

- Auditor independence is a shared responsibility
- Your auditors will need your help
 - Initial evaluation
 - Continuing consideration
- Your auditors may need to be independent of more organizations related to your SLG organization



Overview

Timing

- Auditors and SLG organizations must now apply the Independence Rules and related interpretations to affiliates
 - Effective for years beginning after 12/15/2021*
 - Auditors need to be independent at January 1, 2022*

*In May 2020, AICPA extended implementation by one year to these dates due to COVID.



Determination of Affiliates



Determination of Affiliates

- Several different “paths” to inclusion as an affiliate (we’ll call them “types”)
- Once deemed to be an affiliate, auditor independence is required
- Need to evaluate whether an “entity” is an affiliate
 - Broadly defined – could include funds, department, component units, fiduciary activities, etc.



Determination of Affiliates

Who is an affiliate of your SLG organization?

- Type 1 (Par .03ai)
 - Current guidance still applies – must have all of the following:
 - Included in your SLG organization's financial statements AND
 - No reference to the other auditor



Determination of Affiliates

Who is an affiliate of your SLG organization?

- Type 2 (Par .03aⁱⁱ)
 - New guidance – must have all of the following:
 - Included in your SLG organization's financial statements
 - Does refer to the other auditor
 - Material to your SLG organization AND
 - Your SLG organization has more than minimal influence over the entity's accounting or financial reporting process



Determination of Affiliates

Material to your SLG organization

- Consider the following:
 - Materiality is applied at the reporting entity level, NOT at the individual opinion unit
 - Both qualitative and quantitative factors are important
 - Auditor's will apply professional judgment

This qualification will likely exclude many entities from classification as an affiliate.



Determination of Affiliates

More than minimal influence (MTMI)

- Rebuttable presumption – MTMI exists with funds and blended component units
- Consider the following:
 - Level of involvement your SLG organization has in preparing the entity's financial statements
 - Extent of operational control your SLG organization has over the entity
 - Amount of shared resources between your SLG organization and the entity (accounting staff, accounting systems, internal controls)
 - Extent to which your SLG organization is
 - Able to direct the behaviors or actions of the entity's governing board
 - Able to add or remove members of the entity's governing board
 - Issuing or paying the entity's debt
 - Financing the entity's deficits
 - Using or taking the entity's resources



Determination of Affiliates

More than minimal influence

- **Considering the factors**
 - Some factors may indicate influence while other may indicate little or no influence
 - Some factors may be weighted differently
 - Take a substance over form approach to evaluating the factors



Determination of Affiliates

Determining affiliates: the inclusion pathway





Determination of Affiliates

Who is an affiliate of your SLG organization?

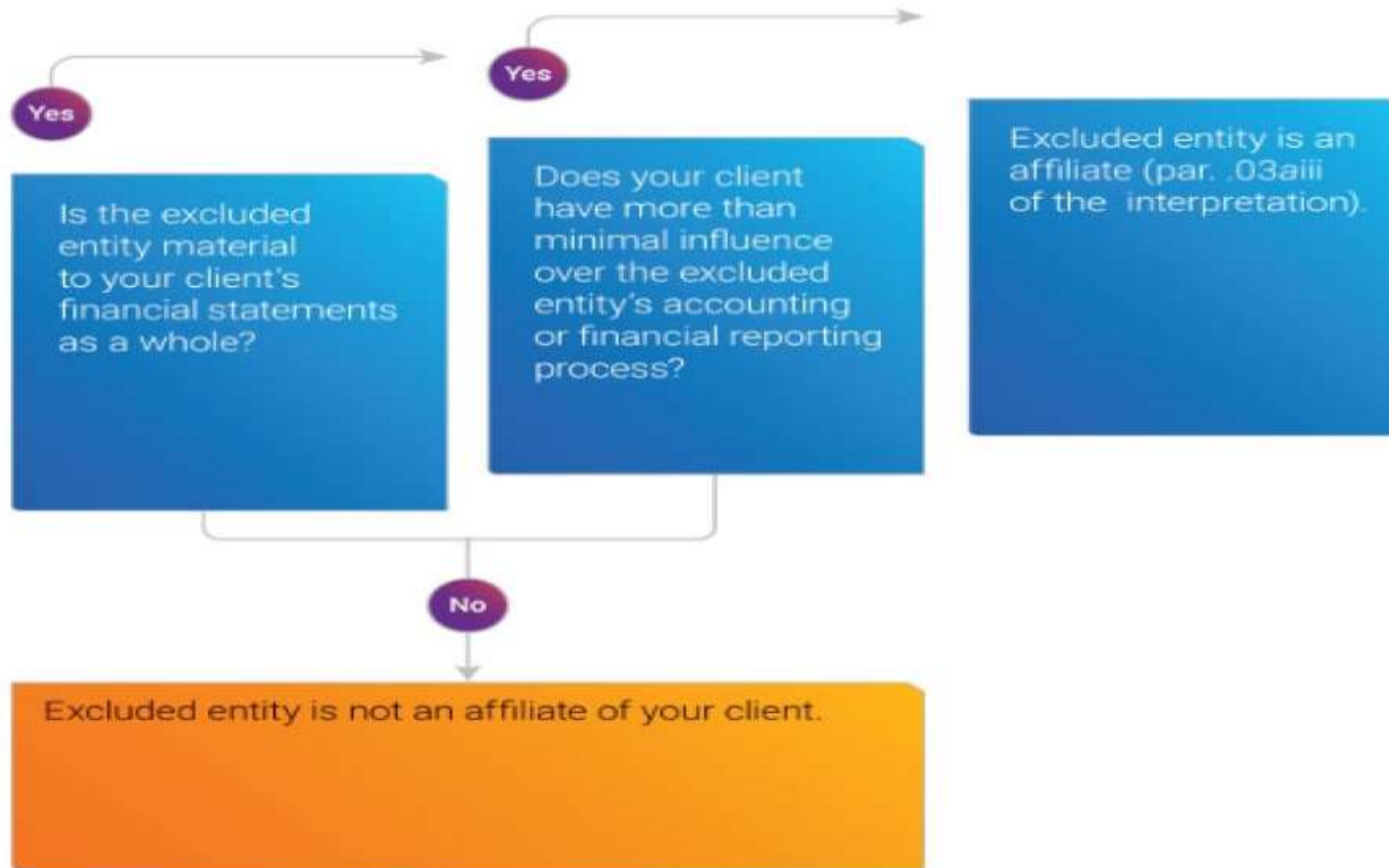
- Type 3 (Par .03aⁱⁱⁱ)
 - New guidance – must have all of the following:
 - Excluded from your SLG organization's financial statements
 - Material to your SLG organization AND
 - Your SLG organization has more than minimal influence

We think this situation will be rare!



Determination of Affiliates

Determining affiliates: the exclusion pathway





Determination of Affiliates

Who is an affiliate of your SLG organization?

- Type 4 (Par .03aiv)
 - New guidance
 - Investments held by your SLG organization (investor)
 - Your SLG organization can control UNLESS the investment is trivial or clearly inconsequential to your SLG organization's financial statements, or
 - Your SLG organization has significance influence AND the investment is material to the financial statements as a whole



Determination of Affiliates

Who is an affiliate of your SLG organization?

- Type 4 (Par .03aiv)
 - New guidance
 - Includes:
 - Securities, or other assets, held by an investor primarily for the purpose of income or profit AND has present service capacity based solely on its ability to generate cash or to be sold to generate cash
 - Investments and ownership in equity interest in common stock accounted for using the equity method of accounting



Determination of Affiliates

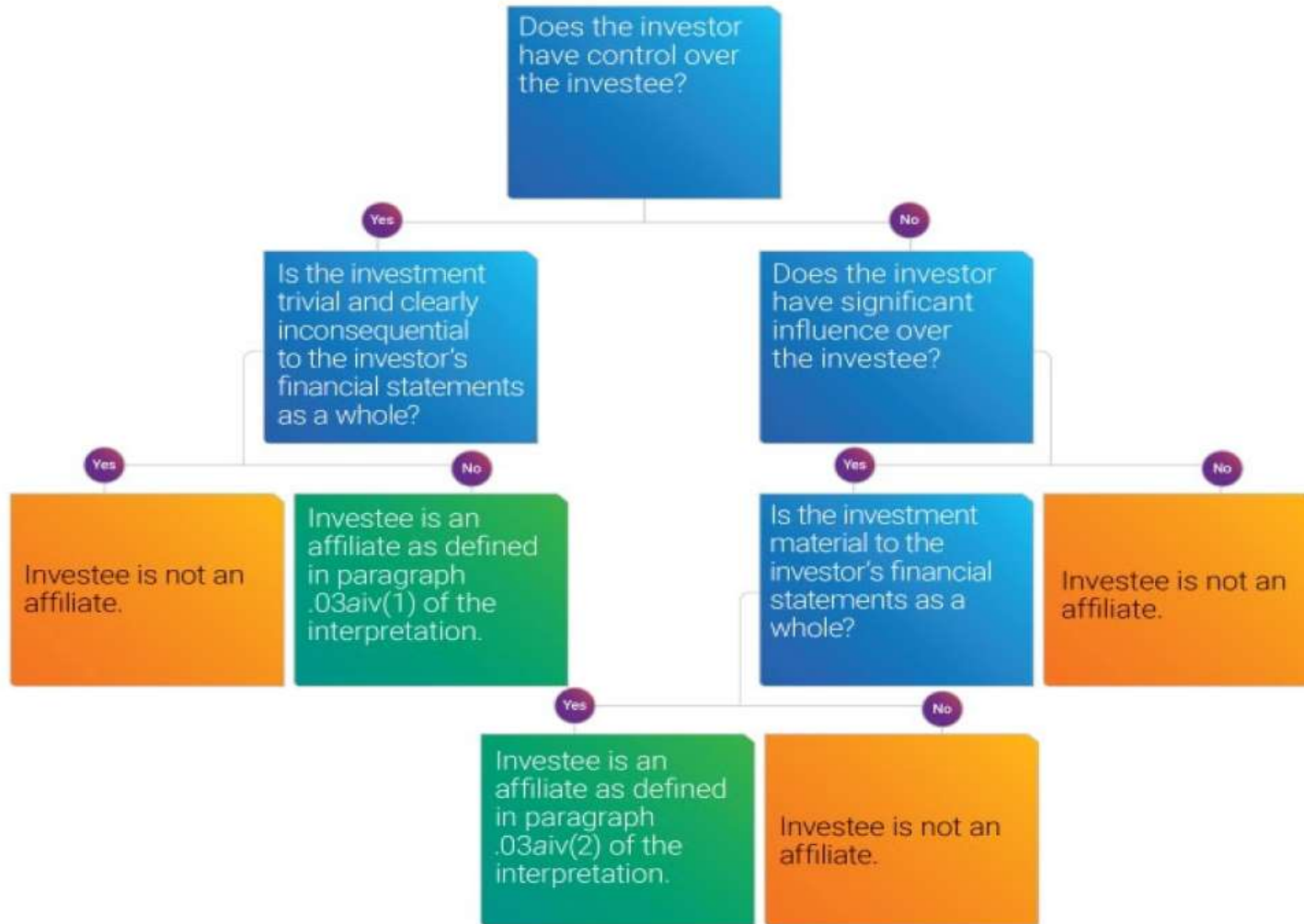
Who is an affiliate of your SLG organization?

- Type 4 (Par .03aiv)
 - New guidance
 - Does NOT include:
 - Equity interests in entities where your SLG organization's primary purposes is to enhances its ability to provide governmental services
 - Interest obtained by your SLG organization as a result of an action by a third party (bequest or a grant) and that your SLG organization does NOT intend to retain



Determination of Affiliates

Determining affiliates: the investment pathway





Determination of Affiliates

- Don't stop now...
 - For Type 1, Type 2, and Type 3 affiliates, we must evaluate entities required to be included in their financial statements that might also be considered affiliates of your SLG organization
 - For example, if a component unit is considered an affiliate, your SLG organization and audit firm must also evaluate the component units, funds, and departments of that component unit affiliate.



Review of Pathways

Inclusion Pathway (Types 1 & 2)

- **Type 1** - No reference to another auditor's report - OR
- **Type 2** - Reference to another auditor's report and: Material and MTMI

Exclusion Pathway (Type 3)

- **Type 3** - Material and MTMI

Investment Pathway (Type 4)

- **Type 4**
 - Control and NOT trivial or inconsequential - OR
 - Significant influence and material



Determination of Affiliates

- Scenario 1: Investments of Public Pension Trust Fund
 - The situation:
 - XYZ County includes Public Pension Trust Fund, which it reports as a fiduciary fund, in its financial statements.
 - Audit Firm determines that Public Pension Trust Fund is an affiliate of XYZ County as defined in paragraph .03ai of the interpretation (Type 1).
 - Audit Firm will need to evaluate Public Pension Trust Fund's investments to determine if there are any investees that are also affiliates as defined in paragraph .03aiv of the interpretation (Type 4).



Determination of Affiliates

- **Scenario 1: Investments of Public Pension Trust Fund**
 - Evaluation of their Investment in DEF Company:
 - Public Pension Trust Fund is an affiliate of XYZ County under paragraph .03ai of the interpretation (Type 1).
 - Public Pension Trust Fund is the investor and has a controlling interest in DEF Company. The trust fund's investment in DEF Company is more than trivial and is clearly consequential to XYZ County's financial statements as a whole.
 - Conclusion: DEF Company IS an affiliate of XYZ County. Independence rules apply to DEF Company. **Audit Firm must be independent of DEF Company.**



Determination of Affiliates

- Scenario 2: Investments of Public Pension Trust Fund
 - Evaluation of their Investment in RST Company:
 - Public Pension Trust Fund is considered an investor as defined in the interpretation. Public Pension Trust Fund also has an interest in RST Company that gives the trust fund significant influence over RST Company.
 - The investment in RST Company is material to XYZ County's financial statements as a whole.
 - Conclusion: RST Company IS an affiliate of XYZ County. Independence rules apply to RST Company. **Audit Firm must be independent of RST Company.**



Determination of Affiliates

- Scenario 3: Investments of Public Pension Trust Fund
 - Evaluation of their Investment in LMN Company:
 - Public Pension Trust Fund is considered an investor as defined in the interpretation. Public Pension Trust Fund also has an interest in LMN Company that gives the trust fund significant influence over LMN Company.
 - The investment in LMN Company is not material to XYZ County's financial statements as a whole.
 - Conclusion: LMN Company IS NOT an affiliate of XYZ County. Independence rules do not apply to LMN Company. **Audit Firm does not need to be independent of LMN Company.**



Determination of Affiliates

- **Scenario 4: Included Entity**
 - The situation:
 - Audit Firm audits the City of Sample. Sample's financial statements include the Sample Housing Authority.
 - The Sample Housing Authority is audited by another firm and the auditor's opinion on the City references the other firm.
 - The Housing Authority is material to the City and the City has more than minimal influence over the accounting and financial reporting processes of the Housing Authority.
 - Conclusion: The Housing Authority IS a Type 2 affiliate of the City. Independence rules apply to the Housing Authority. **Audit Firm must be independent of Housing Authority.**



Determination of Affiliates

- **Scenario 4a: Included Entity**
 - Downstream analysis: The Housing Authority has two component units of its own, both audited by the Housing Authority auditors.
 - Conclusion: The Housing Authority's component units MAY be affiliates of the City. Audit Firm may need to be independent of the Housing Authority's two component units.



Summary of 4 Types of Affiliates

Type 1

- Included in SLG organization's financial statements
- No reference to other auditors

(Current Guidance)

Type 2

- Included in SLG organization's financial statements
- Refer to other auditors
- Material to SLG organization
- SLG organization has more than minimal influence

(New)

Type 3

- Excluded from SLG organization's financial statements
- Material to SLG organization
- SLG organization has more than minimal influence

(New)

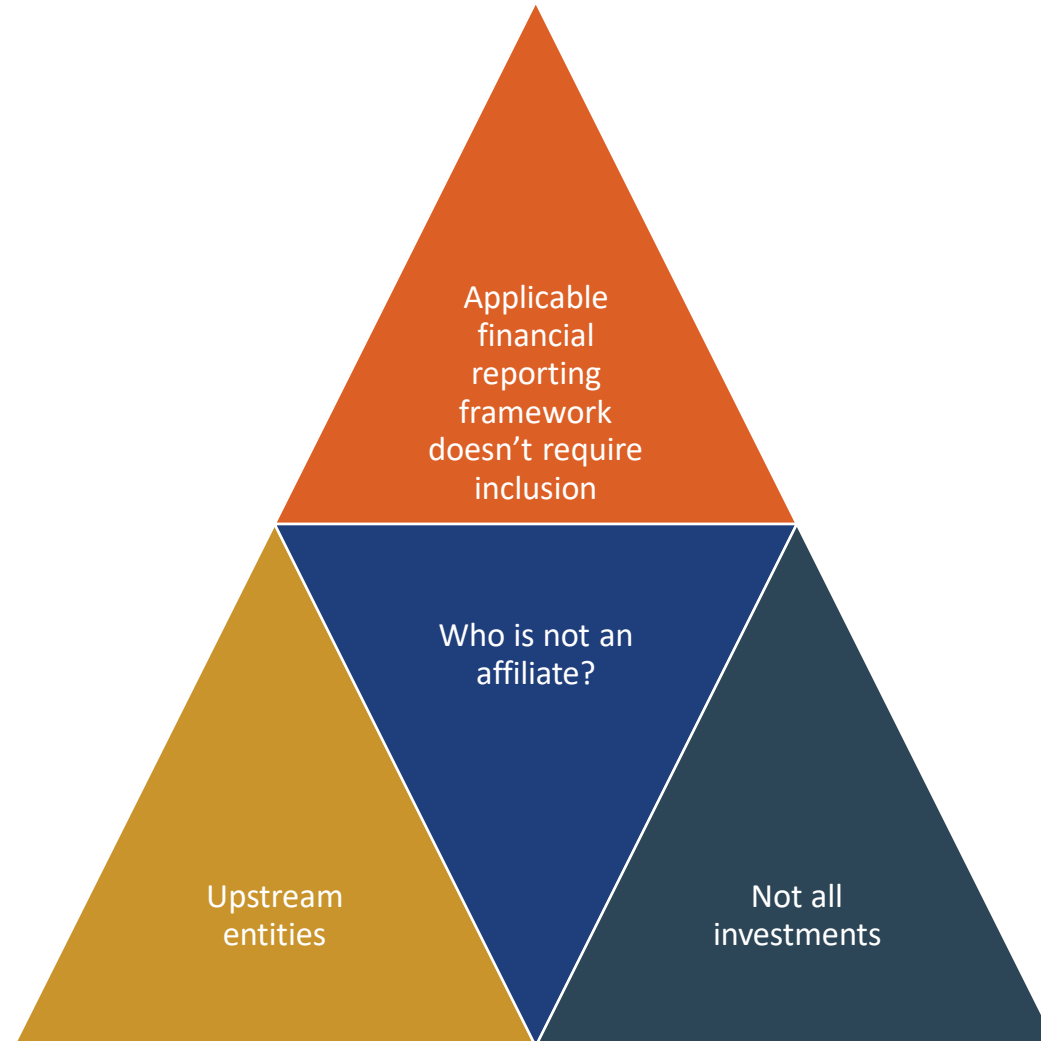
Type 4

- Investments held by investor (SLG organization)
- Investor (SLG organization) has control unless the investment is trivial or has significant influence and investment is material

(New)



Who is Not an Affiliate?





Conceptual Framework

In the absence of an interpretation of the Independence Rule that addresses a particular relationship or circumstance, apply the Conceptual Framework for Independence interpretation.





Conceptual Framework

Examples where the conceptual framework could apply

- Your SLG organization's audit partner's wife is in a key position with a nonaffiliate (e.g. State) that includes your SLG organization in its financial statement as a component unit. The State provides accounting staff, shares financial information systems, or establishes internal controls over financial reporting for your SLG organization.
- Your SLG organization's audit firm is considering providing financial information system design services to a nonaffiliate in which the same financial information system would also be used by your SLG organization
- Your audit partner has a financial interest in a nonaffiliate that includes your SLG organization in its financial statements, and the nonaffiliate prepares the financial statements for your client.



Exception

- **Non-attest services exception**
 - Applies only to Type 2 and Type 3 affiliates of your SLG organization
 - Your SLG organization's audit firm is not prohibited from providing non-attest services when the following apply:
 - Your audit firm can reasonably conclude that the prohibited non-attest service does not create a self-review threat because the results of the non-attest service will not be subject to financial statement attest procedures.
 - Other threats created by providing the non-attest service can be eliminated or reduced to an acceptable level by the application of safeguards.



Exception

- **Scenario 1: Included entity**
 - The situation:
 - Audit Firm audits ABC County. The County Housing Authority meets the definition of an affiliate under paragraph .03a(ii) (Type 2).
 - County Housing Authority asks Audit Firm to provide backup services for its data and records. Under the “Hosting Services” interpretation (ET sec. 1.295.143) of the “Independence Rule,” Audit Firm concludes the services are prohibited hosting services.
 - The question:
 - Do the otherwise prohibited backup services meet the requirements of the non-attest services exception?



Exception

- **Scenario 2: Excluded entity**
 - The situation:
 - Audit Firm audits ABC County. It is determined that NFP Company meets the definition of an affiliate under paragraph .03a(3)(iii) (Type 3).
 - NFP Company asks Audit Firm to perform financial information system design services for it. Under the “Information Systems Design, Implementation, or Integration” interpretation (ET sec. 1.295.145) of the “Independence Rule,” Audit Firm concludes that financial information system design services are prohibited services.
 - The question:
 - Do the otherwise prohibited financial information system design services meet the requirements of the non-attest services exception?



Key Impacts

- More evaluation of:
 - Certain material entities when making reference to another auditor's report
 - Material excluded entities
 - Investments
- Potentially more inclusive
- Impact financial interests



Next Steps

- **Effective date**
 - Periods beginning after 12/15/21
 - Auditors be independent as of January 1, 2022
- **Read through Implementation Guide**
- **Use the flowcharts**
 - Determine if your SLG organization has any affiliates requiring independence
 - Evaluate if there are any other relationships and circumstances that will now require your audit firm to remain independent
 - Consider conceptual framework for other circumstances and relationships



Resources

[AICPA Interpretation – State and Local Government Client Affiliates](#)

[AICPA Implementation Guide – State and local government client affiliates](#)



Questions?