State and local government client affiliates
Agenda

• Background
• Overview
• Determination of affiliates
• Conceptual framework application
• Summary
• Resources
Background
Where we are and where we’ve been

• “State and Local Government Client Affiliates” supersedes “Entities included in State and Local Government Financial Statements” as ET 1.224.020

• Not applicable to single audits (future project)

• Conceptually consistent with the “Client Affiliates” interpretation (ET 1.224.010)
Overview
State and local government client affiliates
ET(1.224.020)

- You must apply the “Independence Rule” and related interpretations to affiliates
- Effective for years beginning after December 15, 2020
- Who is an affiliate?
Affiliate determination
Who is an affiliate of your client?

Par. .03ai
- Included in client’s financial statements
- No reference to other auditor

(Current guidance)

Par. .03aii
- Included in client’s financial statements
- Refers to other auditor
- Material to client
- Client has more than minimal influence

(New)

Par. .03aiii
- Excluded from client’s financial statements
- Material to client
- Client has more than minimal influence

(New)

Par. .03aiv
- Investments held by an investor
- Investor has control unless investment is trivial or has significant influence and investment is material

(New)
Who is not an affiliate?

- Applicable financial reporting framework doesn’t require inclusion
- Upstream entities
- Not all investments

Reminder:
You should consider the conceptual framework if you identify threats to independence
Determining affiliates: the inclusion pathway

1. **Yes**
   - Does your audit report make reference to another auditor’s report on the included entity?

2. **Yes**
   - Is the included entity material to your client’s financial statements as a whole?

3. **Yes**
   - Does your client have more than minimal influence over the included entity’s accounting or financial reporting process?

4. **Included entity is an affiliate (par. .03aii of the interpretation).**

5. **No**
   - Entity is not an affiliate of your client.

6. **No**
   - Included entity is an affiliate (par. .03aii of the interpretation).
Determining affiliates: the exclusion pathway

Is the excluded entity material to your client’s financial statements as a whole?

Yes

Does your client have more than minimal influence over the excluded entity’s accounting or financial reporting process?

Yes

Excluded entity is an affiliate (par. .03a(iii) of the interpretation).

No

Excluded entity is not an affiliate of your client.
Materiality

• Professional judgement
• Applied at the reporting entity level
• Consider qualitative and quantitative factors

The materiality criteria will likely exclude many entities from inclusion as an affiliate.
More than minimal influence

• Level of involvement your client has in preparing the financial statements of the entity

• Does your client and the entity have the same
  – accounting or finance staff
  – accounting systems
  – internal control over financial reporting systems

Some factors may indicate influence, others may indicate little to no influence.

Some factors may be weighted differently.

Take a substance over form approach to evaluating the factors.
More than minimal influence

• What is the extent of operational control your client has over the entity

• Is your client…
  – able to direct the behaviors or actions of the governing board of the entity
  – able to add or remove members of the governing board of the entity
  – issuing or paying for the entity’s debt
  – financing the entity’s deficits
  – using or taking the entity’s financial resources

Make note – There is a rebuttable presumption that when the entity is a fund or a blended component unit the financial statement attest client has more than minimal influence.
Exception: nonattest services

Only applies to affiliates under .03aii and .03aiii

You would not be prohibited from providing these services when the following apply:

- The results will not be subject to financial statement attest procedures
- Other threats can be reduced to an acceptable level
Investments

A security or other asset that an investor:

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.

Includes investments and ownership in equity interest in common stock accounted for using the equity method of accounting.

Investments do not include:

• Temporary investments
• Equity interests in entities that provide governmental services
Determining affiliates - investments

The investor has control and the investment is not trivial

The investor has significant influence and the investment is material

An investor includes your client or an affiliate of your client that meets the definition of an affiliate under paragraph .03ai of the interpretation
Determining affiliates: control investment pathway

Does the investor have control over the investee?

- Yes
  - Is the investment trivial and clearly inconsequential to your client’s financial statements as a whole?
  - No
    - Investee is an affiliate (par. 0.3aiv(1) of the interpretation).
  - Yes
    - Investee is not an affiliate of your client.

- No
  - Go to significant influence pathway (exhibit C.2).
Determining affiliates: significant influence investment pathway

1. *Does the investor have significant influence over the investee?*
2. *Is the investment material to your client’s financial statements as a whole?*
3. Investee is an affiliate (par. .03aiv(2) of the interpretation).

**Yes**

**Yes**

**No**

Investee is not an affiliate of your client.

*Use the control investment pathway (exhibit C:1) before starting here.*
Conceptual framework application
Applying the conceptual framework for independence

In the absence of an interpretation of the “Independence Rule” [1.200.001] that addresses a particular relationship or circumstance, a member should apply the “Conceptual Framework for Independence” interpretation [1.210.010].
Examples of relationships/circumstances where the conceptual framework could be applicable

1. Your immediate family member is in a key position with a nonaffiliate that includes your client in its financial statements. The nonaffiliate provides accounting staff, shares financial information systems, or establishes internal controls over financial reporting for your client.

2. Your firm is considering providing financial information system design services to a nonaffiliate in which the same financial information system would also be your client.

3. You have a financial interest in a nonaffiliate that includes your client in its financial statements, and the nonaffiliate prepares the financial statements for your client.
Key impacts of interpretation

More evaluation
- 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 12/15/20

Implementation guide under development

• Practice aid with examples and graphics
• Three tools to help you evaluate potential affiliates

Consider impact on your clients

• Determine whether there may be new affiliates requiring independence
• Evaluate whether there are circumstances and relationships that require action to remain independent
• Consider conceptual framework for other circumstances and relationships

Additional training and guidance
Resources
Tools to assist members in applying guidance

**Entity affiliate evaluator**

**Entity is an affiliate of the financial statement attest client as defined in paragraph .03a(ii) of the interpretation**

Basis for conclusion:

- The entity is included in the client's financial statements;
- The auditor makes reference to another auditor's report;
- The entity is material to the client's financial statements; and
- The client has more than minimal influence over the entity's accounting or financial reporting process.

Be sure to save this screen for your documentation.

<table>
<thead>
<tr>
<th>Name of the Entity Required Under the Applicable Financial Reporting Framework to be Included in the Financial Statements of the SLG Financial Statement Attest Client</th>
<th>Does the auditor make reference to another auditor's report?</th>
<th>Is the included entity material to the financial statement attest client's financial statements as a whole?</th>
<th>Does the financial statement attest client have more than minimal influence over the included entity's accounting or financial reporting process?</th>
<th>Result</th>
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<tbody>
<tr>
<td>Example</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Affiliate .03 a. i.; Must evaluate investments</td>
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<tr>
<td>Example</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Affiliate .03 a. ii.; May apply paragraph .07 exception</td>
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</table>

Implementation guide

- Decision trees
- Examples

Tools

- Evaluate affiliates
- Provide documentation
Let’s try it out…

Entity affiliate evaluator

Investment affiliate evaluator

Interactive matrix
Communication and Outreach

- Journal of Accountancy
- Webinars
- Podcast
- Train-the-trainer
Resources

• AICPA Code of Professional Conduct – SLG client affiliates interpretation

• AICPA Professional Ethics Division

• State and Local Government Client Affiliates Exposure Draft

• AICPA Governmental Audit Quality Center
Thank you