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Revised Ethics Interpretation for Government Client Affiliates

In June 2019, the AICPA's Professional Ethics Executive Committee adopted the revised ethics Interpretation, "State and Local Government Client Affiliates." This revised Interpretation is under the Independence Rule and is codified at ET 1.224.020.

What Does the Current Interpretation State?

Just to recap, the current Interpretation at ET 1.224.020 generally states that auditors of the basic financial statements of a government must be independent of all the funds or entities that are included in the basic financial statements or notes to such, with some exceptions. In addition, the current Interpretation notes that independence is impaired if an immediate family member of the auditor holds a key position in one of the funds or entities included in the basic financial statements.

For purposes of the current Interpretation, an "affiliate" would include a major fund, a nonmajor fund, an internal service fund, a blended component unit, a fiduciary fund, related organizations, joint ventures, and component units of another government with characteristics of a joint venture. Generally, an auditor is not required to be independent of an affiliate if the auditor explicitly states reliance on other auditors' reports for the affiliate's financial information included in the basic financial statements.

How Is the Revised Interpretation Different?

The revised Interpretation is completely rewritten and much more detailed than before. Here are some key areas of change:

Terminology—A new section is added on terminology with very specific explanations of the terms "affiliate," "entity," and "investment," for use in the revised Interpretation only. This detailed terminology should provide clarity for more of the situations that auditors encounter with their government attest clients.

Reference to Conceptual Framework—Conceptually, the revised Interpretation states that auditors should be independent with respect to affiliates of their government

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attest clients, which isn't really new. What is new is that the revised Interpretation states that when an auditor encounters a threat to independence, they should apply the Conceptual Framework for Independence [ET 1.210.010] to evaluate whether those threats are at an acceptable level. The current Interpretation does not explicitly refer the auditor to that ethical framework, although it is implied.

Nonattest Services to Affiliates—Situations have been added in which nonattest services may be provided to certain entities without impairing independence. Generally, this would be situations in which it is reasonable to conclude that the services do not create a self-review threat with respect to the audit of the attest client.

Best Efforts—The revised Interpretation discusses the auditor's responsibility to identify affiliates. It also provides specific steps to take if the auditor is unable to obtain information needed to identify affiliates.

Minimal Influence—The revised Interpretation contains information for evaluating whether an attest client has more than minimal influence over the accounting and financial reporting process of an entity included in its financial statements. This comes into play when determining whether an entity meets the definition of an affiliate.

Examples of Threats to Independence—The revised Interpretation offers several examples of threats to independence that may require the auditor to apply the Conceptual Framework for Independence. Here are a couple of those:

- The auditor's immediate family member is in a key position of a nonaffiliate that includes the 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 attest client.
- The auditor or 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 their attest client.

What Is an Affiliate under the Revised Interpretation?

While the term *affiliate* as defined in the revised Interpretation is too lengthy to cover completely in this article, the following is an excerpt:

Affiliate—The revised Interpretation states that an affiliate exists in these situations:

a. The entity is included in the attest client's financial statements and the auditor *does not* make reference to another auditor's report on the entity,
b. The entity is included in the attest client's financial statements, the auditor *does* make reference to another auditor's report on the entity, and:
    1. The entity is material to the 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.

When Is the Revised Interpretation Effective?

It is effective for years beginning after December 15, 2020, and will be published in the August 2019 edition of the *Journal of Accountancy*.

Practical Consideration:

The current and revised Interpretations are available at **checkpoint.riag.com** under **Standards and Regulations/ AICPA/Professional Standards/Code of Professional Conduct [ET]/ET Part 1/1.200 Independence/1.224.020** for those that subscribe. After clicking on the ET section, scroll down to the highlighted section starting with "June 2019" for the revised Interpretation.

GASB ED on Subscription Arrangements

In May 2019, the GASB issued an exposure draft inviting comments on *Subscription-Based Information Technology Arrangements* (SBITA) (the proposed Statement).

Background

SBITAs, such as cloud computing, have become increasingly popular as state and local governments move away from on-premise information technology that is internally developed, purchased, or acquired through licensing, which is addressed by existing GASB guidance. However, existing guidance does not address SBITA. The proposed Statement's purpose is to provide guidance and eliminate inconsistency in accounting for SBITAs. It is closely based on the new lease guidance provided in Statement No. 87, *Leases*.

Summary of Key Provisions of the Exposure Draft

Definition of SBITA. SBITA is a contract that conveys control of the right to use an SBITA vendor's hardware, software, or both, including information technology infrastructure, for a period of time in an exchange or exchange-like transaction.

Subscription assets. Governments with SBITA would recognize a right-to-use subscription asset (an intangible asset), which should be amortized over the lesser of the subscription term or the useful life of the underlying hardware or software. The amortization of the subscription asset should be recognized as an outflow of resources over the subscription term. The original amount of the subscription asset should be measured as the sum of the following:

- The original measurement amount of the subscription liability.
- Subscription payment made to the SBITA vendor at or before the beginning of the subscription term, less any incentives received from the SBITA vendor at or before the beginning of the subscription.
- Capitalizable implementation costs.

Subscription liability. Governments should also record a corresponding liability. It should be measured at the present value of subscription payments expected to be made during the subscription term. The measurement of the subscription liability should include the following:

- Fixed payment.
- Variable payments that are measured at the beginning of the subscription term that depends on an index or a rate. The rate used could be the consumer price index or a market interest rate.
- Variable payments that are fixed in substance.
- Payment for penalties for terminating the SBITA, if the subscription term reflects the government exercising a termination option or fiscal funding or cancellation clause.
- Subscription incentives received from the SBITA vendor.
- Any other payments to the SBITA vendor that are reasonably certain of being required, based on an assessment of all relevant factors.

Short-term exception. The proposed Statement would provide an exception for short-term SBITAs with a maximum possible term of twelve months which includes any options to extend, regardless of their probability of being exercised. Subscription payments for short-term SBITAs would be recognized as outflows of resources. If the subscription payments are made *in advance*, the government should recognize an asset. If the subscription payments are made *after* the reporting period, a liability should be recognized. If the SBITA vendor permits the right to use the underlying hardware or software to the government free of charge (for example, one or more months free), the government should *not* recognize an outflow of resources.

Contracts with multiple components. If a government enters into an SBITA that contains multiple components, such as a *subscription* component (which is the right to use the underlying hardware or software) and a *nonsubscription* component (which is a maintenance services contract for the hardware or software), the components should be accounted for as two separate SBITAs. If it is not practical to determine a best estimate for price allocation for some or all components in the contract, a government should account for those components as a single SBITA.

Implementation cost and other outlays. Outlays and implementation cost, other than subscription payments, would be accounted for as follows:

- Preliminary project stage: all activities should be expensed as incurred. Examples of these activities include evaluating alternatives, determining needed technology, and selecting an SBITA.
- Initial implementation stage: all activities should be capitalized as an addition to the subscription asset. Examples of activities include design, programming, and testing. If the contract is a short-term SBITA, expenditures should be expensed as incurred.
- Post-implementation/operation stage: all activities should be expensed as incurred. Expenditures typically are related to maintenance.

Notes to the financial statement. The notes should include information such as a general description of the SBITAs, amount of the subscription asset, accumulated amortization, the amount of outflow of resources, principal and interest requirements for the subscription liability, and other essential information.

Proposed Effective Date

The proposed Statement would be effective for fiscal years beginning after June 15, 2021, with earlier application encouraged.

Comment Deadline

The comment deadline is August 23, 2019.

Practical Consideration:

The full text of the Exposure Draft is available on Checkpoint at **checkpoint.riag.com** for users that subscribe to GASB content, and at **www.gasb.org**.

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Fiduciary Activities Implementation Guide

In June, the GASB issued Implementation Guide No. 2019-2, *Fiduciary Activities*, (the Guide) to clarify, explain, or elaborate on requirements of GASBS No. 84, *Fiduciary Activities*. GASBS No. 84 was issued in January 2017 and was effective for financial statements for reporting periods beginning after December 15, 2018. This Guide supersedes or amends previously issued guidance, while also introducing new questions and answers related to fiduciary activities.

What's Addressed

The Guide supersedes or amends certain questions and answers (Q&A) in GASB Implementation Guides 2015-1, 2016-1, and 2017-2. However, the majority of the Guide focuses on answering new questions that practitioners might have regarding implementing GASBS No. 84. The Guide includes the following new Q&A discussions:

- *Identifying Fiduciary Activities.* The Guide added 38 new Q&A related to this topic. The subtopics include discussions on:
  - Fiduciary Component Units
  - Pension and OPEB Arrangements That Are Not Component Units
  - Other Fiduciary Activities
  - Control of Assets
  - Own-Source Revenues
- *Reporting Fiduciary Activities in Fiduciary Funds.* The Guide added eight new Q&A related to this topic. The subtopics include discussions on determining if an activity should be reported in an investments trust fund, private-purpose trust fund, or custodial fund.
- *Statement of Fiduciary Net Position.* The Guide added one new Q&A related to this topic. The subtopic is Liability to the Beneficiaries. It clarifies that when uniforms and equipment for a youth soccer program are requested by volunteers (non-employees of the city), a liability for those items is not recognized until the goods are actually acquired.
- *Statement of Changes in Fiduciary Net Position.* The Guide added three new Q&A related to this topic. The subtopic is Disaggregation Exception. It clarifies the reporting of parent organized fundraiser monies held by a city's parks and recreation department.
- *Reporting Fiduciary Component Units.* The Guide added two new Q&A related to this topic. The Q&A clarifies reporting of fiduciary component units for a public employee retirement system and a public university that reports as a stand-alone business-type activity.

Effective Date

The Guide is effective for periods beginning after December 15, 2018, with earlier implementation encouraged if GASBS No. 84 has been implemented.

Practical Consideration:

The full text of the Guide is available on Checkpoint at **checkpoint.riag.com** for users that subscribe to GASB content, and at **www.gasb.org**.