



STATE AND LOCAL GOVERNMENT FINANCE DIVISION
AND THE LOCAL GOVERNMENT COMMISSION

GREGORY C. GASKINS
DEPUTY TREASURER

Memorandum #2020-05

TO: North Carolina Local Governments and Public Authorities and their Independent Auditors

FROM: Sharon Edmundson, Director, Fiscal Management Section

SUBJECT: AICPA Interpretations on Independence – *Hosting Services* (ET §1.295.143) and *State and Local Government Client Affiliates* (ET §1.224.020)

DATE: April 17, 2020

The AICPA Professional Ethics Executive Committee (PEEC) has released two interpretations, the requirements of which may impact an auditor's independence when providing attest services and nonattest services to his or her clients. *Hosting Services* in the AICPA's Independence Rule in the *Code of Professional Conduct* went into effect July 1, 2019. *State and Local Government Client Affiliates* is a revised ethics interpretation addressing state and local government (SLG) entities that are financial statement attest clients. This revised interpretation is effective for years beginning after December 15, 2020, which for most North Carolina local governments and public authorities means for fiscal years ending June 30, 2021 or later.

Hosting Services
(effective July 1, 2019)

When an auditor provides hosting services, the auditor is maintaining the attest client's internal control over its data or records. The management participation threat to the auditor's compliance with the *Independence Rule* would NOT be at an acceptable level and could NOT be reduced to an acceptable level by the application of safeguards, and independence would be impaired.

Examples of hosting services include:

- Housing the attest client's website or other non-financial information system as the sole host
- Being the attest client's business continuity or disaster recovery provider
- Having custody or storing the attest client's data or records on the attest client's behalf such that the client's data or records are available only from the auditor; the client's records are incomplete without the records held by the auditor. A great example of this is a depreciation schedule. If the auditor maintains the schedule without providing copies to the client, the auditor is providing a hosting service. Another example is the auditor maintaining a client's accounting records such as the general ledger; this is likely more common with very small entities that use software such as Quickbooks. If the auditor is maintaining the software file that is used to generate the financial statements, the auditor is providing a hosting service. A good way to summarize here is that if the client decided to change auditors, would the client be able to provide the new auditor with everything that is needed to move forward with the new auditor? If the client can do this without relying on the previous auditor to provide data or information, then it is likely there is not a hosting relationship in place.

- Some circumstances that are not hosting would include a client giving the auditor access to a third-party provider that maintains its accounting system in a cloud-based environment while still maintaining access; or the client and the auditor maintain separate files, each on their own systems.

***State and Local Government Client Affiliates
(effective for fiscal years beginning after December 15, 2020)***

This interpretation applies to state and local government entities that are financial statement attest clients. An affiliate of a financial statement attest client exists in the following situations:

- The entity is included in the financial statement attest client's financial statement and the auditor does not make reference to another auditor's report on the entity.
- The entity is included in the financial statement attest client's financial statements, the auditor makes reference to another auditor's report on the entity, and
 - the entity is material to the financial statement attest client's financial statements as a whole and
 - 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.
- 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.
- The investor, which is either the financial statement attest client or an affiliate, has an investment in an investee when the investor either
 - controls the investee, unless the investment in the investee is trivial and clearly inconsequential to the financial statement attest client's financial statement as a whole, or
 - has significant influence over the investee and the investment in the investee is material to the financial statement attest client's financial statement as a whole.

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.

If an auditor encounters circumstances or relationships that may create threats to independence, the auditor should apply the Conceptual Framework for Independence to evaluate whether threats are at an acceptable level. Examples found in the revised interpretation include:

- An auditor'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 attest client.
- The auditor 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.
- An auditor 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.

- The financial statement attest client participates in a public-private partnership or joint venture that does not meet the definition of an investment in this interpretation. An auditor has a financial interest in an organization that is also involved with the public-private partnership or joint venture.
- An auditor owns utility bonds issued by a nonaffiliate, and the financial statement attest client is responsible for payment of the utility bond debt service.
- An auditor 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.

An exception to this allows an auditor to provide prohibited nonattest services to material excluded entities and entities when making reference to other auditor during the period of the professional engagement or during the period covered by the financial statement provided it is reasonable to conclude 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 auditor's financial attest procedures. For any other threats created by the provision of the nonattest services that are not at an acceptable level, the auditor should apply safeguards to eliminate or reduce the threats to an acceptable level.

An auditor must expend his or her best efforts to obtain the information necessary to identify affiliates of a financial statement attest client. If, after expending best efforts, an auditor 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 auditor does all the following:

- discusses the matter, including the potential impact on independence, with those charged with governance,
- documents the results of that discussion and the efforts taken to obtain the information; and
- obtains written assurance from the financial statement attest client that it is unable to provide the auditor with the information necessary to identify the affiliates of the financial statement attest client.

If you have questions about the topics covered in this memorandum, please contact us at slqfd@nctreasurer.com or at (919) 814-4300.