

IAASB CAG PAPER



International Federation of Accountants

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

Agenda Item

L&M

Committee: IAASB Consultative Advisory Group

Meeting Location: Toronto

Meeting Date: September 11-12, 2006

Service Organizations

Objectives of Agenda Item

At the May 11-12, 2006 IAASB CAG meeting, Representatives considered the scope of the proposed projects to revise International Standard on Auditing (ISA) 402, *Audit Considerations Relating to Entities Using Service Organizations* and develop a new International Standard on Assurance Engagements¹ (ISAE) 3402, *Assurance Report on Service Organization's Controls*, as well as major problems and key issues to be addressed as part of these projects. The IAASB approved the project proposals in March 2006. Two Task Forces have been appointed to commence work on the projects. The objective of this agenda item is:

1. To provide a brief report back on the May 11-12, 2006 comments received from Representatives on the project proposals.
2. To obtain the views of Representatives on key issues to be considered by the IAASB at its September 2006 meeting.

May 11-12, 2006 CAG Comments

Below are extracts from the minutes of the May 11-12, 2006 CAG meeting and an indication of how the IAASB Task Force responded to the Representatives' comments.

Representatives' comments	IAASB task force response
Ms. Koski-Grafer noted that the scope of service organizations is broad and that careful consideration should be given to the definition of service organization.	This issue has been raised for the IAASB's consideration. Refer to paragraph 2.3 of Agenda Item L&M.1 and paragraph A.5 of Agenda Item L&M.2)
Mr. Peyret noted that international groups are increasingly making use of international shared service centers. This may lead to the local CFO, who	The issue of international shared service centers and the relationship with ISA 600 are under consideration by the Task Force Refer to paragraph 2.4 of Agenda

¹ According to the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," International Standards on Auditing (ISAs) are to be applied in the audit of historical financial information and International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements dealing with subject matters other than historical financial information.

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Representatives' comments	IAASB task force response
is responsible for the local entity's financial statements, not having control over what is presented to him or her as the financial statements of the local entity. Mr. Popham noted that this is particularly important in the context of proposed ISA 600 (Revised), "The Audit of Group Financial Statements."	Item L&M.1)
Mr. Popham was of the view that it would not be appropriate to adopt SAS 70 of the United States. Service organizations are more sophisticated than what is provided for in SAS 70. The first step should be to identify service organizations to be addressed in the proposed ISA – those in large groups are most probably the most common.	The Task Forces have spent considerable time considering the range of service organizations that exist. Examples of different types of service organization are included in the Appendix to IAASB Agenda Item 4. SAS 70 and other national pronouncements are being reviewed, but the project proposal for ISAE 3402 does not necessarily contemplate the adoption of one or more national standards.
Mr. Morris suggested that the ISAE 3402 Task Force also consider the service organization in terms of a revenue source; that is, both selling and buying services.	ISA 402 will be aimed at financial statement audits of entities that use a service organization. ISAE 4302 could be broader than financial statements audits impacts. Refer to paragraph A.5 of Agenda Item L&M.2)
Mr. Roussey offered to be on the Working Group. He noted that his organization has information that may be useful to the Task Forces. He also suggested that, if the projects do not cover the extended enterprise concept, the concept should be included on a future CAG agenda.	"The extended enterprise is the entire set of collaborating companies, both upstream and downstream, from raw material to end-use consumption, that work together to bring value to the marketplace." ² Reporting entities are defined for financial reporting purposes based on "control," therefore, that is the concept of most relevance to financial statement audits. The ISA may, however, mention the extended enterprise concept in terms of understanding an entity's strategic direction and related risks of material misstatement.

Definitions

For the purposes of discussion at this meeting, the following terms and explanations will be used.

² "The Extended Enterprise: Gaining Competitive Advantage through Collaborative Supply Chains" Edward W. Davis and Robert E. Spekman, Financial Times Prentice Hall Books, 2003.

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- *Service Organization*—the entity (or segment of an entity) that provides services to a user organization. There are many different types of service organizations used today, whose services span a number of dimensions, e.g., from:
 - Traditional activities (such as payroll), to newer frontiers (such as application service provision over the internet);
 - Routine activities (such as call centres), to complex arrangements where the service organization exercises considerable discretion (such as the controllership function);
 - Peripheral activities (such as building maintenance), to core activities (such as investment management for a retirement benefit plan); and
 - Activities that clearly have a direct effect on the user organization's internal control as it relates to the preparation of the financial statements (such as payroll processing), to broader activities that are not directly related to finance and accounting (such as waste disposal).
- *Service Auditor*—the auditor who reports on the controls of a service organization.
- *User Organization*—the entity that uses a service organization and whose financial statements are being audited.
- *User Auditor*—the auditor who audits and reports on the financial statements of the user organization.

Significant issues to be considered by the IAASB in September

ISA 402 "AUDIT CONSIDERATIONS RELATING TO ENTITIES USING SERVICE ORGANIZATIONS"

Existing ISA Risk Assessment Requirements: The Representatives are asked for their views on whether:

- (a) If a service organization performs activities that are part of the entity's information system relevant to financial reporting then the service organization is performing activities that are part of the entity's internal control relevant to the audit?
- (b) A user auditor performing an ISA audit should understand the activities performed by the service organization that affect the entity's information system relevant to financial reporting, and should consider those activities in identifying and assessing the risks of material misstatement?
- (c) If the user auditor's risk assessments are based on the expectation that controls at a service organization are effective, or if it is not possible or practicable to reduce the risks of material misstatement at the assertion level to a an acceptably low level with audit evidence obtained only from substantive procedures because of the activities performed by the service organization that are part of the user organization's internal control, the auditor should perform (or otherwise obtain evidence of) tests of controls at the service organization. **Refer to paragraph 1.6 of Agenda Item L&M.1)**

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Types of Service Organizations to be Encompassed by ISA 402: The Representatives are asked for their views on whether the auditor should consider the activities of service organizations where those activities do not directly affect the user organization's internal control as it relates to the preparation of the financial statements. If so, what is the rationale for requiring the auditor to do so, what boundaries should be specified within the context of current ISAs, and should ISA 402 provide guidance on such situations? **Refer to paragraph 2.3 of Agenda Item L&M.1)**

Procedures to Obtain Information and Evidence: The Representatives are asked for their views on whether:

- (a) The only ways the user auditor can obtain information about the design and implementation of relevant controls at a service organization, or evidence about their operating effectiveness, is by directly performing procedures at the service organization, engaging another auditor to perform procedures at the service organization, obtaining information from manuals, internal audit reports, or other documents, or obtaining information from a report issued by a service auditor?
- (b) Other than acknowledging that the user auditor may specifically engage another auditor to perform procedures at the service organization, ISA 402 need not further address this situation because such other auditor is under the direction of the user auditor. **Refer to paragraph 3.4 of Agenda Item L&M.1)**

Definitions and Relationships: The Representatives are asked for their views on whether:

- (a) ISA 402 (and ISAE 3402) should be written primarily on the assumption of no direct relationship between the service auditor and the user auditor?
- (b) In addition to defining the terms "service auditor," "service organization," "user auditor," and "user organization," ISA 402 and/or ISAE 3402 should address the relationships between these parties?
- (c) ISA 402 and/or ISAE 3402 should provide guidance that reinforces this relationship through such matters as the degree to which a user auditor may rely on the work of a service auditor based on e.g., the distribution of the report, the addressee of the report, and the engagement letter? **Refer to paragraph 4.8 of Agenda Item L&M.1)**

ISAE 3402 "ASSURANCE ON CONTROLS AT A SERVICE ORGANIZATION"

Scope of ISAE 3402: The Representatives are asked for their views on whether, in addition to providing guidance on internal control relevant to financial reporting, ISAE 3402 should recognize and provide guidance on service auditor's reports on broader subject matter, e.g., reports on controls over research methodologies with respect to clinical drug trials? If so, what, if any, boundaries should be placed on such subject matter? **Refer to paragraph A.5 of Agenda Item L&M.2)**

Types of Service Auditor Reports: Existing practice regarding the form and content of service auditor reports includes two types of reports. The "Type A" (or "Type 1") report includes:

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- (a) A description of the controls the service organization has in place to respond to risks that relate to the activities undertaken for user organizations, ordinarily prepared by the management of the service organization; and
- (b) An opinion by the service auditor whether:
 - (i) The above description is accurate/fairly presented;
 - (ii) Controls are suitably designed to achieve their stated objectives; and
 - (iii) Controls have been implemented as at a particular date.

The “Type B” (or “Type II”) report covers the same material in Type A but also includes a fourth opinion by the service auditor on whether the controls have operated effectively over a particular period. The report identifies details of the tests of controls performed and related results upon which the opinion on operating effectiveness is based.

The Representatives are asked for their views on whether:

- (a) ISAE 3402 should provide for both Type A and Type B reports? If so, should it be written assuming a full (Type B) report, and simply mention that in some cases a report without an opinion on operating effectiveness may be appropriate?
- (b) ISAE 3402 should continue the current practice of including a description of the service organization’s controls prepared by the management of the service?
- (c) The service auditor’s opinion should address:
 - (i) Accuracy/fair presentation of the system description?
 - (ii) Suitability of design?
 - (iii) Implementation as at a date?
 - (iv) Operating effectiveness over a period?
- (d) If the report includes an opinion on operating effectiveness over a period, it should be required to also describe the tests of controls performed and results? **Refer to paragraph B.4 of Agenda Item L&M.2)**

Level of Assurance Obtained by a Service Auditor: The Representatives are asked for their views on whether:

- (a) A limited assurance engagement is of practical use to a user auditor?
- (b) If the primary focus of ISAE 3402 is to be on reasonable assurance, should it specifically prohibit limited assurance? **Refer to paragraph C.3 of Agenda Item L&M.2)**

Service Organizations that use Other Service Organizations: The Representatives are asked for their views on whether, when a service organization uses a sub-service organization, the report on the service organization should:

- (a) Carve out the sub-service organization;

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- (b) Include the sub-service organization;
- (c) Include only the monitoring controls over the sub-service organization; or
- (d) Be allowed to use any of these approaches? ***Refer to paragraph D.3 of Agenda Item L&M.2)***

Material Presented – IAASB CAG REFERENCE PAPERS ONLY

Agenda Item L&M.1 Service Organizations –ISAE 402: Significant Issues (September 2006 IAASB Agenda Item 4-A)

Agenda Item L&M.2 Service Organizations –ISAE 3402: Significant Issues (September 2006 IAASB Agenda Item 4-B)

The remainder of the September 2006 IAASB meeting material is available from <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0076&ViewCat=0575>.