

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2006)

Agenda Item L&M.2

Service Organizations—Issues Paper – September 2006 IAASB Agenda Item 4-B

Service Organizations – ISAE 3402—Significant Issues

A. Scope of ISAE 3402

- A.1 The existing ISA 402 contains, in gray letters, a description of information that is ordinarily found in a service auditor's report on the service organization's activities that form part of a user organization's internal control relevant to financial reporting. However, the existing ISA 402 does not provide guidance to service auditors on performing such an engagement. The purpose of the ISAE 3402 project is to provide such guidance.
- A.2 Issue 2 in Agenda Item 4-A addresses whether, for the purpose of ISA 402, the definition of a service organization should include only those that perform activities that directly affect the user organization's internal control as it relates to the preparation of the financial statements, or extend to service organizations that may provide other activities for user organizations.
- A.3 If, in answer to Issue 2 in Agenda Item 4-A, the IAASB decides that ISA 402 should address service organizations whose activities extend beyond those that have a direct effect on the user organization's internal control over preparation of financial statements, it is logical that ISAE 3402 should also have this broader focus. If, however, the IAASB decides that ISA 402 should be limited to service organizations whose activities have a direct effect on the user organization's internal control over preparation of financial statements, ISAE 3402 could be similarly limited in scope or could address broader matters, e.g., reports on controls over research methodologies with respect to clinical drug trials.
- A.4 It was argued at the task force meeting that drafting ISAE 3402 to be responsive to emerging demands for reports on broader controls is in the public interest because it would allow the standard to lead, and therefore shape, practice as it evolves. On the other hand, it was also argued that ISAE 3402 should be limited to reports on a service organization's controls that have a direct effect on a user organization's internal control over preparation of financial statements, and that addressing broader issues could delay finalization of a standard for financial reporting controls, and potentially result in too generic a standard.

A.5 Issue

- (a) *In addition to providing guidance on internal control relevant to financial reporting, should ISAE 3402 recognize and provide guidance on service auditor's reports on broader subject matter? If so, what, if any, boundaries should be placed on such subject matter?*

B. Types of Service Auditor Reports

- B.1 Existing practice regarding the form and content of service auditor reports includes two types of reports (as described in ISA 402). The "Type A" (or "Type 1") report includes:

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2006)

Agenda Item L&M.2

Service Organizations—Issues Paper – September 2006 IAASB Agenda Item 4-B

- (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. This ordinarily includes specific control objectives and details of relevant control activities designed to achieve the objective, as well as a more general description of aspects of the service organization's control environment, risk assessment process, information system, and monitoring controls relevant to those activities. The description is 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.

B.2 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.

B.3 While Type B reports are prevalent, Type A reports are less often produced, and in fact the recently issued UK guidance (AAF 01/06¹) does not include any discussion of them. The task force discussed the usefulness of Type A reports noting that, because of their lesser scope, they may be more economically attractive to service organizations. The task force concluded, however, that they are ordinarily of limited use because they are only as of a point in time and do not provide evidence of the operating effectiveness of controls. Associated with these limitations is the possibility of user organizations, and to a lesser extent user auditors, misinterpreting Type A reports as conveying more assurance than they do in reality, thus leading to potential over-reliance. Nonetheless, it was acknowledged that a Type A report may be appropriate in certain cases, e.g., a when the user organization has strong "in house" monitoring controls over the activities undertaken by the service organization, when the service organization has just started operation (and therefore there is no track record of effective operation), or when the circumstances suit the user auditor obtaining most of the needed assurance from substantive procedures.

B.4 *Issues*

- (a) *Should ISAE 3402 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?*

¹ Technical Release AAF 01/06 "Assurance reports on internal controls of service organizations made available to third parties," issued by the Audit and Assurance Faculty of the ICAEW.

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2006)

Agenda Item L&M.2

Service Organizations—Issues Paper – September 2006 IAASB Agenda Item 4-B

- (b) *Should ISAE 3402 continue the current practice of including a description of the service organization's controls prepared by the management of the service organization (as described in B.1 (a) above)?*
- (c) *Should the service auditor's opinion 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, should it be required to also describe the tests of controls performed and results? Extant ISA 402 and national equivalents require the user auditor to consider whether the nature, timing and extent of tests performed by the service auditor, and the results of such tests, provide sufficient appropriate audit evidence for use in the audit of the user organization's financial statements. It can be argued, however, that it is unnecessary for the user auditor to consider the details of these tests; rather, the user auditor should be entitled to rely on the opinion of the service auditor. Alternatively, it can be argued that if the user auditor is to assess the nature, timing and extent of tests performed by the service auditor, then it is unnecessary for the service auditor to provide an opinion. Therefore, the question is whether (a) details of tests, (b) the service auditor's opinion, or (c) both, should be required.*

NOTE: The task force has had initial discussions on defining "subject matter," "subject matter information" and "criteria" for each of the opinions in (b) above, and on the implications of "direct" versus "assertion based" reports, but is not yet in a position to make a recommendation to the IAASB.

C. Level of Assurance Obtained by a Service Auditor

- C.1 Existing practice for performing service auditor engagements is that the service auditor, in order to meet the needs of user auditors, obtains a reasonable ("high") level of assurance on the matters identified in B.4 (c) above. However, the International Framework for Assurance Engagements (the Framework) provides for both "reasonable assurance" and "limited assurance."
- C.2 The distinction between reasonable and limited assurance is described in Appendix A to this paper, which is an abridged extract from the Engagements. While the nature, timing and extent of procedures required to obtain *reasonable* assurance should be reasonably consistent between auditors, the Framework allows for more variation in the work effort to obtain *limited* assurance: "For some subject matters, there may be specific pronouncements to provide guidance on procedures for gathering sufficient appropriate evidence for a limited assurance engagement. For example, ISRE 2400, "Engagements to Review Financial Statements"

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2006)

Agenda Item L&M.2

Service Organizations—Issues Paper – September 2006 IAASB Agenda Item 4-B

establishes that sufficient appropriate evidence for reviews of financial statements is obtained primarily through analytical procedures and inquiries. In the absence of a relevant pronouncement, the procedures for gathering sufficient appropriate evidence will vary with the circumstances of the engagement, in particular, the subject matter, and the needs of the intended users and the engaging party, including relevant time and cost constraints.” One option is for the IAASB to stipulate the work effort required for expressing limited assurance with respect to controls at a service organization. Another option would be for the IAASB to conclude that only reasonable assurance engagements should be permitted in relation to opinions on controls at a service organization because of the difficulty of differentiating the work effort necessary for two different levels of assurance.

C.3 Issues

- (a) *Is a limited assurance engagement of practical use to a user auditor? The task force is of the view that the ISAE should be aimed at reasonable assurance engagements, which is typically what is required in practice today in the case of a report on controls at service organization. It may be argued, however, that to meet the requirements of the ISAs, a user auditor does not need to be in a position to express an opinion on (i.e., obtain reasonable assurance about) the operating effectiveness of the user organization’s controls and, therefore, it appears incongruous to require a service auditor to do so with respect to controls operating within the service organization. On the other hand, the user auditor needs to be able to design further audit procedures on the basis of controls operating effectively which, when those controls are not fully transparent to the user auditor, justifies the need for reasonable assurance.*
- (b) *If the IAASB decides that the primary focus of ISAE 3402 should be on reasonable assurance, should it specifically prohibit limited assurance?*

D. Service Organizations that use Other Service Organizations

- D.1 A user organization may use a service organization that, in turn, uses another service organization (a sub-service organization) that performs activities which directly affect the user organization’s internal control as it relates to the preparation of the financial statements. For example, an investment funds manager may use a service organization to record transactions and maintain related accounting records. The sub-service organization may be separate from the service organization or may be related to the service organization. As well as needing to consider controls at the service organization, a user auditor may need to consider controls at the sub-service organization. Similarly, a service auditor in preparing a report on controls at a service organization may need to consider controls over activities performed by a sub-service organization.
- D.2 AICPA Audit Guide “Service Organizations: Applying SAS 70, as Amended”, identifies 2 methods for dealing with sub-service organizations:

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2006)

Agenda Item L&M.2

Service Organizations—Issues Paper – September 2006 IAASB Agenda Item 4-B

- *The carve-out method:* The sub-service organization's relevant controls are excluded from the description of controls at the service organization and from the scope of the service auditor's engagement; and
- *The inclusive method:* The sub-service organization's relevant controls are included in the description of controls at the service organization and in the scope of the engagement. The description clearly differentiates between controls of the service organization and controls of the sub-service organization. This requires the service organization to coordinate the preparation and presentation of the description of controls with the sub-service organization.

The task force discussed the carve-out and inclusive methods, and thought both should be allowed as options. Where the carve-out method is used, ISAE 3402 could require the description of the service organization's controls to include monitoring controls implemented by the service organization over the activities performed by sub-service organization. This would often include receipt of an ISAE 3402 report from the sub-service auditor.

D.3 Issue

- (a) *When a service organization uses a sub-service organization, should the report on the service organization:*
 - (i) *Carve out the sub-service organization;*
 - (ii) *Include the sub-service organization;*
 - (iii) *Include only the monitoring controls over the sub-service organization; or*
 - (iv) *Be allowed to use any of these approaches?*

E. Anticipated Format, Extent and Structure of ISAE 3402

- E.1 *Format:* In drafting ISAE 3402, the task force intends to apply the clarity format. Although ISAE 300 is not currently in that format, the task force assumes that it will be converted before ISAE 3402 is finalized.
- E.2 *Extent:* Together, the Framework and ISAE 3000 contain a complete, but generic set of guidance on all aspects of an assurance engagement. ISAE 3402 could adapt all of this material in the context of engagements to report on a service organization's controls (thus making ISAE 3402 a "stand alone" document), or it could contain only guidance that is unique to such engagements. For example, ISAE 3000 addresses the need for the practitioner to "...implement quality control procedures that are applicable to the individual engagement." ISAE 3402 could essentially duplicate this requirement, or it could remain silent on quality control procedures because it is already covered in ISAE 3000. The task force intends to treat ISAE 3402 as a supplement to the Framework and ISAE 3000, i.e., while it may include some brief contextualizing information about assurance engagements, ISAE 3402 will only introduce a requirement and application material where there is a service organization-specific

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2006)

Agenda Item L&M.2

Service Organizations—Issues Paper – September 2006 IAASB Agenda Item 4-B

perspective that the needs to be stated. It will therefore assume that auditors are conversant with the generic requirements of the Framework and ISAE 3000.

- E.3 *Structure*: The task force intends to structure ISAE 3402 along the lines of ISAE 3000 (see Appendix B) to the extent practicable. It will also include illustrative elements from service auditor's reports.

E.4 *Issues*

- (a) *Does the IAASB agree that ISAE 3402 should be written in the clarity format?*
- (b) *Does the IAASB agree that ISAE 3402 should not repeat material covered in the Framework or ISAE 3000 unless there is a service organization-specific perspective that needs to be addressed?*
- (c) *Does the IAASB agree that ISAE 3402 should, to the extent practicable, follow the structure of ISAE 3000?*

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2006)

Agenda Item L&M.2

Service Organizations—Issues Paper – September 2006 IAASB Agenda Item 4-B

Appendix A

Differences between a reasonable assurance engagement and a limited assurance engagement.

Paragraph references are to the International Framework for Assurance Engagements.

Type of engagement	Objective	Evidence-gathering procedures ²	The assurance report
Reasonable assurance engagement	A reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement, as the basis for a positive form of expression of the practitioner's conclusion (Paragraph 11)	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: <ul style="list-style-type: none">• Obtaining an understanding of the engagement circumstances;• Assessing risks;• Responding to assessed risks;• Performing further procedures using a combination of inspection, observation, confirmation, re-calculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures, including, where applicable, obtaining corroborating information, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and• Evaluating the evidence obtained (Paragraphs 51 and 52)	Description of the engagement circumstances, and a positive form of expression of the conclusion (Paragraph 58)
Limited assurance engagement	A reduction in assurance engagement risk to a meaningful level that is acceptable in the circumstances of the engagement but which is greater than for a reasonable assurance engagement. (Paragraph 11)	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances, but in which procedures are deliberately limited relative to a reasonable assurance engagement (Paragraph 53)	Description of the engagement circumstances, and a negative form of expression of the conclusion (Paragraph 59)

² A detailed discussion of evidence-gathering requirements is only possible within ISAEs for specific subject matters.

IAASB CAG REFERENCE PAPER
IAASB CAG Agenda (September 2006)
Agenda Item L&M.2
Service Organizations—Issues Paper – September 2006 IAASB Agenda Item 4-B

Appendix B

Structure of ISAE 3000

Introduction

- Relationship with the Framework, Other ISAEs, ISAs and ISREs

Ethical Requirements

Quality Control

Engagement Acceptance and Continuance

Agreeing on the Terms of the Engagement

Planning and Performing the Engagement

- Assessing the Appropriateness of the Subject Matter
- Assessing the Suitability of the Criteria
- Materiality and Assurance Engagement Risk

Using the Work of an Expert

Obtaining Evidence

- Representations by the Responsible Party

Considering Subsequent Events

Documentation

Preparing the Assurance Report

- Assurance Report Content
- Qualified Conclusions, Adverse Conclusions and Disclaimers of Conclusion

Other Reporting Responsibilities