



**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** London

**Meeting Date:** September 20-21, 2007

### **Service Organizations – ISAE 3402 Report Back and Issues for Discussion**

#### **Objectives of Agenda Item**

1. To provide a brief report back on the September 11-12, 2006 comments received from Representatives on the Issues Paper for the project to develop an International Standard on Assurance Engagements (ISAE) 3402, “Assurance Reports on a Service Organization’s Controls.”
2. To obtain the views of Representatives on the appropriateness of “assertion-based” engagements and service auditors’ assurance reports.

#### **Background Information**

In order to focus on core competencies and derive cost savings, many entities have decided to outsource a variety of functions, including some related to accounting and reporting, to service organizations. Auditors of entities using service organizations need to consider the implications of this outsourcing for the user entity’s financial reporting process, including considering both (a) controls that are maintained by the service organization, and (b) controls that the user organization maintains over the activities of the service organization. The audit evidence implications of outsourcing for *user auditors* is the subject of ISA 402 (Revised and Redrafted), “Audit Considerations Relating to an Entity Using a Third Party Service Organization.”

A service organization usually provides services to many user organizations, and user auditors do not usually have a direct relationship with the service organization or the service auditor. To avoid many different user auditors performing similar audit procedures at a service organization, the service organization will often engage a service auditor to issue a report on controls at the service organization. An engagement undertaken by a *service auditor* to prepare an assurance report on a service organization’s controls is the subject of ISAE3402.

Existing practice regarding the form and content of service auditor reports includes two types of reports. The “Type A” (or “Type 1”) report includes:

- (a) A description of the system the service organization is using to process user transactions, related specific control objectives that system is designed to achieve, and details of relevant control activities designed to achieve the objectives, as well as a more general description of aspects of the service organization’s control environment, risk assessment

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process, 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 fairly presents the system that has been implemented; and
  - (ii) Controls are suitably designed to achieve their stated objectives.

The “Type B” (or “Type II”) report covers the same material as Type A but also includes an 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.

While user auditors have typically used these reports in their risk assessments when auditing the financial statements of user entities, since the management of certain US companies have been required by the Sarbanes-Oxley Act to report on internal control over financial reporting, service auditor’s reports are now also frequently being used by management of user entities.

A first draft of ISAE 3402 will be discussed by the IAASB at its September meeting, with approval of a revised draft scheduled for the December meeting. The covering memorandum to the September agenda item on ISAE 3402 contains a summary of decisions made on this topic by the IAASB at prior meetings. (**Refer to Agenda Item M.1.**)

**September 11-12, 2006 CAG Comments**

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

Representatives’ comments	IAASB task force or the IAASB response
The Representatives did not comment on the proposed scope of ISAE 3402. Mr. Damant noted that it was a matter for consideration by the Task Force and the IAASB.	The IAASB has decided that the ISAE should be drafted in terms of financial reporting controls, but should note that it may also be applied, adapted as necessary in the circumstances of the engagement, for engagements to report on other controls at third party organizations.
Referring to the types of service auditor report, Mr. Roussey suggested that the Task Force determine to what extent Type A reports are being used by user organizations and user auditors. Ms. Blomme preferred Type B reports. She noted that the user auditor is interested in the effectiveness of internal control at the service organization. In addition, Type B reports also include the information provided in	Anecdotal evidence suggests that Type A reports are less frequently issued than Type B reports. They are typically used when the service organization has just started operation (and therefore there is no track record of effective operation of controls). They may be appropriate also when user entities have strong “in house” monitoring controls over the activities undertaken by the service organization, or when the

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Representatives' comments	IAASB task force or the IAASB response
Type A reports.	circumstances suit user auditors obtaining most of the needed assurance from substantive procedures. The IAASB has decided, therefore, that the ISAE should be drafted with a preference for Type B reports, but also cover Type A reports.
Mr. Sekiguchi asked to what extent the service auditor's independence would be addressed in his or her report. Ms. Esdon explained that the service auditor's report is an assurance report. Although it would not address independence specifically, it would refer to the service auditor's compliance with relevant assurance standards and code of ethics.	Example wording for a service auditor's report includes "Independent Service Auditor's Assurance Report" in the title, and the text of the report notes that the engagement was conducted in accordance with ISEA3402, which requires compliance with the Code of Ethics. <b>(Refer to Appendix 3 of Agenda Item M.2.)</b>
Referring to the level of assurance to be obtained by the service auditor, Ms. Blomme indicated that FEE prefers reasonable assurance. Ms. O'Malley was of the view that reasonable assurance is appropriate when the use of a particular service organization gives rise to risks of material misstatement. However, if not the case, a lower level of assurance might be appropriate. Mr. Roussey was of the view that, if user auditors typically issue reasonable assurance financial statement audit reports, it might not be appropriate for user organizations to request limited assurance reports. Mr. Johnson and Ms. Sucher were of a similar view.	The IAASB has decided that the ISAE should be drafted in terms of "reasonable assurance" engagements, consistent with the evidence requirements of ISA402. It is silent on "limited assurance" engagements. Therefore, while limited assurance engagements may be performed, they would not be "3402" engagements.
Referring to service organizations that use other service organizations, Mr. Roussey noted a preference for a service auditor report that addresses the activities of the main service organization and the other service organizations. This is subject to the user organization being able to read the report and identify controls relevant to it. Mr. Asmelash noted that the entire service rendered to the user organization could be performed by one of the other service organizations.	<p>The IAASB has decided that the ISAE should allow either the carve-out method or the inclusive method to be used for controls over activities performed by a <i>subservice</i> organization.</p> <p>The service auditor is required to consider access to evidence before accepting or continuing an engagement to issue a service auditor report. This includes the engagement team being involved in the work of <i>subservice</i> organization auditors, if any, to the extent necessary <b>(Refer to paragraph 13(a)(ii) of Agenda Item M.2.)</b></p>

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**Issues for Discussion**

**A. Assertion-based engagements**

- A1. The US equivalent of ISAE 3402 (SAS 70) states that “If the service auditor prepares the description of controls and control objectives, the representations in the description remain the responsibility of the service organization,” and requires the auditor to receive a written representation from management to this effect. It does not, however, require or otherwise provide for the package that is sent to user entities to include a written assertion by the service organization about the fair presentation of the description, and the implementation and effectiveness of controls. Under the IAASB’s Assurance Framework, if the package does not contain such a written assertion, the engagement would be classified as a “direct reporting engagement.” If it does contain such a written assertion, it would be classified as an “assertion-based engagement.”
- A2. The IAASB believes that it is preferable for a service organization to include written assertions in the package provided to user entities because by publicly accepting responsibility for the description and the implementation and effectiveness of controls, the service organization makes it clear that it is accountable for these matters, rather than the auditor. However, direct reporting engagements are not contrary to the Assurance Framework, and requiring such public assertions as a prerequisite for an assurance engagement would be a departure from current practice in many jurisdictions. ISAE 3402 is, therefore, drafted in terms of assertion-based engagements but does not prohibit direct reporting engagements; it is in fact silent on direct reporting engagements. So, while direct reporting engagements may be performed, they would not be “3402” engagements.
- A3. In discussing this issue, the IAASB debated whether there would be any increased costs associated with moving toward assertion-based reporting. For example, if a service organization needed to undertake significant additional monitoring activities to be satisfied that the assertions they were giving were correct, the cost of doing so may not be entirely offset by a corresponding reduction of audit effort resulting from “reliance” on that additional monitoring. The IAASB was generally of the view, however, that there should not be a need for additional activities by service organizations because ensuring the effectiveness of controls is central to a service organization’s business, so management should already have a high degree of confidence about the matters covered by the assertions. It was also noted that service organizations already provide representations to their auditors.
- A4. Examples of assertions that a service auditor could expect from a service organization are included in the draft ISAE. (*Refer to Appendix 2 of Agenda Item M.2.*)

**Matter for Consideration by the IAASB CAG:**

- 1. The Representatives are asked for their views on the implications of moving to assertion-based engagements, and whether they think assertion-based engagements are a more appropriate form of engagement than direct reporting engagements.**

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**B. The assurance report**

- B1. User auditors typically use “3402 reports” in their risk assessments when auditing the financial statements of user entities. In an increasing number of cases, such reports are a significant component of the evidence upon which a user auditor’s opinion on the financial statements is based.
- B2. As noted in the background information above, “3402 reports” are now increasingly being used by management of those user entities who are required to report on internal control over financial reporting, e.g., as required by the Sarbanes-Oxley Act.
- B3. Example “3402 reports” are included in draft ISAE3402. (*Refer to Appendix 3 of Agenda Item M.2.*)

**Matter for Consideration by the IAASB CAG:**

**2. The Representatives are asked for their views on the content or wording of Type A and B reports.**

**Material Presented – IAASB CAG REFERENCE PAPERS ONLY**

Agenda Item M.1	Cover Memorandum – <i>Agenda Item 10 of the September IAASB meeting material</i>
Agenda Item M.2	Issues Paper – <i>Agenda Item 10-A of the September IAASB meeting material</i>
Agenda Item M.3	First Read Draft ISAE 3402 – <i>Agenda Item 10-B of the September IAASB meeting material</i>

The September IAASB meeting material can also be accessed at  
<http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0092&ViewCat=0819>.