

IAASB CAG REFERENCE PAPER
IAASB CAG Agenda (September 2007)
Agenda Item M.3
Service Organizations – Issues Paper – September 2007 IAASB Agenda Item 10-B

Service organizations – ISAE 3402
Significant issues

A. The Framework and ISAE 3000

- A.1 The Assurance Framework and ISAE 3000 lay the foundations for ISAE 3402. They identify the following components of an assurance engagement:
- (a) The “subject matter,” which is the underlying condition of interest to intended users of the assurance report;
 - (b) The “criteria,” which are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure; and
 - (c) The “subject matter information,” which is the outcome of the evaluation or measurement of the subject matter that results from applying the criteria to the subject matter. So, for example, an assertion about the effectiveness of internal control (outcome/subject matter information) results from applying a framework for evaluating the effectiveness of internal control, such as COSO or CoCo (criteria) to internal control (subject matter).
- A.2 The IAASB at its April (Sydney) meeting asked that the draft ISAE:
- (a) Demonstrate its consistency with the Assurance Framework and with ISAE 3000 (or, if consistency were not possible, that the reason for it be clearly identified and the consequences for the Framework and ISAE 3000, as well as ISAE 3402, be properly addressed); and
 - (b) Provide guidance for practitioners on the application of the concepts in the Framework, and the requirements of ISAE 3000, particularly with respect to identifying and assessing the suitability of criteria for each of the conclusions, and the wording of those conclusion in the service auditor’s report (e.g., whether each conclusion needs to explicitly reference the criteria used).
- A.3 The conclusions (opinions) referred to above are on (i) fair presentation of the description, (ii) suitability of design, and (iii) operating effectiveness of controls. The task force has spent considerable time deliberating on what constitute the subject matter, subject matter information and suitable criteria for each of these opinions.
- A.4 Paragraph 14 requires the auditor to assess the suitability of the criteria, and the table at paragraph A3 assists practitioners to understand the relationship between the subject matter, subject matter information, and the criteria for the three opinions. Criteria are discussed further at section B of this memorandum.
- A.5 Paragraph 40(k) specifies the wording to be used in the three opinions, and Appendix 3 includes example reports. The service auditor’s report is discussed further in Section C of this memorandum.

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B. Criteria

- B.1 Example service organization assertions are included in Appendix 2 to the draft ISAE. These assertions include criteria for each of the three opinions, and are consistent with the requirements of paragraphs 15-17.
- B.2 Paragraph 15 identifies aspects that the criteria for the description of the system, control objectives and related controls must encompass. The reason a user auditor needs the description is to assist the user auditor to obtain a sufficient understanding of that part of the user entity's information system operated by the service organization to be in a position to assess the risks of material misstatement at the user entity. The aspects the criteria must encompass, therefore, are that the description:
- (a) *Presents how the system made available to user entities has been designed and implemented to process relevant transactions, including, as appropriate, specific elements (i)-(vi) (identified in paragraph 15).* This criterion is aimed at the relevance of the description. It includes specific elements that must be present in the description when applicable.

The first five of these elements have been adapted from the list in paragraph 18¹ of ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment." This list constitutes those elements of an entity's information system that a financial statement auditor is required to obtain an understanding of. It is an appropriate basis for this criterion because, as noted above, service organization's descriptions are needed to assist user auditors in understanding that part of each user entity's information system that is operated by the service organization. To do this in accordance with ISA 315 (Redrafted), the user auditors need to understand the elements in ISA 315 (Redrafted) paragraph 18.

¹ 18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

- (a) The classes of transactions in the entity's operations that are significant to the financial statements;
- (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
- (d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and
- (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A77-A81)

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The task force discussed whether, instead of, or as well as, reflecting paragraph 18 of ISA 315 (Redrafted), this criterion should reflect paragraph 15 of ISA 315 (Redrafted):

“The auditor shall obtain an understanding of whether the entity has a process for:

- (a) Identifying business risks relevant to financial reporting objectives;*
- (b) Estimating the significance of the risks;*
- (c) Assessing the likelihood of their occurrence; and*
- (d) Deciding about actions to address those risks.”*

The task force decided this criterion should not reflect paragraph 15 of ISA 315 (Redrafted). A user entity’s information system is an input to that entity’s process for identifying and assessing financial reporting risks. Accordingly, the description of the portion of the user entity’s information system at the service organization should enable user auditors to understand that input, rather than how the user entity uses that input in its own risk assessments process. Further, the task force is of the view that it is not possible for a service auditor to make meaningful judgments about the financial reporting risks at individual user entities in one-to-many situations. What will constitute a risk at a user entity, and the magnitude and implications of that risk, will vary markedly with the entity’s particular circumstances. In one-to-many situations, there is no relationship between the service auditor, and the user entities or user auditors. Therefore, the service auditor will have no knowledge of the relevant circumstances at any particular user entity. The task force has, however, included guidance in the explanatory material that would lead service auditors to reflect, in a general sense, on their experience as financial statement auditors and consider what may be reasonable expectations about what should be included in a description of the system, control objectives and related controls for use in a financial reporting environment.

The sixth element is: *“Other aspects of the service organization’s control environment, risk assessment process, information system (including the related business processes) and communication, control activities and monitoring controls that are relevant to processing and reporting user entities’ transactions.”* This acknowledges the point the IAASB has made in previous discussions that components of internal control at the service organization other than the information system will be relevant to user entities and their auditors to varying degrees.

This criterion also notes that the system has been *“designed and implemented”* to process relevant transactions. These words, deliberately, exclude operation of the system. In Type A reports in particular, where the service auditor does not opine on the operating effectiveness of the system, it is important for the wording of the assertion and of the assurance report not to confuse the concepts of implementation and operation.

Including “implementation” as part of the criteria for the description is different from current practice where implementation (or “existence,” or “placed in operation”) is

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included as a separate opinion. The task force considers the approach in the draft ISAE to be more attune to the Assurance Framework than having a separate opinion on implementation because it is doubtful whether suitable criteria can be articulated in a meaningful way for a separate opinion on “implementation.”

- (b) *Does not omit or distort information relevant to the scope of the system being described, while acknowledging that the description is presented to meet the common needs of a broad range of user entities and may not, therefore, include every aspect of the system that each individual user entity may consider important in its own particular environment.*

The purpose of this criterion is to recognize that, while the of the description needs to be reliable (“does not omit or distort”), in a “one-to-many” situation the description will not necessarily meet all the specific needs of individual users. This additional sentence is consistent with both (a) the concept of general purpose financial statements, and (b) the Assurance Framework’s discussion of intended users, which states at paragraph 28: “*The practitioner may not be able to identify all those who will read the assurance report, particularly where there is a large number of people who have access to it. In such cases, particularly where possible readers are likely to have a broad range of interests in the subject matter, intended users may be limited to major stakeholders with significant and common interests.*” This thought has been adapted here to the development of criteria, rather than to the identification of intended users.

- B.3 Additional criteria may be identified in, e.g., service level agreements, marketing literature used by the service organization, or laws and regulations.

C. The service auditor’s report

- C.1 The IAASB noted that the illustrative report discussed at the April (Sydney) meeting repeated a significant amount of text from the scope paragraph in the opinion paragraph – the scope paragraph spelled out the service organization’s assertions, which were then repeated as the service auditor’s opinions. The IAASB asked the task force to consider whether such repetition was necessary. The IAASB also noted the potential for confusion when the scope section says that the auditor audited the service organization’s assertions, but then the opinion is not expressed in terms of the fair presentation of those assertions, but rather in terms the underlying subject matter.
- C.2 The example report included in the draft ISAE (Appendix 3) has addressed this by referring, in relatively brief terms, to the underlying subject matter/information in both the scope and opinion sections.
- C.3 The IAASB also queried whether the criteria needed to be explicitly cited in the opinion in a similar way to how they are cited in a financial statement audit opinion (i.e., the financial statements are presented fairly *in accordance with the financial reporting framework*). The criteria used in the audit of controls at a service organization are not easily identified in a single expression (such as International Financial Reporting Standards, or COSO). Therefore,

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such an approach does not seem practical for service organization reports. The task force therefore recommends that the service organization's assertions should clearly identify the criteria used, and that the auditor's report should refer to the criteria identified in the assertions. This approach, which is demonstrated in the examples in Appendices of the draft ISAE, also has the advantage of causing service organizations to state the criteria. This is consistent with their responsibility to identify the criteria to be used for each engagement.

D. Independence

D.1 The task force is liaising with the Ethics Board's Independence Task Force (ITF) on the following two issues.

- (a) The appropriateness of the following phrase included in paragraph 12: "in performing an engagement in accordance with this ISAE, the Code does not require the service auditor to be independent from each user entity."
- (b) Whether a service auditor needs to be independent from a subservice organization and/or its users, and whether the answer will vary depending on whether the carve out method or the inclusive method is used with respect to the subservice organization.

D.2 The ITF will be meeting on 22-24 August, and a verbal update of progress on these issues will be provided for the IAASB in Madrid.

E. Modified opinions

E.1 Under US and Canadian national standards, the three separate elements of the opinion (in the case of a Type B report) are not all contained in the same paragraph. The opinions on fair presentation of the description and suitability of design are in separate sentences in a one paragraph, and the opinion on operating effectiveness is contained in a different paragraph. When a modification is issued that relates to one element, only the sentence that contains the opinion on that element is modified. For example, if controls are found to be ineffective, the opinion on operating effectiveness would be qualified, but the opinions on fair presentation of the description and suitability of design would be unqualified.

E.2 The approach taken in the attached draft differs from the approach described above in that the three elements are presented together as subparagraphs in one sentence. When a modified opinion is issued, the expression "except for the matter described in the Basis for Qualified Opinion paragraph" precedes all three subparagraphs. The task force believes it is clearer to group the three elements together in one sentence, and that it is unnecessary to identify within this sentence which elements are qualified and which are not. It is expected that the Basis for Qualified Opinion paragraph will explain the effect of the matter and therefore which elements of the opinion are affected. This approach is also more flexible as it more readily accommodates potentially complex qualifications that can affect more than one element, e.g., when controls are found to be ineffective, it may be that as a consequence the description of the controls is not fairly presented. This can readily be explained in one place, i.e., the Basis for Qualified Opinion paragraph.

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F. Type A reports

- F.1 During discussion at the IAASB's April (Sydney) meeting it was noted that when monitoring controls at the user entity are strong, it may be appropriate in terms of efficiency for a user auditor to request a Type A report rather than a Type B report, and in such cases, it may be helpful for the opinions in the Type A report on the description of controls and the existence of controls to cover the entire period, rather than be as at period end only. The task force was asked to consider this matter further.
- F.2 The task force discussed the suggestion of allowing for Type A reports that cover a period of time, rather than restricting them to a point in time only as is the current practice. The task force believes a Type A report could be appropriate when a service organization is in start-up and does not have a sufficient track record with a stable system to make a type B report feasible. The task force is strongly of the view that Type A reports should only be "as at" reports. There is already a danger that Type A reports may be relied on inappropriately by user auditors, and this danger would be accentuated if Type A reports were to cover a period of time.

G. Disclosure of sample sizes

- G.1 The task force notes for particular consideration by the IAASB that the description of tests of controls included in a Type B report is not required to disclose sample sizes used unless a deviation from controls is found. This is consistent with current practice in most jurisdictions, however the UK guidance on service organizations notes: "In describing the extent of tests, the reporting accountants indicate whether the items tested represent a sample or all the items in the population. If sampling was used, it may be helpful to provide information on the sample size." One reason it may not be appropriate to disclose sample sizes is that readers of the service auditor's report will not have enough information to fully understand the judgments the service auditor necessarily makes in determining sample sizes and may, therefore, misinterpret the significance of different sample sizes if they were disclosed. This misinterpretation may lead user auditors to either under- or over-rely on the work of the service auditor.

H. Complementary controls

- H.1 The concept of complementary controls as used in current practice is somewhat different from that used in the draft ISAE. In current practice complementary controls often include generic "best practice" controls that a service organization might expect user entities to implement with respect to services performed, e.g. review of reports produced by the service organization, or ensuring that input to the service organization is complete and authorized. Such controls are often identified in the service organization's description, with a caveat that unless they are operating at a user entity, the control objectives identified in the description may not be achieved.
- H.2 The task force is of the view, however, that the control objectives that a service organization identifies in the description should, in nearly all cases, be only those which the service organization can achieve without relying on controls at user entities. The task force sees a risk

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in the current practice of wording control objectives in such a way that they can only be achieved if user entities implement “best practice” controls because it may lead to an expectation that service organizations will identify all such controls that user entities need to implement to make systems related to the outsourced service effective. This places an unreasonable expectation on service organizations

- H3. The task force has therefore defined complementary controls as those that *must* be implemented by user entities for control objectives identified in the description to be effective (paragraph 10(g)), and notes in the explanatory material (final bullet of paragraph A8) that complementary controls will be rare because control objectives can (and should) usually be worded to exclude them.

I. Link with ISAE 3000 and the ISAs

- I.1 As noted in the covering memorandum, it has been agreed previously that ISAE 3402 should include key concepts, suitably adapted, from ISAs that are relevant to service organization engagements when those concepts are not adequately covered in ISAE 3000.
- I.2 *Documentation:* The only requirement in ISAE 3000 in relation to documentation is that the auditor “should document matters that are significant in providing evidence that supports the assurance report and that the engagement was performed in accordance with ISAEs.” This was not considered adequate given the recent revision of proposed ISA 230 (Redrafted), “Audit Documentation.” The draft therefore contains several paragraphs of requirements adapted from proposed ISA 230 (Redrafted) (paragraphs 33-39). The suggested additions to ISAE 3402 are not, however, service organization-specific, and the task force seeks the guidance of the IAASB as to whether they should be included in ISAE 3402, or whether the IAASB would prefer that they be proposed as conforming amendments to ISAE 3000.
- I.3 *Quality control:* The only requirement in ISAE 3000 in relation to quality control is that the auditor “should implement quality control procedures that are applicable to the individual engagement.” While the task force has not proposed any specific additions to ISAE 3402 in the current draft, it seeks the guidance of the IAASB as to whether more specific requirements adapted from proposed ISA 220 (Redrafted). “Quality Control for an Audit of Financial Statements” regarding “leadership responsibilities for quality on audits”; “relevant ethical requirements”; “acceptance and continuance of client relationships and audit engagements”; “assignment of engagement teams; engagement performance”; and “monitoring” should be included in either ISAE 3402 or ISAE 3000.
- I.4 *Using the work of an expert:* ISAE 3000 contains the following requirements in relation to experts:
- (a) When the work of an expert is used in the collection and evaluation of evidence, the practitioner and the expert should, on a combined basis, possess adequate skill and knowledge regarding the subject matter and the criteria for the practitioner to determine that sufficient appropriate evidence has been obtained

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- (b) The practitioner should be involved in the engagement and understand the work for which an expert is used, to an extent that is sufficient to enable the practitioner to accept responsibility for the conclusion on the subject matter information.
- (c) The practitioner should obtain sufficient appropriate evidence that the expert's work is adequate for the purposes of the assurance engagement.

As with proposed ISA 220 (Redrafted), the task force has not proposed any specific additions to ISAE 3402 in the current draft, but seeks the guidance of the IAASB as to whether more specific requirements adapted from ISA 620, “Using the Work of an Expert” (the revised version of which is on the agenda for this meeting) should be included, either in ISAE 3402 or ISAE 3000.

- I.5 *Engagement acceptance:* In a similar vein, the contents of paragraph 17 of the Assurance Framework is referenced in the “grey letter” guidance material in ISAE 3000, but is not fully included in the “black letter” requirements. Paragraph 17 of the Framework states:

A practitioner accepts an assurance engagement only where the practitioner's preliminary knowledge of the engagement circumstances indicates that:

- (a) Relevant ethical requirements, such as independence and professional competence will be satisfied; and
- (b) The engagement exhibits all of the following characteristics:
 - (i) The subject matter is appropriate;
 - (ii) The criteria to be used are suitable and are available to the intended users;
 - (iii) The practitioner has access to sufficient appropriate evidence to support the practitioner's conclusion;
 - (iv) The practitioner's conclusion, in the form appropriate to either a reasonable assurance engagement or a limited assurance engagement, is to be contained in a written report; and
 - (v) The practitioner is satisfied that there is a rational purpose for the engagement. If there is a significant limitation on the scope of the practitioner's work (see paragraph 55), it may be unlikely that the engagement has a rational purpose. Also, a practitioner may believe the engaging party intends to associate the practitioner's name with the subject matter in an inappropriate manner (see paragraph 61).

The task force considers these to be significant matters and has reflected them in the draft ISAE. The task force also seeks the guidance of the IAASB as to whether they should be included as a conforming amendment to ISAE 3000.

- I.6 *Limitation to qualified accountants:* The task force noted that ISAE 3000 does not limit its use to qualified accountants. For consistency, ISAE 3402 is also not limited. However, this makes it even more important that ISAE 3000 and ISAE 3402 are quite explicit in their requirements because it cannot be assumed that the person applying either ISAE will have the professional training and background necessary to “fill in the gaps” by extrapolation from the ISAs.

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J. Scope of the engagement

- J.1 The task force is still considering the effect on the acceptance/continuation decision and the content of the assurance report of various decisions by a service organization regarding the scope of the engagement. For example, paragraph A2 identifies that a request to remove certain aspects of the service organization's controls from the scope of the engagement may not have a reasonable justification when, e.g., the request is made because of the likelihood that the auditor's opinion would be qualified with respect to those aspects. Another situation that may affect the acceptance/continuation decision or the content of the assurance report is when the service auditor is asked to report on particular IT applications, but general controls at the service organization are scoped out of the engagement.