

# 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 B.5.1

**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** Basel

**Meeting Date:** March 3-4, 2008

### Report Back—Service Organizations (ISA 402)

#### Objectives of Agenda Item

1. At the September 2006 IAASB CAG meeting, Representatives provided overall direction on the project to revise extant International Standard on Auditing (ISA) 402, “Audit Considerations Relating to Entities Using Service Organizations,” and discussed key issues to be addressed as part of this project. The objectives of this agenda item are:
  - (a) To provide a brief report back on the September 11-12, 2006 comments received from Representatives on significant issues.
  - (b) To highlight other issues considered by the IAASB in reviewing drafts of proposed ISA 402 (Revised and Redrafted), “Audit Considerations Relating to an Entity Using a Third Party Service Organization,” prior to its issuance as an exposure draft in December 2007.

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

2. Below are extracts from the minutes of the September 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 / IAASB response
Mr. Peyret emphasized the importance of a precise definition of the scope of ISA 402. He was of the view that the use of service organizations has a direct effect on the quality of the work of the user auditor. He suggested that local service organizations be distinguished from international service organizations. In particular, he was concerned about international shared service centers.	The ISA is written for entities using a third party service organization. The exposure draft acknowledges that the ISA may also be applicable, adapted as necessary in the circumstances, to situations where an entity uses a shared service center which provides services to a group of related entities. <b>(See paragraph 4 of the exposure draft.).</b>
Dr. Manabat was concerned about situations where purchases are made, transactions processed, and accounting records maintained by international shared service centers, while the user organization is responsible only for distribution. She noted that, in	The Task Force concurs with the view expressed by Mr. Roussey and did not feel that such matter needed to be explicitly covered by the ISA. Rather, the ISA requires the user auditor to obtain an understanding of how a user entity uses a service organization in its

## IAASB CAG PAPER

### IAASB CAG Agenda (March 2008)

#### Agenda Item B.5.1

#### Report Back—Service Organizations (ISA 402)

Representatives' Comments	IAASB Task Force response / IAASB response
<p>such situations, management of the user organization might not have control over financial information reported by the user organization. She was of the view that the ISAs should recognize this paradigm shift. Mr. Roussey was concerned about Dr. Manabat's statement that management of the user organization might not have control over financial reporting. He was of the view that the issue is beyond ISA 402 and ISAE 3402 – it is a matter of corporate governance.</p>	<p>operations and to consider how to obtain audit evidence that controls at a service organization are operating effectively when the user auditor's risk assessment includes an expectation that such controls are operating effectively. <b>(See paragraphs 8-12 of the exposure draft.)</b></p>
<p>Ms. Todd McEnally emphasized the increased importance of ISA 402. She was not sure how the ISA will deal with situations where the core operations of an entity are outsourced, but suggested that the use of service organizations be addressed in its broadest sense. She referred to practical implementation issues such as the testing of controls of an entity (service organization) in another country.</p>	<p>The Task Force believes the proposed revised and redrafted ISA takes on this point. It specifically notes that in some circumstances, a user entity may outsource one or more significant business units or functions, such as its entire tax planning and compliance function, or finance and accounting or the controllership function to one or more service organizations. It also notes that the user auditor is required to obtain evidence of the operating effectiveness of the controls applied only at the service organization by obtaining a Type B report (and evaluating the tests of controls performed by the service auditor), performing appropriate tests of controls at the service organization or requesting the service auditor to perform tests of controls at the service organization on behalf of the service auditor. Finally, the ISA also requires the auditor to determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity, and if not, to perform further audit procedures to obtain sufficient appropriate audit evidence or request the service auditor to perform those procedures on the auditor's behalf. <b>(See paragraphs 12, 18, A15 and A32-35 of the exposure draft.)</b></p>
<p>Mr. Cassel emphasized the increased importance of ISA 402 in the context of public sector audits. He noted that state agencies do not only outsource to other state agencies. They often use private sector</p>	<p>The Task Force included an IAASB member with public sector experience and has ensured that public sector considerations have been included in the ISA where appropriate. <b>(See paragraphs A7 and A8 of</b></p>

## IAASB CAG PAPER

### IAASB CAG Agenda (March 2008)

#### Agenda Item B.5.1

#### Report Back—Service Organizations (ISA 402)

Representatives' Comments	IAASB Task Force response / IAASB response
service organizations. He noted the importance of having a clear understanding of the responsibilities of management of the user organization.	<i>the exposure draft.</i>
Ms. Koski-Grafer asked whether the scope of the ISA should be described as dealing with service organizations that perform activities that are part of the entity's <i>internal control</i> relevant to the audit (as per the issues paper) or part of entity's <i>financial reporting system</i> relevant to the audit. Mr. Tucker explained that by definition (in ISA 315) the entity's internal control includes the processes by which transactions are processed and reported. If the service organization is doing that, by definition it would be part of the entity's internal control.	The definition of a service organization is a third party organization (or segment of a third party organizations) that provides services to user entities that are part of those entities' information system relevant to financial reporting. The scope of the ISA is specifically linked to ISA 315 (Redrafted), <sup>1</sup> noting when a service organization's services are part of an entity's information system, the auditor is required to understand the user entity's internal control relevant to the audit. <i>(See paragraphs 3, 8(c) and 10 of the exposure draft.)</i>
Mr. Rabine noted that the use of service organizations could range from one that does not affect the user organization's internal control to one that forms a significant part of the user organization's internal control. He was concerned that this range of use is not apparent from the issues paper. He was wondering whether the introduction of a "sliding scale" (such as that discussed during the project of the use of the work of experts) could be helpful in the case of this ISA.	The Task Force believes that the range of potential activity is highlighted in the ISA, and the requirements highlight that the user's understanding of how an entity uses a service organization in its operations should include the significance of the services to the user entity, including the user entity's internal control. <i>(See paragraphs 2, 9, and A1-A4 of the exposure draft.)</i>
Referring to the types of service organization to be encompassed by ISA 402, Dr. Manabat noted that the structure of doing business in the world has changed. She suggested that consideration be given as to how a business is created and operates. While each entity within the business might appear to be stand-alone, looking at the big picture, they are merely business units created to improve the bottom line. She was of the view that this creates audit concerns. She did not	The Task Force believes the ISA adequately expands on how the auditor applies ISA 315 (Redrafted) and ISA 330 (Redrafted) <sup>2</sup> in identifying and assessing the risks of material misstatement and in designing and performing further audit procedures. The risk that arises from the nature of the entity, including how it uses service organizations in its operations, is one of the assessments that that auditor is required to make

<sup>1</sup> ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment."

<sup>2</sup> ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks."

## IAASB CAG PAPER

### IAASB CAG Agenda (March 2008)

#### Agenda Item B.5.1

#### Report Back—Service Organizations (ISA 402)

Representatives' Comments	IAASB Task Force response / IAASB response
believe that the tests of ownership and influence applied by the auditors were always the correct ones. Ms. Sucher was of the view that, in situations where a service organization is acting as an agent for the user organization, there might be increased risk. She suggested that this might be another way of approaching the subject.	under the audit risk standards.
Mr. Rabine was of the view that it would be difficult to design boundaries for activities of service organizations where those activities do not directly affect the user organization's internal control as it relates to preparing the financial statements. He preferred limiting the requirements and guidance to activities that directly affect the user organization's internal control as it relates to preparing the financial statements. Mr. Pickeur asked whether the ISA would distinguish between outsourcing within and outsourcing outside a group. He was of the view that outsourcing outside a group is more complicated, making it more difficult to establish boundaries. Mr. Roussey was of the view that it would be very difficult to design boundaries. He suggested a focus on activities that directly affect the user organization's internal control as it relates to preparing the financial statements. He also suggested that the IAASB consider a separate project addressing the extended enterprise concept. Mr. Johnson emphasized the importance of identifying the types of service provided to an entity and effect that each of them might have on the audit of the financial statements.	The Task Force believes that the concerns raised have been addressed during the IAASB's deliberations regarding the scope of the ISA and the necessary requirements to meet the objective of the ISA.

#### Other Issues Discussed by the IAASB during the Development of the Exposure Draft

The IAASB approved the exposure draft of proposed ISA 402 (Revised and Redrafted) at its December 2007 meeting. In considering the exposure draft,<sup>3</sup> the IAASB further discussed the

---

<sup>3</sup> The IAASB considered the exposure draft at its April, September and December 2007 meetings.

## IAASB CAG PAPER

### IAASB CAG Agenda (March 2008)

#### Agenda Item B.5.1

#### Report Back—Service Organizations (ISA 402)

issues that were noted in the issues paper discussed with the IAASB CAG at the September 2006 meeting as follows:

- The alignment of the proposed revised and redrafted ISA with the risk assessment standards – the Task Force was mindful not to repeat the requirements of ISA 315 (Redrafted) and ISA 330 (Redrafted) but rather expand them to specifically address what the auditor should do when a user entity uses a service organization. The Task Force prepared an analysis that mapped the alignment of the proposed revised ISA with these standards, and the IAASB agreed that the linkage was appropriate.
- It was initially suggested by the IAASB CAG that the ISA be applicable to the audits of shared service centers. In developing the ISA, the IAASB considered whether specific material could be included to illustrate how the standard could be applied in such circumstances, and concluded that it was most appropriate to indicate that the ISA could be applied, adapted as necessary, to the audits of shared service centers.

Other issues that arose during the discussion of the proposed revised ISA and the conclusions reached by the IAASB included:

- The definition of a service auditor was restricted to an auditor who provides an assurance report on the controls of a service organization, however, the ISA does not preclude the service auditor, in a separate engagement, to perform further audit procedures on the user auditor's behalf if the auditor is unable to perform the procedures. *(See paragraphs 8(b) and 18 of the exposure draft.)*
- The definitions in the proposed revised ISA were aligned with those contained in the new assurance standard, proposed ISAE 3402,<sup>4</sup> which was also approved as an exposure draft by the IAASB in December 2007.
- The requirements in the ISA were specified and ordered such that the user auditor is first required to evaluate the design and implementation of relevant controls at the user entity, and if necessary, obtain audit evidence regarding controls at the service organization by a) obtaining a Type A or Type B report from a service auditor, b) contacting the service organization to obtain specific information, c) requesting that a service auditor be engaged to perform procedures that will provide the necessary information or d) visiting the service organization and performing such procedures. The IAASB was of the view that this presentation illustrates the process by which the auditor applies judgment to determine what controls need to be understood and tested in accordance with the risk assessment standards. *(See paragraphs 9-11 of the exposure draft.)*
- Explicit language was included to highlight to auditors that a Type A report, which is defined as a report on the description and design of controls at a service organization, does not provide any evidence of the operating effectiveness of the relevant controls. The IAASB believed

---

<sup>4</sup> Proposed International Standard on Assurance Engagements 3402, "Assurance Reports on Controls at a Third Party Service Organization."

## IAASB CAG PAPER

### IAASB CAG Agenda (March 2008)

#### Agenda Item B.5.1

#### Report Back—Service Organizations (ISA 402)

such a statement was necessary to ensure that overreliance was not being placed on these types of reports, though it was noted that they are not as frequently issued in practice as Type B reports. *(See paragraph A18 of the exposure draft.)*

- While many of the requirements were based on extant ISA 402, they now further specify what is required when the user auditor intends to rely on a Type B report regarding the effectiveness of controls. Such material includes the consideration of whether the report is at a date or for a period that is appropriate for the user auditor's purposes, the time period covered by the tests of controls, and the disclosure of the specific tests of controls and results thereof in order to determine whether sufficient appropriate audit evidence has been obtained. Additional application and other explanatory material was included in this area, in part to align the proposed revised ISA with other national standards that had been more recently updated. *(See paragraphs 13-15 and A18-A29 of the exposure draft.)*

The comment period for proposed ISA 402 (Revised and Redrafted) ends on April 30, 2008. It is anticipated that the IAASB will discuss the significant comments received at its September 2008 meeting, with the aim of approving the ISA as a final standard in December 2008.

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

Available from  
<http://www.ifac.org/Guidance/EXD-Details.php?EDID=0101>

Exposure Draft of Proposed ISA 402 (Revised and Redrafted), "Audit Considerations Relating to an Entity Using a Third Party Service Organization," published in December 2007