



International Federation of Accountants

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## Agenda Item

# H.1

**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** Toronto

**Meeting Date:** September 4-5, 2008

### **ED-ISA 402 (Revised and Redrafted), “Audit Considerations Relating to an Entity Using a Third-Party Service Organization”**

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

To review a summary of significant comments on ED-ISA 402 (Revised and Redrafted), “Audit Considerations Relating to an Entity Using a Third-Party Service Organization” and the Task Force’s recommendations.

The IAASB will consider the summary of significant comments and the Task Force’s recommendations, and the proposed ISA at its September meeting. **Approval of the final ISA is planned for the December IAASB meeting.**

#### **IAASB Task Force**

The IAASB Task Force members are:

- Denise Esdon (Task Force Chair), IAASB member
- Susan Jones, IAASB member
- Kjell Larsson, IAASB member, supported by Kelly Ånerud, IAASB technical advisor
- Kevin O’Donovan, KPMG, Ireland
- Jens Poll, Moore Stephens, Germany

#### **Background**

The IAASB commenced this project in March 2006 in response to developments that indicated a need to revise extant ISA 402, “Audit Considerations Relating to Entities Using Service Organizations,” including:

- (a) The recent updating of corresponding national auditing standards in a number of jurisdictions, and requests received by the IAASB to do the same;
- (b) The need to align the standard with the risk assessment standards; and
- (c) The increasing use of service organizations by entities and complexity of relationships between the two parties since the development of the extant ISA.

The IAASB believes that the proposed ISA will enhance the consistency of auditor performance in an audit of financial statements through more specific requirements and expanded guidance. In

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particular, the proposed ISA expands upon the requirements in the extant ISA when the user auditor, defined as the auditor who audits and reports on the financial statements of an entity that uses a service organization (a user entity), intends to use a Type A or Type B report provided by a service organization.

ED-ISA 402 was issued in December 2007. The comment date was April 30, 2008. Forty-six comment letters were received. (ED-ISA 402 and the comment letters are available at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0101>).

#### **Significant Comments**

The majority of respondents expressed general support for the proposed ISA. Significant comments relating to matters identified for the Representatives' consideration are summarized below. The Task Force's recommendations follow each significant comment.

#### **SHARED SERVICE CENTERS**

1. In some cases, a shared service center that provides services “internally” to a group of related companies may be considered a service organization from the perspective of the auditor of a component of the group. Paragraph 4 of ED-ISA 402 stated: “The focus of this ISA is on an entity’s use of a third party service organization, but it 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.”
2. Respondents were asked for their views as to whether the ISA is capable of being adapted for these circumstances and whether additional guidance relating to shared service centers could be added to enhance the ISA without duplicating material in other ISAs.
3. The majority of those who responded suggested the ISA could be adapted. Many did not believe it was necessary for additional guidance to be added, nor did they propose any specific wording, however a greater number of respondents were of the view that the ISA could be adapted but only if further reference and guidance was developed, in particular how the requirements of this ISA would interact with ISA 600 (Revised and Redrafted) <sup>1</sup> in a shared service center situation. A few respondents did not believe the ISA could be adapted, as suggesting that it could be adapted could be misinterpreted that ISA 402 (Revised and Redrafted) would apply rather than ISA 600 (Revised and Redrafted) in a group situation.
4. One respondent specifically noted that the use of shared service centers by large groups is expanding and suggested that there is a need for a specific standard or practice statement that addresses the unique circumstances that apply to the use of an intra-group financial shared service center and urged the IAASB to consider undertaking a project to develop specific guidance in this area. It also had been suggested in the last CAG meeting that IAASB should take on a separate project about the extended enterprise.

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<sup>1</sup> ISA 600 (Revised and Redrafted), “Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors).”

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##### *Task Force's Recommendations*

5. In developing ED-ISA 402, the Task Force believed that it was important that proposed ISA make reference to shared service centers in light of their increasing use in practice. However, given that in many cases a shared service center is used in the context of a group audit, a point raised by a number of respondents, the Task Force was also of the view that the ISA should not be seen to override the authority of ISA 600 (Revised and Redrafted). The Task Force has acknowledged in its debates that the audit considerations that impact a statutory auditor when a shared service center is used in a group audit context are not currently addressed in the ISAs and remain a matter of professional judgment.
6. As a result of the comments received, the Task Force agreed it was necessary to revise the material in paragraph 4 of ED-ISA 402 to explain the context in which the ISA could be adapted. This paragraph now reads:

The focus of this ISA is on a user entity's use of a third-party service organization, but it may also be applicable, adapted as necessary in the circumstances, to situations where a component auditor is engaged to perform a statutory audit of the financial statements of a component who uses the shared services provided by another component, and those services are relevant to the audit of the component's financial statements.

7. The Task Force believes that the modifications to this paragraph now describe the common situations in practice that occur when the component auditor has a statutory reporting responsibility. In fulfilling this responsibility, the component auditor will need to obtain an understanding of the services provided by the shared service center (i.e., a related service organization) in order to identify and assess the risks of material misstatement, and will need to design and perform audit procedures responsive to those risks. While it is acknowledged that, in many cases, a Type A or Type B report will not be available for a shared service center, this ISA provides guidance to the component auditor (a statutory auditor) as to how to obtain the necessary audit evidence, for example by requesting the component auditor who has audited the group's shared service center to perform procedures on the component auditor's behalf.
8. ***See paragraphs 3-12 of Agenda Item H.1.1 for a detailed discussion of the Task Force's recommendations. Note that this Agenda Item makes reference to Agenda Item 9-B of the September IAASB meeting material (Agenda Item H.1.2 of the September IAASB CAG meeting material) to illustrate the proposed changes to the ISA as a result of these recommendations.***

##### **Matters for Consideration by the IAASB CAG:**

1. **Do the Representatives agree with that the ISA can be adapted as necessary to situations where an entity uses a shared service center which provides services to a group of related entities?**
2. **Do the Representatives agree that the changes proposed by the Task Force**

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**adequately respond to the comments of respondents regarding the adaptability of the ISA?**

- 3. Do the Respondents believe there is a need for a specific standard or practice statement that addresses the unique circumstances that apply to the use of an intra-group financial shared service center at this time, in light of the other projects planned in the IAASB's work program?**

#### SMALLER ENTITIES AND THE PERCEIVED EMPHASIS OF THE ISA ON THE USE OF TYPE A AND TYPE B REPORTS

9. A number of respondents were concerned that the application of the ISA would be too difficult in the context of smaller entities or particular jurisdictions. At the last CAG meeting, the IAASB was encouraged to include more application and other explanatory material to address the needs of SMEs. It was also noted that Type A and Type B reports may not often be used in SME audits.
10. The EC commented that “the standard over-emphasizes the need for a Type A or Type B report. The availability of a Type A or B report will depend on factors such as the jurisdiction’s regulatory environment and/or the contractual arrangements with a client’s service organization. These factors are beyond the user auditor’s reach.” The EC also did not support the fact that the ISA sets on equal footing a range of possible procedures, and believes that this, combined with the over-emphasis on Type A and Type B reports, may entail significant burdens for user entities and service organizations, and generate higher costs than expected or necessary.

#### Task Force’s Recommendations

11. It was not the intent of the IAASB in revising the ISA to suggest a Type A or Type B report was required whenever a service organization was used, recognizing, however, that extant ISA 402 dealt primarily with the auditor’s use of a service organization auditor’s report.
12. ED-ISA 402 required the user auditor to perform one or more procedures in order to gain an understanding of the service organization or test controls at the service organization. The order in which the procedures appeared in the requirement reflected what the Task Force believed is the order most commonly applied in practice. Nevertheless, the requirement allowed auditors dealing with entities of all sizes the ability to select any one or more procedures to provide the auditor with sufficient appropriate audit evidence.
13. However, after some debate, the Task Force agreed to include the phrase “if available” in reference to Type A and Type B reports and reorder the procedures. The requirements now read as follows:

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##### *Paragraph 12*

If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures:

- (a) Obtaining a Type A or Type B report, if available;
- (b) Contacting the service organization, through the user entity, to obtain specific information;
- (c) Visiting the service organization and performing such procedures; or
- (d) Using an other auditor to perform procedures that will provide the necessary information about the relevant controls at the service organization.

##### *Paragraph 16*

When the user auditor's risk assessment includes an expectation that controls at the service organization are operating effectively, the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures:

- (a) Obtaining a Type B report, if available;
- (b) Performing appropriate tests of controls at the service organization; or
- (d) Using an other auditor to perform tests of controls at the service organization on behalf of the user auditor.

14. Additionally, related application material now describes some factors that may influence the auditor's decision of which of the procedures to undertake; for example, the size of the user entity and the service organization, the complexity of the respective transactions, and the location of the service organization. The ISA also now indicates that it may not always be possible or practicable for a user auditor to obtain a Type A or Type B report. (See paragraphs A15-A18 of Agenda Item H.1.2)
15. The Task Force remains of the view that the user entity is responsible to have a system of internal control that enables it to prepare financial statements that are free from material misstatement, whether due to fraud or error. The fact that the user entity uses a service organization does not change this responsibility. It may be that the service organization provides a Type A or Type B report that the user entity can use to be satisfied as to the controls in place at the service organization, but if a Type A or Type B report is not available, then it would be expected that the user entity obtain information from the various sources noted in proposed ISA 402 (Revised and Redrafted), including visit(s) to the service organization. From the user auditor's perspective, the fact that a Type A or Type B report is available assists the auditor in doing risk assessments. However, if a Type A or Type B report is not available, the user auditor then has to obtain information from other sources to do the risk assessments.

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16. The SMPC Committee Rapid Response Team will review the revised ISA and provide comments on whether any further guidance could be developed.
17. ***See paragraphs 22-29 of Agenda Item H.1.1 for a detailed discussion of the Task Force's recommendations. Note that this Agenda Item makes reference to Agenda Item 9-B of the September IAASB meeting material (Agenda Item H.1.2 of the September IAASB CAG meeting material) to illustrate the proposed changes to the ISA as a result of these recommendations.***

#### Matter for Consideration for the IAASB CAG:

4. **Do the Representatives agree that the changes proposed by the Task Force now serve to balance the ISA and remove any perceived bias towards the use of Type A and Type B reports?**

#### OTHER SIGNIFICANT COMMENTS

18. ***See Agenda Item H.1.1 for other significant comments identified by the Task Force:***
- The objective of the ISA – paragraphs 13-16 of Agenda Item H.1.1
  - Alignment of the ISA with ISA 315 (Redrafted)<sup>2</sup> and ISA 330 (Redrafted)<sup>3</sup> – paragraphs 18-21 of Agenda Item H.1.1
  - Using the work of a service auditor when the user auditor is unable to obtain evidence – paragraphs 30-34 of Agenda Item H.1.1
  - New requirement to modify the opinion in the auditor's report – paragraph 45 of Agenda Item H.1.1
  - Conforming amendment to ISA 315 (Redrafted) – paragraphs 37-40 of Agenda Item H.1.1

#### Material Presented – FOR IAASB CAG REFERENCE PURPOSES ONLY

Agenda Item H.1.1	Summary of Significant Comments on ED-ISA 402 (Revised and Redrafted) – <i>Agenda Item 9-A of the September IAASB meeting material</i>
Agenda Item H.1.2	Proposed ISA 402 (Revised and Redrafted) – MARK-UP – <i>Agenda Item 9-B of the September IAASB meeting material</i>

<sup>2</sup> ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment."

<sup>3</sup> ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks."

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### **Action Requested**

The IAASB CAG is asked to review the significant comments on ED-ISA 402 highlighted in this paper, and to comment on the Task Force's proposed recommendations.