

PROJECT PROPOSAL—AUDIT CONSIDERATIONS RELATING TO ENTITIES USING SERVICE ORGANIZATIONS

1. Subject

Revision of ISA 402, “Audit Considerations Relating to Entities Using Service Organizations.”

2. Project Rationale

ISA 402 was originally issued in October 1992 and codified in March 1994 (with certain conforming amendments processed thereafter). Since then, the use of service organizations has advanced and the relationship between service organizations and their client entities has become more complex. Consequently, the standards and guidance for the auditor of a client entity (entity auditor) need to be updated, in particular those dealing with obtaining an understanding of internal control and the assessment of identified risks, and the consideration of the service auditor’s competence, work and report.

Furthermore, other audit standard setters have recently revised their corresponding standards and, in particular, have addressed the responsibilities, work and report of the auditor of the service organization (service auditor). The IAASB does not have any standards or guidance for service auditors. It is desirable that the IAASB take account of these developments.

Should the IAASB conclude that it should develop standards and guidance for service auditors, it should be decided whether the standards and guidance should be dealt with in the existing ISA or in a new Standard. To facilitate the decision-making process, this project proposal is divided into two parts, Part I states the objectives and the issues to be addressed with regard the entity auditor’s consideration and Part II states the objectives and the issues to be addressed with regard the service auditor’s responsibilities. The approaches followed by national audit standard setters and arguments for and against developing two Standards are set out in section 7.

PART I: ENTITY AUDITOR’S CONSIDERATIONS

3. Objectives to be Achieved

- To address the entity auditor issues arising from the advanced use of service organizations.
- To further align the standards and guidance with the audit risk standards.
- To revise the standards and guidance on the entity auditor’s consideration of the service auditor’s competence.
- To revise the standards and guidance on the entity auditor’s understanding of internal control and assessment of identified risks.
- To revise the standards and guidance on the entity auditor’s consideration of the service auditor’s work and report.

4. Key Issues to be Addressed

OBTAINING AN UNDERSTANDING OF THE ENTITY’S INTERNAL CONTROL

The internal control of many entities have been devolved as a result of outsourcing, creating complex structures and resulting in possibly higher control risk in the process. An entity may be affected by weaknesses in or failures of internal control at its service organization. Consequently, the auditor has to obtain an understanding of the outsourcing relationship, and of the service organization and its internal control, and identify and assess related risks of material misstatement. Although ISA 402 provides guidance in this respect, the increased importance of the client entity/service organization and entity auditor/service auditor relationships should be acknowledged and additional standards and guidance developed to enhance existing practice and ensure consistent application of the audit risk model.

EVALUATION OF THE SERVICE AUDITOR AND THE SERVICE AUDITOR’S WORK AND REPORT

ISA 402 requires the auditor to “assess the usefulness and appropriateness of reports issued by the service organization auditor.”¹ In addition, when the entity auditor uses the report of the service auditor, “the auditor should consider making inquiries concerning that auditor’s professional competence.”² Due to the advancement of outsourcing and the increased importance of the service auditor’s work and report in the context of the audit of the financial statements of a client entity, the existing standards and guidance should be expanded to provide for:

- A consideration of the service auditor’s professional qualifications, independence and professional competence;
- A consideration of the service auditor’s work and report; and
- Communication with the service auditor, including requests for performance of additional procedures where applicable.

PART II: SERVICE AUDITOR’S RESPONSIBILITIES

5. Objectives to be Achieved

- To develop standards and guidance on the service auditor’s responsibilities in the context of the audit of the financial statements of a client entity.
- To develop standards and guidance on the form and content of the service auditor’s report.

6. Key Issues to be Addressed

WORK PERFORMED BY SERVICE AUDITOR

Although outsourcing has existed for some time, its popularity has increased significantly in response to increasing cost pressures. With the advance of globalization, international outsourcing in particular has become very popular. By some estimates, the outsourcing of critical business functions to less-developed countries may have only just begun.

¹ ISA 402.13

² ISA 402.9

At the time ISA 402 was issued, the use of service organizations was frequently limited to simple or supporting functions and therefore the standards and guidance were limited to the identification of significant service organizations and the auditor's consideration of their effect on control risk. While these topics are still relevant, the shift toward outsourcing of entire operations has changed the position of the service auditor and his or her work has become more prominent in the audit of the financial statements of a client entity. The shift means, among other things, that internal controls over the operations being outsourced are implemented by the service organization and not by the client entity. This has increased the importance of the service auditor's work and report. The Sarbanes Oxley Act of 2002 has increased the prominence of "SAS 70 reports" issued in accordance with AU Section 324, "Service Organizations," in the United States.³

Standards and guidance on the service auditor's responsibilities in the context of the audit of the financial statements of a client entity should be developed. The service auditor may perform procedures to obtain sufficient appropriate audit evidence in relation to the design and implementation of the service organization's internal control, or in relation to the design, implementation and operating effectiveness of the service organization's internal control.

COMMUNICATION AND REPORTING CONSIDERATIONS

ISA 402 currently describes two types of services auditor's report: the design and implementation of the service organization's internal control is the subject of type A reports, and the design, implementation and operating effectiveness of the service organization's internal control are the subject of type B reports. To ensure a consistent application of the standards and guidance as the significance of the reports increases, there is a need to expand the standards and guidance on the form and content of the service auditor's report, in line with identified best practice.

7. Interrelationship of Entity Auditor and Service Auditor Standards and Guidance

The proposed revision represents a significant expansion of the scope of ISA 402 and the question arises whether the issues pertaining to the entity auditor's considerations and the service auditor's responsibilities should be dealt with in one or two Standards, addressed as one or two projects and, if two projects, undertaken by one or two task forces. Furthermore, should the IAASB conclude to develop standards and guidance for service auditors and to include them in a separate standard, consideration should be given as to whether the Standard is an ISA or an International Standard on Assurance Engagements (ISAE).

To establish which practice prevails among national audit standard setters, ten countries were selected and their equivalent Standards or guidance reviewed.

³ For example, KPMG: Momentum, Vol. 3, Nr. 3, 2003: "While Type I reports are useful in that they describe controls and procedures, the requirements under Sarbanes-Oxley sections 302 and 404 will place a far greater emphasis on Type II reports. With those developments and market conditions as a backdrop, this issue of *Momentum* will examine the increasingly important role that SAS 70 reports play in the realm of the internal control of public companies that outsource tasks affecting their financial statements."

Country	Standard on entity auditor's considerations only	Standard on entity auditor's considerations AND separate <i>Standard</i> on service auditor's work and report	Standard on entity auditor's considerations and separate <i>guidance</i> for service auditors
South Africa			X
Canada		X	
United States			X
Australia			X
New Zealand	X		
Sri Lanka	X		
Czech Republic	X		
Germany	X		
United Kingdom/Ireland	X		
The Netherlands	X		

Arguments for two separate Standards, addressed as two separate projects:

- Unlike the entity auditor's work, the work and report of the service auditor do not directly relate to an audit of financial statements. Therefore, the standard should be a separate standard. In addition, it should be included in an ISAE;
- The use of the work and report of the service auditor in the context of the audit of the financial statements of a client entity has become so significant that it is necessary to establish standards and provide detailed guidance for a service auditor – these may be better positioned in a separate Standard.
- The use of service organizations has not only gained on importance but also has become complicated - developing standards and guidance for service auditors will require the involvement of specialists on outsourcing issues.
- The use of service organizations is likely to grow well into the future – a separate Standard for service auditors may become necessary in the future as the significance of the service auditor's work and report for the audit of the financial statements of a client entity further increases.
- The development of standards and guidance for the service auditor is likely to take a significant amount of time - undertaking a separate project to develop standards and guidance for service auditors could facilitate a more timely revision of ISA 402.

- An entity auditor may only be interested in the standards and guidance relevant to his or her audit of the financial statements of the service entity. This is particularly relevant to small and medium practitioners, who do not want to have to read material not relevant to their work.

Arguments against two separate Standards:

- Canada has been identified as the only country having two separate Standards. However, other countries have developed guidance in a separate document for service auditors.
- The service auditor's work and report is considered in the context of the audit of the financial statements of the service entity and, consequently, the issues should be dealt with concurrently and standards and guidance presented in one Standard.
- The practical arrangement would likely involve addressing the entity auditor's considerations first and the service auditor's responsibilities second – this may result in conforming amendments to the revised ISA 402, following the completion of the standards and guidance for service auditors.

Based on the arguments above, whether it is effective, or even possible, to revise ISA 402 without understanding the issues and interrelatedness involved in such project is the key to determine the appropriate development process. Accordingly, it is recommended that one Task Force be initially formed to advise the IAASB on whether one or two standards should be developed, in what sequence the work should proceed and whether one or two task forces should be set up.

8. Describe the Implications for any Specific Persons or Groups

Except as described in section 10 below, the project does not have implications for any specific persons or groups.

9. Development Process, Project Timetable and Project Output

PROJECT TIMETABLE

ISA 402 revision:

Issues paper (This issues paper will include the fundamental issues, scope of the project and recommendations as to whether one or two standards should be developed)

September 2005

Issues paper (client auditor considerations)

December 2005

Issues paper (service auditor's responsibilities)

March 2006

First read:

June 2006*

Exposure draft:

September 2006*

*This timetable may change depending on the Task Force recommendations as to whether the revision of ISA 402 proceeds as one project, or whether two projects proceed concurrently.

PROJECT OUTPUT

- ISA 402 (Revised)

- New standards and guidance for service auditors
- Possible conforming amendments to other IAASB pronouncements.

10. Resources Required

TASK FORCE(S)

Irrespective of the number of task forces established, the task force(s) should include individuals with experience in service organization issues (including auditors of the financial statements of entities in industries such as financial services) and with strong IT auditing backgrounds.

The Institute of Internal Auditors should be asked to nominate a representative. In addition, the INTOSAI Auditing Standards Committee Working Group on Financial Audit Guidelines should be requested to consider the relevance of ISA 402 to the public sector and, if considered necessary, to appoint a representative to both task forces.

Consideration should be given to include representatives of the US ASB or CICA AASB, as they recently dealt with or revised their related auditing standards.

The task force should consult the following groups at appropriate stages of the project:

- The IFAC SMP Permanent Task Force;
- The CAG, including IOSCO, due to stakeholder and regulatory interest in reporting on internal control; and
- National standard setters, due to the potential affect any revised international auditing standard on service organizations may have on corresponding national standards, particularly from the perspective of convergence.
- A language reviewer should be involved at appropriate stages of the project.

STAFF

One IAASB staff member should provide staff support to the task force.

11. List Important Sources of Information that Address the Matter being Proposed

- AU 324, “Service Organizations,” revised January 2003
- CICA 5310, “Audit Evidence Considerations When an Enterprise Uses A Service Organization,” revised November 2001
- CICA 5900, “Opinions on Control Procedures at a Service Organization,” revised July 2000
- Proposed ISA 402 (UK and Ireland), “Audit Considerations Relating to Entities Using Service Organizations,” June 2004
- AUS 404, “Audit Implications Relating to Entities Using a Service Entity,” revised July 2002

- PCAOB Briefing Paper, Proposed Auditing Standard – An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, October 7, 2003
- PCAOB Auditing Standard 2, “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,” June 2004

Prepared by Jan Tyl

Date January 2005

Approved by _____

Date _____

(Chair on behalf of the IAASB)

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COMMENTS BY TECHNICAL MANAGERS

The comments of Technical Manager from each technical area are required before this Project Proposal is considered by the board, committee or permanent task force proposing to undertake the project.

Technical Manager to the Compliance Advisory Panel

Best left to IAASB in context of their priorities.

Signed Sylvia Barrett Date January 31, 2005

Technical Manager to the Developing Nations Permanent Task Force

No comments at this point.

Signed Claire Egan Date February 3, 2005

Technical Manager to the Education Committee

No issues for Education Committee.

Signed: Claire Egan Date February 1, 2005

Technical Manager to Ethics Committee

No issues for Ethics Committee.

Signed Jan Munro Date February 3, 2005

Technical Manager to the IAASB

[Insert comments (prompts – views on importance of project, other matters wished to be communicated)]

Signed _____ Date _____

Technical Manager to the PAIB Committee

The project is not of significance to the PAIB.

Signed Robin Mathieson Date January 31, 2005

International Public Sector Accounting Standards Board

Service contracts and outsourcing are used extensively in the public sector. It is anticipated that INTOSAI when asked, will nominate a member(s) of the Task Force(s) who will provide public sector input to this project/these projects.

Signed

A handwritten signature in cursive script, appearing to read "Matthew Fisher".

Date January 31, 2005

Technical Manager to the SMP Permanent Task Force

General

From an SMP perspective the importance of this standard varies from low to high depending on the country in which the SMP is operating and the main industry sectors they serve. That said we observe that: the outsourcing (contracting out) industry has grown exponentially and the trend shows no sign of abating; the service provider is often and increasingly overseas, typically in a less developed country; and all sizes of companies appear to make equal use of it. In many countries and industries SMEs often use service organizations for handling their, accounting, billing, maintenance, pay-roll and other services. This contracting out is typically prompted by the lack of economies of scale to justify having the expertise in-house. We also expect that SMPs will have more work in the future when acting as an auditor for a service organisation, for instance reporting on internal controls.

On the basis of the above we've chosen to give this project MEDIUM PRIORITY and wish to track its development.

Specific

1. We support the division of the existing ISA 402 into two separate standards as the work carried out by the entity's auditors and that of the service organization's auditors are quite different in nature and scope.
2. We recommend that more illustrative reports be included in the appendices of the revised ISA and the separate standard for the service auditors. This will clarify the exact wording to be used in the reports and help guide those SMPs following the standard.
3. There are a great number of small service organizations in less-developed countries. Should the type B report be made mandatory, some of these organizations might not be able to accept the service engagement. This will impact economic development in both such countries. As the ISA will have global application it is worth considering the risk of such 'side-effects'.
4. Some consideration may need to be given to providing guidance on the "size" element of the client entities and service organizations when drafting the revised ISA 402. In particular, when SMEs outsource to larger service organizations they may not be in a position to request for a report on the design, implementation and operating effectiveness of the internal controls, i.e. the type B report, from the large service organizations as the latter may regard the transaction amount as small and ignore such a request. This scenario may prompt the client's auditors to adjust the control risk level by reference to the availability of the type B report. Unfortunately, this may lead to more reservations found in the auditors' reports of SMEs even where they have engaged in the services of larger service organizations. Consequently, some guidance would be welcome on the on the auditors' judgment as to the assertions in respect of the financial statements of the SMEs in the absence of the type B report. This includes the kinds of substantive procedures deemed sufficient and appropriate to achieve the relevant audit objectives
5. There may be value in taking into account the "chain" service situation, where the service organizations may also outsource some of their operations to other organizations. Any impact of this arrangement on the nature, extent and timing of the auditors' works can be noted.

6. In some jurisdictions and circumstances (payroll, book-keeping) confidentiality regulations mean that service organization auditors may not be able to provide the information that ISA 402 requires. This forces auditors to do a lot of substantive verification work resulting in larger sample sizes than it would normally use for companies using outside service providers.

Signed Paul Thompson

Date January 27, 2005

Technical Manager to the Transnational Auditors Committee

High priority project.

Signed Victoria Rand

Date January 27, 2005

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