

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 and Objectives**(a) Issue Identification**

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 entities has become more complex. Consequently, the standards and guidance for the auditor of an entity that uses a service organization need to be updated, in particular those dealing with obtaining an understanding of internal control and the assessment of identified risks, and the entity auditor’s consideration of a service auditor’s competence, work and report, when the auditor intends to rely on a service auditor’s report.

(b) Rationale for IAASB’s Undertaking the Project

Numerous national standard-setters, who have recently reviewed and updated their standards and requested that the IAASB consider a revision of extant ISA.

(c) Objectives to Be Achieved

- To address the entity auditor issues arising from the use by entities of service organizations.
- To 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 work and report.

3. Outline of the Project**(a) Project Scope**

This project will focus on the auditor’s considerations when the entity being audited uses a service organization. The section of ISA 402 on the entity auditor’s consideration in using a service auditor’s report will be updated to provide guidance to the entity auditor in using such reports.

The scope of this project will not, however, be expanded to include the development of standards and guidance on the service auditor’s responsibilities in performing an engagement to issue a report on controls at a service organization or the form and content of the service auditor’s report. These considerations are addressed in a separate project proposal submitted to the IAASB.

(b) List the Major Problems and Key Issues that Should Be Addressed

CONFORMING WITH ISA 315 AND RISK-BASED AUDIT MODEL

The internal control of many entities has been changed as a result of outsourcing, creating complex structures and resulting in possibly higher control risk in the process. An entity's internal control may be affected by weaknesses in, or failures of, controls at its service organization. Consequently, the auditor has to obtain an understanding of the outsourcing relationship, and of the service organization's effect on the internal control of the entity, 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 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, as well as the developments in ISA 600, the existing standards and guidance may require to 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 or review of the service auditor's working papers, where applicable.

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. If a project proposal to develop standards and guidance for assurance report on service organization's controls is approved by the IAASB, reports will be addressed as part of that project. Should the IAASB conclude that only this project will go ahead at this time, the reports would be addressed by this project.

(c) Cost-Benefit Considerations

A decision by the IAASB to amplify the entity auditor's considerations for certain matters or circumstances may have cost benefit implications. The task force will consider and

¹ ISA 402.13

² ISA 402.9

explore cost benefit implications in developing its recommendations to the IAASB, using a format to be developed for IAASB projects.

4. Describe the Implications for any Specific Persons or Groups

Except as described in section 6 below, the project does not have implications for any specific persons or groups.

5. Development Process, Project Timetable and Project Output

(a) Project timetable

The timetable for the project is expected to be as follows:

- Issues Paper – September 2006
- First Read of draft exposure draft – February 2007
- Exposure Draft – July 2007
- Final revised ISA – June 2008.

(b) Project output

A revised ISA 402. The revised ISA will be drafted in accordance with the new drafting conventions under the IAASB Clarity project (as refined, as necessary, based on the present consultation thereon).

Consideration will also be given to repositioning or amalgamating any related requirements and guidance in other ISAs, as appropriate.

6. Resources Required

The task force should include individuals with experience in service organization issues (including auditors of the financial statements of entities in industries such as financial services). 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 the task force.

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. Further, at least one member needs to be an IT specialist due to the nature of the ISA.

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

- The IFAC SMP Committee;
- The IAASB CAG, 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.

- One IAASB staff member will provide staff support to the task force. A language reviewer will be involved at appropriate stages of the project.

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

- AU 324, “Service Organizations,” revised January 2003, Auditing Standards Board, USA.
- CICA 5310, “Audit Evidence Considerations When an Enterprise Uses A Service Organization,” revised November 2001, Canada.
- 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, Auditing and Assurance Standards Board of the Australian Accounting Research Foundation.
- PCAOB Auditing Standard 2, “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,” June 2004.
- Press archives.
- Academic journals archives.

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Date February 10, 2006

Approved by John Kellas

Date March 2006

(Chair on behalf of the IAASB)