

PROPOSED INTERNATIONAL STANDARD ON AUDITING 402**(REVISED AND REDRAFTED)****AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE
ORGANIZATION**(Effective for audits of financial statements for periods beginning on or after [date])^{*}**CONTENTS**

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International Standard on Auditing (ISA) 402, “Audit Considerations Relating to An Entity Using a Service Organization” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services,” which sets out the application and authority of ISAs.

^{*} See footnote 1.

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities to obtain sufficient appropriate audit evidence when an entity uses one or more service organizations that perform services that are part of the entity's information system relevant to financial reporting. Specifically, it expands on how the auditor applies ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding The Entity and Its Environment," and ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks" in identifying and assessing the risks of material misstatement and in designing and performing further audit procedures.
2. Many entities use outsourcing organizations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity's entire business units or functions. Many of the services provided by such organizations are integral to the entity's business operations; however not all those services are directly linked to an entity's information system relevant to financial reporting.
3. A service organization's services are part of an entity's information system, including related business processes, relevant to financial reporting if they affect any of the following:
 - (a) The classes of transactions in the entity's operations that are significant to the entity's financial statements;
 - (b) The procedures, both automated and manual, by which the entity's transactions are initiated, authorized, recorded, processed and reported from their occurrence to their inclusion in the financial statements;
 - (c) The related accounting records, whether electronic or manual, supporting information and specific accounts in the entity's financial statements involved in initiating, authorizing, recording, processing and reporting the entity's transactions;
 - (d) How the entity's information system captures other events and conditions that are significant to the financial statements; and
 - (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
4. The primary 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.
5. This ISA does not apply to situations where the services provided by a service organization are limited to processing an entity's transactions that are specifically authorized by the entity, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker. In addition, this ISA does not apply to the audit of transactions arising from proprietary financial interests in other

entities such as partnerships, corporations and joint ventures, when proprietary interests are accounted for and reported to interest holders.

Effective Date

6. This ISA is effective for audits of financial statements for periods beginning on or after [date].¹

Objective

7. The objective of the auditor is to obtain sufficient appropriate audit evidence when an entity uses a service organization that performs services that are part of the entity's information system relevant to financial reporting in order to identify and assess the risks of material misstatement and design and perform further audit procedures to address the assessed risks.

Definitions

8. For purposes of this ISA, the following terms have the meanings attributed below:
 - (a) Complementary user entity controls – Controls that the service organization assumes, in the design of its service, will be implemented by a user entity.
 - (b) Service Auditor – An auditor who provides an assurance report on the controls of a service organization or who performs tests of controls or substantive procedures at a service organization on behalf of a user auditor.
 - (c) Service Organization – An organization (or segment of an organization) that provides services to a user entity that are part of a user entity's information system relevant to financial reporting.
 - (d) Subservice Organization – A service organization used by another service organization to perform some or all of the services provided to a user entity that are part of a user entity's information system relevant to financial reporting.
 - (e) User Auditor – An auditor who audits and reports on the financial statements of the user entity.
 - (f) User Entity – An entity that uses a service organization and whose financial statements are being audited.
 - (g) Report on the Description, Design and Existence of Controls at a Service Organization (referred to in this ISA as a Type A report) – A report that comprises:
 - (i) A description of controls and control objectives prepared by management of the service organization;
 - (ii) A written assertion by the service organization's management that:

¹ This date will not be earlier than December 15, 2008.

- (a) The description of controls and control objectives presents fairly, in all material respects, the relevant aspects of the service organization's controls that had been implemented as at a specified date;
 - (b) The controls are suitably designed to provide reasonable assurance that the specified control objectives will be achieved if the controls operate effectively; and
 - (c) The controls were in existence as at a specified date; and
 - (iii) An assurance report that includes the service auditor's opinion about the matters in (ii)(a) – (ii)(c) above.
- (h) Report on the Description, Design, Existence, and Effective Operation of Controls at a Service Organization (referred to in this ISA as a Type B report) – A report that comprises:
- (i) A description of controls and control objectives prepared by management of the service organization;
 - (ii) A written assertion by the service organization's management that:
 - (a) The description of controls and control objectives presents fairly, in all material respects, the relevant aspects of the service organization's controls that had been implemented throughout a specified period;
 - (b) The controls are suitably designed to provide reasonable assurance that the specified control objectives will be achieved if the controls operate effectively;
 - (c) The controls were in existence throughout a specified period; and
 - (d) The controls operated effectively throughout a specified period; and
 - (iii) An assurance report that includes:
 - (a) The service auditor's opinion about the matters in (ii)(a) – (ii)(d) above; and
 - (b) A description of the service auditor's tests of the controls and the results thereof.

Requirements

Obtaining an Understanding of the Services Provided by a Service Organization

9. When obtaining an understanding of the entity in accordance with ISA 315 (Redrafted), the user auditor shall obtain an understanding of how a user entity uses a service organization in its operations, including:
- (a) The nature of the services provided by the service organization and the significance of those services to the user entity, including its internal control; and

- (b) The nature and materiality of the transactions processed or accounts affected by the service organization and the degree of interaction between the activities of the service organization and those of the user entity. (Ref. Para. A1-A8, A10)
- 10. When obtaining an understanding of internal control relevant to the audit in accordance with ISA 315 (Redrafted), the user auditor shall evaluate the user entity's design and implementation of relevant controls as they relate to the services performed by the service organization, including those that are applied to the transactions processed by the service organization, and relevant monitoring controls. (Ref. Para. A9, A11-A12, A14-A15)
- 11. In considering the various sources of information about a service organization, the user auditor shall determine whether the user auditor's understanding of the services provided by the service organization is sufficient to perform risk assessment procedures as a basis for the identification and assessment of risks of material misstatement. (Ref. Para. A13)

Assessing the Risks of Material Misstatement

- 12. When the user auditor's risk assessment includes an expectation that the service organization's controls are operating effectively for certain assertions for which controls are applied only at the service organization, 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 that describes both the relevant tests of controls and the results of the service auditor's tests of those controls;
 - (b) Performing appropriate tests of controls at the service organization; or
 - (c) Requesting the service auditor to perform tests of controls at the service organization on behalf of the user auditor. (Ref. Para. A16-A17)

Using a Report on Controls at a Service Organization as Audit Evidence

Using a Type A Report

- 13. When the user auditor decides to use a Type A report as audit evidence about the design and implementation of the service organization's controls for certain assertions, the user auditor shall:
 - (a) Evaluate the sufficiency and appropriateness of the evidence provided for the relevant assertions; and
 - (b) Determine whether complementary user entity controls identified by the service organization are relevant to the user entity and if so, obtain an understanding of whether the user entity has designed and implemented such controls. (Ref. Para. A18-A19)

Using a Type B Report

- 14. When the user auditor decides to use a Type B report as audit evidence about the design and implementation of the service organization's controls for certain assertions and that the service organization's controls are operating effectively, the user auditor shall:

- (a) Evaluate the sufficiency and appropriateness of the evidence provided about the effectiveness of controls for the relevant assertions;
- (b) Determine whether complementary user entity controls identified by the service organization are relevant to the user entity and if so, obtain an understanding of whether the user entity has designed and implemented such controls and if so, test their operating effectiveness; and
- (c) Evaluate the specific tests of controls performed by the service auditor and the results thereof relevant to those assertions to determine if sufficient appropriate audit evidence has been obtained about the operating effectiveness of the controls to support the user auditor's risk assessments. (Ref: Para. A20-A27)

Using an Assurance Report from a Service Auditor

- 15. In determining whether the service auditor's assurance report provides sufficient appropriate audit evidence to support the user auditor's opinion, when the service auditor is not well known to the user auditor, the user auditor shall inquire about the service auditor's professional reputation, competence and independence. (Ref: Para. A28)
- 16. When the user auditor uses an assurance report from a service auditor, the user auditor shall not refer to the service auditor in the user auditor's report containing an unmodified opinion unless required to do so by law or regulation. If the user auditor is required to do so, the user auditor's report shall clearly indicate that such reference does not alter the user auditor's opinion as stated in the report, or diminish the user auditor's sole responsibility for the report. (Ref: Para. A29)

Other Audit Evidence Considerations Regarding Service Organizations

- 17. Based on the user auditor's understanding of the aspects of the user entity's information system relating to relevant services provided by the service organization and the user auditor's responses to assessed risks in accordance with ISA 330 (Redrafted), the user auditor shall:
 - (a) Assess whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and if not,
 - (b) Perform further audit procedures to obtain sufficient appropriate audit evidence or request the service auditor to perform those procedures on the user auditor's behalf. (Ref: Para. A30-A33)

Fraud, Illegal Acts and Uncorrected Misstatements in Relation to Activities at the Service Organization

- 18. The user auditor shall inquire of management of the user entity whether the service organization has reported any fraud, illegal acts or uncorrected misstatements that affect the user entity and if so, the user auditor shall evaluate how they affect the nature, timing and extent of the user auditor's further audit procedures. (Ref: Para. A34)

Communications with Management and Those Charged with Governance

19. As required by ISA 315 (Redrafted) and ISA 330 (Redrafted), the user auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility and, as required by [proposed] ISA 260 (Revised and Redrafted), “Communication with Those Charged with Governance,” with those charged with governance (unless all of those charged with governance are involved in managing the entity). (Ref. Para. A35)

* * *

Application and Other Explanatory Material

Obtaining an Understanding of the Services Provided by a Service Organization (Ref. Para. 9-11)

- A1. A user entity may use a service organization such as one that processes transactions and maintains related accountability, or records transactions and processes related data. Service organizations that provide such services include, for example, bank trust departments that invest and service assets for employee benefit plans or for others, mortgage bankers that service mortgages for others, and application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions. The Appendix to this ISA provides examples of some types of service organizations used in practice today.
- A2. Examples of service organization services that are relevant to the audit include:
- Maintenance of the user entity’s accounting records.
 - Other finance functions (such as the computation of tax liabilities, or debtor management and credit risk analysis) which involve establishing the carrying value of items in the financial statements.
 - Management of assets.
 - Undertaking or making arrangements for transactions as agent of the user entity.
- A3. Information on the nature of the services provided by a service organization may be available from a wide variety of sources, such as:
- User manuals;
 - System overviews;
 - Technical manuals;
 - The contract between the user entity and the service organization; and
 - Reports by service organizations, internal auditors or regulatory authorities on the service organization’s controls.

- A4. The contract or service level agreement between the user entity and the service organization may state whether the service organization will provide a Type A or Type B report and whether the user auditor has rights of access to the accounting records of the user entity and other information necessary for the conduct of the audit.
- A5. Information obtained through the user auditor's prior experience with the service organization may also be helpful in obtaining an understanding of the nature of the services provided by the service organization. This may be particularly helpful if the services and the service organization's controls over those services are highly standardized.
- A6. A service organization may establish policies and controls that affect the user entity's internal control. These policies and controls are at least in part, physically and operationally separate from the user entity. The significance of the controls of the service organization to those of the user entity depends on the nature of the services provided by the service organization, including the nature and materiality of the transactions it processes for the user entity. In certain situations, the transactions processed and the accounts affected by the service organization may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may require that the user auditor obtain an understanding of those controls. The significance of the controls of the service organization to those of the user entity also depends on the degree of interaction between its activities and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organization. For example, a high degree of interaction exists between the activities of the user entity and those at the service organization when the user entity authorizes transactions and the service organization processes and does the accounting of those transactions. On the other hand, when the service organization initiates or initially records, processes, and does the accounting of the user entity's transactions, there is a lower degree of interaction between the two organizations.
- A7. A service organization may engage a service auditor to report on the description, design and implementation of its controls at a point in time or on the description, design and implementation of its controls and their operating effectiveness over a period of time. There is a direct relationship between the service organization and the user entity and between the service organization and the service auditor. These relationships do not necessarily create a direct relationship between the user auditor and the service auditor. When there is no direct relationship between the user auditor and the service auditor, communications between the user auditor and the service auditor are usually conducted through the user entity and the service organization.
- A8. A direct relationship may be created between a user auditor and a service auditor, taking into account the relevant ethical and confidentiality considerations. A user auditor, for example, may request a service auditor to perform specific procedures on the user auditor's behalf and report on actual findings such as:
- (a) Tests of controls at the service organization as specified by the user auditor; or

- (b) Substantive procedures on the user entity's financial statement transactions and balances maintained by a service organization.
- A9. The user entity may establish controls over the service organization's services that may be tested by the user auditor and that may enable the user auditor to conclude that the user entity's controls are operating effectively for some or all of the related assertions. If a user entity, for example, uses a service organization to process its payroll transactions, the user entity may establish controls over the submission and receipt of payroll information that could prevent or detect material misstatements. In this situation, the user auditor may perform tests of the user entity's controls over payroll processing that would provide a basis for the user auditor to conclude that the user entity's controls are operating effectively for the assertions related to payroll transactions.
- A10. A user entity may use a service organization that in turn uses a subservice organization. The subservice organization may perform functions or processing that is part of the user entity's information system as it relates to an audit of the financial statements. The subservice organization may be a separate entity from the service organization or may be related to the service organization. A user auditor may need to consider controls at the subservice organization. In situations where one or more subservice organizations are used, the interaction between the user entity and the service organization is expanded to include the interaction between the user entity, the service organization and the subservice organizations. The degree of this interaction, as well as the nature and materiality of the transactions processed by the service organization and the subservice organizations, are the most important factors for the user auditor to consider in determining the significance of the subservice organization's controls to the user entity's controls.
- A11. As noted in ISA 315 (Redrafted), it is a matter of the user auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. Factors relevant to the user auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:
- Materiality.
 - The significance of the related risk.
 - The size of the user entity.
 - The nature of the user entity's business, including its organization and ownership characteristics.
 - The diversity and complexity of the user entity's operations.
 - Applicable legal and regulatory requirements.
 - The circumstances and the applicable component of internal control.
 - The nature and complexity of the systems that are part of the user entity's internal control.

- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatements.

A12. As noted in ISA 315 (Redrafted), in respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions and account balances, the characteristics of which often permit highly automated processing with little or no manual intervention, which may be particularly true in the case of service organizations. In such cases, the entity's controls over such risks are relevant to the audit and the user auditor is required to obtain an understanding of such controls in accordance with paragraph 10 of this ISA.

A13. After considering the various sources of information about a service organization, the user auditor may conclude that a sufficient understanding of the nature of the services provided by the service organization has not been obtained. If that is the case, the user auditor may consider the following alternatives:

- (a) Contacting the service organization, through the user organization, to obtain specific information;
- (b) Requesting that a service auditor be engaged to perform procedures that will provide the necessary information;
- (c) Visiting the service organization and performing such procedures; or
- (d) Considering the effect on the auditor's report because of a scope limitation in accordance with ISA 705 (Revised), "Modifications to the Opinion in the Independent Auditor's Report."

Considerations Specific to Smaller Entities

A14. In some circumstances, a user entity may outsource one or more significant business units or functions, such as its entire tax planning and compliance functions, or finance and accounting or the controllership function to one or more service organizations. The user auditor's ability to gain an understanding of controls at the service organizations may be dependent on the direct interaction with management at the service organizations, as a report on controls at the service organizations may not be available.

Considerations Specific to Public Sector Entities

A15. Public sector auditors generally have broad rights of access established by legislation. However, there may be situations where such rights of access are not available, for example when the service organization is located in a different jurisdiction. In such cases, a public sector auditor may need to obtain an understanding of the legislation applicable in the different jurisdiction to determine whether appropriate access rights can be obtained, or ask the user entity to incorporate rights of access in any contractual arrangements between the user entity and the service organization.

Assessing the Risks of Material Misstatement (Ref: Para. 12)

A16. If a Type B report is not available, a user auditor may contact the service organization, through the user entity, to request that a service auditor be engaged to perform a Type B report that includes tests of the operating effectiveness of the relevant controls or to perform agreed-upon procedures that test the operating effectiveness of those controls. A user auditor may also visit the service organization and perform tests of relevant controls if the service organization agrees to it. In all cases, the user auditor's risk assessments are based on the combined evidence provided by service auditor's report and the user auditor's own procedures.

A17. A Type A report may be helpful in providing a sufficient understanding to identify and assess the risks of material misstatement of the user entity. Such a report, however, is not intended to provide any evidence of the operating effectiveness of the relevant controls.

Using a Report on Controls at a Service Organization as Audit Evidence*Using a Type A Report* (Ref: Para. 13)

A18. A Type A report, along with information about the user entity, may be helpful in providing an understanding of:

- (a) The aspects of the service organization's controls that may affect the processing of the user entity's transactions, including the use of subservice organizations;
- (b) The flow of significant transactions through the service organization to determine the points in the transaction flow where material misstatements in the user entity's financial statements could occur;
- (c) The control objectives at the service organization that are relevant to the user entity's financial statement assertions;
- (d) Whether the service organization's controls are suitably designed to prevent or detect processing errors that could result in material misstatements in the user entity's financial statements.

The user auditor also considers whether the service organization's description of controls is at a date that is appropriate for the user auditor's purposes.

A19. A Type A report that is as of a date outside of the reporting period of a user entity may be helpful in providing a user auditor with a preliminary understanding of the controls implemented at the service organization if the report is supplemented by additional current information from other sources. If the service organization's description of controls is as of a date that precedes the beginning of the period under audit, the user auditor may perform procedures to update the information in a Type A report, such as:

- Discussing the changes at the service organization with user entity personnel who would be in a position to know of such changes;
- Reviewing current documentation and correspondence issued by the service organization; and

- Discussing the changes with service organization personnel or with the service auditor.

Using a Type B Report (Ref: Para. 14)

A20. A Type B report may be intended to satisfy the needs of several different user auditors; therefore specific tests of controls and results in the service auditor's report may not be relevant to assertions that are significant in the user entity's financial statements. For those tests of controls and results that are relevant, the nature, timing and extent of such tests of controls is evaluated to determine that the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment. In doing so, the user auditor may consider the following factors:

- (a) The time period covered by the tests of controls and the time elapsed since the performance of the tests of controls;
- (b) The scope of the audit and applications covered, the controls tested, and the way in which tested controls relate to the user entity's controls; and
- (c) The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

A21. For certain assertions, the shorter the period covered by a specific test and the longer the time elapsed since the performance of the test, the less audit evidence the test may provide. To be useful to a user auditor, a Type B report covers a minimum reporting period of six months. The period covered by the Type B report is compared to the user entity's financial reporting period. When there is little overlap between the period covered by the Type B report and the period for which the user auditor intends to rely on the report, the Type B report offers less audit evidence.

A22. When this is the case, it may be necessary for the user auditor to obtain additional evidence about significant changes to the relevant controls at the service organization outside of the period covered by the Type B report or determine additional audit procedures to be performed. Relevant factors in determining what additional audit evidence to obtain about controls at the service organization that were operating during the period outside of the period covered by the service auditor's report include:

- The significance of the assessed risks of material misstatement at the assertion level.
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel.
- The degree to which audit evidence about the operating effectiveness of those controls was obtained.
- The length of the remaining period.
- The extent to which the user auditor intends to reduce further substantive procedures based on the reliance of controls.

- The control environment.

A23. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the user entity's monitoring controls.

A24. If the service auditor's testing period is completely outside the user entity's financial reporting period, the user auditor will be unable to rely on such tests for the user auditor to conclude that the user entity's controls are operating effectively because they do not provide current audit period evidence of the effectiveness of the controls, unless other procedures are performed.

A25. In certain circumstances, a service provided by the service organization may be designed with the assumption that certain controls will be implemented by the user entity. For example, the service may be designed with the assumption that the user entity will have controls in place for authorizing transactions before they are sent to the service organization for processing. In such a situation, the service organization's description of controls may include a description of those complementary user entity controls. The user auditor considers whether those complementary user entity controls are required and whether they are relevant to the service provided to the user entity.

A26. If the user auditor believes that the service auditor's assurance report may not provide sufficient audit evidence, the user auditor may supplement the understanding of the service auditor's procedures and conclusions by discussing with the service auditor the scope and results of the service auditor's work. Also, if the user auditor believes it is necessary, the user auditor may contact the service organization, through the user entity, to request that the service auditor perform agreed-upon procedures at the service organization, or the user auditor may perform such procedures.

A27. The service auditor's assurance report identifies results of tests, including exceptions and other information, that could affect the user auditor's conclusions. Exceptions noted by the service auditor or a modified opinion in the service auditor's assurance report do not automatically mean that the service auditor's assurance report will not be useful for the audit of the user entity's financial statements or in assessing the risks of material misstatement. Rather, the exceptions and the matter giving rise to a modified opinion in the service auditor's assurance report are considered in the user auditor's assessment of the testing of controls performed by the service auditor.

Using an Assurance Report from a Service Auditor (Ref. Para. 15-16)

A28. Appropriate sources of information concerning the professional reputation of the service auditor include inquiries as to the professional reputation and standing of the service auditor of one or more of the following:

- (a) The auditor's professional organization;
- (b) Other practitioners; and
- (c) Bankers and other credit grantors.

The service auditor may be practicing in a jurisdiction where different standards are followed in respect of reports on controls at a service organization. In such a situation, the user auditor may inquire about the adequacy of those standards.

- A29. The user auditor does not make reference to the service auditor's assurance report as a basis, in part, for the user auditor's opinion on the user entity's financial statements. The fact that a user entity uses a service organization does not change the user auditor's responsibility under ISAs to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. However, when the user auditor expresses a modified opinion because of a modified opinion in a service auditor's assurance report, the user auditor is not precluded from referring to the service auditor's assurance report if such reference assists in explaining the reason for the user auditor's modified opinion.

Other Audit Evidence Considerations Regarding Service Organizations (Ref: Para. 17)

- A30. When the service organization maintains material elements of the accounting records of the user entity, the user auditor may require direct access to those records in order to obtain sufficient appropriate audit evidence relating to the operations of controls over those records or to substantiate transactions and balances recorded in them, or both. Such access may involve either physical inspection of records at the service organization's premises or interrogation of records maintained electronically from the user entity or another location, or both. Where direct access is achieved electronically, the user auditor may obtain evidence as to the adequacy of controls operated by the service organization over the completeness and integrity of the user entity's data for which the service organization is responsible. The user auditor may also request the service auditor, on the user auditor's behalf, to gain access the user entity's records maintained by the service organization.
- A31. In determining the nature and extent of audit evidence to be obtained in relation to balances representing assets held or transactions undertaken by a service organization, the user auditor considers the efficiency and effectiveness of the following procedures:
- (a) Inspecting records and documents held by the user entity: the effectiveness of this source of evidence is determined by the nature and extent of the accounting records and supporting documentation retained by the user entity. In some cases the user entity may not maintain detailed records or documentation confirming specific transactions undertaken on its behalf;
 - (b) Obtaining confirmations of balances and transactions from the service organization: where the user entity maintains independent records of balances and transactions and a service organizations processes transactions only at the specific authorization of the user entity or acts as a simple custodian of assets, confirmation from the service organization corroborating those records usually constitutes reliable audit evidence concerning the existence of the transactions and assets concerned.
- If the user entity does not maintain independent records, information obtained in confirmations from the service organization is merely a statement of what is reflected

in the records maintained by the service organization. Hence such confirmations do not, taken alone, constitute reliable audit evidence. In these circumstances the user auditor considers whether there is a separation of functions for the services provided such that an alternative source of independent evidence can be identified.

- (c) Performing analytical procedures on the records maintained by the user entity or on the returns received from the service organization: the effectiveness of analytical procedures is likely to vary by assertion and will be affected by the extent and detail of information available;
- (d) Inspecting records and documents held by the service organization: the user auditor's access to the records of the service organization is likely to be established as part of the contractual arrangements between the user entity and the service organization;
- (e) Requesting the service auditor to perform further audit procedures on the user auditor's behalf at the service organization.

A32. A service auditor may perform procedures that are substantive in nature for the benefit of user auditors. Such an engagement may involve the performance, by the service auditor, of procedures agreed upon by the user entity and its user auditor and by the service organization and its service auditor. The findings resulting from the procedures performed by the service auditor are reviewed by the user auditor to determine whether they constitute sufficient appropriate audit evidence. In addition, there may be requirements imposed by governmental authorities or through contractual arrangements whereby a service auditor performs designated procedures that are substantive in nature. The results of the application of the required procedures to balances and transactions processed by the service organization may be used by user auditors as part of the evidence necessary to support their audit opinions. In these circumstances, it may be useful for the user auditor and the service auditor to agree upfront to the audit documentation or access to audit documentation that will be provided to the user auditor.

A33. In certain circumstances, in particular when a user entity outsources some or all of its finance function to a service organization, the user auditor may face a situation where a significant portion of the audit evidence resides at the service organization. This may require substantive procedures to be performed at the service organization by the user auditor or the service auditor on behalf of the user auditor. A service auditor may provide a Type B report and, in addition, may perform substantive procedures on behalf of the user auditor. As noted in paragraph A29, the involvement of a service auditor does not alter the user auditor's responsibility to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Accordingly, the user auditor's consideration of whether sufficient appropriate audit evidence has been obtained includes the user auditor's involvement with, or evidence of, the direction, supervision and performance of the substantive procedures performed by the service auditor and whether the user auditor needs to perform further substantive procedures.

Fraud, Illegal Acts and Uncorrected Misstatements in Relation to Activities at the Service Organization (Ref: Para. 18)

A34. A service organization is responsible for disclosing to affected user entities any fraud, illegal acts or uncorrected misstatements attributable to the service organization's management or employees that may affect one or more user entities. The user auditor evaluates whether any matters reported by the service organization affect the nature, timing and extent of the user auditor's further audit procedures. In certain circumstances, the user auditor may require additional information to perform this evaluation, and may consider contacting the service organization or the service auditor to obtain the necessary information.

Communications with Management and Those Charged with Governance (Ref: Para. 19)

A35. Other matters that the user auditor may wish to communicate to management and those charged with governance include:

- Any monitoring controls that could be implemented by the user entity, including those identified as a result of obtaining a Type A or Type B report;
- Instances where complementary user controls are noted in the Type A or Type B report and are not implemented at the user entity; and
- Controls that may be needed at the service organization that do not appear to have been implemented or that are not specifically covered by a Type B report.

Appendix

(Ref. Para. A1)

Types of Service Organizations

The following are examples of service organizations which perform services that are part of the user entity's information system relevant to financial reporting:

- *Trust departments of banks and insurance companies.* The trust department of a bank or an insurance company may provide a wide range of services to user entities such as employee benefit plans. This type of service organization could be given authority to make decisions about how a plan's assets are invested. It also may serve as custodian of the plan's assets, maintain records of each participant's account, allocate investment income to the participants based on a formula in the trust agreement, make distributions to the participants, and prepare filings for the plan.
- *Transfer agents, custodians, and record keepers for investment companies.* Transfer agents process purchases, sales, and other shareholder activity for investment companies. Custodians may be responsible for the receipt, delivery, and safekeeping of the company's portfolio securities; the receipt and disbursement of cash resulting from transactions in these securities; and the maintenance of records of the securities held for the investment company. The custodian also may perform other services for the investment company, such as collecting dividend and interest income and distributing that income to the investment company. Record keepers maintain the financial accounting records of the investment company based on information provided by the transfer agent and the custodian of the investment company's investments.
- *Insurers that maintain the accounting for ceded reinsurance.* Reinsurance is the assumption by one insurer (the assuming company) of all or part of the risk originally undertaken by another insurer (the ceding company). Generally, the ceding company retains responsibility for claims processing and is reimbursed by the assuming company for claims paid.
- *Mortgage servicers or depository institutions that service loans for others.* Investor organizations may purchase mortgage loans or participation interests in such loans from thrifts, banks, or mortgage companies. These loans become assets of the investor organizations, and the sellers continue to service the loans. Mortgage servicing activities generally include collecting mortgage payments from borrowers, conducting collection and foreclosure activities, maintaining escrow accounts for the payment of property taxes and insurance, paying taxing authorities and insurance companies as payments become due, remitting monies to investors (user entities), and reporting data concerning the mortgage to user entities.
- *Application service providers.* Application service providers generally provide packaged software applications and a technology environment that enable customers to process financial and operational transactions. An Application service provider may specialize in providing a particular software package solution to its users, may provide services similar

to traditional mainframe data center service bureaus, may perform business processes for user entities that they traditionally had performed themselves, or some combination of these services.

- *Internet service providers and Web hosting service providers.* Internet service providers enable user entities to connect to the Internet. Web hosting service providers generally develop, maintain, and operate Web sites for user entities. If the user entity is using the Internet or Web site to process transactions, the user entity's information system may be affected by certain controls maintained by the Internet service provider or Web hosting service provider, such as controls over the completeness and accuracy of the recording of transactions and controls over access to the system.
- *Third party financial shared service center.* A third party financial shared service center enables an entity to centralize finance and administrative operations and handling of financial processing activities to eliminate redundancies and create economies of scale. A third party financial shared service center operates as a stand alone business, treating individual units as customers.

Examples of service organizations whose activities are not necessarily as clearly linked with the financial statements of the user entities as those above include organizations that provide services such as:

- Human resource management;
- Research and development activities;
- Physical security;
- Library services;
- Waste disposal;
- Transport, logistics and supply chain management;
- Maintenance of assets, such as motor vehicles, buildings and gardens; and
- Non-governmental organizations that carry out specific activities on behalf of a federal government, such as international development agencies.