Explanatory Memorandum to the Exposure Draft

(Revised) Standard on Auditing (SA) 402[1]
Audit Considerations Relating to an Entity Using a Third Party Service Organisation

Background

The Institute of Chartered Accountants of India had in August 2002 issued the Auditing and Assurance Standard (AAS) 24, *Audit Considerations Relating to Entities Using Service Organisations.* The AAS 24 was effective for all audits relating to accounting periods beginning on or after 1st April, 2003. The Institute being a member of the International Federation of Accountants (IFAC), as a part of its membership obligations, the Institute, while formulating any Auditing and Assurance Standard is required to harmonise with the corresponding International Standards on Auditing, if any, issued by the International Auditing and Assurance Standards Board (IAASB) of the IFAC. The AAS 24 was, therefore, based on the corresponding Revised International Standard (ISA) 402 of the same name issued by the International Auditing and Assurance Standards Board (IAASB).

IAASB's Clarity Project

The IAASB, in December 2007, pursuant to its Clarity Project issued the Exposure Draft of the Revised and Redrafted ISA 402, ***Audit Considerations Relating to An Entity Using A Third Party Service Organisation.*** As a part of its Clarity Project, an International Standard on Auditing is now presented in a new format. As per the new format, the Standard is divided into two sections, one the Requirements part containing the fundamental principles of the Standard and second, the application guidance and appendices, detailing the implementation aspects of the principles. The IAASB is also revising and/ or redrafting all its existing International Standards on Auditing in line with the said presentation.

Attention of the readers is also drawn to, ***"A Guide for National Standard Setters that Adopt IAASB's International Standards but Find it Necessary to Make Limited Modifications***[2]*,* issued by IAASB in July, 2006.

ICAI's Response

The Council of the Institute, at its 267th meeting held in April, 2007 has also decided to adopt this approach for writing Standards. The Council, at the said meeting, also decided to rename, re-categorise and re-number the existing Auditing and Assurance Standards on the lines that followed by the IAASB. The details of this exercise are published elsewhere in the Journal. The readers are also requested to refer to the ***Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services***[3] published elsewhere in the Journal.

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[1] Hitherto known as Auditing and Assurance Standard (AAS) 24, *Audit Considerations Relating to Entities Using Service Organisations.*

[2] The full text of the Policy Position can be downloaded free of charge at http://www.ifac.org/IAASB/downloads/Modification_Policy_Position.pdf.

[3] The full text of the Preface can be downloaded free of charge at http://www.icai.org/icairoot/announcements/announ1050.pdf.

Highlights of the New Preface

I. Engagement Standards

The new Preface introduces the concept of Engagement Standards. The term "Engagement Standards" comprises the following Standards:

(a) ***Standards on Auditing (SAs)***, to be applied in the audit of historical financial information.

(b) ***Standards on Review Engagements (SREs)***, to be applied in the review of historical financial information.

(c) ***Standards on Assurance Engagements (SAEs)***, to be applied in assurance engagements, dealing with subject matters other than historical financial information.

(d) ***Standards on Related Services (SRSs)***, to be applied to engagements involving application of agreed upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

The new Preface therefore, does away with the terminology "***Auditing and Assurance Standards***" in use till date.

The ***Standards on Quality Control (SQCs)*** are to be applied to all services covered by the Engagement Standards.

II. Standards on Auditing

The Standards on Auditing (SAs) referred to in I. above are formulated in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

III. New Format of Presenting the Standards on Auditing

In line with the format adopted by the IAASB under its Clarity Project, the Standards on Auditing would now contain two distinct sections, one, the Requirements section and, two, the Application Guidance section.

Requirements

The fundamental principles of the Standard are contained in the Requirements and represented by use of "shall". Hitherto, the word, "should" was used in the Standards, for this purpose. Further, this format also does away with the need to present the principles laid down by the Standard in bold text.

Application & Other Explanatory Material

The application and other explanatory material contained in an SA is an integral part of the SA as it provides further explanation of, and guidance for carrying out, the requirements of an SA, along with the background information on the matters addressed in the SA. It may include examples of procedures, some of which the auditor may judge to be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement.

In view of this format of writing, the standard portion or principles enunciated in a Standard are no longer given in **bold face.**

The new presentation format has, however, not as yet being followed in drafting the Standards on Quality Control and other Standards.

The Preface also contains the principles as to when a Standard on Auditing would be inapplicable as also the reporting responsibilities of the members in case of non compliance with any of the Standards.

There is no change in the authority attached to the Standards, i.e., they are mandatory in nature, notwithstanding the new format of writing the Standards.

This Exposure Draft

This Exposure Draft of the Revised Standard on Auditing (SA) 402, ***Audit Considerations Relating to An Entity Using A Third Party Service Organisation*** is based on the corresponding above mentioned Exposure Draft of ISA 402 issued by the IAASB in December, 2007 and follows the same writing style.

The first, i.e., the Introduction and Requirements Section contains the principles. The second, i.e., the Application and Other Explanatory Material Section contains implementation guidance on the topics discussed in the Requirements Section. Cross-reference to the relevant paragraphs of the Application Material is built within the Requirements Section. The paragraphs in the Requirements Section have been numbered as 1 to 19 and the paragraphs in the Application and Other Explanatory Material are numbered as A1 to A36.

Topics Covered by Revised SA 402

The Standard covers the following main aspects:

- Scope of the Standard
- Objectives
- Definitions
- Requirements
  - Obtaining an understanding of the services provided by a service organisation
  - Assessing the risk of material misstatement
  - Using an assurance report from service auditor
  - Other audit evidence considerations regarding service organisations
  - Fraud, non-compliance with laws and regulations and uncorrected misstatement in relation to activities at the service organisation
- Application & other explanatory material
- Appendix

Highlights of SA 402

1. The Exposure Draft of SA 402 adopts a risk-based approach to the auditor's consideration of the nature and significance of the services rendered by the service organisation, their effect on entity's internal controls relevant to audit for identification, assessment and responding to risks of material misstatement. The Standard, therefore, links the process of obtaining and using an understanding of the service organisation to the principle laid down in SA 315 in this regard.

2. The proposed Standard introduces certain new terminology such as complementary user entity controls, service auditor, service organisation, sub-service organisation, user auditor. All these terms have been defined comprehensively in the Standard.

3. Unlike the existing Standard, which requires the auditor of the service organisation to give an opinion that the description of the controls as given in the Report is **accurate,** the Exposure Draft requires that auditor to express only a **reasonable assurance** on the description of those controls.

4. The Exposure Draft also explicitly prohibits reference to the work of the service auditor in the report of the auditor of the client (user auditor) except where required by any law/ regulation or such reference would provide better understanding of the auditor's opinion. In such cases, however, the user auditor should make a clear statement that this does not diminish his responsibility in any way.

5. The Exposure Draft also contains guidance for the user auditor in respect of situations where there are non compliance with laws and regulations and uncorrected misstatements in relation to activities of the service organisation.

6. The Exposure Draft contains comprehensive and detailed guidance on application of the principles laid down in the Standard such as considerations in use of Type A/ Type B reports, understanding controls at service organisation, sufficiency of auditor's understanding, assessing the risk of material misstatement, using the assurance report from service organisation's auditor, communication of deficiencies in internal controls identified during the audit, service auditor's professional reputation, competence and independence, other audit evidence, etc.

Your comments on the Exposure Draft should reach us by **DECEMBER 1, 2008**. *Comments are most helpful if they indicate the specific paragraph(s) to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.*

The comments should be sent to:

Secretary, Auditing and Assurance Standards Board
The Institute of Chartered Accountants of India
***ICAI Bhawan,* C-1, Sector-1,**
NOIDA,
Uttar Pradesh – 201 301.

Comments can also be emailed at: **aasb@icai.org**

EXPOSURE DRAFT

REVISED STANDARD ON AUDITING (SA) 402
AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A THIRD PARTY SERVICE ORGANIZATION[4]

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Proposed Standard on Auditing (SA) 402 (Revised), "Audit Considerations Relating to an Entity Using a Third Party Service Organization" should be read in conjunction with [proposed] SA 200 (Revised), "Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with Standards on Auditing[5]".

[4] Hitherto known as AAS 24, " Audit Considerations Relating to Entities Using Service Organisations".

[5] Presently, SA 200 (AAS 1), "Basic Principles Governing an Internal Audit" and SA 200A (AAS 2), "Objective and Scope of an Audit of Financial Statements" correspond to Proposed International Standard on Auditing (ISA) 200 (Revised and Redrafted). Both the SAs are currently being revised in the light of the Proposed ISA 200 (Revised and Redrafted). Post this revision, the principles covered by SA 200 and SA 200A will be merged into one Standard i.e., SA 200.

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the user auditor's responsibilities to obtain sufficient appropriate audit evidence when an entity uses one or more third party service organizations. Specifically, it expands on how the auditor applies SA 315[6] and SA 330[7] in identifying and assessing the risks of material misstatement and in designing and performing further audit procedures.

2. Many entities outsource aspects of their business to 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, within both information technology (IT) and manual systems, by which the entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

(c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the entity's financial statements that are used to initiate, record, process and report the entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;

(d) How the entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;

(e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and

(f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

4. The focus of this SA 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.

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[6] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

[7] SA 330, "The Auditor's Responses to Assessed Risks".

5. This SA does not apply to services provided by an organization, such as a financial institution, that are limited to processing an entity's transactions that are specifically authorized by the entity, such as the processing of bank transactions by a bank or the processing of securities transactions by a broker. In addition, this SA 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 SA is effective for audits of financial statements for periods beginning on or after _____[date].

Objective

7. The objective of the auditor, when the user entity uses a service organization, is to obtain an understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's internal control relevant to the audit sufficient to identify, assess and respond to the risks of material misstatement.

Definitions

8. For purposes of this SA, 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 user entities, and which, if necessary to achieve control objectives, are identified in the description of the system.

(b) ***Service auditor*** – An auditor who provides an assurance report on the controls of a service organization.

(c) ***Service organization*** – A third party organization (or segment of a third party organization) that provides services to user entities that are part of those entities' information system relevant to financial reporting.

(d) ***Sub-service organization*** – A service organization used by another service organization to perform some of the services provided to user entities that are part of those user entities' information system relevant to financial reporting.

(e) ***User auditor*** – An auditor who audits and reports on the financial statements of a user entity.

(f) ***User entity*** – An entity that uses a service organization and whose financial statements are being audited.

(g) ***Report on the description and design of controls at a service organization (referred to in this SA as a Type A report)*** – A report that comprises:

  (i) A description, prepared by management of the service organization, of the system, control objectives and related controls that have been designed and implemented as at a specified date; and

(ii) A report conveying reasonable assurance that includes the service auditor's opinion on the description of the system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.

(h) ***Report on the description, design, and operating effectiveness of controls at a service organization (referred to in this SA as a Type B report)*** – A report that comprises:

(i) A description, prepared by management of the service organization, of the system, control objectives and related controls, their design and implementation, and their operating effectiveness throughout a specified period; and

(ii) A report conveying reasonable assurance that includes:

a. The service auditor's opinion on the description of the system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; 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 SA 315 (Redrafted),[8] 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 the user entity's internal control; (Ref: Para. A1-A2)

(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; and (Ref: Para. A3-A4)

(c) The nature of the relationship between the user entity and the service organization, including the contractual terms for the relevant activities undertaken by the service organization. (Ref: Para. A5-A8)

10. When obtaining an understanding of internal control relevant to the audit in accordance with SA 315,[9] the user auditor shall evaluate the design and implementation of relevant controls at the user entity that 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)

11. The user auditor shall determine whether a sufficient understanding of the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material

[8] SA 315, paragraph 11.

[9] SA 315, paragraph 12.

misstatement. If the user auditor is unable to obtain that understanding from information on the service organization available at the user entity, the user auditor shall obtain audit evidence from one or more of the following procedures: (Ref: Para. A12-A16)

(a) Obtaining a Type A or Type B report;

(b) Contacting the service organization, through the user entity, 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.

Assessing the Risks of Material Misstatement

12. When the user auditor's risk assessment includes an expectation that controls at the service organization 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: (Ref: Para. A17)

(a) Obtaining a Type B report;

(b) Requesting the service auditor to perform tests of controls at the service organization on behalf of the user auditor; or

(c) Performing appropriate tests of controls at the service organization.

Using an Assurance Report from a Service Auditor

13. If the user auditor plans to use a Type A or Type B report as audit evidence about the design and implementation of controls at the service organization, the user auditor shall: (Ref: Para. A18-A19)

(a) Evaluate whether the description of controls at the service organization is at a date or for a period that is appropriate for the user auditor's purposes;

(b) Evaluate the sufficiency and appropriateness of the evidence provided for the understanding of internal control relevant to the audit; and

(c) 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.

14. If the user auditor plans to use a Type B report as audit evidence that controls at the service organization are operating effectively, the user auditor shall: (Ref: Para. A20-A28)

(a) Evaluate whether the description of controls at the service organization is at a date or for a period that is appropriate for the user auditor's purposes;

(b) Evaluate the sufficiency and appropriateness of the evidence provided about the effectiveness of controls for the relevant assertions;

(c) 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;

(d) Evaluate the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and

(e) 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 assessment.

15. In determining the sufficiency and appropriateness of the audit evidence provided by a Type A or Type B report in support of the user auditor's opinion, the user auditor shall be satisfied as to the service auditor's professional reputation, competence and independence where such service auditor is not a member of the Institute of Chartered Accountants of India .(Ref: Para. A29)

16. The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion. (Ref: Para. A30)

17. If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion. (Ref: Para. A31)

Other Audit Evidence Considerations Regarding Service Organizations

18. In responding to assessed risks in accordance with SA 330 , the user auditor shall: (Ref: Para. A32-A35)

(a) Determine 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.

Fraud, Non-Compliance with Laws and Regulations and Uncorrected Misstatements in Relation to Activities at the Service Organization

19. The user auditor shall inquire of management of the user entity whether the service organization has reported to the user entity any fraud, non-compliance with laws and regulations or uncorrected misstatements 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. A36)

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Application and Other Explanatory Material

Obtaining an Understanding of the Services Provided by a Service Organization

Nature of the Services Provided by the Service Organization (Ref: Para. 9(a))

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 SA provides examples of some types of service organizations.

A2. Examples of service organization services that are relevant to the audit include:

- Maintenance of the user entity's accounting records.
- Management of assets.
- Initiating, recording or processing transactions as agent of the user entity.

Nature and Materiality of Transactions Processed by the Service Organization and the Degree of Interaction (Ref: Para. 9(b))

A3. 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 be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.

A4. 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. In these circumstances, it may be practicable for the user entity to implement effective controls over 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. In these circumstances, the user entity may be unable to, or may elect not to, implement effective controls over these transactions.

Nature of the Relationship between the User Entity and the Service Organization (Ref: Para. 9(c))

A5. The contract or service level agreement between the user entity and the service organization may provide for matters such as:

- The information to be provided to the user entity and responsibilities for initiating transactions relating to the activities undertaken by the service organization;
- The application of requirements of regulatory bodies concerning the form of records to be maintained, or access to them;
- The indemnification, if any, to be provided to the user entity in the event of a performance failure;
- 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 service organization and other information necessary for the conduct of the audit.

A6. 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. A direct relationship may also 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 procedures on the user auditor's behalf, such as:

(a) Tests of controls at the service organization; or

(b) Substantive procedures on the user entity's financial statement transactions and balances maintained by a service organization.

A7. In case of certain entities, such as national, local or regional governments, auditors may 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, the 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.

A8. The user auditors, in case of entities covered by paragraph A7 above, may also request a service auditor to perform tests of controls or substantive procedures in relation to compliance with legislation or proper authority.

Understanding the Controls Relating to Services Provided by the Service Organization (Ref: Para.10)

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 sub-service organization to perform some of the services provided to a user entity that are part of the user entity's information system as it relates to an audit of the financial statements. The sub-service 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 sub-service organization. In situations where one or more sub-service 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 sub-service organizations. The degree of this interaction, as well as the nature and materiality of the transactions processed by the service organization and the sub-service organizations are the most important factors for the user auditor to consider in determining the significance of the service organization's and sub-service organization's controls to the user entity's controls.

A11. As noted in SA 315,[10] 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. Such automated processing characteristics may be particularly present when the user entity uses service organizations. In

[10] SA 315, paragraph 29.

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 SA.

Sufficiency of the User Auditor's Understanding (Ref: Para. 11)

A12. 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;
- Reports by service organizations, internal auditors or regulatory authorities on controls at the service organization; and
- Reports by the service auditor, including management letters, if available.

A13. Knowledge obtained through the user auditor's 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 controls at the service organization over those services are highly standardized.

A14. A service organization may engage a service auditor to report on the description and design of its controls (Type A report) or on the description and design of its controls and their operating effectiveness (Type B report). Type A and Type B reports are typically reports issued under [proposed] Standard for Assurance Engagements (SAE) 3402[11].

A15. 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.

A16. If the user auditor is unable to obtain an understanding of the user entity's internal control relevant to the audit by performing the procedures required by paragraphs 9-11 of this SA, the auditor is required to modify the opinion in the auditor's report.[12]

[11] [Proposed] SAE 3402, "Assurance Reports on Controls at a Third Party Service Organization".

[12] [Proposed] SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph [9].

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

A17. 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 provide a Type B report that includes tests of the operating effectiveness of the relevant controls or to perform 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.

Using an Assurance Report from a Service Auditor

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 controls at the service organization that may affect the processing of the user entity's transactions, including the use of sub-service 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; and

(d) Whether controls at the service organization are suitably designed to prevent or detect processing errors that could result in material misstatements in the user entity's financial statements. 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, does not provide any evidence of the operating effectiveness of the relevant controls.

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; or
- Discussing the changes with service organization personnel.

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 are 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 tests that were performed, 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. In comparing the period covered by the Type B report to the user entity's financial reporting period, the auditor may conclude that the Type B report offers less audit evidence if 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. When this is the case, a Type B report covering a preceding or subsequent period may provide additional audit evidence.

A22. It may also 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 outside of the period covered by the service auditor's report may 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; and
- The effectiveness of the control environment and monitoring controls at the user organization.

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, for example, if a service auditor's report does not contain a description of the service auditor's tests of controls and results thereon, the user auditor may supplement the understanding of the service auditor's procedures and conclusions by contacting the service organization, through the user entity, to request 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 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 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. In considering the exceptions and matters giving rise to a modified opinion, the user auditor may wish to discuss such matters with the service auditor. Such communication is dependent upon the user entity contacting the service organization, and obtaining the service organization's approval for the communication to take place.

Communication of Deficiencies in Internal Control Identified during the Audit

A28. The user auditor is required to communicate all deficiencies in internal control identified during the audit on a timely basis to management at an appropriate level of[13] responsibility and is required to communicate all significant deficiencies with those charged with governance (unless all of those charged with governance are involved in managing the entity).[14] Matters that the user auditor may identify during the audit and may wish to communicate to management and those charged with governance of the user entity 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.

The Service Auditor's Professional Reputation, Competence and Independence (Ref: Para. 15)

A29. In case the service auditor is not a member of the Institute of Chartered Accountants of India, the user auditor may inquire as to the professional reputation and standing of the service auditor from the auditor's professional organization or other practitioners and inquire whether the service auditor is subject to regulatory oversight. 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.

Reference to the Work of a Service Auditor (Ref: Para. 16-17)

A30. In some cases, law or regulation may require a reference to the work of a service auditor in the user auditor's report, for example, for the purposes of transparency in the public sector. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.

A31. The fact that a user entity uses a service organization does not alter the user auditor's responsibility under SAs to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Therefore, 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. 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. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.

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[13] The Exposure Draft of SA 265, "Communicating Deficiencies in Internal Control", has been published in the August, 2008 issue of the Journal. Refer paragraph [9].

[14] SA 265, paragraphs [9-10]. Refer footnote 13.

Other Audit Evidence Considerations Regarding Service Organizations (Ref: Para. 18)

A32. When the service organization maintains material elements of the accounting records of the user entity, direct access to those records may be necessary in order for the user auditor 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 to the user entity's records maintained by the service organization.

A33. 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 following procedures may be considered by the user auditor:

(a) Inspecting records and documents held by the user entity: the reliability 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 independent detailed records or documentation of specific transactions undertaken on its behalf.

(b) 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.

(c) Obtaining confirmations of balances and transactions from the service organization: where the user entity maintains independent records of balances and transactions and a service organization processes transactions only at the specific authorization of the user entity or acts only 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.

(d) Performing analytical procedures on the records maintained by the user entity or on the reports 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.

(e) Requesting the service auditor to perform further audit procedures on the user auditor's behalf at the service organization.

A34. 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, prior to the performance of the procedures, to the audit documentation or access to audit documentation that will be provided to the user auditor.

A35. 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. Substantive procedures may need 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 A31, 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 and whether the user auditor needs to perform further substantive procedures includes the user auditor's involvement with, or evidence of, the direction, supervision and performance of the substantive procedures performed by the service auditor.

Fraud, Non-Compliance with Laws and Regulations and Uncorrected Misstatements in Relation to Activities at the Service Organization (Ref: Para. 19)

A36. A service organization may be required under the terms of the contract with user entities to disclose to affected user entities any fraud, non-compliance with laws and regulations or uncorrected misstatements attributable to the service organization's management or employees. As required by paragraph 19, the user auditor makes inquiries of the user entity management regarding whether the service organization has reported any such matters and 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.

Material Modifications to ISA 402, "Audit Considerations Relating to an Entity Using a Third Party Service Organization"

Deletions

1. Paragraph A7 of the Application Section of ISA 402 deals with the application of the requirements of ISA 402 to the audits of public sector entities regarding broad rights of access available to the public sector auditor. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the auditor may have broad rights of access established by legislation. Accordingly, the spirit of erstwhile A7, highlighting the fact that in case of certain entities, the auditors may have broad rights of access, has been retained.

Additions

1. Paragraph 15 of the Requirements Section of ISA 402 dealing with determining the sufficiency and appropriateness of the audit evidence provided by a Type A or Type B report in support of the user auditor's opinion, mentions that "the user auditor shall be satisfied as to the service auditor's professional reputation, competence and independence". The SA 402 has retained this concept subject to the condition that it applies "where such service auditor is not a member of the Institute of Chartered Accountants of India".

2. Paragraph A29 of the Application Section of ISA 402 dealing with The Service Auditor's Professional Reputation, Competence and Independence mentions that the user auditor may inquire as to the professional reputation and standing of the service auditor from the auditor's professional organization or other practitioners and inquire whether the service auditor is subject to regulatory oversight. The SA 402 has retained this concept subject to the condition that it applies "In case the service auditor is not a member of the Institute of Chartered Accountants of India".

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 re-insurance.* Re-insurance 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.