

IAASB CAG PAPER



International Federation of Accountants

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

Agenda Item

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Committee: IAASB Consultative Advisory Group

Meeting Location: Paris

Meeting Date: May 11-12, 2006

Project Proposals—Service Organizations

Objectives of Agenda Item

To consider the scope of the proposed projects to revise International Standard on Auditing (ISA) 402, *Audit Considerations Relating to Entities Using Service Organizations* and develop a new International Standard on Assurance Engagements¹ (ISAE) 3402, *Assurance Report on Service Organization's Controls*, as well as major problems and key issues to be addressed as part of these projects. The IAASB approved the project proposals in March 2006. Two Task Forces have been appointed to commence work on the projects.

Proposal to Revise ISA 402

PROJECT SCOPE

This project will focus on the auditor's considerations when the entity being audited uses a service organization.

KEY ISSUES

Applying the Audit Risk Standards

Since ISA 402 was issued in 1994, the use of service organizations has advanced considerably. Many entities' internal control has changed as a result of outsourcing, creating complex structures and resulting in possibly higher control risk in the process. The audit risk standards require the auditor to obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risk of material misstatement and design audit procedures to respond to the assessed risks. When an entity uses a service organization, the auditor of the entity (entity auditor) has to obtain an understanding of the outsourcing relationship and of the service organization's effect on the entity's internal control, in order to identify and assess related risks of material misstatement of the entity's financial statements. Although extant ISA 402 provides guidance in this respect, the increased importance of the relationship between the entity and its service organization, and the entity auditor and the auditor of the service organization (service

¹ According to the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," International Standards on Auditing (ISAs) are to be applied in the audit of historical financial information and International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements dealing with subject matters other than historical financial information.

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auditor) should be acknowledged, and additional requirements and guidance developed to enhance existing practice and consistent application of the audit risk standards.

Evaluation of the Service Auditor and the Service Auditor's Work and Report

Extant ISA 402 requires the entity auditor to assess the usefulness and appropriateness of reports issued by the service auditor. In addition, when the entity auditor uses the report of the service auditor, the entity auditor is required to consider making inquiries about the service auditor's professional competence. Due to the advancement of outsourcing, and the increased importance of the service auditor's work and report in the context of the audit of the entity's financial statements, the existing requirements and guidance may have to be expanded to provide for:

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

Communication and Reporting Considerations

Extant ISA 402 currently describes two types of service auditor's report: a report that deals with the "design and implementation of the service organization's internal control," and a report that deals with the "design, implementation and operating effectiveness of the service organization's internal control." The types of service auditor's report and related requirements and guidance will be considered as part of the project to develop ISAE 3402.

Proposal to Develop ISAE 3402

PROJECT SCOPE

This project includes the development of an International Standard on Assurance Engagement (ISAE) to specify the requirements and provide guidance on the service auditor's responsibilities in performing an engagement to obtain assurance on the service organization's controls that may be relevant to entities that use the service organization, and the form and content of the service auditor's report. This project is linked to the revision of extant ISA 402 to ensure the proper alignment of the two standards.

KEY ISSUES

Obtaining an Understanding of the Service Organization's Controls relevant to User Organizations

The service auditor has to obtain an understanding of the services provided by a service organization to an entity using the service organization and of the service organization's controls that may be relevant to such entity's internal control, and identify and assess related weaknesses. Extant ISA 402 provides some guidance in this respect from the perspective of the entity auditor. However, the increased importance of service organizations and of the relationship between the

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entity auditor and the service auditor requires additional requirements and guidance to enhance existing practice and consistent application of the audit risk standards.

Communication and Reporting Considerations

It is proposed that the usefulness of the types of service auditor's report described in extant ISA 402 be assessed to determine whether they are relevant for current practice. The project will also address the level of assurance to be provided by the service auditor.

Action Required

CAG members are asked to consider the project scope and major problems and key issues to be addressed as part of these projects, and to note any additional matters that may need to be considered by the Task Forces.