



**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](http://www.ifac.org)

## Agenda Item



**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** Washington

**Meeting Date:** September 9–11, 2009

### **Controls at a Service Organization—Key Issues**

#### **Objective of Agenda Item**

1. The objective of this Agenda Item is to obtain the Representatives' views on a number of key issues relating to draft ISAE 3402,<sup>1</sup> which the IAASB will consider for approval as a final standard at its September 2009 meeting.

#### **Background**

2. The IAASB commenced this project in 2006 concurrently with a project to revise extant ISA 402.<sup>2</sup> ISA 402 deals with the auditor's responsibility to obtain sufficient appropriate audit evidence when the entity being audited uses the services of a service organization. This proposed ISAE deals with engagements to provide users of a service organization's services, and their auditors, with an assurance report on the controls at the service organization. ISAE 3402 is intended to complement ISA 402, in that reports prepared in accordance with proposed ISAE 3402 will be capable of providing appropriate evidence under ISA 402. ISA 402 was approved by the IAASB in December 2008.<sup>3</sup>
3. An Exposure Draft of proposed ISAE 3402 (ED-ISAE 3402) was issued in December 2007, with a response date of May 31, 2008. Forty-seven responses were received, distributed as follows. A list of all respondents is included in Appendix to this Paper.<sup>4</sup>
  - 21 Professional Accounting Bodies
  - 3 National Auditing Standard Setters
  - 5 Service Organizations
  - 6 Public Sector Organizations
  - 2 Regulators and Oversight Authorities

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<sup>1</sup> International Standard on Assurance Engagements (ISAE) 3402, "Assurance Reports on Controls at a Service Organization."

<sup>2</sup> ISA 402, "Audit Considerations Relating to an Entity Using a Service Organization."

<sup>3</sup> ISA 402 was considered at the September 2008 CAG meeting – Refer Agenda Item 8 at <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0132&ViewCat=0975>.

<sup>4</sup> ED-ISAE 3402 and copies of respondent's letters are available at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0099>.

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- 7      Audit Firms
- 3      Individuals and Others
- 4. At the September 2008 CAG meeting, a paper providing a preliminary analysis of key issues arising on exposure was distributed, and Ms Esdon gave a brief overview of the project at that time. However, since the IAASB had not yet reviewed respondents' comments, the project was not discussed in detail. Therefore, some of the issues included in this paper are the same as those included in the paper for, but not discussed at, the September 2008 CAG.
- 5. The IAASB considered key issues arising on exposure at its December 2008 meeting. At that meeting, it was noted that over the past few decades, in the absence of an IAASB pronouncement, SAS 70,<sup>5</sup> developed by the AICPA's Auditing Standards Board (ASB), had been accepted in many jurisdictions as the de facto international standard, and that the ASB had just issued an Exposure Draft of a revised SAS 70 in November 2008. The IAASB therefore decided to defer further consideration of ED-ISAIE 3402 until June 2009 to allow the Task Force to liaise with the AICPA Task Force in an effort to harmonize the two standards to the extent possible.
- 6. The Task Force held a successful joint meeting with the ASB Task Force in March 2009, and has continued to liaise since that time. There are now few differences of any substance between the draft ASB standard and the draft ISAE.
- 7. The IAASB considered a first draft of a revised ISAE at its June 2009 meeting, and will consider whether to issue an amended version as a final ISAE at its September 2009 meeting.

#### Matters for CAG Consideration

- 8. Given the unusual pattern of events described above and the consequent time lag, the primary issues on which the Task Force is seeking Representatives' comments were initially discussed by the IAASB at their December 2008 meeting, as outlined at **Agenda Item 7-A of the December 2008 IAASB meeting**.
- 9. Nonetheless, the Task Force welcomes Representatives' comments on any matters arising from their consideration of Agenda Item 2 of the June 2009 IAASB meeting material, or Agenda Item 1 of the September 2009 IAASB meeting material. Where matters included in those later papers are relevant to the issues discussed below, the information below reflects that later discussion, and where a paragraph number of the draft ISAE is referred to, it is a reference to the most recent draft of the final ISAE at **Agenda Item 9-B of the September 2009 IAASB meeting**.
- 10. The Task Force is particularly interested to obtain Representatives' feedback on the questions set out below.

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<sup>5</sup> Statement of Auditing Standards 70, "Reports on the Processing of Transactions by Service Organizations."

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##### A. Assertion-based Engagements

**(See Issue A in Agenda Item 7-A of the December 2008 IAASB meeting)**

- 1) The IAASB requested views on the proposal that the ISAE be written for application to assertion-based engagements, i.e., where management of the service organization confirms, in a statement made available to intended users that accompanies the description of the system, that the description of the system is fairly presented, the controls are suitably designed and, in the case of a type 2 report<sup>6</sup> (previously known as a Type B report), the controls have operated effectively. In particular, the IAASB asked whether there are situations in which it would not be possible or practicable for management of a service organization to provide an assertion.
- 2) Forty-two respondents commented on this proposal:
  - (a) Thirty-six<sup>7</sup> respondents supported the proposal. Some of those made additional suggestions or comments, including:
    - (i) The ISAE should include an expectation that management has a sound basis for the assertion it makes. The question of whether management, when making its assertion, is entitled to rely on the work undertaken by the service auditor was also raised. These matters have now been addressed in the draft **(See paragraph A9 of Agenda Item 9-B of the September 2009 IAASB meeting)**
    - (ii) One respondent (APB) expressed concern that some of the proposals in ED-ISA 3402 may not be practicable. That respondent felt strongly that the ISAE should not be finalized without the support of representatives of management confirming that the proposals are practicable, which may require testing to establish whether this is the case. The IAASB has discussed this issue and is satisfied with the level and nature of consultation, nonetheless, this matter may be discussed at the September 2009 IAASB meeting.
    - (iii) The ISAE should make it clear whether direct reporting engagements: (a) should not be undertaken at all; (b) should only be undertaken in certain circumstances (e.g., when required by law or regulation); or (c) may be undertaken at the auditor's discretion (and if undertaken, what Standard applies). The IAASB has decided to allow some flexibility for direct reporting under ISA 3000 in unusual circumstances, for example, when required by law or regulation, or when the intended user of the assurance report is someone other than user entities and their auditors. The IAASB noted that the market would provide a natural mechanism to prevent inappropriate use of ISA 3000 for reporting on controls at a service

<sup>6</sup> A type 2 report is a report on the on the description, design and operating effectiveness of controls at a service organization; as opposed to a type 1 report, which covers only the description and design of such controls.

<sup>7</sup> AICPA, AIA, CSCPA, CICA, CIPFA, CNCC-CSOEC, DnR, FEE, FICPA, HKICPA, IdW, ICPAS, ICAEW, ICAIre, ICAP, JICPA, NIVRA, SAICA, AUASB, APB, IRBA, Mn Serv, AGA, ACAG, OAGC, GAO, NAO, PA Sask, BDO, DTT, EYG, GTI, KPMG, PwC, ISACA, VanRanst.

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organization because such reports would be unlikely to be treated with the same credibility as an ISAE 3402 report in the absence of unusual circumstances to justify such an approach.

- (b) Six respondents did not support the proposal.
  - (i) Three respondents<sup>8</sup> were IFAC member bodies. The main reason offered was that it may discourage use of ISAE 3402 in certain jurisdictions, particularly the US, where assertion-based engagements are not prevalent. The IAASB considers that with the US developing a new standard that is consistent with the IAASB standard, this will no longer be an issue.
  - (ii) The other three respondents<sup>9</sup> who did not support the proposal were service organizations. The ED was sent to 37 service organizations identified by IAASB members, firms and member bodies around the world, 5 of which responded. One of the 5 supported the proposal, one did not comment on it, and 3 did not support the proposal. Of those 3, two are very large global service organizations (Hewlett Packard and IBM). The IAASB has noted that the main reasons provided focused primarily on *one-to-one* situations in which the user entity designs the system, which is operated for it by the service organization. ISAE 3402, on the other hand, is aimed at *one-to-many* situations, in which the service organization is responsible for the design and operation of the system. This distinction is now more clearly articulated in the ISAE **(See paragraph 2 of Agenda Item 9-B of the September 2009 IAASB meeting)**

#### B. Suitable Criteria

**(See Issue B in Agenda Item 7-A of the December 2008 IAASB meeting)**

- 3) ED-ISAE 3402 identified the minimum elements of suitable criteria. Thirty-eight respondents commented on this matter:
  - (a) Twenty-nine respondents<sup>10</sup> supported the minimum elements; either as stated, or with some changes to improve the wording, including four respondents<sup>11</sup> who thought that the criteria for evaluating whether the description of the system is fairly presented should be more explicit about the completeness of the control objectives identified in the description. The question of completeness of control objectives was discussed extensively prior to exposure. In essence, the concept of completeness is only meaningful when it is tied to a specific circumstance. As neither the service organization nor the service auditor can be sure of the exact circumstances in which the description of the system will be used

<sup>8</sup> ACCA, FSR, NZICA.

<sup>9</sup> HP, IBM, Robeco.

<sup>10</sup> AICPA, ACCA, AIA, CICA, CIPFA, CNCC-CSOEC, DnR, FICPA, FSR, HKICPA, IdW, ICPAS, ICAP, JICPA, NIVRA, KICPA, NZICA, AGA, ACAG, OAGC, NAO, PA Sask, BDO, EYG, GTI, ISACA, VanRanst.

<sup>11</sup> CICA, IdW, BDO, VanRanst.

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by any particular user entity or user auditor in a one-to-many situation (e.g., they will not know what other controls are in place at the user entity), the criteria cannot be absolute about the completeness of control objectives. This has now been made clearer in the ISAE *(See paragraph A23 (3<sup>rd</sup> dot point) of Agenda Item 9-B of the September 2009 IAASB meeting)*

- (b) The remaining nine respondents<sup>12</sup> offered a range of comments and specific suggestions for changes – a number of which have been adopted

#### C. Disclosure of Sample Sizes

*(See Issue C in Agenda Item 7-A of the December 2008 IAASB meeting)*

- 4) The IAASB requested views on whether the description of tests of controls included in a type 2 report should include the disclosure of sample sizes only when a deviation from controls is found. This is the approach followed in ED-ISA 3402, and is consistent with current practice in most jurisdictions. The rationale for this approach, as noted in the explanatory memorandum accompanying ED-ISA 3402, is as follows:

The IAASB concluded that disclosure of sample sizes may not provide, on its own, sufficient information to the intended users to understand the judgments made by the service auditor in their determination; therefore, there might be a risk that intended users may misinterpret the significance of different sample sizes as they relate to user entities. The IAASB concluded, on the other hand, that disclosure of sample size when a deviation from controls is found provides intended users with relevant information as to the rate of deviation encountered in the sample. This information assists user auditors in the performance of their risk assessments.

- 5) Thirty-seven respondents commented on this proposal:

- (a) Twenty-six respondents<sup>13</sup> supported disclosure of sample sizes only when a deviation from controls is found.
- (b) Ten respondents<sup>14</sup> queried or disagreed with the IAASB's rationale for differentiating between cases when deviations are found and cases when they are not, as articulated in the explanatory memorandum.
- (c) One respondent<sup>15</sup> believes that a type 2 report need not describe the tests of controls undertaken by the service auditor, and therefore need not include disclosure of sample sizes whether or not deviations are found.

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<sup>12</sup> ICAEW, FEE, HP, AUASB, APB, IRBA, DTT, KPMG, PwC.

<sup>13</sup> AICPA, CICA, CIPFA, CNCC-CSOEC, FEE, FSR, HKICPA, ICPAS, ICAEW, ICAIre, JICPA, AUASB, IRBA, AGA, ACAG, OAGC, GAO, NAO, PA Sask, Basel, DTT, EYG, GTI, PwC, ISACA, VanRanst.

<sup>14</sup> DnR, FICPA, ICAP, IdW, KICPA, SAICA, KPMG, NIVRA, NZICA, APB.

<sup>15</sup> ACCA.

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- 6) The IAASB decided that user auditors need to have information about the nature of the tests of controls the service auditor has performed to be able to make appropriate linkages with their own work at the user entity and thus have sufficient confidence that the tests performed fulfill their own responsibilities under ISA 402. However, user auditors do not need to be informed of either the sample size or the details of all the factors the service auditor considered in determining the extent of testing. In part, detailing such factors in a meaningful way that avoids boilerplate disclosures would be unnecessarily burdensome (not only for the service auditor as author, but also for user entities and user auditors as readers). Also, determining the extent of testing is rightly a matter of professional judgment by the service auditor upon which the user auditor is entitled to rely. Information about the extent of testing is needed however when deviations are found, because knowledge of the sample size provides user auditors with relevant information as to the rate of deviation, which assists them in performing their risk assessments under ISA 402.

#### D. Restrictions on Use or Distribution of the Service Auditor's Report

**(See Issue G in Agenda Item 7-A of the December 2008 IAASB meeting)**

- 7) ED-ISA 3402 included a proposed reporting requirement to identify “the purpose(s) and intended users of the service auditor’s assurance report.”
- 8) Seven respondents commented on this matter. Three respondents<sup>16</sup> recommended that the ISAE explicitly require restriction of the assurance report.
- 9) Two respondents<sup>17</sup> argued for a more flexible, principles-based approach, noting that it is not always appropriate to restrict the service auditor’s report. For example, one respondent (PwC) “strongly encouraged the IAASB to at least acknowledge in the ISAE that it is a wide-spread reporting practice in jurisdictions where allowed by relevant law or regulation ... to insert additional wording (in the service auditor’s report) to reflect any liability arrangements agreed between the service auditor, the service organisation and other users, including confirmation of the purpose for which the service auditor’s report has been prepared and the basis on which other parties may use the report.” This respondent noted that this is “clearly in the public interest as (such wording) guards against the possibility of unwarranted reliance on the report by prospective users of it.”
- 10) A service organization (HP) noted: “The issue arises with potential clients of a service organization. As part of their due diligence activities (prior to signing a contract), such potential clients often require evidence of controls. The evidence typically requested is a current 3rd party assurance report (SAS 70, Section 5970, etc.) covering the site / service of interest. Caveats are typically issued during such sharing such that the potential client is aware that the report would be for “information purposes only”, would offer no guarantees to future compliance, and could not be used for audit or controls reliance. If this standard, in

<sup>16</sup> NAO, NZICA, KPMG.

<sup>17</sup> FEE, NIVRA.

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*conjunction with ISAE 3000, absolutely prohibits the sharing of reports with potential clients, what mechanism would be available to provide such assurance? Workarounds would end up arising, such as requests to firms to issue confirmation letters, which could end up defeating the purpose of these restrictions.”*

- 11) The IAASB is of the view that the assurance report will only be useful to those who have a sound understanding of the *subject matter*, i.e., the service organization’s system, and how it has been used. The draft therefore requires the assurance report to include a “statement that the report and, in the case of a type 2 report, the description of tests of controls are intended only for user entities and their auditors, who have a sufficient understanding to consider it, along with other information including information about controls operated by user entities themselves, when assessing the risks of material misstatements of user entities’ financial statements.” **(See paragraph 53(e) of Agenda Item 9-B of the September 2009 IAASB meeting)**
- 12) A further issue is what does it mean to “restrict” the assurance report. In particular, does including a statement of “Intended Users and Purpose,” such as that in the paragraph above, constitute a restriction? Or is it necessary for the assurance report to go further than this and specifically state that it is not to be distributed to or used by anyone other than the intended users or used for any other purpose? The IAASB considers it to be unnecessary in the case of ISAE 3402 to require the assurance report to specifically state that it is not to be distributed to or used by others or used for other purposes.

#### *E. Specimen Control Objectives*

- 13) The explanatory memorandum noted that the IAASB had discussed whether to include specimen control objectives in an appendix to the proposed ISAE. The IAASB took the view that any benefit of providing specimen objectives would be outweighed by the risk that they may be inappropriately used on engagements when objectives specific to the services provided by the service organization should be used.
- 14) Seven respondents<sup>18</sup> noted that it would be helpful for the ISAE to: include specimen control objectives like those in certain national publications on service organization engagements (APB, GTI, ISACA); refer to externally developed objectives such as the IT Governance Institute’s publication *IT Control Objectives for Sarbanes-Oxley* (FSR, KPMG, APB, ISACA); or establish a mechanism for national bodies who develop specimen objectives to share them (ICAEW). These respondents believe that accessible specimen control objectives could be an important step in helping to ensure consistent application of ISAE 3402 in practice.
- 15) The IAASB considers that the ISAE stands apart from the specific control objectives used by service organizations, and that it is not the role of the IAASB to prepare, refer to, or endorse any specific objectives. It acknowledges, however, that some IFAC member bodies, national standard setters (NSS) and others, such as ISACA, develop specimen control objectives, the

<sup>18</sup> FEE, FSR, GTI, ICAEW, APB, KPMG, ISACA.

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use of which could lead to more consistent application of ISAE 3402 in practice, and will consult with the NSS to determine whether there is potential for collaboration between NSS and others to develop international implementation guidance that includes specimen control objectives.

#### **Material Presented – FOR IAASB CAG REFERENCE PURPOSES ONLY**

Agenda Item 7-A of the December 2008  
IAASB Meeting – Service Organizations –  
ISAE 3402 – Significant Issues

<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4376>

Agenda Item 9-B of the September 2009  
IAASB Meeting – Service Organizations –  
Draft ISAE 3402

<http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0168&ViewCat=1157>

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## APPENDIX

### List of Respondents

#### Professional Accounting Bodies

AICPA	American Institute of Certified Public Accountants
ACCA	Association of Chartered Certified Accountants
AIA	The Association of International Accountants
CSCPA	California Society of Certified Public Accountants
CICA	The Canadian Institute of Chartered Accountants
CIPFA	Chartered Institute of Public Finance and Accountancy
CNCC-CSOEC	Compagnie Nationale des Commissaires aux Comptes & Conseil Supérieur de l'Ordre des Experts-Comptables
DnR	Den norske Revisorforening
FEE	Federation des Experts Comptables Europeens
FICPA	Florida Institute of Certified Public Accountants
FSR	Foreningen af Statsautoriserede Revisorer (Denmark)
HKICPA	Hong Kong Institute of Certified Public Accountants
IdW	Institut der Wirtschaftsprüfer
ICPAS	Institute of Certified Public Accountants of Singapore
ICAEW	The Institute of Chartered Accountants in England and Wales
ICAIre	The Institute of Chartered Accountants in Ireland
ICAP	Institute of Chartered Accountants of Pakistan
JICPA	The Japanese Institute of Certified Public Accountants
NIVRA	Koninklijk Nederlands Instituut van Registeraccountants
KICPA	Korean Institute of Certified Public Accountants
NZICA	New Zealand Institute of Chartered Accountants
SAICA	The South African Institute of Chartered Accountants

#### Independent National Auditing Standard Setters

AUASB	Auditing and Assurance Standards Board (Australia)
APB	Auditing Practices Board (UK)
IRBA	Independent Regulatory Board for Auditors (South Africa)

#### Service Organizations

Atos	Atos Origin
IBM	IBM Global Services
HP	Hewlett-Packard
Mn Serv	Mn Services
Robeco	Robeco

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##### Public Sector Organizations

AGA	Association of Government Accountants
ACAG	Australasian Council of Auditors-General
OAGC	Office of the Auditor General of Canada
GAO	General Accounting Office (US)
NAO	National Audit Office (UK)
PA Sask	Provincial Auditor Saskatchewan

##### Regulators and Oversight Authorities

Basel	Basel Committee on Banking Supervision
IOSCO	International Organization of Securities Commissions

##### Audit Firms

BDO	BDO Global Coordination B.V.
DTT	Deloitte Touche Tohmatsu
EYG	Ernst & Young Global
GTI	Grant Thornton International
KPMG	KPMG
PwC	PricewaterhouseCoopers

##### Individuals and Others

ISACA	Information Security and Control Association
Maresca	Joseph Maresca
VanRanst	Al Van Ranst