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Proposed statement on auditing standards: audit considerations relating to an entity using a service organization (redrafted); Exposure draft (American Institute of Certified Public Accountants), 2008, November 17

American Institute of Certified Public Accountants. Auditing Standards Board

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EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANIZATION (REDRAFTED)

(To supersede Statement on Auditing Standards No. 70, Service Organizations [AICPA, Professional Standards, vol. 1, AU sec. 324])

November 17, 2008

Comments are requested by February 17, 2009.

Prepared by the AICPA Auditing Standards Board for comment from persons interested in auditing and reporting issues.

Comments should be addressed to Sharon Macey at smacey@aicpa.org,
or Audit and Attest Standards, AICPA, 1211 Avenue of the Americas,
New York, NY 10036-8775

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EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background for the proposed Statement on Auditing Standards (SAS) *Audit Considerations Relating to an Entity Using a Service Organization* (Redrafted). This proposed SAS would supersede Statement on Auditing Standards No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), which contains guidance for auditors auditing the financial statements of entities that use a service organization (user auditors) and for auditors reporting on controls at a service organization (service auditors). The proposed SAS will only contain guidance for user auditors. Guidance for service auditors will be contained in a new Statement on Standards for Attestation Engagements (SSAE), *Reporting on Controls at a Service Organization*, which is being exposed for comment concurrently with this proposed SAS.

How the Proposed SAS Affects Existing Standards

The proposed SAS would affect AU section 324 in the following ways:

- A user organization would be known as a user *entity*.
- In a type 2 report, the service auditor's report would contain an opinion on the fairness of the description of the service organization's system and on the suitability of the design of the controls for a period rather than as of a specified date, as it currently does.
- A user auditor would be permitted to make reference to the work of a service auditor in his or her report to explain a modification of the user auditor's opinion. In those circumstances, the user auditor's report would be required to indicate that such reference does not diminish the user auditor's responsibility for that opinion. (As in extant AU section 324, the user auditor would be prohibited from making reference to the work of a service auditor in a user auditor's report containing an unmodified opinion.)
- A user auditor would be required to inquire of management of the user entity about whether the service organization has reported to the user entity any fraud, noncompliance with laws and regulations, or uncorrected misstatements. If so, the user auditor would be required to evaluate how such matters affect the nature, timing, and extent of the user auditor's further audit procedures.
- The SAS would also be applicable to situations in which an entity uses a shared service organization that provides services to a group of related entities.

Background

Clarity

To address concerns over the clarity, length, and complexity of its standards, the Auditing Standards Board (ASB) is undertaking a significant effort to clarify its standards.¹ In March 2007, the ASB issued a discussion paper, "Improving the Clarity of ASB Standards."² In response to the feedback received on the

¹ The pamphlet "Clarification and Convergence," provides information about the Auditing Standards Board's (ASB) clarity project and can be viewed at [www.aicpa.org/download/auditstd/ASB_Clarify_%20and_Convergence_\(8.5x11\).pdf](http://www.aicpa.org/download/auditstd/ASB_Clarify_%20and_Convergence_(8.5x11).pdf).

² The discussion paper *Improving the Clarity of ASB Standards* can be viewed at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

discussion paper and subsequent discussions with interested parties, the ASB established clarity drafting conventions and began to revise its standards in accordance with those conventions. The clarity drafting conventions include the following:

- Establishing objectives for each of the standards
- Including a definitions section in each standard, where relevant
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using an A- prefix and presenting them in a separate section that follows the requirements section
- Using formatting techniques, such as bulleted lists, to enhance readability
- Including, where appropriate, special considerations relevant to audits of smaller, less complex entities
- Including, where appropriate, special considerations relevant to audits of governmental entities

Convergence

Consistent with the ASB's strategy to converge its standards with those of the International Auditing and Assurance Standards Board (IAASB),¹ the proposed SAS has been drafted using the December 2007 exposure draft of International Standard on Auditing (ISA) 402 (Revised and Redrafted), *Audit Considerations Relating to an Entity Using a Third Party Service Organization*, as a base. Differences between the proposed SAS and the ISA 402 exposure draft, for which the ASB believes there is no compelling reason, have been eliminated. Any differences in objectives, definitions, or requirements between the proposed SAS and the ISA 402 exposure draft are identified in exhibit B.

The ASB has made various changes to the language in the proposed ISA, including replacing terms or phrases used in the proposed ISA with those more commonly used in the United States, and tailoring examples and guidance so that they are more appropriate for the U.S. environment. Where the ASB believes that such changes in language have resulted in a substantive difference, these differences have been identified in exhibit B.

Effective Date

Paragraph 6 of the exposure draft indicates that the SAS is effective for audits of financial statements for periods beginning on or after December 15, 2010. Although this is a provisional effective date, the actual effective date will not be earlier than December 15, 2010.

Guide for Respondents

The ASB is seeking comments on the effect on the proposed SAS of applying the clarity drafting conventions to the proposed SAS and of converging it with the ISA 402 exposure draft. Respondents are asked to comment in particular on the appropriateness of

1. the objectives stated in the proposed SAS to be achieved by the auditor.

³ The paper *AICPA's Auditing Standards Board International Convergence Plan*, can be viewed at www.aicpa.org/download/auditstd/ASB_Convergence_Plan.pdf.

2. the revisions made to the existing standards to converge with the ISA 402 exposure draft.
3. the differences between the proposed SAS and the ISA 402 exposure draft identified in exhibit B, and other language changes.
4. the manner with which considerations for audits of smaller, less complex entities and governmental entities have been dealt.

Comments are most helpful when they refer to specific paragraphs; include the reasons for the comments; and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in the exposure draft, it is helpful if the ASB is made aware of this view.

The comment period for the exposure draft ends on February 17, 2009. Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA after March 17, 2009, for one year. Responses should be sent to Sharon Macey at smacey@aicpa.org, or mailed to Audit and Attest Standards, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775 in time to be received by February 17, 2009.

Supplements to the Exposure Draft

To assist respondents in commenting on the proposed SAS, the Audit and Attest Standards staff has prepared the following supplementary materials:

- A table comparing the ISA 402 exposure draft to the proposed SAS. The table is a paragraph-by-paragraph comparison that contains the following four columns:
 1. The December 2007 exposure draft of ISA 402
 2. A marked draft of the ISA 402 exposure draft showing changes made to that draft to arrive at the proposed SAS
 3. Related paragraphs in extant AU section 324
 4. Explanations of substantive changes to the ISA 402 exposure draft and other comments
- A table showing how the paragraphs in extant AU section 324 are reflected in the proposed SAS and in the proposed SSAE. This table is a paragraph-by-paragraph comparison that contains the following three columns:
 1. The paragraphs in extant AU section 324
 2. The related paragraphs in the proposed SAS and in the proposed SSAE
 3. Comments and explanations

This staff-prepared supplementary material is for informational purposes only and is not a part of the exposure draft. However, it may be useful to respondents in formulating comments and is available on the AICPA Web site at

www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.

Comment Period

The comment period for this exposure draft ends on February 17, 2009.

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**PROPOSED STATEMENT ON AUDITING STANDARDS
AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING
A SERVICE ORGANIZATION (REDRAFTED)**

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Proposed Statement on Auditing Standards *Audit Considerations* Relating to an Entity Using a Service Organization (Redrafted)

Introduction

Scope of This Statement on Auditing Standards

1. This Statement on Auditing Standards (SAS) addresses the user auditor's responsibilities for obtaining sufficient appropriate audit evidence in an audit of the financial statements of an entity that uses one or more service organizations. Specifically, it expands on how the auditor applies AU section 314, *Understanding The Entity and Its Environment and Assessing the Risks of Material Misstatement*, and AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), 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 activities to organizations that provide services ranging from performing a specific task under the direction of the entity to replacing entire business units or functions of the entity. Many of the services provided by such organizations are integral to the entity's business operations; however, not all of those services are necessarily directly linked to an entity's information and communication systems relevant to financial reporting.¹

3. A service organization's services are part of an entity's information and communication systems, 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 automated and manual systems by which the entity's transactions are initiated, authorized, recorded, processed, corrected as necessary, and reported 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. This includes the correction of incorrect information.
- d. How the entity's information and communication systems capture 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

4. The focus of this SAS is on an entity's use of an outside service organization, but it may also be applicable, adapted as necessary in the circumstances, to situations where an entity uses a shared service organization that provides services to a group of related entities.

5. This SAS does not apply to services that 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 these situations, the user entity retains

¹ Paragraph .41 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), indicates that an entity's information and communication systems is a component of its internal control over financial reporting. The other components are the control environment, the entity's risk assessment, control activities, and monitoring.

responsibility for authorizing the transactions and maintaining the related accountability. In addition, this SAS 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 SAS is effective for audits of financial statements for periods beginning on or after December 15, 2010.* Earlier application is permitted.

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 SAS, the following terms have the meanings attributed as follows:

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 the control objectives stated in the description of the service organization's system, are identified as such in that description.

Report on a description of a service organization's system and the suitability of the design of controls (referred to in this SAS as a *type 1 report*). (Ref: par. A1) A report that comprises

- a. a description of the service organization's system, prepared by management of the service organization.
- b. a written assertion by the service organization's management about whether, in all material respects, and based on suitable criteria
 - (1) the description of the service organization's system fairly presents the service organization's system that was designed and implemented as of a specified date.
 - (2) the controls related to the control objectives stated in the description were suitably designed to achieve those control objectives as of the specified date.
- c. a service auditor's report that expresses an opinion on the matters in *b(1)–b(2)*.

Report on a description of a service organization's system and the suitability of the design and operating effectiveness of controls (referred to in this SAS as a *type 2 report*). (Ref: par. A1) A report that comprises

- a. a description of the service organization's system prepared by management of the service organization.

* This effective date is provisional, but will not be earlier than December 15, 2010.

- b. a written assertion by the service organization's management, about whether in all material respects and, based on suitable criteria,
 - (1) the description of the service organization's system fairly presents the service organization's system that was designed and implemented throughout the specified period.
 - (2) the controls related to the control objectives stated in the description of the service organization's system were suitably designed throughout the specified period to achieve those control objectives.
 - (3) the controls related to the control objectives stated in the description of the service organization's system operated effectively throughout the specified period to achieve those control objectives.
- c. A service auditor's report that
 - (1) expresses an opinion about the matters in *b(1)–b(3)*.
 - (2) includes a description of the service auditor's tests of controls and the results thereof.

Service auditor. A practitioner who reports on controls at a service organization.

Service organization. An organization or segment of an organization that provides services to user entities that are part of those user entities' information and communication systems relevant to financial reporting.

Subservice organization. A service organization used by another service organization to perform some of the services provided to user entities that are part of the user entities' information and communication systems relevant to financial reporting.

User auditor. An auditor who audits and reports on the financial statements of a user entity.

User entity. An entity that uses a service organization and whose financial statements are being audited.

Requirements

Obtaining an Understanding of the Services Provided by a Service Organization

9. When obtaining an understanding of the entity in accordance with paragraphs .21 and .40 of AU section 314, the user auditor should obtain an understanding of how the 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: par. A2–A3)
- 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: par. A4–A5)
- 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: par. A6–A9)

10. When obtaining an understanding of internal control relevant to the audit in accordance with paragraphs .40 and .47 of AU section 314, the user auditor should evaluate the design and implementation of relevant controls at the user entity that relate to the services performed by the service organization, including those controls that are applied to the transactions processed by the service organization, and relevant monitoring controls. (Ref: par. A10–A12)

11. The user auditor should determine whether he or she has obtained a sufficient understanding of the user entity's internal control relevant to the audit to provide a basis for the identification and assessment of risks of material misstatement. If the user auditor is unable to obtain that understanding from information about the service organization available at the user entity, the user auditor should obtain audit evidence from one or more of the following procedures: (Ref: par. A13–A17)

- a. Obtaining a type 1 or type 2 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
- 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 should obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures: (Ref: par. A18)

- a. Obtaining a type 2 report
- b. Requesting through the user entity that the service auditor perform tests of controls at the service organization on behalf of the user auditor
- c. Performing appropriate tests of controls at the service organization
- d. Performing tests of the user entity's controls over the activities of the service organization

Using a Service Auditor's Report

13. If the user auditor plans to use a type 1 or type 2 report as audit evidence about the design and implementation of controls at the service organization, the user auditor should (Ref: par. A19–A29)

- a. evaluate whether the description of the service organization's system is as of 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.
- 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. A type 2 report may be intended to satisfy the needs of several different user auditors; therefore,

specific tests of controls and results thereof in the service auditor's description of tests of controls may not be relevant to assertions that are significant to a particular user entity's financial statements. If the user auditor plans to use information in a type 2 report as audit evidence that the controls at the service organization are operating effectively, the user auditor should perform the procedure in paragraph 13b and the following procedures to determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment: (Ref: par. A21–A28)

- a. Evaluate whether (1) the description of the service organization's system, and (2) the service auditor's description of tests of controls and results thereof are for a period that is appropriate for the user auditor's purposes.
- 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. If so, test their operating effectiveness.
- c. Evaluate the adequacy of the period covered by the tests of controls and the time elapsed since the performance of the tests of controls.
- d. Evaluate whether the specific tests of controls performed by the service auditor and the results thereof as described in the type 2 report are relevant to assertions in the user entity's financial statements.

15. In determining the sufficiency and appropriateness of the audit evidence provided by a type 1 or type 2 report in support of the user auditor's opinion, the user auditor should be satisfied concerning the service auditor's professional reputation, competence, and independence. (Ref: par. A30–A31)

Reference to the Work of a Service Auditor (Ref: par. A32)

16. The user auditor should not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion.

17. If reference to the work of a service auditor is relevant to an understanding of a modification of the user auditor's opinion, the user auditor's report should indicate that such reference does not diminish the user auditor's responsibility for that opinion.

Other Audit Evidence Considerations Regarding Service Organizations

18. In responding to assessed risks in accordance with AU section 318, the user auditor should (Ref: par. A33–A36)

- 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 ask the service auditor through the user entity to perform those procedures on the user auditor's behalf.

Fraud, Noncompliance With Laws and Regulations, and Uncorrected Misstatements in Relation to Activities at the Service Organization

19. The user auditor should inquire of management of the user entity about whether the service organization has reported to the user entity any fraud, noncompliance with laws and regulations, or uncorrected misstatements. If so, the user auditor should evaluate how such matters affect the nature, timing, and extent of the user auditor's further audit procedures. (Ref: par. A37)

Application and Explanatory Material

Definitions

A1. The terms *type 1 report* and *type 2 report* have the same meaning as the terms *type A report* and *type B report*, respectively, that are used in International Standards on Auditing and International Standards for Assurance Engagements issued by the International Auditing and Assurance Standards Board. (Ref: par. 8)

Obtaining an Understanding of the Services Provided by a Service Organization

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

A2. A user entity may use a service organization, such as one that processes transactions and maintains the related accountability for the user entity or records transactions and processes related data for the user entity. 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 servicers 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. Exhibit A of this SAS contains examples of service organizations.

A3. Examples of services provided by service organizations that are relevant to the audit include

- maintaining the user entity's accounting records.
- management of assets.
- initiating, recording, or processing transactions for user entities.

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

A4. A service organization may establish policies and procedures (controls) that affect the user entity's information and communication systems. These controls are at least in part physically and operationally separate from the user entity. The significance of the controls at the service organization to the user entity's internal control 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.

A5. The significance of the controls at the service organization to the user entity's internal control also depends on the degree of interaction between the service organization's 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 accounts for 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, processes, and accounts for 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: par. 9c)

A6. 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 the 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 1 or type 2 report.
- whether the user auditor has rights of access to the user entity's accounting records at the service organization and other information necessary for the conduct of the audit.
- how the service organization is compensated.

A7. There is a direct relationship between the service organization and the user entity (the user entity enters into an agreement with the service organization) and between the service organization and the service auditor (the service organization engages the service auditor). These relationships do not create a 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 user auditor, for example, may request through the user entity that a service auditor perform procedures on behalf of the user auditor in addition to reporting on controls. For example, a service auditor may be engaged to perform an agreed-upon procedures engagement related to controls at a service organization or a user entity's transactions or balances maintained by the service organization. AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance for agreed-upon procedures engagements.

Considerations Specific to Governmental Entities

A9. For governmental entities, the auditor may be required to perform audit procedures with respect to the entity's compliance with laws and regulations. Such required procedures may include obtaining an understanding of internal control over compliance, performing tests of compliance controls, and performing tests of compliance. Consequently, governmental entities that use a service organization or their auditors may determine that it is appropriate to request that the service auditor perform such compliance-related audit procedures with respect to services provided by the service organization.²

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

A10. 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 and correct material misstatements. In this situation, the user auditor may perform tests of the user entity's controls over payroll processing that

² AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1), addresses audits of an entity's compliance.

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.

A11. A user entity may use a service organization that in turn uses a subservice organization to perform some of the services provided to the user entity that are part of the user entity's information and communication systems as it relates to an audit of 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 organization. The degree of this interaction, and the nature and materiality of the transactions processed by the service organization and the subservice organization, are the most important factors for the user auditor to consider in determining the significance of the service organization's and subservice organization's controls to the user entity's internal control.

A12. As noted in paragraph .117 of AU section 314, for 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 that often involve highly automated processing with little or no manual intervention. Risks related to such automated processing may be particularly present when the user entity uses a service organization. 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 SAS.

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

A13. Information about 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 the service organization's internal auditors or by regulatory authorities on controls at the service organization; and
- reports by the service auditor.

A14. 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 at the service organization and controls over those services are highly standardized.

A15. A service organization may engage a service auditor to report on a description of its system and the suitability of the design of controls (type 1 report) or on a description of its system and the suitability of the design and operating effectiveness of controls (type 2 report). Type 1 and type 2 reports typically are reports issued under AT section XXX, [†] *Reporting on Controls at a Service Organization*.

A16. If a report on controls at the service organization is not available, the user auditor's ability to gain an

[†] The number of this Statement on Standards for Attestation Engagements (and subsequent AT section in *Professional Standards*) will be determined when it is issued as a final standard.

understanding of controls at the service organization that affect user entities' internal control may depend on the user auditor's direct interaction with management of the service organization.

A17. Paragraphs .22–.26 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), provide guidance on modifying the report 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 SAS.

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

A18. If a type 2 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 2 engagement 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; for example, procedures a user auditor may perform to test a user entity's controls over the activities of the service organization include independent reperformance of selected items processed by the service organization and tests of the user organization's reconciliation of output reports with source documents. 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 the service auditor's report and the user auditor's own procedures.

Using a Service Auditor's Report

Using a Type 1 Report (Ref: par. 13)

A19. A type 1 report, along with information about the user entity, may be helpful in providing an understanding of

- a. the controls at the service organization 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's system to determine the points in the transaction flow where material misstatements in the user entity's financial statements could occur.
- c. the control objectives stated in the description of the service organization's system that are relevant to the user entity's financial statement assertions.
- d. whether controls at the service organization are implemented and suitably designed to prevent or detect and correct processing errors that could result in material misstatements in the user entity's financial statements. A type 1 report may be helpful in providing a sufficient understanding to identify and assess the risks of material misstatement of the user entity's financial statements. Such a report, however, does not provide any evidence of the operating effectiveness of the relevant controls.

A20. A type 1 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 type 1 report is as of a date that precedes the period under audit, the user auditor may perform procedures to update the information in a type 1 report, such as

- discussing 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 2 Report (Ref: par. 14–15)

A21. In evaluating the nature, timing, and extent of tests of controls relevant to the user entity and results thereof included in a service auditor's type 2 report to determine whether the report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment, the user auditor may consider the following factors:

- a. The period covered by the tests of controls and the time elapsed since the performance of the tests of controls
- b. The applications covered, controls tested, types of tests performed, and way in which tested controls relate to the user entity's financial statement assertions
- c. The results of the tests of controls and the service auditor's opinion on the operating effectiveness of the controls

A22. 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 2 report to the user entity's financial reporting period, the auditor may conclude that the type 2 report offers less audit evidence if there is little overlap between the period covered by the type 2 report and the period covered by the user entity's financial statements. When this is the case, an additional type 2 report covering a preceding or subsequent period may provide additional audit evidence.

A23. If there is little overlap between the period covered by the type 2 report and the period covered by the user entity's financial statements, it may be necessary for the user auditor to obtain additional evidence about significant changes in the relevant controls at the service organization during the period outside the period covered by the type 2 report, or to determine what additional audit procedures need to be performed. Relevant factors in determining the additional audit evidence to obtain about controls at the service organization that were operating outside 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 and communication systems, 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 on controls;
- the control environment; and
- the effectiveness of the control environment and monitoring controls at the user entity.

A24. Additional audit evidence may be obtained, for example, by performing tests of controls during the

remaining period or testing the user entity's monitoring controls.

A25. 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 to conclude that the user entity's controls are operating effectively because the tests do not provide current audit period evidence of the effectiveness of the controls.

A26. 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 description of the service organization's system 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. (Ref: par. 13c)

A27. If the user auditor believes that the service auditor's 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 thereof, the user auditor may supplement his or her understanding of the service auditor's procedures and conclusions by contacting the service organization through the user entity to discuss 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.

A28. The service auditor's description of tests of controls identifies results of tests, including deviations, and other information that could affect the user auditor's conclusions. Deviations noted by the service auditor or a modified opinion in the service auditor's report do not automatically mean that the service auditor's report will not be useful for the audit of the user entity's financial statements in assessing the risks of material misstatement. Rather, the deviations and the matter giving rise to a modified opinion in the service auditor's report are considered in the user auditor's assessment of the tests of controls performed by the service auditor. In considering the deviations and matters giving rise to a modified opinion, the user auditor may wish to discuss such matters with the service auditor through the user entity and the service organization.

Communication of Significant Deficiencies and Material Weaknesses Identified During the Audit

A29. When assessing a service organization's controls and how they interact with a user entity's internal control relevant to the audit, the user auditor may identify user entity control deficiencies related to the use of a service organization, for example:

- Any needed monitoring controls that have not been implemented by the user entity, including those identified as a result of obtaining a type 1 or type 2 report
- Instances where complementary user entity controls identified in the type 1 or type 2 report are not implemented at the user entity
- Controls that may be needed at the service organization that do not appear to have been implemented or that were implemented, but are not operating effectively

If a deficiency in internal control is deemed a significant deficiency or material weakness, the user auditor is required to communicate these deficiencies in writing on a timely basis to management and those charged with governance in accordance with AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1).

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

A30. The user auditor may inquire about 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 with respect to reports on controls at a service organization. In such a situation, the user auditor may inquire about the adequacy of those standards.

A31. A service auditor need not be independent of each user entity.

Reference to the Work of a Service Auditor (Ref: par. 16–17)

A32. The fact that a user entity uses a service organization 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. Therefore, the user auditor does not make reference to the service auditor's examination 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 examination report, the user auditor is not precluded from referring to the service auditor's examination 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 and need not identify the service auditor by name.

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

A33. When the service organization maintains material elements of the accounting records of the user entity, direct access to those records may be necessary for the user auditor to obtain sufficient appropriate audit evidence relating to the operations of controls over those records, to substantiate transactions and balances recorded in them, or both. Such access may involve physical inspection of records at the service organization's premises, electronic access from the user entity or another location to electronic records, or both. Where direct access is achieved electronically, the user auditor may obtain evidence concerning the adequacy of the service organization's controls over the completeness and integrity of the user entity's data for which the service organization is responsible. The user auditor also may ask the service organization through the user entity for access to the user entity's records maintained by the service organization.

A34. In determining the nature and extent of audit evidence to be obtained for financial statement assertions about balances maintained or transactions processed by a service organization for a user entity, 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 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.*

A35. As noted in paragraph A8, a service auditor may perform procedures under AT section 201 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 the user auditor as part of the evidence necessary to support his or her audit opinions. In these circumstances, it may be useful for the user auditor and the service auditor to establish an understanding prior to the performance of the procedures regarding the audit documentation or means of access to the audit documentation that will be provided to the user auditor.

A36. 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 2 report and, in addition, may perform substantive procedures on behalf of the user auditor. As noted in paragraph A32, 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, Noncompliance With Laws and Regulations, and Uncorrected Misstatements in Relation to Activities at the Service Organization (Ref: par. 19)

A37. A service organization may be required under the terms of the contract with user entities to disclose to affected user entities any fraud, noncompliance 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.

A38.

Exhibit A: Examples of Service Organizations (Ref: par. A2)

The following are examples of service organizations that perform services that are part of the user entity's information and communication systems 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, provide services similar to traditional mainframe data center service bureaus, 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 and communication systems 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.
- *Payroll Processors.* User entities commonly outsource their payroll function to a service organization. The user entity transmits the payroll data (name, address, salary, withholding rate, 401(k) contribution rate, and so on) to the payroll processor either manually or electronically. The payroll processor calculates the amounts for each paycheck, generates the paychecks or executes direct deposit instructions, and provides the user entity with the data for the journal entry that records the payroll.

A39.

Exhibit B: Substantive Differences Between the Proposed Statement on Auditing Standards, *Audit Considerations Relating to an Entity Using a Service Organization*, and the Exposure Draft of International Standard on Auditing 402 (Revised and Redrafted), *Audit Considerations Relating to an Entity Using a Third Party Service Organization*

This analysis was prepared by the AICPA Audit and Attest Standards staff to highlight substantive differences between the proposed Statement on Auditing Standards (SAS), *Audit Considerations Relating to an Entity Using a Service Organization*, and the December 2007 exposure draft of International Standard on Auditing (ISA) 402 (Revised and Redrafted), *Audit Considerations Relating to an Entity Using a Third Party Service Organization*, and to explain the rationale for those differences. This analysis is not authoritative and is prepared for informational purposes only. It has not been acted on or reviewed by the Auditing Standards Board.

Description of Difference	Explanation
<p>1. Definitions of type 1 and type 2 reports. The definitions of <i>Report on a description of a service organization’s system and the suitability of the design of controls (type 1 report)</i> and <i>Report on a description of a service organization’s system and the suitability of the design and operating effectiveness of controls (type 2 report)</i>, in paragraph 8 of the proposed SAS, indicate that</p> <ul style="list-style-type: none"> a. management’s written assertion is an element of these reports. b. the service auditor reports on management’s written assertion. <p>The definitions of <i>Report on the description and design of controls at a service organization (Type A report)</i> and <i>Report on the description, design and operating effectiveness of controls at a service organization (Type B report)</i>, in paragraph 9 of the ISA 402 exposure draft, differ from the definitions in the proposed SAS because</p> <ul style="list-style-type: none"> a. management’s written assertion is not listed as an element of the reports. b. the service auditor expresses an opinion directly on the subject matter rather than on management’s assertion. 	<p>Requiring management to provide a written assertion about the subject matter, and the auditor to report on that assertion underscores the fact that management of the service organization is responsible for controls at the service organization that affect user entities’ information and communication systems.</p>
<p>2. Procedures for obtaining evidence about operating effectiveness of controls. Paragraph 12 of the proposed SAS lists a fourth procedure, “Performing tests of the user entity’s controls over</p>	<p>In some situations, a user entity may be able to establish controls over the activities of the service organization to prevent or detect and correct financial statement misstatements that might result</p>

the activities of the service organization,” as one or more of the audit procedures an auditor should perform when obtaining audit evidence about the operating effectiveness of controls. The ISA 402 exposure draft does not include this procedure.

if incorrect information were provided to the user entity. For example, user entities commonly outsource their payroll function to a payroll processor. The user entity transmits payroll data (name, address, salary, withholding rate, 401(k) contribution rate, and so on) to the payroll processor. The user entity records the payroll based on the data provided by the payroll processor. A user entity may establish controls over the information provided by the payroll processor, for example, by recalculating a sample of the paychecks each pay period.