



January 2008

To: Members of the Hong Kong Institute of CPAs
All other interested parties

**INVITATION TO COMMENT ON IAASB EXPOSURE DRAFTS
OF INTERNATIONAL STANDARDS ON AUDITING AND
INTERNATIONAL STANDARD ON ASSURANCE
ENGAGEMENTS**

Part A

- **Proposed ISA 501 (Redrafted), *Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures***
- **Proposed ISA 520 (Redrafted), *Analytical Procedures***

Comments to be received by 15 March 2008

Part B

- **Proposed ISA 265, *Communicating Deficiencies in Internal Control and Related Conforming Amendments to Other ISAs***
- **Proposed ISA 402 (Revised and Redrafted), *Audit Considerations Relating to an Entity Using a Third Party Service Organization***

Comments to be received by 15 April 2008

Part C

- **Proposed ISAE 3402, *Assurance Reports on Controls at a Third Party Service Organization***

Comments to be received by 15 May 2008

The Hong Kong Institute of Certified Public Accountants' (Institute) Auditing and Assurance Standards Committee is seeking comments on the IAASB Exposure Drafts which have been posted on the Institute's website at:

www.hkicpa.org.hk/professionaltechnical/assurance/exposedraft/.

The Explanatory Memorandum to the Exposure Drafts provides background information and explanation of the proposed ISAs and ISAE.



In summary, the IAASB's intentions in developing the new and revised ISAs and ISAE (in addition to the new clarity drafting conventions) are set out below:

Part A

ISA 501 – Long-term Investments

Extant ISA 501 requires the auditor to obtain sufficient appropriate audit evidence regarding the valuation and disclosure of long-term investments and provides guidance on auditing procedures that the auditor considers, including procedures related to obtaining audit evidence about the entity's intent and ability to hold investments on a long term basis.

The IAASB understands that the term "long term investments" is no longer prevalent under International Financial Reporting Standards or other major financial reporting frameworks and is of the view that audit issues in connection with the valuation and disclosure of investments would arise principally where estimation uncertainty is involved. Accordingly, the guidance in extant ISA 501 may be unhelpful or potentially misleading. Furthermore, proposed ISA 540 (Revised and Redrafted) *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* provides relevant requirements and guidance in relation to estimation uncertainty. In addition, ISA 580 (Revised and Redrafted) *Written Representations* provides guidance relevant to obtaining evidence about management's intentions where important to the valuation basis for investments.

The IAASB therefore proposes that the material in extant ISA 501 regarding long-term investments be removed.

ISA 520 - Scope of the ISA

The extant ISA 520 deals with analytical procedures as:

- Risk assessment procedures;
- Substantive procedures in response to assessed risks; and
- Procedures that assist in forming the auditor's overall conclusion on the financial statements.

The substance of the standard, however, is primarily concerned with the latter two categories. Relatively little is said about analytical procedures as part of the auditor's risk assessment.

Given that ISA 315 (Redrafted) *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* contains the requirement to use analytical procedures as risk assessment procedures and includes relevant guidance, the IAASB decided that it would be more appropriate for all guidance on analytical risk assessment procedures to be in one place in support of the requirement and consequently, agreed that the relevant material in extant ISA 520 should be relocated to ISA 315.

Part B

ISA 265 – Communicating Deficiencies in Internal Control

This new proposed standard is intended to deal with the auditor's responsibility to communicate to management and those charged with governance deficiencies in internal control that have been identified by the auditor.

It distinguishes between significant and other deficiencies in order to establish requirements to communicate to the appropriate levels within the audited entity. It also requires the former to be communicated in writing to those charged with governance.

ISA 402 – Third Party Service Organizations

Following a risk-based approach, the proposed ISA deals with the auditor's responsibilities to obtain audit evidence when an entity uses one or more service organizations. This may include obtaining reports prepared by the auditors of those organizations.

Part C

ISAE 3402 – Assurance Reports on Controls at Third Party Service Organizations

The proposed ISAE is the first subject matter-specific standard developed under the IAASB's International Framework for Assurance Engagements.

It complements proposed ISA 402 above in that reports prepared in accordance with proposed ISAE 3402 will be capable of providing appropriate audit evidence under the proposed ISA 402. It is the intention that this proposed ISAE will help to bring consistency in reporting on controls at service organizations, thereby assisting such organizations to meet the needs of clients and their auditors.

In accordance with the Institute's International Standards Convergence Due Process, comments are invited from any interested party and the Institute would like to hear from both those who do agree and those who do not agree with the proposals contained in the IAASB Exposure Drafts.

Comments should be supported by specific reasoning and should be submitted in written form.

To allow your comments on the IAASB Exposure Drafts to be considered, comments on the exposure drafts are requested by the due dates shown above.

Comments may be sent by mail, fax or e-mail to:

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Hong Kong Institute of Certified Public Accountants
37/F., Wu Chung House
213 Queen's Road East
Hong Kong

Fax number (+852) 2865 6776

E-mail: commentletters@hkipa.org.hk

Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

PART A

Response Due Date
15 March 2008

ED of Proposed ISA 501 (Redrafted)

**Audit Evidence Regarding Specific
Financial Statement Account Balances and
Disclosures**

ED of Proposed ISA 520 (Redrafted)

Analytical Procedures

PART B

Response Due Date
15 April 2008

ED of Proposed ISA 265

**Communicating Deficiencies in Internal
Control and Related Conforming
Amendments to Other ISAs**

ED of Proposed ISA 402 (Revised and Redrafted)

**Audit Considerations Relating to an Entity
Using a Third Party Service Organization**



PART C

Response Due Date
15 May 2008

ED of Proposed ISAE 3402

**Assurance Reports on Controls at a Third
Party Service Organization**



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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IAASB Press release

These Exposure Drafts may be filed in the “Exposure Drafts, Invitations to Comment” section of Volume III of the Institute Members’ Handbook.

The Exposure Drafts can also be found on the Institute’s website at:
www.hkicpa.org.hk/professionaltechnical/assurance/exposedraft/.

*Proposed Redrafted International Standard on
Auditing*

ISA 501, Audit Evidence Regarding
Specific Financial Statement Account
Balances and Disclosures



International Federation
of Accountants

REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Auditing (ISA) 501 (Redrafted), “Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures” for publication in December 2007. This proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by email, so that they will be received by **March 31, 2008**. All comments will be considered a matter of public record. Comments should be addressed to:

International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Comments should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to the above address.

Copies of the exposure draft may be downloaded free-of-charge from the IFAC website at <http://www.ifac.org>.

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EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to proposed International Standard on Auditing (ISA) 501 (Redrafted), “Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures.” The proposed ISA has been redrafted in accordance with conventions agreed by the International Auditing and Assurance Standards Board (IAASB) to be applied to all ISAs. The IAASB approved the proposed redrafted ISA for exposure in December 2007.

Background

As part of its project to improve the clarity of its International Standards, the IAASB has undertaken to redraft all of its ISAs in accordance with its new clarity drafting conventions. This approach responds to the desire for all ISAs to be consistently drafted, and subject to a single statement of their authority and effect. The IAASB has agreed, in response to the general call for the Clarity project to be completed within a reasonable time, that while a significant number of the ISAs are under substantive revision as well as redrafting to reflect the new conventions, others will be subject to a limited redrafting to reflect only the conventions and matters of clarity generally. Proposed ISA 501 (Redrafted) is in the latter category.

The conventions used by the IAASB in redrafting extant ISA 501,¹ and the authority and obligation attaching to those conventions, are established in proposed ISA 200 (Revised and Redrafted)² approved by the IAASB as an exposure draft in April 2007, and in the amended “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services” (Preface), approved by the IAASB in September 2006.³

Effective Date

The current timetable envisages that all ISAs will have been revised and redrafted, or redrafted only, by late 2008 and the IAASB has agreed that the complete set of ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009. The IAASB believes that it is in the interests of auditors and others who use the ISAs that the ISAs should be released as soon as they are approved so as to facilitate their implementation.

Significant Matters

Long-term Investments

Extant ISA 501 requires the auditor to obtain sufficient appropriate audit evidence regarding the valuation and disclosure of long-term investments, when such investments are material to the financial statements. It provides guidance on auditing procedures that the auditor considers, including procedures related to obtaining audit evidence about the entity’s intent and ability to hold

¹ ISA 501, “Audit Evidence—Additional Considerations for Specific Items.”

² Proposed ISA 200 (Revised and Redrafted), “Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing.”

³ The amended Preface can be accessed at http://web.ifac.org/download/IAASB_Preface.pdf. Proposed ISA 200 (Revised and Redrafted) can be accessed at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0079>.

investments on a long term basis, and procedures addressing circumstances where values, such as those obtained by market quotations, do not exceed the carrying amount of an investment.

Since the issue of extant ISA 501 in 1994, financial reporting frameworks have undergone much change. The IAASB understands that the term “long-term investments” is no longer prevalent under International Financial Reporting Standards or other major financial reporting frameworks. Further, current financial reporting requirements place less emphasis on whether an entity intends to hold an investment on a long term basis in accounting for impairments in value. Accordingly, the IAASB believes that the guidance in extant ISA 501 may be unhelpful or potentially misleading.

The IAASB is of the view that audit issues in connection with the valuation and disclosure of investments would arise principally where estimation uncertainty is involved. The IAASB’s proposed ISA 540 (Revised and Redrafted)⁴ provides relevant requirements and guidance in this regard. In addition, ISA 580 (Revised and Redrafted)⁵ provides guidance relevant to obtaining evidence about management’s intentions where important to the valuation basis for investments. The IAASB therefore proposes that the material in extant ISA 501 regarding long-term investments be removed.

Guide for Respondents

Request for Specific Comments

The IAASB would welcome views on the following:

Do you agree with the proposal to remove the requirement and guidance on auditing the valuation and disclosure of long-term investments?

Request for Comments on the Application of the Clarity Drafting Conventions

Except for the matter referred to above, the IAASB is seeking comments **only** on changes resulting from applying the clarity drafting conventions, and their effect on the content of the extant ISA. Respondents are asked to respond in particular to the following questions:

1. Are the objectives to be achieved by the auditor, stated in the proposed redrafted ISA, appropriate?
2. Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and reporting, and the use of professional judgment by auditors?⁶

⁴ Proposed ISA 540 (Revised and Redrafted), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.”

⁵ ISA 580 (Revised and Redrafted), “Written Representations.”

⁶ The IAASB has identified the following criteria for determining the requirements of a Standard:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; or, in the case of circumstances that are reasonably likely to exist or arise in an engagement, the requirement is considered necessary to the consistent application of the ISA and the action specified is expected to be appropriate in virtually all such circumstances; and

Recognizing that the final ISA will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below.

- *Special Considerations in the Audit of Smaller Entities*—Respondents are asked to comment whether, in their opinion, considerations in the audit of smaller entities have been dealt with appropriately in the proposed redrafted ISA.
- *Special Considerations in the Audit of Public Sector Entities*—Respondents are asked to comment whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in the proposed redrafted ISA.
- *Developing Nations*—Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed redrafted ISA in a developing nation environment.
- *Translations*—Recognizing that many respondents intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing the proposed redrafted ISA.

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 will be helpful for the IAASB to be made aware of this view.

Respondents are also invited to comment on any undue costs, set against the benefits of more consistent auditor performance, arising from the fact that the proposed redrafted ISA includes requirements that would previously have been guidance under the old drafting conventions, as in the extant ISA (see below). In commenting on this matter, respondents should bear in mind the criteria that the IAASB has applied in redrafting the proposed ISA (see footnote 2) and the fact that the IAASB is seeking to clarify that there was some guidance in extant ISAs that was more in the nature of requirements and would already have been followed by many auditors.

Supplement to the Exposure Draft

To assist respondents in tracking changes, IAASB staff has prepared an analysis of the decisions that have been made by the IAASB with respect to the treatment of the present tense in the explanatory paragraphs of the extant ISA. This analysis also demonstrates how the material in the extant ISA has been reflected in the proposed redrafted ISA. In particular, the analysis:

- Identifies existing sentences in the present tense and whether they are now treated as a requirement or as application material;
- Maps the material of the extant ISA to the proposed redrafted ISA; and

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- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards. In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement. The criteria, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

EXPLANATORY MEMORANDUM

- Identifies explanatory material that is proposed to be eliminated or repositioned as a result of redrafting.

These staff-prepared mapping documents are available on the IAASB website at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0102>. They are for information purposes only and do not form part of the exposure draft.

To be considered, responses should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to 545 Fifth Avenue, 14th Floor, New York, NY 10017, USA. They should be received by **March 31, 2008**.

PROPOSED INTERNATIONAL STANDARD ON AUDITING 501

(REDRAFTED)

**AUDIT EVIDENCE REGARDING SPECIFIC FINANCIAL STATEMENT ACCOUNT
BALANCES AND DISCLOSURES**

(Effective for audits of financial statements for periods beginning on or after [December 15, 2009])

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International Standard on Auditing (ISA) 501, “Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures” should be read in conjunction with [proposed] ISA 200 (Revised and Redrafted), “Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing.”

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the obtaining of sufficient appropriate audit evidence regarding certain assertions and related considerations for specific financial statement account balances and disclosures. It establishes requirements and provides guidance additional to that contained in ISA 330 (Redrafted)¹ and other relevant ISAs.

Effective Date

2. This ISA is effective for audits of financial statements for periods beginning on or after [December 15, 2009].

Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding:
 - (a) The existence and condition of inventory;
 - (b) The completeness of litigation and claims involving the entity; and
 - (c) The presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

Requirements

Inventory

4. When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding its existence and condition by, unless impracticable, attendance at the entity's physical inventory count (or counts) and: (Ref: Para. A1-A3)
 - (a) Evaluating management's instructions and procedures for recording and controlling the results of the entity's physical inventory count; (Ref: Para. A4)
 - (b) Observing management's count procedures, inspecting the inventory, and performing test counts; and (Ref: Para. A5-A7)
 - (c) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results. (Ref: Para. A8)
5. If the entity's physical inventory count is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. (Ref: Para. A9-A10)
6. If the auditor is unable to attend the entity's physical inventory count on the date planned due to unforeseen circumstances, the auditor shall make or observe some physical counts on an

¹ ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks."

alternative date and perform audit procedures on intervening transactions.

7. If attendance at the entity's physical inventory count is impracticable, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with [proposed] ISA 705 (Revised and Redrafted).² (Ref: Para. A11-A13)
8. When inventory under the custody and control of a third party is material to the financial statements, the auditor shall either:
 - (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity; or (Ref: Para. A14)
 - (b) Perform inspection or other audit procedures appropriate in the circumstances to obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory. (Ref: Para. A15)

Litigation and Claims

9. The auditor shall design and perform audit procedures in order to become aware of litigation and claims involving the entity which may give rise to a risk of material misstatement, including:
 - (a) Inquiry of management and others within the entity, including, where applicable, in-house legal counsel; and
 - (b) Review of minutes of meetings of those charged with governance and correspondence with the entity's external legal counsel. (Ref: Para. A16-A18)
10. When the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when the auditor believes that other litigation or claims may exist, the auditor shall, in addition to the procedures required by other ISAs:
 - (a) Seek direct communication with the entity's external legal counsel through a letter of general inquiry or specific inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor; and (Ref: Para. A19-A21)
 - (b) When considered necessary, meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. (Ref: Para. A22)
11. The auditor shall modify the opinion in the auditor's report in accordance with [proposed] ISA 705 (Revised and Redrafted)³ when:
 - (a) Management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel; or

² [Proposed] ISA 705 (Revised and Redrafted), "Modifications to the Opinion in the Independent Auditor's Report," paragraphs [10 and 12].

³ [Proposed] ISA 705 (Revised and Redrafted), paragraphs [10 and 12-16].

- (b) The entity’s external legal counsel refuses to respond appropriately to the letter of inquiry, referred to in paragraph 10(a), and the auditor is unable to obtain sufficient appropriate audit evidence by applying alternative audit procedures.
12. The auditor shall obtain audit evidence about the status of litigation and claims involving the entity which may give rise to a risk of material misstatement up to the date of the auditor’s report. (Ref: Para. A23)

Written Representations

13. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and appropriately dealt with in the financial statements.

Segment Information

14. The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by performing analytical procedures and other audit procedures appropriate in the circumstances, including: (Ref: Para. A24)
- (a) Obtaining an understanding of the methods used by management in determining segment information, and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and (Ref: Para. A25)
- (b) Where appropriate, testing the application of the methods used by management in determining segment information.

Application and Other Explanatory Material

Inventory

Attendance at the Entity’s Physical Inventory Count (Ref: Para. 4)

- A1. Management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and to ascertain the reliability of the entity’s perpetual inventory system, if applicable.
- A2. The auditor’s attendance at the entity’s physical inventory count enables the auditor to:
- Inspect the inventory to determine its existence and evaluate its condition, and perform test counts.
 - Observe compliance with management’s instructions and procedures for recording and controlling the results of the physical inventory count.
 - Obtain audit evidence as to the reliability of management’s procedures.
- A3. Matters relevant in planning attendance at the entity’s physical inventory count (or in

designing and performing audit procedures pursuant to paragraphs 4-8 of this ISA) include, for example:

- The risks of material misstatement related to inventory.
- The nature of the internal control related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for the physical inventory count.
- The timing of the physical inventory count.
- The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate.
- Whether the assistance of an auditor's expert is needed.

Management's Instructions and Procedures (Ref: Para. 4(a))

A4. Matters relevant in evaluating management instructions and procedures for recording and controlling the results of the physical inventory count include whether they address, for example:

- The application of appropriate control activities, for example, collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures.
- The accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment.
- The procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile.
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.

Observing Management's Count Procedures, Inspecting Inventory, and Performing Test Counts (Ref: Para. 4(b))

- A5. Observing management's count procedures assists the auditor in obtaining audit evidence that management's instructions and count procedures, for example, those relating to the control over the movement of inventory before, during and after the count, are adequately designed and implemented. In addition, the auditor may obtain copies of cutoff information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.
- A6. Inspecting inventory when attending the entity's physical inventory count assists the auditor in determining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory.
- A7. When performing test counts, audit evidence about the completeness and the accuracy of management's physical inventory count records may be obtained by tracing items selected

from those count records to the physical inventory, and tracing items selected from the physical inventory to management's count records.

Final Inventory Records (Ref: Para. 4(c))

- A8. When attending the entity's physical inventory count, in addition to recording the auditor's test counts, the auditor may obtain copies of management's completed physical inventory count records to assist the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

Physical Inventory Count Conducted Other Than At The Date of The Financial Statements (Ref: Para. 5)

- A9. For practical reasons, the entity's physical inventory count may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory count or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of a physical inventory count at a date other than the date of the financial statements is appropriate for audit purposes.
- A10. If the entity maintains a perpetual inventory system to determine the period-end inventory balance, the auditor may consider the following matters in evaluating the reliability of the inventory quantity information included in the entity's perpetual inventory records:
- The reasons for any significant differences between the information obtained during the physical count and the perpetual inventory records.
 - Whether the perpetual inventory records are properly adjusted.

Attendance at the Entity's Physical Inventory Count is Impracticable (Ref: Para. 7)

- A11. In some cases, attendance at the entity's physical inventory count may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety or well-being of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable.
- A12. In some cases where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory count, may provide sufficient appropriate audit evidence of the existence and condition of inventory.
- A13. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, [proposed] ISA 705 (Revised and Redrafted) requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.⁴

⁴ [Proposed] ISA 705 (Revised and Redrafted), paragraphs [10 and 12].

Inventory Under the Custody and Control of a Third Party

Confirmation (Ref: Para. 8(a))

A14. [Proposed] ISA 505 (Revised and Redrafted)⁵ establishes requirements and provides guidance for performing external confirmation procedures.

Other Audit Procedures (Ref: Para. 8(b))

A15. Depending on the circumstances, for example, where information is obtained that raises doubt about the integrity and independence of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party, for example:

- Attending, or arranging for another auditor to attend, the third party's physical count of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.

Litigation and Claims*Completeness of Litigations and Claims* (Ref: Para. 9)

A16. Litigation and claims involving an entity may have a material effect on the financial statements and thus may be required to be disclosed or provided for in the financial statements.

A17. In addition to the procedures identified in paragraph 9, the auditor may consider reviewing legal expense accounts and examining related source documents such as invoices for legal expenses. Further, the use of information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment may also assist the auditor to become aware of litigation and claims involving the entity.

A18. Audit evidence obtained for purposes of identifying litigation and claims that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant assertions, such as valuation or measurement, regarding litigations and claims. ISA 540 (Revised and Redrafted)⁶ establishes requirements and provides guidance relevant to the auditor's consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.

⁵ [Proposed] ISA 505 (Revised and Redrafted), "External Confirmations."

⁶ ISA 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures."

Communication with the Entity's External Legal Counsel (Ref: Para. 10(a))

- A19. Direct communication with the entity's external legal counsel assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reasonable.
- A20. In some cases, the auditor may seek direct communication with the entity's legal counsel through a letter of general inquiry. For this purpose, a letter of general inquiry requests the entity's external counsel to inform the auditor of any litigation and claims that the counsel is aware of, together with an assessment of the outcome of the litigation and claims, and an estimate of the financial implications, including costs involved.
- A21. If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:
- (a) A list of litigation and claims;
 - (b) Management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
 - (c) A request that the entity's legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's legal counsel to be incomplete or incorrect.

Meeting with the Entity's External Legal Counsel (Ref: Para. 10(b))

- A22. In certain circumstances, the auditor may consider it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims, for example, where:
- The auditor determines that the matter is a significant risk.
 - The matter is complex.
 - There is disagreement between management and the entity's legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

Status of Litigation and Claims Up to the Date of the Auditor's Report (Ref: Para. 12)

- A23. Audit evidence about the status of litigation and claims up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel.

Segment Information (Ref: Para. 14)

- A24. Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements. The auditor's responsibility regarding the presentation and disclosure of segment information is in relation

to the financial statements taken as a whole. Accordingly, the auditor is not required to apply audit procedures that would be necessary to express an opinion on the segment information presented on a stand alone basis.

Understanding of the Methods Used by Management (Ref: Para. 14(a))

A25. Matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information include, for example:

- Sales, transfers and charges between segments, and elimination of inter-segment amounts.
- Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
- The allocation of assets and costs among segments.
- Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.



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Proposed Redrafted International Standard on Auditing

ISA 520, Analytical Procedures

Proposed Conforming Amendment

ISA 315 (Redrafted), Identifying and
Assessing the Risks of Material
Misstatement Through Understanding
the Entity and Its Environment



REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Auditing (ISA) 520, “Analytical Procedures” for publication in December 2007. This proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by email, so that they will be received by **March 31, 2008**. All comments will be considered a matter of public record. Comments should be addressed to:

International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Comments should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to the above address.

Copies of the exposure draft may be downloaded free-of-charge from the IFAC website at <http://www.ifac.org>.

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EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to proposed International Standard on Auditing (ISA) 520 (Redrafted), “Analytical Procedures.” The proposed ISA has been redrafted in accordance with conventions agreed by the International Auditing and Assurance Standards Board (IAASB) to be applied to all ISAs. The IAASB approved the proposed redrafted ISA and related conforming amendment to ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment” for exposure in December 2007.

Background

As part of its project to improve the clarity of its International Standards, the IAASB has undertaken to redraft all of its ISAs in accordance with its new Clarity drafting conventions. This approach responds to the desire for all ISAs to be consistently drafted, and subject to a single statement of their authority and effect. The IAASB has agreed, in response to the general call for the Clarity project to be completed within a reasonable time, that while a significant number of the ISAs are under substantive revision as well as redrafting to reflect the new conventions, others will be subject to a limited redrafting to reflect only the conventions and matters of clarity generally. Proposed ISA 520 (Redrafted) is in the latter category.

The conventions used by the IAASB in redrafting extant ISA 520, and the authority and obligation attaching to those conventions, are established in proposed ISA 200 (Revised and Redrafted)¹ approved by the IAASB as an exposure draft in April 2007, and in the amended “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services” (Preface), approved by the IAASB in September 2006.²

Effective Date

The current timetable envisages that all ISAs will have been revised and redrafted, or redrafted only, by late 2008 and the IAASB has agreed that the complete set of ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009. The IAASB believes that it is in the interests of auditors and others who use the ISAs that the ISAs should be released as soon as they are approved so as to facilitate their implementation.

Significant Matter

Scope of ISA 520

The extant ISA 520 deals with analytical procedures as:

- Risk assessment procedures;

¹ Proposed ISA 200 (Revised and Redrafted), “Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing.”

² The amended Preface can be accessed at http://web.ifac.org/download/IAASB_Preface.pdf. Proposed ISA 200 (Revised and Redrafted) can be accessed at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0079>.

- Substantive procedures in response to assessed risks; and
- Procedures that assist in forming the auditor’s overall conclusion on the financial statements.

The substance of the standard, however, is primarily concerned with the latter two categories. Relatively little is said about analytical procedures as part of the auditor’s risk assessment. Further, ISA 315 (Redrafted) contains the requirement to use analytical procedures as risk assessment procedures and includes relevant guidance. The IAASB decided that it would be more appropriate for all guidance on analytical risk assessment procedures to be in one place in support of the requirement and, consequently, agreed that the relevant material in extant ISA 520 should be relocated to ISA 315 (Redrafted). Proposed ISA 520 (Redrafted) therefore only deals with analytical procedures used as substantive procedures in response to assessed risks and analytical procedures that assist in arriving at the auditor’s overall conclusion on the financial statements.

Guide for Respondents

The IAASB is seeking comments **only** on changes resulting from applying the clarity drafting conventions, including the matter discussed above, and their effect on the content of the extant ISA. Respondents are asked to respond in particular to the following questions:

1. Are the objectives to be achieved by the auditor, stated in the proposed redrafted ISA, appropriate?
2. Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and reporting, and the use of professional judgment by auditors?³

Recognizing that the final ISA will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below.

³ The IAASB has identified the following criteria for determining the requirements of a Standard:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; or, in the case of circumstances that are reasonably likely to exist or arise in an engagement, the requirement is considered necessary to the consistent application of the ISA and the action specified is expected to be appropriate in virtually all such circumstances; and
- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.

In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

The criteria, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

- *Special Considerations in the Audit of Smaller Entities*—Respondents are asked to comment whether, in their opinion, considerations in the audit of smaller entities have been dealt with appropriately in the proposed redrafted ISA.
- *Special Considerations in the Audit of Public Sector Entities*—Respondents are asked to comment whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in the proposed redrafted ISA.
- *Developing Nations*—Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed redrafted ISA in a developing nation environment.
- *Translations*—Recognizing that many respondents intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing the proposed redrafted ISA.

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 will be helpful for the IAASB to be made aware of this view.

Respondents are also invited to comment on any undue costs, set against the benefits of more consistent auditor performance, arising from the fact that the proposed redrafted ISA includes requirements that would previously have been guidance under the old drafting conventions, as in the extant ISA (see below). In commenting on this matter, respondents should bear in mind the criteria that the IAASB has applied in redrafting the proposed ISA (see footnote 2) and the fact that the IAASB is seeking to clarify that there was some guidance in extant ISAs that was more in the nature of requirements and would already have been followed by many auditors.

Supplement to the Exposure Draft

To assist respondents in tracking changes, IAASB staff has prepared an analysis of the decisions that have been made by the IAASB with respect to the treatment of the present tense in the explanatory paragraphs of the extant ISA. This analysis also demonstrates how the material in the extant ISA has been reflected in the proposed redrafted ISA. In particular, the analysis:

- Identifies existing sentences in the present tense and whether they are now treated as a requirement or as application material;
- Maps the material of the extant ISA to the proposed redrafted ISA; and
- Identifies explanatory material that is proposed to be eliminated or repositioned as a result of redrafting.

These staff-prepared mapping documents are available on the IAASB website at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0103>. They are for information purposes only and do not form part of the exposure draft.

EXPLANATORY MEMORANDUM

To be considered, responses should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to 545 Fifth Avenue, 14th Floor, New York, NY 10017, USA. They should be received by **March 31, 2008**.

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 520
(REDRAFTED)
ANALYTICAL PROCEDURES**

(Effective for audits of financial statements for periods beginning on or after [December 15, 2009])

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[Proposed] International Standard on Auditing (ISA) 520 (Redrafted), “Analytical Procedures” should be read in conjunction with [proposed] ISA 200 (Revised and Redrafted), “The Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing.”

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's use of analytical procedures as substantive procedures in response to assessed risks, and as procedures that assist in arriving at the auditor's overall conclusion in an audit of financial statements. The use of analytical procedures as risk assessment procedures is dealt with in ISA 315 (Redrafted).¹

Nature of Analytical Procedures

2. Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:
 - Comparable information for prior periods.
 - Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
 - Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.
3. Analytical procedures also include consideration of relationships, for example:
 - Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
 - Between financial information and relevant non-financial information, such as payroll costs to number of employees.
4. Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components (such as subsidiaries, divisions, branches or segments) and individual elements of financial information.

Effective Date

5. This ISA is effective for audits of financial statements for periods beginning on or after [December 15, 2009].

Objectives

6. The objectives of the auditor are:

¹ ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment."

- (a) When using analytical procedures as substantive procedures in response to assessed risks, to design and perform such analytical procedures so that they are effective in responding to assessed risks of material misstatement in the financial statements at the assertion level; and
- (b) To design and perform analytical procedures that assist in arriving at the overall conclusion in an audit of financial statements.

Definition

7. For the purposes of the ISAs, the term “analytical procedures” means evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Requirements

Analytical Procedures as Substantive Procedures in Response to Assessed Risks

8. In deciding to use, and when designing and performing, analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with ISA 330 (Redrafted),² the auditor shall: (Ref: Para. A1-A2)
- (a) Determine the suitability of using substantive analytical procedures given the assertions, taking account of the assessed risks of material misstatement and tests of details, if any, directed towards the same assertion; (Ref: Para. A3-A8)
 - (b) Develop an expectation of recorded amounts or ratios;
 - (c) Evaluate the reliability of data, whether internal or external, from which the auditor’s expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation; (Ref: Para. A9-A11)
 - (d) Evaluate whether the expectation is sufficiently precise to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated;³ and (Ref: Para. A12)
 - (e) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 10. (Ref: Para. A13-A14).

² ISA 330 (Redrafted), “The Auditor’s Responses to Assessed Risks.”

³ [Proposed] ISA 450 (Revised and Redrafted), “Evaluation of Misstatements Identified during the Audit,” paragraphs [12-14].

Analytical Procedures that Assist in Arriving at the Auditor's Overall Conclusion in an Audit of Financial Statements

9. The auditor shall design and perform analytical procedures that assist in arriving at the overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity. (Ref: Para. A15-A17)

Investigating Results of Analytical Procedures

10. If analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:
 - (a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
 - (b) Performing other audit procedures as necessary in the circumstances. (Ref: Para. A18-A19)

Application and Other Explanatory Material

Analytical Procedures as Substantive Procedures in Response to Assessed Risks (Ref: Para. 8)

- A1. The decision about which audit procedures to use is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.
- A2. The auditor may inquire of management as to the availability and reliability of information needed to apply analytical procedures as substantive procedures, and the results of any such procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

Suitability of Using Analytical Procedures Given the Assertions (Ref: Para. 8(a))

- A3. Analytical procedures as substantive procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and occurrence of transactions captured in the information produced by the entity's information system relevant to financial reporting. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated.
- A4. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has employed a known number of staff at fixed

rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in analytical procedures to provide evidence to support the reasonableness of recorded items.

- A5. Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the components are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.
- A6. The determination of the suitability of analytical procedures as substantive procedures is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than analytical procedures for assertions related to receivables; or if inventory balances are material, the auditor may decide not to rely only on analytical procedures when performing audit procedures on the existence assertion.
- A7. Analytical procedures as substantive procedures may also be considered appropriate when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

Considerations Specific to Public Sector Entities

- A8. The relationships between individual financial statement items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities; for example, in many public sector entities there may be little direct relationship between revenue and expenditure. In addition, because expenditure on the acquisition of assets may not be capitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. Also, industry data or statistics for comparative purposes may not be available in the public sector. However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired.

The Reliability of the Data (Ref: Para. 8(c))

- A9. The reliability of data is influenced by its source and by its nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing analytical procedures as substantive procedures:
- (a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;⁴
 - (b) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products;
 - (c) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
 - (d) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.
- A10. The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in applying analytical procedures as substantive procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor could test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. [Proposed] ISA 500 (Redrafted) establishes requirements and provides guidance in determining the audit procedures to apply to the information to be used for analytical procedures as substantive procedures.⁵

Considerations Specific to Smaller Entities

- A11. The extent of use of analytical procedures as substantive procedures in response to assessed risks in the audit of a smaller entity may be limited because of the unreliability, or lack, of information on which the analytical procedures are based.

⁴ [Proposed] ISA 500 (Redrafted), "Considering the Relevance and Reliability of Audit Evidence," paragraph [A23].

⁵ [Proposed] ISA 500 (Redrafted), paragraph [12].

Evaluation whether the Expectation is Sufficiently Precise (Ref: Para. 8(d))

A12. In evaluating whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, the auditor may consider matters such as the following:

- The accuracy with which the expected results of analytical procedures as substantive procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.
- The degree to which information can be disaggregated. For example, analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
- The availability of the information, both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design analytical procedures as substantive procedures. If the information is available, the auditor may also consider the reliability of the information as discussed in paragraphs A9 and A10 above.

Amount of Difference of Recorded Amounts from Expected Values that is Acceptable (Ref: Para. 8(e))

A13. The auditor's determination of the amount of difference from expectation that can be accepted without further investigation is influenced by materiality and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, when aggregated with other misstatements, may cause the financial statements to be materially misstated. ISA 330 (Redrafted) requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of risk.⁶ Accordingly, a smaller amount of difference that would be considered acceptable without investigation is needed to achieve the desired level of assurance as the assessed risk increases.

A14. The matters discussed in paragraph 9(a)-(d) are relevant irrespective of whether the auditor performs analytical procedures as substantive procedures on the entity's period end financial statements, or at an interim date and plans to perform analytical procedures as substantive procedures with respect to the intervening period as part of the period end. ISA 330 (Redrafted)⁷ establishes requirements and provides guidance on substantive procedures performed at an interim date.

⁶ ISA 330 (Redrafted), paragraph 7(b).

⁷ ISA 330 (Redrafted), paragraphs 23-24.

Analytical Procedures that Assist in Arriving at the Auditor’s Overall Conclusion in an Audit of Financial Statements (Ref: Para. 9)

- A15. The conclusions drawn from the results of analytical procedures during the overall review stage of the audit are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements, and assist in arriving at the auditor’s overall conclusion on whether the financial statements as a whole are free from material misstatements.
- A16. The results of such analytical procedures may identify a previously unrecognized risk of material misstatement. In such circumstances, ISA 315 (Redrafted) requires the auditor to revise the auditor’s assessment of the risks of material misstatement and modify the further planned audit procedures accordingly.⁸
- A17. The analytical procedures performed as part of the auditor’s overall review of the financial statements are often similar to those that would be used as risk assessment procedures.

Investigating Results of Analytical Procedures (Ref: Para. 10)

- A18. Audit evidence relevant to management’s responses may be obtained by considering how those responses compare with the auditor’s understanding of the entity and its environment, or with other audit evidence obtained during the course of the audit.
- A19. The need to apply other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation is not considered adequate.

⁸ ISA 315 (Redrafted), paragraph 30.

PROPOSED CONFORMING AMENDMENT

ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”

Analytical Procedures

- A7. Analytical procedures performed during risk assessment of the entity may indicate aspects of the entity of which the auditor was unaware and will assist in assessing the risks of material misstatement in order to determine the nature, timing and extent of further audit procedures. Analytical procedures applied as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.
- A78. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
- A89. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures. ~~ISA 520, “Analytical Procedures,” establishes requirements and provides guidance on the use of analytical procedures.~~

Considerations Specific to Smaller Entities

- A10. The availability of information to perform analytical procedures as risk assessment procedures in the audit of a smaller entity may be limited by the timeliness of processing of transactions and preparation of reliable financial information by the entity. Further, smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. Accordingly, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity’s financial statements is available.



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Proposed International Standard on Auditing

ISA 265, Communicating
Deficiencies in Internal Control
and
Related Conforming Amendments to
Other ISAs



REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Auditing (ISA) 265, “Communicating Deficiencies in Internal Control” for publication in December 2007. This proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by email, so that they will be received by **April 30, 2008**. All comments will be considered a matter of public record. Comments should be addressed to:

International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Comments should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to the above address.

Copies of the exposure draft may be downloaded free-of-charge from the IFAC website at <http://www.ifac.org>.

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EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to, and an explanation of, proposed International Standard on Auditing (ISA) 265, “Communicating Deficiencies in Internal Control,” approved for exposure by the International Auditing and Assurance Standards Board (IAASB) in December 2007.

Background

The IAASB commenced this project in October 2005 in response to regulatory and standard-setting developments around the world regarding internal control-related matters, including, in particular:

- The requirement under the European Union’s Statutory Audit Directive for auditors to report identified material weaknesses in internal control (“material weakness”) to audit committees; and
- The U.S. Public Company Accounting Oversight Board’s (PCAOB’s) issue of an auditing standard addressing an audit of internal control over financial reporting.¹

In addition, it was recognized that the current definition of the term “material weakness” within the ISAs is rather general² and that there is a need to clarify its meaning in order to improve the consistency with which auditors treat identified weaknesses in internal control as material, and how such matters are reported. Accordingly, the IAASB set out to develop a revised definition of material weakness for the purposes of the ISAs. In doing so, the IAASB acknowledged the need also to clarify the auditor’s responsibilities in relation to the evaluation and communication of internal control-related matters identified during the audit to management and those charged with governance.

As the project has evolved and new considerations have emerged during debate at a number of meetings of the IAASB and the IAASB Consultative Advisory Group (CAG), there has been a shift from the original aim to develop a revised definition of material weakness to a current focus on developing a clear definition of the threshold of significance at which deficiencies in internal control should be communicated to those charged with governance.

The IAASB believes that the proposed ISA provides clearer guidance regarding the relevant internal control-related matters to be communicated in an audit of financial statements, which will enhance the consistency of auditor performance in this area. The proposed ISA has been drafted in accordance with the IAASB’s clarity drafting conventions.

¹ Auditing Standard 2, “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements” subsequently superseded by Auditing Standard 5, “An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements.”

² ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment” defines a material weakness as one that could have a material effect on the financial statements.

Significant Matters

Definition of Significant Deficiency

The IAASB believes that the most important public interest consideration for the wide range of audits covered by the ISAs is to ensure that the auditor communicates identified non-trivial deficiencies in internal control (“deficiencies”) to those parties within the entity who can competently deal with them on a timely basis. This is consistent with current practice under the ISAs whereby auditors have historically applied their judgment to determine broadly the control matters that they would consider to be “material weaknesses” for reporting to management and those charged with governance (without being required to perform specific evaluations of the level of severity of such matters).

Having established this principle, the IAASB took the view that it would be inappropriate to require the auditor to communicate all the relevant deficiencies identified during the audit to those charged with governance to the same extent as to management. This is because the range of deficiencies that the auditor might judge to be non-trivial could be quite large and, while potentially important for management to be aware of them all, the attention of those charged with governance will rightly be directed at the more significant deficiencies only. The IAASB therefore agreed that some prioritization of the identified deficiencies for purposes of communication with those charged with governance is necessary, based on the auditor’s judgment.

The IAASB determined that the term “significant deficiency” should be defined for this purpose, consistent with the term used in the PCAOB’s Auditing Standard 5 to define those deficiencies meriting the attention of those overseeing the financial reporting process.³ To avoid creating an unnecessary difference in definitions internationally, the IAASB also decided that the definition of significant deficiency in the ISAs should be closely aligned with that in the PCAOB’s Auditing Standard 5. The proposed ISA therefore establishes the following definition of a significant deficiency:

A deficiency or combination of deficiencies in internal control relevant to the audit⁴ that, in the auditor’s professional judgment, is of sufficient importance to merit the attention of those charged with governance. (See paragraph 6(b).)

Communication of Significant Deficiencies to Those Charged with Governance

The IAASB determined that the auditor should be required to communicate significant deficiencies identified during the audit to those charged with governance on a timely basis. The IAASB also decided that this communication should be in writing to recognize the importance of the deficiencies being communicated (see paragraph 10).

³ The PCAOB’s Auditing Standard 5 defines a significant deficiency as a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company’s financial reporting.

⁴ This is consistent with the requirement in paragraph 12 of ISA 315 (Redrafted) for the auditor to obtain an understanding of internal control relevant to the audit.

To accommodate different circumstances in practice, proposed guidance in the application and other explanatory material explains that the level of detail at which significant deficiencies should be communicated to those charged with governance varies with the engagement circumstances. Paragraph A17 sets out relevant factors the auditor may consider in this regard.

In addition, guidance in the proposed ISA indicates that the auditor may also communicate *other* identified deficiencies to those charged with governance, whether in summarized form or as otherwise agreed (see paragraph A18).

Communication of Identified Deficiencies to Management

In relation to non-trivial deficiencies that are not judged to be significant deficiencies, the IAASB determined that these should be communicated to management. Accordingly, the proposed ISA requires the auditor to communicate all non-trivial deficiencies (including significant deficiencies) identified during the audit to management at an appropriate level of responsibility on a timely basis, unless:

- (a) The auditor has obtained sufficient appropriate audit evidence about the operating effectiveness of other controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies; or
- (b) It would be inappropriate to communicate directly to management in the circumstances. (See paragraph 9).

This would then result in the auditor duly informing those who are responsible for the relevant control matters so that they may take appropriate action.

However, the IAASB believes that requiring the auditor to communicate all identified deficiencies formally to management in *writing* could place an undue and excessive documentation burden on the auditor, particularly in smaller entity audits. Accordingly, the IAASB agreed that the communication to management need not be in writing.

Rationale for not Defining Material Weakness

The IAASB considered establishing a definition similar to the definition of material weakness set out in the PCAOB's Auditing Standard 5, which would have had the benefit of harmonizing the definition of material weakness internationally. The PCAOB definition, however, is intended to represent a threshold for purposes of reporting publicly on the effectiveness of internal control, as required by the Sarbanes-Oxley Act in the USA. That threshold is higher than that defined for the purposes of reporting to those charged with governance. The IAASB concluded that this definition would not be appropriate for the ISAs as they contain no requirement for a report by auditors on the effectiveness of internal control, and in the absence of such a requirement a further categorization of deficiencies would place an unnecessary evaluation burden on auditors to no purpose.

The IAASB also decided against developing a definition of material weakness that would be different from that set out in the PCAOB's Auditing Standard 5. The co-existence of two different definitions of the same term in IAASB and PCAOB standards could potentially generate confusion amongst practitioners and users of financial statements around the world, and lead to attempts at

reconciling their meanings for varying reporting purposes. The IAASB believes that this outcome would not be in the public interest.

Guidance on Material Weakness

In light of the above decisions, the IAASB proposes that the term “material weakness” no longer be used in the ISAs and that appropriate conforming amendments be made to the relevant ISAs (see pages 18-24). However, to highlight the fact that there may be legal or regulatory requirements for the auditor to communicate such control matters as “material weaknesses,” the IAASB proposes the following guidance in paragraph A8 of the application material:

Law or regulation in some jurisdictions may establish requirements for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) details of specific types of deficiencies in internal control that the auditor has identified during the audit, and may define terms such as “material weakness” for this purpose.

The IAASB believes that the approach to the definitions as explained above achieves the aim of clarifying what control-related matters the auditor should communicate to management and those charged with governance based on the audit work performed, and how these should be determined.

Further, by not defining the term “material weakness,” the IAASB has avoided an unnecessary inconsistency with the standards of the PCAOB, while leaving it open to other regulators to define the term appropriately within the context of their environments.

Determining When Identified Deficiencies Constitute Significant Deficiencies

The proposed ISA notes that significant deficiencies may exist even though the auditor has not identified misstatements during the audit. It further explains that the significance of a deficiency or combination of deficiencies depends not only on whether a misstatement has actually occurred, but also on the *risk* that a misstatement could occur and the *potential magnitude* of the misstatement (see paragraph A5). The IAASB believes that these are ultimately matters of the auditor’s professional judgment in the circumstances of the engagement. Nevertheless, to assist auditors in making the determination as to whether a deficiency or combination of deficiencies constitutes a significant deficiency, the IAASB proposes guidance on indicators of significant deficiencies (see paragraph A6), and on other matters the auditor may consider in making that determination (see paragraph A7).

Objective and Orientation of the Proposed ISA

As indicated earlier, the original aim of this project was to clarify the meaning of the term “material weakness” as defined in ISA 315 (Redrafted), and the auditor’s responsibility to evaluate whether material weaknesses have been identified based on the audit work performed.⁵ Accordingly, the IAASB’s initial presumption was that the clarified requirements and guidance on material weaknesses would be contained in a companion ISA to ISA 315 (Redrafted).

⁵ ISA 315 (Redrafted), paragraph 31.

While the IAASB considers that this aim has been achieved in the proposed ISA, it believes that it is appropriate to orientate the ISA towards a communication objective. This reflects the outcome that the auditor should achieve in the public interest, i.e., bringing to the notice of management and those charged with governance, as appropriate, those deficiencies in internal control the auditor has identified. Accordingly, the IAASB proposes an objective for the auditor that reflects this desired communication outcome (see paragraph 5). The IAASB also agreed that the proposed ISA be placed in the communication series as a companion ISA to ISA 260 (Revised and Redrafted).⁶

Effective Date

The current IAASB project timetable envisages that all ISAs will have been revised and redrafted, or redrafted only, by late 2008. The IAASB has agreed that the complete set of ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009. The IAASB believes that it should be possible to finalize this standard within that timetable.

Guide for Respondents

The IAASB welcomes comments on all matters addressed in the exposure draft. 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 this exposure draft (especially those calling for change in current practice), it will be helpful for the IAASB to be made aware of this view.

Request for Specific Comments

The IAASB would welcome views on the following:

The proposed ISA recognizes that in discussing the auditor's findings regarding suspected deficiencies with management (see paragraphs A1-A3), the auditor may be informed by management of the existence of other controls that management may assert would prevent, or detect and correct, misstatements arising from the identified deficiencies. The proposed ISA makes it clear that the auditor is not required to obtain audit evidence regarding the design and operating effectiveness of these other controls (unless otherwise necessary for the purposes of the audit), although the auditor may choose to do so (see paragraph A3).

The IAASB determined that, in such cases the auditor should communicate identified deficiencies to management *unless* the auditor has obtained sufficient appropriate audit evidence about the operating effectiveness of other controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies (see paragraph 9(a)). The IAASB believes that, without such audit evidence about the *operating effectiveness* of these other controls, the auditor does not have sufficient audit evidence to conclude that a deficiency in internal control does not exist. The IAASB has therefore taken the view that audit evidence regarding the effective design and implementation of such other controls is not in itself sufficient to support a conclusion that a deficiency does not exist (see paragraph A12); and this is the case even though the auditor's view that there is a deficiency may be based solely on evidence about the design or implementation of a control.

⁶ ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance."

Do you agree with this guidance?

Request for Comments on the Application of the Clarity Drafting Conventions

In addition to the matters referred to above, the IAASB is seeking comments on the application of the clarity drafting conventions.⁷ Respondents are asked to consider whether the objective for the proposed ISA is appropriate, and whether the proposed requirements are appropriate responses to that objective.

Comments on Other Matters

Recognizing that the final ISA will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below.

- *Special Considerations in the Audit of Smaller Entities*— Respondents are asked to comment whether, in their opinion, guidance addressing special considerations in the audit of smaller entities should be provided in the proposed ISA. If so, respondents are asked to explain why, and to suggest the nature of any such considerations.
- *Special Considerations in the Audit of Public Sector Entities*— Respondents are asked to comment whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in the proposed ISA.
- *Developing Nations*— Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed ISA in a developing nation environment.
- *Translations*— Recognizing that many respondents intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing the proposed ISA.

To be considered, responses should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to 545 Fifth Avenue, 14th Floor, New York, NY 10017, USA. They should be received by **April 30, 2008**.

⁷ The IAASB has identified the following criteria for determining the requirements of a Standard:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; or, in the case of circumstances that are reasonably likely to exist or arise in an engagement, the requirement is considered necessary to the consistent application of the ISA and the action specified is expected to be appropriate in virtually all such circumstances; and
- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.

In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

The criteria, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 265
COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL**

(Effective for audits of financial statements for periods beginning on or after [December 15, 2009])

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Proposed International Standard on Auditing (ISA) 265, “Communicating Deficiencies in Internal Control” should be read in conjunction with [proposed] ISA 200 (Revised and Redrafted), “Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing.”

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to communicate appropriately to management and those charged with governance deficiencies in internal control¹ that the auditor has identified in an audit of the financial statements. This ISA does not address deficiencies in internal control the potential financial effects of which are clearly trivial.²
2. The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement.³ In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. Knowledge of deficiencies in internal control is relevant to management and those charged with governance in fulfilling their respective responsibilities in relation to the financial reporting process. This ISA therefore establishes communication responsibilities for the auditor regarding identified deficiencies in internal control.
3. Nothing in this ISA precludes the auditor from communicating control matters that the auditor has identified during the audit that are not relevant to the audit but that the auditor considers important.

Effective Date

4. This ISA is effective for audits of financial statements for periods beginning on or after [December 15, 2009].

Objective

5. The objective of the auditor is to communicate appropriately to management or those charged with governance deficiencies in internal control relevant to the audit that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

Definitions

6. For purposes of the ISAs, the following terms have the meanings attributed below:
 - (a) Deficiency in internal control – A control that is either missing or is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis.

¹ ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment," paragraph 4, defines the terms "internal control" and "controls."

² [Proposed] ISA 450 (Revised and Redrafted), "Evaluation of Misstatements Identified during the Audit," paragraph [A1], describes the meaning of "clearly trivial."

³ ISA 315 (Redrafted) paragraph 12. Paragraphs A56-A61 provide guidance on controls relevant to the audit.

- (b) Significant deficiency – A deficiency or combination of deficiencies in internal control relevant to the audit that, in the auditor’s professional judgment, is of sufficient importance to merit the attention of those charged with governance.

Requirements

Identification of Deficiencies in Internal Control

7. The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: Para. A1-A3)
8. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A4-A8)

Communication of Deficiencies in Internal Control

9. The auditor shall communicate all deficiencies in internal control (other than those that are clearly trivial) identified during the audit to management at an appropriate level of responsibility on a timely basis, unless: (Ref: Para. A9-A11, A22)
 - (a) The auditor has obtained sufficient appropriate audit evidence about the operating effectiveness of other controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies; or (Ref: Para. A3, A12)
 - (b) It would be inappropriate to communicate directly to management in the circumstances. (Ref: Para. A13)
10. The auditor shall communicate significant deficiencies identified during the audit to those charged with governance in writing and on a timely basis. (Ref: Para. A14-A18, A22)
11. The auditor shall include in the written communication of significant deficiencies:
 - (a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A19)
 - (b) Sufficient information to enable those charged with governance to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A20-A21)
 - (i) The auditor did not plan and perform the audit with a view to identifying all deficiencies in internal control that might exist;
 - (ii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded should be reported to those charged with governance; and
 - (iii) The purpose of the audit was for the auditor to express an audit opinion on the financial statements, and the auditor has not performed audit procedures to obtain reasonable assurance, and is not providing any assurance, on the effectiveness of internal control.

Application and Other Explanatory Material

Identification of Deficiencies in Internal Control (Ref: Para. 7)

- A1. Deficiencies in internal control may be identified at any stage of the audit. In determining whether the auditor has identified one or more deficiencies, the auditor may seek to agree the relevant facts and circumstances of the auditor's findings with management. Doing so also provides an opportunity for the auditor to alert management on a timely basis to the existence of deficiencies of which management may not have been previously aware.
- A2. In agreeing the facts and circumstances of the auditor's findings with management, the auditor may obtain other relevant information for further consideration, such as:
- Management's understanding of the actual or suspected causes of the deficiencies.
 - Exceptions arising from the deficiencies that management may have noted, for example, misstatements that were not prevented by the relevant IT controls.
 - A preliminary indication from management of its response to the findings.
- A3. Management may also inform the auditor of controls not previously known to the auditor that it believes would prevent, or detect and correct, potential misstatements that would not be caught by the control(s) giving rise to the deficiencies. The existence of these other controls does not change the fact that the auditor has identified deficiencies in internal control. This ISA does not require the auditor to obtain audit evidence regarding the design and operating effectiveness of these other controls. In concluding whether deficiencies in internal control exist, the auditor is, however, not precluded from obtaining and evaluating additional audit evidence regarding such other controls.

Determination of Whether Identified Deficiencies Constitute Significant Deficiencies (Ref: Para. 8)

- A4. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements.⁴ For example, controls in an IT subsystem may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the relevant account balances. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same account or disclosure, relevant assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.
- A5. Significant deficiencies may exist even though the auditor has not identified misstatements during the audit. The significance of a deficiency or combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the risk that a misstatement could occur and the potential magnitude of the misstatement.
- A6. Indicators of significant deficiencies include, for example:
- Deficiencies in the control environment, such as:

⁴ ISA 315 (Redrafted), paragraph A62.

- Ineffective oversight of the financial reporting process by those charged with governance, especially in an environment with limited segregation of duties.
 - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
 - A deficiency in a control over a significant risk.
 - Material misstatements detected by the auditor's procedures that were not identified by the entity's internal control.
 - Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.
- A7. Examples of other matters that the auditor may consider in determining whether a deficiency or combination of deficiencies constitutes a significant deficiency include:
- The susceptibility to loss or fraud of the related asset or liability.
 - The subjectivity and complexity of determining estimated amounts, such as those involving fair values.
 - The financial statement amounts exposed to the deficiencies.
 - The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
 - The importance of the controls to the financial reporting process; for example:
 - General monitoring controls (such as oversight of management).
 - Controls over the prevention and detection of fraud.
 - Controls over the selection and application of significant accounting policies.
 - Controls over significant transactions outside the entity's normal course of business.
 - Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
 - The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
 - The interaction of the deficiency in internal control with other deficiencies in internal control.
- A8. Law or regulation in some jurisdictions may establish requirements for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) details of specific types of deficiencies in internal control that the auditor has identified during the audit, and may define terms such as "material weakness" for this purpose.

Communication of Deficiencies in Internal Control

Communication of Identified Deficiencies to Management (Ref: Para. 9)

- A9. The auditor may identify deficiencies in certain controls that do not relate directly to the financial reporting objective of internal control. These controls may, nevertheless, be relevant to the audit if they address in particular the completeness and accuracy of information produced by the entity that the auditor intends to use in designing and performing audit procedures. For example, it is appropriate to communicate to management, in accordance with paragraph 9, a deficiency in a control that did not detect the use of a superseded price list by the entity's computerized sales system, resulting in lower margins than would be expected.
- A10. How the auditor communicates a deficiency may be influenced by whether the auditor has communicated it in a previous audit, or whether management already has knowledge of it. If the auditor has previously communicated the matter to management, the current year's communication may include the same description of the deficiency as previously communicated. Alternatively, it may be summarized, specifically referring to the previous communication. However, the fact that the auditor communicated a deficiency to management in a previous audit, or that management already had knowledge of the deficiency through other means (such as from relevant work done by internal auditors), does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. The auditor may ask management why the deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.
- A11. Management may already be aware of deficiencies that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management. Accordingly, the requirement for the auditor to communicate deficiencies to management applies regardless of cost or other considerations that management may consider relevant in determining whether to remedy such deficiencies.
- A12. Unless the auditor has obtained sufficient appropriate audit evidence about the operating effectiveness of other controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies, the auditor does not have sufficient audit evidence to conclude that a deficiency in internal control does not exist. Audit evidence regarding the effective design and implementation of such other controls is not in itself sufficient to support such a conclusion.
- A13. It may be inappropriate to communicate identified deficiencies directly to management in situations that call into question the integrity or competence of management. For example, there may be evidence of actual or suspected fraud on management's part, or management may exhibit an inability to prepare adequate financial statements that may raise doubt about management's competence.

Communication of Significant Deficiencies to Those Charged with Governance (Ref: Para. 10)

- A14. Communicating significant deficiencies to those charged with governance in writing reflects the importance of these matters, and assists those charged with governance in fulfilling their responsibility relating to overseeing the financial reporting process. The communication may include details of any proposed remedial action from management, together with a statement as to whether the auditor has undertaken any steps to verify that such action has been implemented.
- A15. In determining when to issue the written communication to those charged with governance, the auditor may consider that receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. Further, for listed entities in certain jurisdictions, those charged with governance may need to receive the auditor's written communication before the date of approval of the financial statements in order to discharge specific responsibilities in relation to internal control for regulatory or other purposes. For other entities, the auditor may issue the written communication at a later date. Nevertheless, in the latter case, as the auditor's written communication of significant deficiencies forms part of the final audit file, the written communication is subject to the overriding requirement⁵ for the auditor to complete the assembly of the final audit file on a timely basis.⁶
- A16. Regardless of the timing of the written communication of significant deficiencies to those charged with governance, the auditor may communicate these orally in the first instance to management and, when the auditor considers it appropriate to do so, to those charged with governance. This may assist them in taking timely remedial action to minimize the risks of material misstatement. Doing so, however, does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing to those charged with governance, as paragraph 10 requires.
- A17. The level of detail at which to communicate significant deficiencies to those charged with governance is a matter of the auditor's professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example:
- The nature and size of the entity.
 - The nature and volume of significant deficiencies that the auditor has identified.
 - The entity's governance structure.
 - The nature of the oversight responsibilities of those charged with governance.
 - The preferences of those charged with governance.

⁵ ISA 230 (Redrafted), "Audit Documentation," paragraph 14.

⁶ ISA 230 (Redrafted), paragraph A21, states that an appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

- Legal or regulatory requirements regarding the communication of specific types of deficiencies in internal control.
- Whether the significant deficiencies were communicated to those charged with governance in previous audits.
- Whether those charged with governance already had knowledge of the significant deficiencies through other means, such as from relevant internal audit reports.

A18. The auditor may also communicate other control deficiencies to those charged with governance, whether in summarized form or as otherwise agreed. For example, in some circumstances those charged with governance may prefer to know of all deficiencies communicated to management. In other circumstances, those charged with governance may prefer only brief descriptions or summaries of the nature of the other deficiencies.

Content of Written Communication of Significant Deficiencies (Ref: Para. 11)

A19. In explaining the potential effects of significant deficiencies, the auditor need not quantify those effects.

A20. The auditor may consider it appropriate to include the following information as additional context for the communication:

- An indication that if the auditor had performed more extensive audit procedures on internal control, the auditor might have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not, in fact, have been reported.
- An indication that such communication has been provided for the purposes of management and those charged with governance, and that it may not be suitable for other purposes.

A21. Laws or regulations may require the auditor or management to furnish a copy of the auditor's written communication on significant deficiencies to appropriate regulatory authorities. Where this is the case, the auditor's written communication may identify such regulatory authorities.

Considerations Specific to Public Sector Entities

A22. Public sector auditors may have additional responsibilities to communicate deficiencies in internal control that the auditor has identified during the audit, in ways, at a level of detail and to parties not envisaged in this ISA. For example, significant deficiencies may have to be communicated to the legislature or other governing body. Legislation may also mandate that public sector auditors report deficiencies in internal control, irrespective of the significance of the potential effects of those deficiencies. Further, legislation may require public sector auditors to report on broader internal control-related matters than the deficiencies in internal control required to be communicated by this ISA.

PROPOSED CONFORMING AMENDMENTS

ISA 240 (Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”

A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.
- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific ~~weaknesses~~ deficiencies in internal control.
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

Appendix 1 – Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.
- Accounting and information systems that are not effective, including situations involving ~~material weaknesses~~ significant deficiencies in internal control.

Attitudes/Rationalizations

- Management failing to ~~correct~~ remedy known ~~material weaknesses~~ significant deficiencies in internal control on a timely basis.

Risk Factors Arising From Misstatements Arising From Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and

~~weaknesses~~ other deficiencies in internal control ~~that is not effective~~ may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Appendix 3 – Examples of Circumstances that Indicate the Possibility of Fraud

- An unwillingness to address identified ~~weaknesses~~ significant deficiencies in internal control on a timely basis.

ISA 260 (Revised and Redrafted), “Communicating with Those Charged with Governance”

12. The auditor shall communicate with those charged with governance (Ref: Para. A20):
- (a) The auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity (Ref: Para. A21);
 - (b) Significant difficulties, if any, encountered during the audit (Ref: Para. A22);
 - (c) Unless all of those charged with governance are involved in managing the entity:
 - (i) ~~Material weaknesses, if any, in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention and have been communicated to management as required by ISA 315 (Redrafted), or ISA 330 (Redrafted);~~
 - (ii) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management (Ref: Para. A23); and
 - (iii) Written representations the auditor is requesting; and
 - (d) Other matters, if any, arising from the audit that are, in the auditor’s professional judgment, significant to the oversight of the financial reporting process (Ref: Para. A24).
- A44. The appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:
- Communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.
 - It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion. Similarly, ~~it may be appropriate to the auditor~~ may communicate material weaknesses in the design, implementation or operating effectiveness of significant deficiencies in

internal control that ~~have come to the auditor's attention~~ the auditor has identified orally in the first instance to those charged with governance as soon as practicable, prior to communicating these in writing on a timely basis as required by [proposed] ISA 265.¹⁴

- Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, e.g., when accepting an engagement to provide non-audit services, and at a concluding discussion. A concluding discussion may also be an appropriate time to communicate findings from the audit, including the auditor's views about the qualitative aspects of the entity's accounting practices.
- When auditing both general purpose and special purpose financial statements, it may be appropriate to coordinate the timing of communications.

ISA 300 (Redrafted), "Planning the Audit of Financial Statements"

Appendix – Considerations in Establishing the Overall Audit Strategy

- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified ~~weaknesses~~ deficiencies and action taken to address them.

ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
 - (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
 - (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment ~~weaknesses~~. (Ref: Para. A65-A74)
16. If the entity has established such a process (referred to hereafter as the 'entity's risk assessment process'), the auditor shall obtain an understanding of it, and the results thereof. Where the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or if there is a ~~material weakness~~ significant deficiency in the entity's risk assessment process.
17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives

¹⁴ [Proposed] ISA 265, "Communicating Deficiencies in Internal Control," paragraphs [8 and A16].

have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or represents a ~~material weakness~~ significant deficiency in the entity's internal control. (Ref: Para. A76)

Material Weakness in Internal Control

31. ~~The auditor shall evaluate whether, on the basis of the audit work performed, the auditor has identified a material weakness in the design, implementation or maintenance of internal control. (Ref: Para. A124-A125)~~
32. ~~The auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility, and, as required by ISA 260, "The Auditor's Communication with Those Charged with Governance," with those charged with governance (unless all of those charged with governance are involved in managing the entity). (Ref: Para. A126)~~
- A62. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a ~~material weakness~~ significant deficiency in the entity's internal control.
- A70. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, ~~weaknesses~~ deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in ISA 330 (Redrafted), the control environment also influences the nature, timing, and extent of the auditor's further procedures.
- A99. Risks at the financial statement level may derive in particular from a weak control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, ~~weaknesses~~ deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.
- A119. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. This may indicate a ~~material weakness~~ significant deficiency in the entity's internal control.

Material Weakness in Internal Control (Ref: Para. 31)

~~A124. The types of material weaknesses in internal control that the auditor may identify when obtaining an understanding of the entity and its internal controls may include:~~

- ~~• Risks of material misstatement that the auditor identifies and which the entity has not controlled, or for which the relevant control is inadequate.~~
- ~~• A weakness in the entity’s risk assessment process that the auditor identifies as material, or the absence of a risk assessment process in those cases where it would be appropriate for one to have been established.~~

~~A125. Material weaknesses may also be identified in controls that prevent, or detect and correct, error, or those to prevent and detect fraud.~~

Considerations Specific to Public Sector Entities (Ref: Para. 32)

~~A126. In the audit of public sector entities, there may be additional communication or reporting requirements for public sector auditors. For example, internal control weaknesses may have to be reported to the legislature or other governing body.~~

Appendix 2 – Conditions and Events that may Indicate Risks of Material Misstatement

Conditions and Events that may Indicate Risks of Material Misstatement

- ~~Weaknesses~~ Significant deficiencies in internal control, especially those not addressed by management.

ISA 330 (Redrafted), “The Auditor’s Responses to Assessed Risks”

~~18. The auditor shall evaluate whether, on the basis of the audit work performed, the auditor has identified a material weakness in the operating effectiveness of controls.~~

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

A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor’s overall responses, is affected by the auditor’s understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. ~~Weaknesses~~ Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period end rather than at an interim date.
- Obtaining more extensive audit evidence from substantive procedures.

- Increasing the number of locations to be included in the audit scope.

~~A40. A material misstatement detected by the auditor’s procedures may indicate the existence of a material weakness in internal control.~~

A56. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures. Information may come to the auditor’s attention that differs significantly from the information on which the risk assessment was based. For example,

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor’s judgment about the risk assessments and may indicate a ~~material weakness~~ significant deficiency in internal control.
- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement.

In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. ISA 315 (Redrafted) contains further guidance on revising the auditor’s risk assessment.

ISA 600 (Revised and Redrafted), “Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)”

41. The group engagement team shall request the component auditor to communicate matters relevant to the group engagement team’s conclusion with regard the group audit. Such communication shall include:

- (g) Description of any identified ~~material weaknesses~~ significant deficiencies in internal control ~~over financial reporting~~ relevant to the audit at the component level;

46. The group engagement team shall make group management aware, on a timely basis and at an appropriate level of responsibility, of:

- (a) ~~Material weaknesses in the design or operating effectiveness of~~ All deficiencies in group-wide controls (other than those that are clearly trivial) that the group engagement team has identified, unless:
 - (i) The group engagement team has obtained sufficient appropriate audit evidence about the operating effectiveness of other group-wide controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies; or (Ref: Para. A64)
 - (ii) It would be inappropriate to communicate directly to group management in the circumstances. (Ref: Para. A65)

- (b) ~~Material weaknesses~~ Significant deficiencies that the group engagement team has identified in internal controls at components and judges are of significance to the group; and
- (c) ~~Material weaknesses~~ Significant deficiencies that component auditors have identified in internal controls at components and brought to the attention of the group engagement team that the group engagement team judges are of significance to the group.

A20. As required in ISA 210, the terms of engagement ~~identifies~~ identify the applicable financial reporting framework. Additional matters may be included in the terms of a group audit engagement, such as the fact that:

- Important communications between the component auditors, those charged with governance of the component, and component management, including communications on ~~material weaknesses~~ significant deficiencies in internal control, should be communicated as well to the group engagement team.

A64. Unless the group engagement team has obtained sufficient appropriate audit evidence about the operating effectiveness of other group-wide controls that would prevent, or detect and correct, misstatements arising from the identified deficiencies, the group engagement team does not have sufficient audit evidence to conclude that a deficiency in internal control does not exist. Audit evidence regarding the effective design and implementation of such other group-wide controls is not in itself sufficient to support such a conclusion.

A65. It may be inappropriate to communicate identified deficiencies directly to group management in situations that call into question the integrity or competence of group management. For example, there may be evidence of actual or suspected fraud on group management's part, or group management may exhibit an inability to prepare adequate group financial statements that may raise doubt about group management's competence.

Appendix 5 – Required and Additional Matters Included in the Group Engagement Team's Letter of Instruction

Other information

- ~~Material weaknesses~~ Significant deficiencies in controls that ~~have come to the attention of~~ the component auditor has identified during the performance of the work on the financial information of the component, and information that indicates the existence of fraud.



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*Proposed Revised and Redrafted International
Standard on Auditing*

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



REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft of proposed International Standard on Auditing (ISA) 402 (Revised and Redrafted), “Audit Considerations Relating to an Entity Using a Third Party Service Organization” for publication in December 2007. The proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by e-mail, so that they will be received by **April 30, 2008**. All comments will be considered a matter of public record. Comments should be addressed to:

International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Comments should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to the above address.

Copies of the exposure drafts may be downloaded free-of-charge from the IFAC website at <http://www.ifac.org>.

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EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to, and an explanation of, proposed International Standard on Auditing (ISA) 402 (Revised and Redrafted), “Audit Considerations Relating to an Entity Using a Third Party Service Organization.” The International Auditing and Assurance Standards Board (IAASB) approved the proposed ISA in December 2007 for exposure.

Background

The IAASB commenced this project in March 2006 in response to developments that indicated a need to revise extant ISA 402, “Audit Considerations Relating to Entities Using Service Organizations,” including:

- (a) The recent updating of corresponding national auditing standards in a number of jurisdictions, and requests received by the IAASB to do the same;
- (b) The need to align the standard with the risk assessment standards; and
- (c) The increasing use of service organizations by entities and complexity of relationships between the two parties since the development of the extant ISA.

The IAASB believes that the proposed ISA will enhance the consistency of auditor performance in an audit of financial statements through more specific requirements and expanded guidance. In particular, the proposed ISA expands upon the requirements in the extant ISA when the user auditor, defined as the auditor who audits and reports on the financial statements of an entity that uses a service organization (a user entity), intends to use a Type A or Type B service auditor’s report.

Significant Matters

Alignment with the Risk Assessment Standards

When the IAASB agreed to undertake a project to revise extant ISA 402, one of the objectives to be achieved was to align the requirements and guidance with the risk assessment standards. Proposed ISA 402 (Revised and Redrafted) does so by expanding on the requirements in ISA 315 (Redrafted)¹ and ISA 330 (Redrafted)² as appropriate when a user entity uses one or more service organizations that perform services that are part of the entity’s information system relevant to financial reporting.

In particular, proposed ISA 402 (Revised and Redrafted) specifically requires a user auditor to understand the services of a service organization when they directly affect the user entity’s internal control as it relates to the preparation of the financial statements – when those services, had they been performed “in house,” would have been covered by the auditor in applying ISA 315 (Redrafted) and ISA 330 (Redrafted).

¹ ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment.”

² ISA 330 (Redrafted), “The Auditor’s Responses to Assessed Risks.”

In addition, when the user auditor intends to rely on controls at the service organization, the proposed ISA requires the user auditor to test those controls, use a Type B report provided by a service auditor that is for an appropriate period, or engage a service auditor to perform tests of controls at the service organization on behalf of the user auditor.

Shared Service Centers

In some cases, a shared service center that provides services “internally” to a group of related companies may be considered a service organization from the perspective of the auditor of a component of the group. While the focus of proposed ISA 402 (Revised and Redrafted) is on an entity’s use of a third party service organization, the IAASB is of the view that it may also be applicable, adapted as necessary in the circumstances, to situations where an entity uses a shared service center that provides services to a group of related entities.

Linkage with ISAE 3402

In December 2007, the IAASB also approved an exposure draft of a proposed new assurance standard, ISAE 3402, “Assurance Reports on Controls at a Third Party Service Organization.” This proposed ISAE deals with considerations relevant to engagements performed by service auditors to report on controls at third party service organizations. The standard was developed concurrently with the revisions of extant ISA 402 in order to ensure that the reports issued under the new ISAE would meet the needs of a user auditor who would be applying proposed ISA 402 (Revised and Redrafted) and intending to use such a report. However, a user auditor in the scope of proposed ISA 402 (Revised and Redrafted) is not precluded from using a service auditor’s report that has been prepared under recognized national standards as described in the proposed ISA.

Effective Date

The current IAASB project timetable envisages that all ISAs will have been revised and redrafted, or redrafted only, by late 2008. The IAASB has agreed that the complete set of ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009. The IAASB expects that this proposed ISA will be approved as a final standard in accordance with this timetable.

Guide for Respondents

The IAASB welcomes comments on all matters addressed in the exposure draft. 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 this exposure draft (especially those calling for change in current practice), it will be helpful for the IAASB to be made aware of this view.

Request for Specific Comments

The IAASB would welcome views on the following:

1. Paragraph 4 of proposed ISA 402 (Revised and Redrafted) allows for the ISA to be adapted, as necessary in the circumstances, to situations where an entity uses a shared

service center which provides services to a group of related entities. In particular, the IAASB would welcome views as to whether:

- (a) The ISA is capable of being adapted for these circumstances; and
- (b) If there are additional opportunities within the Application and Other Explanatory Material where additional guidance relating to shared service centers could be added to enhance the ISA without duplicating material in other ISAs.

Request for Comments on the Application of the Clarity Drafting Conventions

In addition to the matters referred to above, the IAASB is seeking comments on the application of the clarity drafting conventions.³ Respondents are asked to consider whether the objective for the proposed ISA is appropriate, and whether the proposed requirements are appropriate responses to that objective.

Comments on Other Matters

Recognizing that the final ISA will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below.

- *Special Considerations in the Audit of Smaller Entities*—Respondents are asked to comment whether, in their opinion, considerations in the audit of smaller entities have been dealt with appropriately in the proposed ISA.
- *Special Considerations in the Audit of Public Sector Entities*—Respondents are asked to comment whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in the proposed ISA.
- *Developing Nations*—Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed ISA in a developing nation environment.

³ The IAASB has identified the following criteria for determining the requirements of a Standard:

- The requirement is necessary to achieve the objective stated in the Standard;
- The requirement is expected to be applicable in virtually all engagements to which the Standard is relevant; or, in the case of circumstances that are reasonably likely to exist or arise in an engagement, the requirement is considered necessary to the consistent application of the ISA and the action specified is expected to be appropriate in virtually all such circumstances; and
- The objective stated in the Standard is unlikely to have been met by the requirements of other Standards.

In determining the requirements of a Standard, the IAASB will consider whether the requirements are proportionate to the importance of the subject matter of the Standard in relation to the overall objective of the engagement.

The criteria, which are intended only to assist the IAASB in appropriately and consistently determining requirements, may be refined as further experience is gained.

EXPLANATORY MEMORANDUM

- *Translations*—Recognizing that many respondents intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing the proposed ISA.

To be considered, responses should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to 545 Fifth Avenue, 14th Floor, New York, NY 10017, USA. They should be received by **April 30, 2008**.

PROPOSED INTERNATIONAL STANDARD ON AUDITING 402

(REVISED AND REDRAFTED)

**AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A THIRD PARTY
SERVICE ORGANIZATION**

(Effective for audits of financial statements for periods beginning on or after [December 15, 2009])

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

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the user auditor's responsibilities to obtain sufficient appropriate audit evidence when an entity uses one or more third party service organizations. Specifically, it expands on how the auditor applies ISA 315 (Redrafted)¹ and ISA 330 (Redrafted)² in identifying and assessing the risks of material misstatement and in designing and performing further audit procedures.
2. Many entities outsource aspects of their business to organizations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity's entire business units or functions. Many of the services provided by such organizations are integral to the entity's business operations; however, not all those services are directly linked to an entity's information system relevant to financial reporting.
3. A service organization's services are part of an entity's information system, including related business processes, relevant to financial reporting if they affect any of the following:
 - (a) The classes of transactions in the entity's operations that are significant to the entity's financial statements;
 - (b) The procedures, within both information technology (IT) and manual systems, by which the entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
 - (c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the entity's financial statements that are used to initiate, record, process and report the entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;
 - (d) How the entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;
 - (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and
 - (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.
4. The focus of this ISA is on an entity's use of a third party service organization, but it may also be applicable, adapted as necessary in the circumstances, to situations where an entity uses a shared service center which provides services to a group of related entities.

¹ ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment."

² ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks."

5. This ISA does not apply to services provided by an organization, such as a financial institution, that are limited to processing an entity's transactions that are specifically authorized by the entity, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker. In addition, this ISA does not apply to the audit of transactions arising from proprietary financial interests in other entities, such as partnerships, corporations and joint ventures, when proprietary interests are accounted for and reported to interest holders.

Effective Date

6. This ISA is effective for audits of financial statements for periods beginning on or after [December 15, 2009].

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 ISA, the following terms have the meanings attributed below:
 - (a) Complementary user entity controls – Controls that the service organization assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of the system.
 - (b) Service auditor – An auditor who provides an assurance report on the controls of a service organization.
 - (c) Service organization – A third party organization (or segment of a third party organization) that provides services to user entities that are part of those entities' information system relevant to financial reporting.
 - (d) Subservice organization – A service organization used by another service organization to perform some of the services provided to user entities that are part of those user entities' information system relevant to financial reporting.
 - (e) User auditor – An auditor who audits and reports on the financial statements of a user entity.
 - (f) User entity – An entity that uses a service organization and whose financial statements are being audited.
 - (g) Report on the description and design of controls at a service organization (referred to in this ISA as a Type A report) – A report that comprises:

- (i) A description, prepared by management of the service organization, of the system, control objectives and related controls that have been designed and implemented as at a specified date; and
 - (ii) A report conveying reasonable assurance that includes the service auditor’s opinion on the description of the system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.
- (h) Report on the description, design, and operating effectiveness of controls at a service organization (referred to in this ISA as a Type B report) – A report that comprises:
- (i) A description, prepared by management of the service organization, of the system, control objectives and related controls, their design and implementation, and their operating effectiveness throughout a specified period; and
 - (ii) A report conveying reasonable assurance that includes:
 - a. The service auditor’s opinion on the description of the system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
 - b. A description of the service auditor’s tests of the controls and the results thereof.

Requirements

Obtaining an Understanding of the Services Provided by a Service Organization

9. When obtaining an understanding of the entity in accordance with ISA 315 (Redrafted),³ the user auditor shall obtain an understanding of how a user entity uses a service organization in its operations, including:
 - (a) The nature of the services provided by the service organization and the significance of those services to the user entity, including the user entity’s internal control; (Ref: Para. A1-A2)
 - (b) The nature and materiality of the transactions processed or accounts affected by the service organization and the degree of interaction between the activities of the service organization and those of the user entity; and (Ref: Para. A3-A4)
 - (c) The nature of the relationship between the user entity and the service organization, including the contractual terms for the relevant activities undertaken by the service organization. (Ref: Para. A5-A8)
10. When obtaining an understanding of internal control relevant to the audit in accordance with ISA 315 (Redrafted),⁴ the user auditor shall evaluate the design and implementation

³ ISA 315 (Redrafted), paragraph 11.

⁴ ISA 315 (Redrafted), paragraph 12.

of relevant controls at the user entity that relate to the services performed by the service organization, including those that are applied to the transactions processed by the service organization, and relevant monitoring controls. (Ref: Para. A9-A11)

11. The user auditor shall determine whether a sufficient understanding of the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement. If the user auditor is unable to obtain that understanding from information on the service organization available at the user entity, the user auditor shall obtain audit evidence from one or more of the following procedures: (Ref: Para. A12-A16)
 - (a) Obtaining a Type A or Type B report;
 - (b) Contacting the service organization, through the user entity, to obtain specific information;
 - (c) Requesting that a service auditor be engaged to perform procedures that will provide the necessary information; or
 - (d) Visiting the service organization and performing such procedures.

Assessing the Risks of Material Misstatement

12. When the user auditor's risk assessment includes an expectation that controls at the service organization are operating effectively for certain assertions for which controls are applied only at the service organization, the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures: (Ref: Para. A17)
 - (a) Obtaining a Type B report;
 - (b) Requesting the service auditor to perform tests of controls at the service organization on behalf of the user auditor; or
 - (c) Performing appropriate tests of controls at the service organization.

Using an Assurance Report from a Service Auditor

13. If the user auditor plans to use a Type A or Type B report as audit evidence about the design and implementation of controls at the service organization, the user auditor shall: (Ref: Para. A18-A19)
 - (a) Evaluate whether the description of controls at the service organization is at a date or for a period that is appropriate for the user auditor's purposes;
 - (b) Evaluate the sufficiency and appropriateness of the evidence provided for the understanding of internal control relevant to the audit; and
 - (c) Determine whether complementary user entity controls identified by the service organization are relevant to the user entity and if so, obtain an understanding of whether the user entity has designed and implemented such controls.

14. If the user auditor plans to use a Type B report as audit evidence that controls at the service organization are operating effectively, the user auditor shall: (Ref: Para. A20-A28)
 - (a) Evaluate whether the description of controls at the service organization is at a date or for a period that is appropriate for the user auditor’s purposes;
 - (b) Evaluate the sufficiency and appropriateness of the evidence provided about the effectiveness of controls for the relevant assertions;
 - (c) Determine whether complementary user entity controls identified by the service organization are relevant to the user entity, and if so, obtain an understanding of whether the user entity has designed and implemented such controls and, if so, test their operating effectiveness;
 - (d) Evaluate the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and
 - (e) Evaluate the specific tests of controls performed by the service auditor and the results thereof relevant to those assertions to determine if sufficient appropriate audit evidence has been obtained about the operating effectiveness of the controls to support the user auditor’s risk assessment.
15. In determining the sufficiency and appropriateness of the audit evidence provided by a Type A or Type B report in support of the user auditor’s opinion, the user auditor shall be satisfied as to the service auditor’s professional reputation, competence and independence. (Ref: Para. A29)
16. The user auditor shall not refer to the work of a service auditor in the user auditor’s report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor’s report shall indicate that the reference does not diminish the user auditor’s responsibility for the audit opinion. (Ref: Para. A30)
17. If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor’s opinion, the user auditor’s report shall indicate that such reference does not diminish the user auditor’s responsibility for that opinion. (Ref: Para. A31)

Other Audit Evidence Considerations Regarding Service Organizations

18. In responding to assessed risks in accordance with ISA 330 (Redrafted), the user auditor shall: (Ref: Para. A32-A35)
 - (a) Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and, if not,
 - (b) Perform further audit procedures to obtain sufficient appropriate audit evidence or request the service auditor to perform those procedures on the user auditor’s behalf.

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

19. The user auditor shall inquire of management of the user entity whether the service organization has reported to the user entity any fraud, non-compliance with laws and regulations or uncorrected misstatements and if so, the user auditor shall evaluate how they affect the nature, timing and extent of the user auditor's further audit procedures. (Ref. Para. A36)

Application and Other Explanatory Material

Obtaining an Understanding of the Services Provided by a Service Organization

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

- A1. A user entity may use a service organization such as one that processes transactions and maintains related accountability, or records transactions and processes related data. Service organizations that provide such services include, for example, bank trust departments that invest and service assets for employee benefit plans or for others, mortgage bankers that service mortgages for others, and application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions. The Appendix to this ISA provides examples of some types of service organizations.
- A2. Examples of service organization services that are relevant to the audit include:
- Maintenance of the user entity's accounting records.
 - Management of assets.
 - Initiating, recording or processing transactions as agent of the user entity.

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

- A3. A service organization may establish policies and controls that affect the user entity's internal control. These policies and controls are at least in part physically and operationally separate from the user entity. The significance of the controls of the service organization to those of the user entity depends on the nature of the services provided by the service organization, including the nature and materiality of the transactions it processes for the user entity. In certain situations, the transactions processed and the accounts affected by the service organization may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.
- A4. The significance of the controls of the service organization to those of the user entity also depends on the degree of interaction between its activities and those of the user entity.

The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organization. For example, a high degree of interaction exists between the activities of the user entity and those at the service organization when the user entity authorizes transactions and the service organization processes and does the accounting of those transactions. In these circumstances, it may be practicable for the user entity to implement effective controls over those transactions. On the other hand, when the service organization initiates or initially records, processes, and does the accounting of the user entity's transactions, there is a lower degree of interaction between the two organizations. In these circumstances, the user entity may be unable to, or may elect not to, implement effective controls over these transactions.

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

- A5. The contract or service level agreement between the user entity and the service organization may provide for matters such as:
- The information to be provided to the user entity and responsibilities for initiating transactions relating to the activities undertaken by the service organization;
 - The application of requirements of regulatory bodies concerning the form of records to be maintained, or access to them;
 - The indemnification, if any, to be provided to the user entity in the event of a performance failure;
 - Whether the service organization will provide a Type A or Type B report; and
 - Whether the user auditor has rights of access to the accounting records of the service organization and other information necessary for the conduct of the audit.
- A6. There is a direct relationship between the service organization and the user entity and between the service organization and the service auditor. These relationships do not necessarily create a direct relationship between the user auditor and the service auditor. When there is no direct relationship between the user auditor and the service auditor, communications between the user auditor and the service auditor are usually conducted through the user entity and the service organization. A direct relationship may also be created between a user auditor and a service auditor, taking into account the relevant ethical and confidentiality considerations. A user auditor, for example, may request a service auditor to perform procedures on the user auditor's behalf, such as:
- (a) Tests of controls at the service organization; or
 - (b) Substantive procedures on the user entity's financial statement transactions and balances maintained by a service organization.

Considerations Specific to Public Sector Entities

- A7. Public sector auditors generally have broad rights of access established by legislation. However, there may be situations where such rights of access are not available, for example when the service organization is located in a different jurisdiction. In such cases,

a public sector auditor may need to obtain an understanding of the legislation applicable in the different jurisdiction to determine whether appropriate access rights can be obtained, or ask the user entity to incorporate rights of access in any contractual arrangements between the user entity and the service organization.

- A8. Public sector auditors may also request a service auditor to perform tests of controls or substantive procedures in relation to compliance with legislation or proper authority.

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

- A9. The user entity may establish controls over the service organization's services that may be tested by the user auditor and that may enable the user auditor to conclude that the user entity's controls are operating effectively for some or all of the related assertions. If a user entity, for example, uses a service organization to process its payroll transactions, the user entity may establish controls over the submission and receipt of payroll information that could prevent or detect material misstatements. In this situation, the user auditor may perform tests of the user entity's controls over payroll processing that would provide a basis for the user auditor to conclude that the user entity's controls are operating effectively for the assertions related to payroll transactions.
- A10. A user entity may use a service organization that in turn uses a subservice organization to perform some of the services provided to a user entity that are part of the user entity's information system as it relates to an audit of the financial statements. The subservice organization may be a separate entity from the service organization or may be related to the service organization. A user auditor may need to consider controls at the subservice organization. In situations where one or more subservice organizations are used, the interaction between the user entity and the service organization is expanded to include the interaction between the user entity, the service organization and the subservice organizations. The degree of this interaction, as well as the nature and materiality of the transactions processed by the service organization and the subservice organizations are the most important factors for the user auditor to consider in determining the significance of the service organization's and subservice organization's controls to the user entity's controls.
- A11. As noted in ISA 315 (Redrafted),⁵ in respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions and account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. Such automated processing characteristics may be particularly present when the user entity uses service organizations. In such cases, the entity's controls over such risks are relevant to the audit and the user auditor is required to obtain an understanding of such controls in accordance with paragraph 10 of this ISA.

⁵ ISA 315 (Redrafted), paragraph 29.

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

A12. Information on the nature of the services provided by a service organization may be available from a wide variety of sources, such as:

- User manuals;
- System overviews;
- Technical manuals;
- The contract between the user entity and the service organization;
- Reports by service organizations, internal auditors or regulatory authorities on controls at the service organization; and
- Reports by the service auditor, including management letters, if available.

A13. Knowledge obtained through the user auditor's experience with the service organization may also be helpful in obtaining an understanding of the nature of the services provided by the service organization. This may be particularly helpful if the services and controls at the service organization over those services are highly standardized.

A14. A service organization may engage a service auditor to report on the description and design of its controls (Type A report) or on the description and design of its controls and their operating effectiveness (Type B report). Type A and Type B reports are typically reports issued under [proposed] International Standard for Assurance Engagements (ISAE) 3402⁶ or recognized national standards.

A15. In some circumstances, a user entity may outsource one or more significant business units or functions, such as its entire tax planning and compliance functions, or finance and accounting or the controllership function to one or more service organizations. The user auditor's ability to gain an understanding of controls at the service organizations may be dependent on the direct interaction with management at the service organizations, as a report on controls at the service organizations may not be available.

A16. If the user auditor is unable to obtain an understanding of the user entity's internal control relevant to the audit by performing the procedures required by paragraphs 9-11 of this ISA, the auditor is required to modify the opinion in the auditor's report.⁷

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

A17. If a Type B report is not available, a user auditor may contact the service organization, through the user entity, to request that a service auditor be engaged to provide a Type B report that includes tests of the operating effectiveness of the relevant controls or to perform procedures that test the operating effectiveness of those controls. A user auditor may also visit the service organization and perform tests of relevant controls if the service organization agrees to it. In all cases, the user auditor's risk assessments are based

⁶ [Proposed] ISAE 3402, "Assurance Reports on Controls at a Third Party Service Organization."

⁷ [Proposed] ISA 705 (Revised and Redrafted), "Modifications to the Opinion in the Independent Auditor's Report," paragraph [9].

on the combined evidence provided by service auditor's report and the user auditor's own procedures.

Using an Assurance Report from a Service Auditor

Using a Type A Report (Ref: Para. 13)

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

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

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

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

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

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

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

user auditor's risk assessment. In doing so, the user auditor may consider the following factors:

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

A21. For certain assertions, the shorter the period covered by a specific test and the longer the time elapsed since the performance of the test, the less audit evidence the test may provide. In comparing the period covered by the Type B report to the user entity's financial reporting period, the auditor may conclude that the Type B report offers less audit evidence if there is little overlap between the period covered by the Type B report and the period for which the user auditor intends to rely on the report. When this is the case, a Type B report covering a preceding or subsequent period may provide additional audit evidence.

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

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

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

- A24. If the service auditor's testing period is completely outside the user entity's financial reporting period, the user auditor will be unable to rely on such tests for the user auditor to conclude that the user entity's controls are operating effectively because they do not provide current audit period evidence of the effectiveness of the controls, unless other procedures are performed.
- A25. In certain circumstances, a service provided by the service organization may be designed with the assumption that certain controls will be implemented by the user entity. For example, the service may be designed with the assumption that the user entity will have controls in place for authorizing transactions before they are sent to the service organization for processing. In such a situation, the service organization's description of controls may include a description of those complementary user entity controls. The user auditor considers whether those complementary user entity controls are required and whether they are relevant to the service provided to the user entity.
- A26. If the user auditor believes that the service auditor's assurance report may not provide sufficient audit evidence, for example, if a service auditor's report does not contain a description of the service auditor's tests of controls and results thereon, the user auditor may supplement the understanding of the service auditor's procedures and conclusions by contacting the service organization, through the user entity, to request discussing with the service auditor the scope and results of the service auditor's work. Also, if the user auditor believes it is necessary, the user auditor may contact the service organization, through the user entity, to request that the service auditor perform procedures at the service organization, or the user auditor may perform such procedures.
- A27. The service auditor's assurance report identifies results of tests, including exceptions and other information that could affect the user auditor's conclusions. Exceptions noted by the service auditor or a modified opinion in the service auditor's assurance report do not automatically mean that the service auditor's assurance report will not be useful for the audit of the user entity's financial statements in assessing the risks of material misstatement. Rather, the exceptions and the matter giving rise to a modified opinion in the service auditor's assurance report are considered in the user auditor's assessment of the testing of controls performed by the service auditor. In considering the exceptions and matters giving rise to a modified opinion, the user auditor may wish to discuss such matters with the service auditor. Such communication is dependent upon the user entity contacting the service organization, and obtaining the service organization's approval for the communication to take place.

Communication of Deficiencies in Internal Control Identified during the Audit

- A28. The user auditor is required to communicate all deficiencies in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility⁸ and is required to communicate all significant deficiencies with those charged with governance (unless all of those charged with governance are involved in

⁸ [Proposed] ISA 265, "Communicating Deficiencies in Internal Control," paragraph [9].

managing the entity).⁹ Matters that the user auditor may identify during the audit and may wish to communicate to management and those charged with governance of the user entity include:

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

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

A29. The user auditor may inquire as to the professional reputation and standing of the service auditor from the auditor's professional organization or other practitioners and inquire whether the service auditor is subject to regulatory oversight. The service auditor may be practicing in a jurisdiction where different standards are followed in respect of reports on controls at a service organization. In such a situation, the user auditor may inquire about the adequacy of those standards.

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

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

A31. The fact that a user entity uses a service organization does not alter the user auditor's responsibility under ISAs to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Therefore, the user auditor does not make reference to the service auditor's assurance report as a basis, in part, for the user auditor's opinion on the user entity's financial statements. However, when the user auditor expresses a modified opinion because of a modified opinion in a service auditor's assurance report, the user auditor is not precluded from referring to the service auditor's assurance report if such reference assists in explaining the reason for the user auditor's modified opinion. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.

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

A32. When the service organization maintains material elements of the accounting records of the user entity, direct access to those records may be necessary in order for the user auditor to obtain sufficient appropriate audit evidence relating to the operations of controls over those records or to substantiate transactions and balances recorded in them, or both. Such access may involve either physical inspection of records at the service

⁹ [Proposed] ISA 265, paragraphs [9-10].

organization's premises or interrogation of records maintained electronically from the user entity or another location, or both. Where direct access is achieved electronically, the user auditor may obtain evidence as to the adequacy of controls operated by the service organization over the completeness and integrity of the user entity's data for which the service organization is responsible. The user auditor may also request the service auditor, on the user auditor's behalf, to gain access to the user entity's records maintained by the service organization.

A33. In determining the nature and extent of audit evidence to be obtained in relation to balances representing assets held or transactions undertaken by a service organization, the following procedures may be considered by the user auditor:

- (a) Inspecting records and documents held by the user entity: the reliability of this source of evidence is determined by the nature and extent of the accounting records and supporting documentation retained by the user entity. In some cases the user entity may not maintain independent detailed records or documentation of specific transactions undertaken on its behalf.
- (b) Inspecting records and documents held by the service organization: the user auditor's access to the records of the service organization is likely to be established as part of the contractual arrangements between the user entity and the service organization.
- (c) Obtaining confirmations of balances and transactions from the service organization: where the user entity maintains independent records of balances and transactions and a service organization processes transactions only at the specific authorization of the user entity or acts only as a simple custodian of assets, confirmation from the service organization corroborating those records usually constitutes reliable audit evidence concerning the existence of the transactions and assets concerned.

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

- (d) Performing analytical procedures on the records maintained by the user entity or on the reports received from the service organization: the effectiveness of analytical procedures is likely to vary by assertion and will be affected by the extent and detail of information available.
- (e) Requesting the service auditor to perform further audit procedures on the user auditor's behalf at the service organization.

A34. A service auditor may perform procedures that are substantive in nature for the benefit of user auditors. Such an engagement may involve the performance, by the service auditor, of procedures agreed upon by the user entity and its user auditor and by the service

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

- A35. In certain circumstances, in particular when a user entity outsources some or all of its finance function to a service organization, the user auditor may face a situation where a significant portion of the audit evidence resides at the service organization. Substantive procedures may need to be performed at the service organization by the user auditor or the service auditor on behalf of the user auditor. A service auditor may provide a Type B report and, in addition, may perform substantive procedures on behalf of the user auditor. As noted in paragraph A31, the involvement of a service auditor does not alter the user auditor's responsibility to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Accordingly, the user auditor's consideration of whether sufficient appropriate audit evidence has been obtained and whether the user auditor needs to perform further substantive procedures includes the user auditor's involvement with, or evidence of, the direction, supervision and performance of the substantive procedures performed by the service auditor.

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

- A36. A service organization may be required under the terms of the contract with user entities to disclose to affected user entities any fraud, non-compliance with laws and regulations or uncorrected misstatements attributable to the service organization's management or employees. As required by paragraph 19, the user auditor makes inquiries of the user entity management regarding whether the service organization has reported any such matters and evaluates whether any matters reported by the service organization affect the nature, timing and extent of the user auditor's further audit procedures. In certain circumstances, the user auditor may require additional information to perform this evaluation, and may consider contacting the service organization or the service auditor to obtain the necessary information.

Appendix

(Ref. Para. A1)

Types of Service Organizations

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

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

user entities that they traditionally had performed themselves, or some combination of these services.

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



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*Proposed International Standard on Assurance
Engagements*

ISAE 3402, Assurance Reports on
Controls at a Third Party Service
Organization

Proposed Conforming Amendment

Preface to the International Standards
on Quality Control, Auditing, Review,
Other Assurance and Related Services



REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Assurance Engagements (ISAE) 3402, “Assurance Reports on Controls at a Third Party Service Organization” for publication in December 2007. This proposed ISAE may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by email, so that they will be received by **May 31, 2008**. All comments will be considered a matter of public record. Comments should be addressed to:

International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Comments should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to the above address.

Copies of the exposure draft may be downloaded free-of-charge from the IFAC website at <http://www.ifac.org>.

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EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to, and an explanation of, the proposed International Standard on Assurance Engagements (ISAE) 3402, “Assurance Reports on Controls at a Third Party Service Organization.” The International Auditing and Assurance Standards Board (IAASB) approved the proposed ISAE in December 2007 for exposure.

Background

The IAASB commenced this project in 2006 concurrently with a project to revise extant ISA 402.¹ The IAASB recognized the growing use of service organizations by user entities and the need for a service organization to be able to provide user entities and their auditors with a service auditor’s assurance report on its controls. This proposed ISAE will provide the standards for such assurance reports. It is intended to complement proposed ISA 402 (Revised and Redrafted),² in that reports prepared in accordance with proposed ISAE 3402 will be capable of providing appropriate evidence under proposed ISA 402 (Revised and Redrafted).

The IAASB believes that the proposed ISAE will enhance the consistency of auditor performance in relation to assurance reports on controls at third party service organizations, particularly in those jurisdictions that have adopted IAASB standards and have not, to date, had a specific standard on this topic. It is expected that proposed ISAE 3402, in conjunction with proposed ISA 402 (Revised and Redrafted), will enhance the consistency of auditor performance in relation to the audit of the financial statements of user entities.

The proposed ISAE is drafted on the assumption that a service organization has many customers (user entities) and each user entity and its financial statement auditor receive a copy of the description of the system and the service auditor’s assurance report. For this reason, the proposed ISAE assumes a direct relationship between user entities and user auditors, and between service organizations and service auditors, but does not assume any direct relationship between the service auditor and either user entities or user auditors. The proposed ISAE can also be applied, however, to other situations, where a direct relationship between the service auditor and the user entity or user auditor may exist.

Significant Matters

Form of the Standard

The standard has been drafted using the conventions developed for International Standards on Auditing by the IAASB (‘the clarity drafting conventions’). These are currently being applied to ISAs in a project whereby all ISAs will be completed or revised in clarity form by the end of 2008. As part of that project, the “Preface to the International Standards on Quality Control, Auditing,

¹ ISA 402, “Audit Considerations Relating to Entities Using Service Organizations.”

² Proposed ISA 402 (Revised and Redrafted), “Audit Considerations Relating to an Entity Using a Third Party Service Organization,” approved for exposure by the IAASB in December 2007.

Review, Other Assurance and Related Services” (Preface) has been revised to describe the authority of the revised standards, which will all become effective together in 2010.³

The IAASB has not yet applied the clarity drafting conventions to ISAEs – of which there are at present only two: ISAE 3000⁴ and ISAE 3400.⁵ Proposed ISAE 3402, which has been drafted under the clarity drafting conventions, requires the service auditor to comply with ISAE 3000 and well as the proposed standard. The IAASB believes it is appropriate to use the clarity drafting conventions in drafting ISAEs, as it represents IAASB’s view of the clearest way of presenting standards so as to distinguish requirements from guidance and promote consistent interpretation and performance by auditors.

The IAASB has no immediate plans to redraft ISAE 3000 in the clarity form, or to revise that standard, though it acknowledges that this will be necessary at some stage when resources become available. In the meantime, the IAASB believes that because ISAE 3000 is a more general standard establishing the basic principles for the conduct of assurance engagements it is unlikely that practitioners will have difficulty in applying both ISAE 3000 and proposed ISAE 3402 notwithstanding their different forms.

An appropriate conforming amendment is proposed to the Preface as a result of this distinction (see page 49).

Type of Report

The proposed ISAE allows for two types of reasonable assurance reports: Type A, which is confined to opinions on the fairness of the description of the service organization’s controls and on whether those controls were suitably designed for their purpose; and Type B, which additionally includes an opinion, based on tests of the controls, on the operating effectiveness of the controls tested (which may not be all controls described). The proposed ISAE requires that Type B reports should cover a reasonable period, while Type A reports are required to be at a point in time.

There are a number of reasons for the distinction in the time period covered. First, Type A reports are likely to be more common in the initial stages of the operation of a service organization when it is unlikely that there have been significant changes in controls over the period to the date of the report or, where there have been such changes, the more important consideration will be what controls are now in place. A Type A report may also be appropriate when a service organization does not have a sufficient track record with a stable system to make a Type B report feasible, which is the usual circumstance in which a Type A report currently is sought in practice. Secondly, since no tests of controls are undertaken for the purposes of a Type A report, there is no basis upon which a user auditor may choose to rely on the controls at the service organization without further work; there is therefore no clear need for a report that covers a period of time. Thirdly, the provision of a Type A report that covers a period may imply, or may be read as implying, that there is some basis

³ The amended Preface can be accessed at http://web.ifac.org/download/IAASB_Preface.pdf.

⁴ ISAE 3000, “Assurance Engagements.”

⁵ ISAE 3400, “The Examination of Prospective Financial Information.”

for reliance and may therefore be misleading. Consequently, the IAASB considers that there will be neither demand for nor benefit in a Type A report that covers a period of time.

Assertion-based Engagements

The proposed ISAE has been written for application to assertion-based engagements,⁶ where management of the service organization confirms, in a statement made available to intended users that accompanies the description of the system, the matters noted in paragraph 9(j)(ii) of the proposed ISAE for a Type B engagement, and paragraph 9(i)(ii) for a Type A engagement.

The IAASB is of the view that an assertion-based engagement is more appropriate than the alternative (a direct reporting engagement, under which all relevant information is included in the service auditor's assurance report and there is no public assertion⁷) because it includes an explicit acknowledgement, by management of the service organization to the user entities, of its responsibility for the fair presentation of the description of the system, the suitable design of controls and, in the case of a Type B report, the operating effectiveness of controls. Assertion-based engagements are prevalent in some jurisdictions; in others, direct reporting engagements are more common. It should be noted that the nature, timing and extent of the service auditor's procedures would ordinarily be the same regardless of whether the engagement to report on controls at a service organization is an assertion-based or direct reporting engagement. Further, in the case of a direct reporting engagement, a service auditor obtains representations from the management of the service organization that contain confirmations equivalent to the assertions proposed in ISAE 3402. (See Question 1 on page 9.)

Link with International Standards on Auditing (ISAs)

The IAASB is of the view that because the engagement seeks to provide reasonable assurance, and therefore is comparable to a financial statement audit, it would be desirable for the proposed ISAE, taken with ISAE 3000, to cover similar matters and at a similar level of detail to the ISAs to the extent practicable and relevant. Alternative ways to achieve this in the proposed ISAE include replicating or adapting relevant requirements from the ISAs when they are appropriate to the scope of the ISAE; or requiring that all ISAs be applied, adapted as necessary in the circumstances of the engagement.

The IAASB is of the view that it is not appropriate to adopt the approach of requiring all ISAs to be applied, adapted as necessary in the circumstances of the engagement, because to do so would not result in sufficient clarity as to which requirements of the ISAs should be applied or how they ought to be adapted. Therefore, in preparing the proposed ISAE, the IAASB has included a number of requirements based on proposed ISAs dealing with matters such as using the work of the internal

⁶ Assertion-based engagements are contrasted with direct reporting engagements in paragraph 10 of the "International Framework for Assurance Engagements."

⁷ In a direct reporting engagement to report on controls at a service organization, the service auditor would ordinarily obtain a representation from the service organization regarding the matters noted in paragraph 9(j)(ii) of the proposed ISAE for a Type B engagement, and paragraph 9(i)(ii) for a Type A engagement, but that representation would not accompany the description of the system or otherwise be made available to user entities or their auditors.

audit function, sampling, documentation, and using the work of a service auditor's expert. To the extent comments on these proposed ISAs result in changes to the requirements and application and other explanatory material in those standards, the parallel requirements in this ISAE would be conformed.

Further alternatives to this approach might be to amend ISAE 3000, or to draft further ISAEs dealing with such general matters as are likely to be relevant in all assurance engagements.

Auditor's External Experts

With respect to using the work of a service auditor's expert, the Explanatory Memorandum to proposed ISA 620 noted that proposed ISQC 1 (Redrafted) includes a revised definition of engagement team that "specifically excludes 'an auditor's external expert' from the engagement team."⁸ If a similar definition of engagement team were to be adopted in the International Federation of Accountants' Code of Ethics for Professional Accountants (the Code), external auditors' experts, i.e., those who are engaged, not employed, by the auditor, would not be subject to the Code, including its independence requirements. In recognition of this, paragraph 26 of proposed ISAE 3402 includes the following requirements: "the service auditor shall evaluate whether the service auditor's expert whose work is to be used has the necessary ... objectivity for the purposes of the engagement. In the case of a service auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity."⁹ If the proposed definition of engagement team is ultimately adopted in proposed ISQC 1 (Redrafted) and the Code, it will affect all ISAEs, including ISAE 3000. Therefore, if and when that definition is adopted, the IAASB will consider whether ISAE 3000 should include requirements similar to those in paragraph 26 of the proposed ISAE 3402.

Suitable Criteria

The existence of suitable criteria is a prerequisite for any assurance engagement. For an assurance engagement to report on controls at a service organization, suitable criteria are required for evaluating whether the description of the system is fairly presented, whether the controls are suitably designed and, in the case of a Type B report, whether the controls have operated effectively. To ensure an appropriate level of consistency in the application of the proposed ISAE in relation to the suitability of criteria, the IAASB has specified the minimum elements of suitable criteria.¹⁰ The minimum elements of suitable criteria, for evaluating whether the description of the system is fairly presented, have primarily been adapted from ISA 315 (Redrafted).¹¹

⁸ Proposed ISA 620 (Revised and Redrafted), "Using the Work of an Auditor's Expert;" and proposed International Standard on Quality Control (ISQC) 1 (Redrafted), "Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements," approved for exposure by the IAASB in July 2007.

⁹ Proposed ISAE 3402, paragraph 26.

¹⁰ Proposed ISAE 3402, paragraphs 15-17.

¹¹ ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," paragraph 14(a).

Control Objectives

The IAASB discussed whether to include specimen control objectives in an appendix to the proposed ISAE. It recognized that some may find these helpful. On the other hand, any such objectives would not be comprehensive, and would need to be supplemented (or supplanted) by objectives specific to the services provided by the service organization. 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 a specific engagement. Those with the necessary skill and experience required to undertake these engagements are expected to have the expertise to identify appropriate control objectives and to assess the completeness of those identified by a service organization.

Description of Tests of Controls

In a Type B report, the service auditor expresses an opinion on the operating effectiveness of controls. That opinion is based on tests of controls. The proposed standard will require that the report include a description of those tests.

The IAASB debated whether to require such disclosure when an opinion is also being given. On the one hand, receipt of a satisfactory opinion might be thought to be all that the user auditor requires. On the other hand, the tests of controls have been conducted on controls that in effect form part of the information systems of the user entity, and therefore of those information systems that form a basis for the financial statements that are subject to audit by the user entity's auditor. Since the report will be used by many user entity auditors who do not in general have the opportunity to instruct the service auditor as to the work to be done, the IAASB considers that it is important for the user auditor both to know that the service auditor is satisfied with the operating effectiveness of controls and to obtain an understanding of the work that has been undertaken to reach that conclusion. This is because the user auditor must form a view as to whether that work is sufficient in the context of the user entity under audit, and how that work relates to the procedures undertaken by the user auditor.

Disclosure of Sample Sizes

The description of tests of controls required to be included in a Type B report does not include the disclosure of sample sizes used by the service auditor unless a deviation from controls is found.¹² This is consistent with current practice in most jurisdictions

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.

¹² Proposed ISAE 3402, paragraphs 57.

Guide for Respondents

The IAASB welcomes comments on all matters addressed in the exposure draft. 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 this exposure draft (especially those calling for change in current practice), it will be helpful for the IAASB to be made aware of this view.

Request for Specific Comments

The IAASB would welcome views on the following:

1. The proposal that the ISAE be written for application to assertion-based engagements. In particular, the IAASB would welcome any views on whether there are situations in which it would not be possible or practicable for management of the service organization to provide an assertion.
2. The inclusion in the proposed ISAE of a number of requirements based on ISAs dealing with matters such as using the work of the internal audit function, sampling, documentation, and using the work of a service auditor's expert. In particular, has the IAASB identified all such matters as are relevant? And should these matters be dealt with in proposed ISAE 3402 or in ISAE 3000?
3. Whether ISAE 3000 should be amended with respect to auditor's external experts as outlined above.
4. The proposed requirements regarding the minimum elements of suitable criteria.
5. Whether the description of tests of controls included in a Type B report should include the disclosure of sample sizes determined by the service auditor only when a deviation from controls is found.

Comments on Other Matters

The IAASB is also interested in comments on matters set out below.

- *Special Considerations in the Audit of Public Sector Entities*—Respondents are asked to comment whether, in their opinion, special considerations with respect to public sector entities have been dealt with appropriately in the proposed ISAE.
- *Developing Nations*—Recognizing that many developing nations have adopted or are in the process of adopting the International Standards, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed ISAE in a developing nation environment.
- *Translations*—Recognizing that many respondents may intend to translate the final ISAE for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing the proposed ISAE.

EXPLANATORY MEMORANDUM

To be considered, responses should be emailed to Edcomments@ifac.org. They may also be faxed to +1-212-286-9570 or mailed to 545 Fifth Avenue, 14th Floor, New York, NY 10017, USA. They should be received by **May 31, 2008**.

PROPOSED INTERNATIONAL STANDARD ON ASSURANCE ENGAGEMENTS 3402
ASSURANCE REPORTS ON CONTROLS AT A THIRD PARTY SERVICE
ORGANIZATION

(Effective for service auditor’s assurance reports covering periods beginning on or after [date])

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<p>[Proposed] International Standard on Assurance Engagements (ISAE) 3402, “Assurance Reports on Controls at a Third Party Service Organization” should be read in conjunction with the “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services.”</p>
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Introduction

Scope of this ISAE

1. This International Standard on Assurance Engagements (ISAE) deals with reasonable assurance engagements undertaken by a professional accountant¹ to report on the controls at a third party organization that provides a service to user entities when those controls are likely to be part of user entities' information systems relevant to financial reporting. It complements [proposed] ISA 402 (Revised and Redrafted),² in that reports prepared in accordance with this ISAE are capable of providing appropriate evidence under [proposed] ISA 402 (Revised and Redrafted).
2. The focus of this ISAE is on controls at third party service organizations relevant to financial reporting by user entities. It may also be applied, adapted as necessary in the circumstances of the engagement, for engagements to report on:
 - (a) Controls at a service organization other than those that are likely to be part of user entities' information systems relevant to financial reporting (for example, controls that affect user entities' regulatory compliance, production or quality control).
 - (b) Controls at a shared service center, which provides services to a group of related entities.
3. In addition to issuing an assurance report on controls, a service auditor may also be engaged to provide the following reports, which are not dealt with in this ISAE:
 - (a) A report on a user entity's transactions or balances maintained by a service organization; or
 - (b) An agreed-upon procedures report on controls at a service organization.
4. The "International Framework for Assurance Engagements" (the Assurance Framework) notes that an assurance engagement may be either an "assertion-based" engagement or a "direct reporting" engagement. This ISAE applies to assertion-based engagements.

Relationship with Other Professional Pronouncements

5. The service auditor is required by paragraph 10 of this ISAE to comply with ISAE 3000³ in addition to this ISAE. The Assurance Framework, which defines and describes the elements and objectives of an assurance engagement, provides the context for understanding this ISAE and ISAE 3000.
6. Compliance with ISAE 3000 requires, among other things, that the service auditor comply with the International Federation of Accountants' Code of Ethics for Professional

¹ A professional accountant is defined in the International Federation of Accountants' (IFAC) Code of Ethics for Professional Accountants as an individual who is a member of an IFAC member body.

² [Proposed] ISA 402 (Revised and Redrafted), "Audit Considerations Relating to an Entity Using a Third Party Service Organization."

³ ISAE 3000, "Assurance Engagements Other than Audits or Reviews of Historical Financial Information."

Accountants, and implement quality control procedures that are applicable to the individual engagement.⁴

Effective Date

7. This ISAE is effective for service auditor's assurance reports covering periods beginning on or after [date].

Objectives

8. The objectives of the service auditor are to:
 - (a) Obtain reasonable assurance about whether, in all material respects, based on suitable criteria:
 - (i) Management's description of the system is fairly presented;
 - (ii) The controls are suitably designed;
 - (iii) When included in the scope of the engagement, the controls operated effectively.
 - (b) Report in accordance with the service auditor's findings.

Definitions

9. For purposes of this ISAE, the following terms have the meanings attributed below:
 - (a) Carve-out method – Method of dealing with the services provided by a subservice organization, whereby the service organization's description of its system includes the nature of the activities performed by a subservice organization, but that subservice organization's relevant control objectives and related controls are excluded from the service organization's description of the system and from the scope of the service auditor's engagement. The service organization's description of the system and the scope of the service auditor's engagement include controls at the service organization to monitor the effectiveness of controls at the subservice organization, which may include the service organization's review of an assurance report on controls at the subservice organization.
 - (b) Complementary user entity controls – Controls that the service organization assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of the system.
 - (c) Control objectives – The aim or purpose of a particular aspect of controls at the service organization. Control objectives ordinarily relate to risks that controls seek to mitigate.
 - (d) Controls at the service organization – The process designed, implemented and maintained by the service organization to provide reasonable assurance about the achievement of the control objectives that are relevant to the services covered by the

⁴ ISAE 3000, paragraphs 4 and 6.

service auditor's assurance report and that are likely to be relevant to user entities' internal control as it relates to financial reporting. (Ref: Para. A1)

- (e) Controls at a subservice organization – The process designed, implemented and maintained by a subservice organization to provide reasonable assurance about the achievement of the control objectives that are relevant to the services covered by the service auditor's assurance report.
- (f) Criteria – Benchmarks used to evaluate or measure a subject matter including, where relevant, benchmarks for presentation and disclosure. Suitable criteria are required for reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. Criteria need to be available to the intended users to allow them to understand how the subject matter has been evaluated or measured. See paragraphs 15-17 for minimum elements encompassed by criteria that are suitable for engagements to report on controls at the service organization.
- (g) Inclusive method – Method of dealing with the services provided by a subservice organization, whereby the service organization's description of its system includes the nature of the services performed by a subservice organization, and that subservice organization's relevant control objectives and related controls are included in the service organization's description of the system and in the scope of the service auditor's engagement.
- (h) Internal audit function – The service organization's internal auditors and others (for example, a compliance or risk department) who perform similar activities to internal auditors.
- (i) Report on the description and design of controls at a service organization (referred to in this ISAE as a "Type A report") – A report that comprises:
 - (i) A description of the service organization's system prepared by management of the service organization;
 - (ii) A written assertion by the service organization's management that, in all material respects, and based on suitable criteria:
 - a. The description fairly presents the service organization's system that had been designed and implemented as at the specified date;
 - b. The controls related to the control objectives stated in the description were suitably designed as at the specified date; and
 - (iii) A service auditor's assurance report that conveys reasonable assurance about the matters in (ii)a.-b. above.
- (j) Report on the description, design and operating effectiveness of controls at a service organization (referred to in this ISAE as a "Type B report") – A report that comprises:
 - (i) A description of the service organization's system prepared by management of the service organization;

- (ii) A written assertion by the service organization’s management that, in all material respects, and based on suitable criteria:
 - a. The description fairly presents the service organization’s system that had been designed and implemented throughout the specified period;
 - b. The controls related to the control objectives stated in the description were suitably designed throughout the specified period; and
 - c. The controls related to the control objectives stated in the description operated effectively throughout the specified period;
- (iii) A service auditor’s assurance report that:
 - a. Conveys reasonable assurance about the matters in (ii)a.-c. above; and
 - b. Includes a description of the service auditor’s tests of controls and the results thereof.
- (k) Service auditor – An auditor who provides an assurance report on the controls of a service organization.
- (l) Service organization – A third party organization (or segment of a third party organization) that provides services to user entities that are part of those entities’ information system relevant to financial reporting.
- (m) Service organization’s system –The policies and procedures designed, implemented and maintained by the service organization to provide user entities with the services covered by the service auditor’s assurance report. The description of the system prepared by management of the service organization includes identification the services covered, the period to which the description relates, control objectives and related controls.
- (n) Subservice organization – A service organization used by another service organization to perform some of the services provided to user entities that are part of those user entities’ information systems relevant to financial reporting.
- (o) Test of controls – A procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, errors that could result in the non-achievement of specified control objectives.
- (p) User auditor – An auditor who audits and reports on the financial statements of a user entity.
- (q) User entity – An entity that uses a service organization.

Requirements

ISAE 3000

10. In addition to this ISAE, the service auditor shall comply with ISAE 3000.

Ethical Requirements

11. The service auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to assurance engagements. (Ref: Para. A2)

Acceptance and Continuance

12. The service auditor shall continue (or accept where applicable) an engagement only if: (Ref: Para. A3)
 - (a) The service auditor's (preliminary) knowledge of the engagement circumstances indicates that:
 - (i) The criteria to be used will be suitable and available to the intended users;
 - (ii) The service auditor will have access to sufficient appropriate evidence to the extent necessary; and
 - (iii) The description of the system included in the scope of the engagement will not be so limited that it is unlikely that the engagement has a rational purpose.
 - (b) In agreeing the terms of the engagement, management of the service organization acknowledges and understands its responsibility for:
 - (i) Preparing and presenting the description of the system and accompanying assertion, including the completeness, accuracy and method of presentation of the description and assertion;
 - (ii) Stating in the assertion the criteria used;
 - (iii) Stating the control objectives (where not specified by law or regulation, or another party, for example a user group or a professional body), and identifying the risks that threaten their achievement;
 - (iv) Designing, implementing and maintaining controls to provide reasonable assurance that the stated control objectives will be achieved; and
 - (v) Providing the service auditor with:
 - a. All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the description of the system and accompanying assertion;
 - b. Any additional information that the service auditor may request; and
 - c. Unrestricted access to those within the service organization from whom the service auditor determines it necessary to obtain evidence.
13. If management requests a change in the scope of the engagement before the completion of the engagement, the auditor shall be satisfied that there is a reasonable justification for the change. (Ref: Para. A4)

Assessing the Suitability of the Criteria

14. As required by ISAE 3000, the service auditor shall assess whether the service organization has used suitable criteria in preparing and presenting the description of the system, in evaluating whether controls are suitably designed, and, in the case of a Type B report, in evaluating whether controls are operating effectively.⁵
15. Suitable criteria for evaluating whether the description of the system is fairly presented shall encompass at a minimum whether the description:
 - (a) Presents how the service organization's system made available to user entities has been designed and implemented to process relevant transactions, including, as appropriate:
 - (i) The classes of transactions processed;
 - (ii) The procedures, within both information technology and manual systems, by which transactions are initiated, recorded, processed, corrected as necessary, and transferred to the reports presented to user entities;
 - (iii) The related accounting records, supporting information and specific accounts that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the reports presented to user entities;
 - (iv) How the service organization's system captures significant events and conditions, other than transactions;
 - (v) The process used to prepare reports presented to user entities;
 - (vi) The stated control objectives and controls designed to achieve those objectives; and
 - (vii) Other aspects of the service organization's control environment, risk assessment process, information system (including the related business processes) and communication, control activities and monitoring controls that are relevant to the services provided.
 - (b) Does not omit or distort information relevant to the scope of the service organization's system being described, while acknowledging that the description is presented to meet the common needs of a broad range of user entities and their auditors and may not, therefore, include every aspect of the service organization's system that each individual user entity and its auditor may consider important in its particular environment.
16. Suitable criteria for evaluating whether controls are suitably designed to provide reasonable assurance that the stated control objectives will be achieved shall encompass at a minimum whether:
 - (a) The risks that threaten achievement of the control objectives stated in the description have been identified; and

⁵ ISAE 3000, paragraph 19.

- (b) The identified controls would, if operated as described, provide reasonable assurance that those risks do not prevent the stated control objectives from being achieved.
17. Suitable criteria for evaluating whether controls have operated effectively to provide reasonable assurance that the stated control objectives identified in the description will be achieved shall encompass at a minimum whether the controls were consistently applied as designed. This includes whether manual controls were applied by individuals who have the appropriate competence and authority. (Ref: Para. A5)

Materiality

18. The service auditor shall consider materiality with respect to the fair presentation of the description, the suitability of the design of controls and, in the case of a Type B report, the operating effectiveness of controls when planning and performing the engagement. (Ref: Para. A6)

Using the Work of an Internal Audit Function

Obtaining an Understanding of the Internal Audit Function

19. The service auditor shall obtain an understanding of the aspects of the internal audit function that are relevant to the engagement. (Ref: Para. A7-A8)

Planning to Use the Work of the Internal Audit Function

20. When the service auditor intends to use the work of the internal audit function, the service auditor shall evaluate:
- (a) The objectivity and technical competence of members of the internal audit function;
 - (b) Whether the internal audit function is carried out with due professional care; and
 - (c) The effect of any constraints or restrictions placed on the internal audit function by management or those charged with governance.
21. In making judgments about the effect of the internal audit function's work on the service auditor's procedures, the service auditor shall consider:
- (a) The significance of that work to the service auditor's conclusions; and
 - (b) The degree of subjectivity involved in the evaluation of the evidence gathered in support of those conclusions.

Using the Work of the Internal Audit Function

22. When the service auditor uses specific work of the internal audit function, the service auditor shall perform procedures to evaluate the adequacy of that work.
23. When evaluating specific work performed by the internal audit function, the service auditor shall consider the adequacy of the scope of work and whether the evaluation of the internal audit function remains appropriate. The service auditor shall evaluate whether:
- (a) The work is performed by persons having appropriate skills and expertise;

- (b) The work is properly supervised, reviewed and documented;
- (c) Sufficient appropriate evidence is obtained to be able to draw reasonable conclusions;
- (d) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed; and
- (e) Any exceptions or unusual matters disclosed by the internal audit function are properly resolved.

Effect on the Service Auditor's Assurance Report

- 24. If the work of the internal audit function has been used, the service auditor shall make no reference to that work in the section of the service auditor's assurance report that contains the service auditor's opinion. Notwithstanding its degree of autonomy and objectivity, the internal audit function is not independent of the service organization. The service auditor has sole responsibility for the opinion expressed in the service auditor's assurance report and, accordingly, that responsibility is not reduced by the service auditor's use of the work of the internal audit function.
- 25. In the case of a Type B report, if the work of the internal audit function has been used in performing tests of controls, that part of the service auditor's assurance report that describes the service auditor's tests of controls and the results thereof shall include a description of the internal auditor's work and of the service auditor's procedures with respect to that work.

Using the Work of a Service Auditor's Expert

The Capabilities, Competence and Objectivity of the Service Auditor's Expert

- 26. When the service auditor intends to use the work of a service auditor's expert, the service auditor shall evaluate whether the service auditor's expert whose work is to be used has the necessary capabilities, competence and objectivity for the purposes of the engagement. In the case of a service auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity.

Obtaining an Understanding of the Field of Expertise of the Service Auditor's Expert

- 27. The service auditor shall obtain a sufficient understanding of the field of expertise of the service auditor's expert to enable the service auditor to:
 - (a) Determine the nature, scope and objectives of that expert's work for the purposes of the engagement; and
 - (b) Evaluate the adequacy of that work for the purposes of the engagement.

Agreement with the Service Auditor's Expert

- 28. The service auditor shall agree, in writing when appropriate, the following matters with the service auditor's expert:
 - (a) The nature, scope and objectives of that expert's work;
 - (b) The respective roles of the service auditor and that expert; and

- (c) The nature, timing and extent of communication between the service auditor and that expert, including the form of any report to be provided by that expert.

Evaluating the Adequacy of the Service Auditor’s Expert’s Work

- 29. The service auditor shall evaluate the adequacy of the service auditor’s expert’s work for the purposes of the engagement.

Effect on the Service Auditor’s Assurance Report

- 30. If the work of a service auditor’s expert has been used, the service auditor shall make no reference to that work in the section of the service auditor’s assurance report that contains the service auditor’s opinion. The service auditor has sole responsibility for the opinion expressed in the service auditor’s assurance report and, accordingly, that responsibility is not reduced by the service auditor’s use of the work of a service auditor’s expert.
- 31. In the case of a Type B report, if the work of a service auditor’s external expert has been used in performing tests of controls, that section of the service auditor’s assurance report that describes the service auditor’s tests of controls and the results thereof shall include a description of the service auditor’s external expert’s work and of the service auditor’s procedures with respect to that work.

Obtaining an Understanding of the Service Organization’s System

- 32. The service auditor shall obtain an understanding of the service organization’s system, including controls, that are included in the scope of the engagement. (Ref: Para. A9-A10)

Obtaining Evidence Regarding the Description

- 33. The service auditor shall obtain and read the service organization’s description of the system, and shall evaluate whether those aspects of the description included in the scope of the engagement are presented fairly, including whether: (Ref: Para. A11-A12)
 - (a) Stated control objectives are reasonable in the circumstances; (Ref: Para. A13)
 - (b) Controls identified in the description were implemented;
 - (c) Complementary user entity controls, if any, are adequately described; and
 - (d) Services performed by a subservice organization, if any, are adequately described, including whether the inclusive method or the carve-out method has been used in relation to them. (Ref: Para. A14)
- 34. The service auditor shall confirm the implementation of the service organization’s system through other procedures in combination with inquiries of management and other service organization personnel. Those other procedures shall include observation, and inspection of records and other documentation, of the manner in which transactions are processed through the system and controls are applied.

Obtaining Evidence Regarding Design of Controls

35. The service auditor shall determine which of the controls at the service organization are necessary to achieve the stated control objectives included in the scope of the engagement, and shall assess whether those controls were suitably designed. This shall include: (Ref: Para. A15-A17)
- (a) Identifying the risks that threaten the achievement of the stated control objectives included in the scope of the engagement; and
 - (b) Evaluating the linkage of controls identified in the description with those risks.

Obtaining Evidence Regarding Effectiveness of Controls

36. If providing a Type B report, the service auditor shall test those controls that the service auditor has determined are necessary to achieve the stated control objectives included in the scope of the engagement, and assess their operating effectiveness throughout the period. (Ref: Para. A18-A22)
37. When designing and performing tests of controls, the service auditor shall:
- (a) Perform other procedures in combination with inquiry to obtain evidence about:
 - (i) How the control was applied;
 - (ii) The consistency with which the control was applied; and
 - (iii) By who or by what means the control was applied;
 - (b) Determine whether controls to be tested depend upon other controls (indirect controls), and if so, whether it is necessary to obtain evidence supporting the operating effectiveness of those indirect controls; and
 - (c) Determine means of selecting items for testing that are effective in meeting the objectives of the procedure. (Ref: Para. A23-A24)
38. When determining the extent of tests of controls, the service auditor shall consider the characteristics of the population to be tested, including the nature of controls, the frequency of their application (for example, monthly, daily, a number of times per day), and the expected rate of deviation.

Attribute Sampling

39. When the service auditor uses attribute sampling, the service auditor shall: (Ref: Para. A23-A24)
- (a) Determine a sample size sufficient to conclude with an appropriately low level of sampling risk that the total rate of deviation does not exceed the tolerable rate of deviation;
 - (b) Select items for the sample in such a way that all sampling units in the population have a chance of selection;
 - (c) If a designed procedure is not applicable to a selected item, perform the procedure on a replacement item; and

- (d) If unable to apply the designed procedures, or suitable alternative procedures, to a selected item, treat that item as a deviation.

Nature and Cause of Deviations

- 40. The service auditor shall investigate the nature and cause of any deviations identified and shall determine whether:
 - (a) Identified deviations are within the expected rate of deviation and are acceptable; therefore, the testing that has been performed provides an appropriate basis for concluding that the control is operating effectively throughout the specified period;
 - (b) Additional testing of the control or of compensating controls is necessary to reach a conclusion on whether the controls relative to the stated control objective are operating effectively throughout the specified period; or
 - (c) The testing that has been performed provides an appropriate basis for concluding that the control did not operate effectively throughout the specified period.
- 41. In the extremely rare circumstances when the service auditor considers a deviation discovered in a sample to be an anomaly and no compensating controls have been identified, the service auditor shall obtain a high degree of certainty that such deviation is not representative of the population. The service auditor shall obtain this degree of certainty by performing additional procedures to obtain sufficient appropriate evidence that such deviations do not exist in the remainder of the population.

Written Representations

- 42. The service auditor shall request management or those charged with governance to provide written representations based on their knowledge and belief, having made appropriate inquiries for them to be able to provide such representations: (Ref: Para. A25-A26)
 - (a) That reaffirm the assertion accompanying the description of the system;
 - (b) Whether all records, documentation, unusual matters of which they are aware, and other information relevant to the assurance engagement have been made available to the service auditor; and
 - (c) That they have disclosed to the service auditor any of the following of which they are aware:
 - (i) Non-compliance with laws and regulations, or uncorrected errors attributable to the service organization's management or employees that may affect one or more user entities;
 - (ii) Design deficiencies in controls, including those for which management believes the cost of corrective action may exceed the benefits;
 - (iii) Instances where controls have not operated as described; and
 - (iv) Subsequent events regarding the services covered by the engagement that could have a significant effect on user entities.

43. These written representations shall be in the form of a representation letter addressed to the service auditor, and shall be as of the same date as the service auditor's assurance report.
44. If management does not provide one or more of the written representations requested by the service auditor, the auditor shall:
 - (a) Discuss the matter with management;
 - (b) Reconsider the assessment of the integrity of management; and
 - (c) Take appropriate actions, including determining the possible effect on the opinion in the service auditor's assurance report.

Other Information

45. The service auditor shall read the other information, if any, included in a document containing the description of the system and the service auditor's assurance report, to identify material inconsistencies, if any, with that description. While reading the other information for the purpose of identifying material inconsistencies, the service auditor may become aware of an apparent misstatement of fact in that other information.
46. If the service auditor becomes aware of a material inconsistency or an apparent misstatement of fact in the other information, the service auditor shall discuss the matter with management. If the service auditor concludes that there is a material inconsistency or a misstatement of fact in the other information that management refuses to correct, the service auditor shall take further appropriate action.

Subsequent Events

47. The service auditor shall inquire whether management is aware of any events subsequent to the period covered by the description of the system up to the date of the service auditor's assurance report that could have a significant effect on the service auditor's assurance report. If the service auditor is aware of a subsequent event that could have a significant effect on the service auditor's assurance report, and information about that event is not disclosed by the service organization, the service auditor shall disclose it in the service auditor's assurance report.
48. The service auditor has no obligation to perform any procedures regarding the description of the system, or the suitability of design or operating effectiveness of controls after the date of the service auditor's assurance report.

Documentation

49. The service auditor shall prepare documentation so as to enable an experienced service auditor, having no previous connection with the engagement, to understand:
 - (a) The nature, timing, and extent of the procedures performed to comply with this ISAE and applicable legal and regulatory requirements;
 - (b) The results of the procedures and the evidence obtained; and

- (c) Significant matters arising during the engagement, and the conclusions reached thereon and significant professional judgments made in reaching those conclusions.
50. In documenting the nature, timing and extent of procedures performed, the service auditor shall record:
 - (a) The identifying characteristics of the specific items or matters being tested;
 - (b) Who performed the procedures and the date such procedures were completed; and
 - (c) Who reviewed the work performed and the date and extent of such review.
 51. The service auditor shall document discussions of significant matters with the service organization and others including when and with whom the discussions took place.
 52. If the service auditor has identified information that is inconsistent with the service auditor's final conclusion regarding a significant matter, the service auditor shall document how the service auditor addressed the inconsistency in forming the final conclusion.
 53. The service auditor shall complete the assembly of the final engagement file on a timely basis after the date of the service auditor's assurance report.
 54. After the assembly of the final engagement file has been completed, the service auditor shall not delete or discard documentation before the end of its retention period.
 55. If the service auditor finds it necessary to modify existing engagement documentation or add new documentation after the assembly of the final engagement file has been completed, the service auditor shall, regardless of the nature of the modifications or additions, document:
 - (a) When and by whom they were made, and (where applicable) reviewed;
 - (b) The specific reasons for making them; and
 - (c) Their effect, if any, on the service auditor's conclusions.

Preparing the Service Auditor's Assurance Report

Content of the Service Auditor's Assurance Report

56. The service auditor's assurance report shall include the following basic elements: (Ref: Para. A27)
 - (a) A title that clearly indicates the report is an independent service auditor's assurance report.
 - (b) An addressee.
 - (c) Identification of:
 - (i) The description of the system, and management's assertion, which includes the matters described in paragraph 9(j)(ii) for a Type B report, or paragraph 9(i)(ii) for a Type A report.
 - (ii) If parts of the description of the system are not covered by the service auditor's opinion, an identification of those parts.

- (iii) If the description refers to the need for complementary user entity controls, a statement that the service auditor has not evaluated the suitability of design or operating effectiveness of complementary user entity controls, and that the stated control objectives can be achieved only if complementary user entity controls are suitably designed or operating effectively, along with the controls at the service organization.
 - (iv) If services are performed by a subservice organization, those services and whether the inclusive method or the carve-out method has been used in relation to them. Where the carve-out method has been used, a statement that the description of the system excludes the control objectives and related controls at relevant subservice organizations, and that the service auditor’s procedures do not extend to the subservice organization. Where the inclusive method has been used, a statement that the description of the system includes the stated control objectives and related controls at the subservice organization, and that the service auditor’s procedures included the subservice organization.
- (d) Identification of the criteria, and the party specifying the control objectives.
 - (e) A statement of the limitations of controls and, in the case of a Type B report, of the risk of projecting to future periods any evaluation of the effectiveness of controls.
 - (f) Identification of the purpose(s) and intended users of the service auditor’s assurance report. (Ref: Para. A28)
 - (g) A description of the service organization’s and the service auditor’s responsibilities, including a statement that the service organization is responsible for:
 - (i) Preparing and presenting the description of the system, and accompanying assertion, including the completeness, accuracy and method of presentation of the description and assertion;
 - (ii) Providing the services covered by the description of the system;
 - (iii) Stating the control objectives (where not identified by law or regulation, or another party, for example a user group or a professional body), and the risks that threaten their achievement; and
 - (iv) Designing, implementing and maintaining controls to achieve the stated control objectives.
 - (h) A statement that the engagement was performed in accordance with ISAE 3402, “Assurance Reports on Controls at a Third Party Service Organization.”
 - (i) A summary of the service auditor’s procedures to obtain reasonable assurance and, in the case of a Type A report, a statement that the service auditor has not performed any procedures regarding the operating effectiveness of controls and therefore no opinion is expressed thereon.
 - (j) The service auditor’s opinion, expressed in the positive form, on whether, in all material respects, based on suitable criteria:

- (i) In the case of a Type B report:
 - a. The description fairly presents the service organization’s system that had been designed and implemented throughout the specified period;
 - b. The controls related to the control objectives stated in the description were suitably designed throughout the specified period; and
 - c. The controls the service auditor tested operated effectively throughout the specified period.
 - (ii) In the case of a Type A report:
 - a. The description fairly presents the service organization’s system that had been designed and implemented as at the specified date; and
 - b. The controls related to the control objectives stated in the description were suitably designed as at the specified date.
 - (k) The date of the service auditor’s assurance report.
 - (l) The name of the service auditor, and the city where the service auditor maintains the office that has responsibility for the engagement.
57. In the case of a Type B report, the service auditor’s assurance report shall include a separate section after the opinion, or an attachment, that describes the service auditor’s tests of controls and the results thereof. In describing the tests of controls, the auditor shall clearly state which controls have been tested and the period during which they were tested, identify whether the items tested represent all or a selection of the items in the population, and indicate the nature of the tests in sufficient detail to enable user auditors to determine the effect of such tests on their risk assessments. If deviations have been identified, the service auditor shall include the extent of testing performed by the service auditor that led to identification of the deviations, and the number of deviations noted. The service auditor shall report deviations even if, on the basis of tests performed, the service auditor has concluded that the related control objective has been achieved. (Ref: Para. A29)

Modified Opinions

58. If the service auditor concludes that: (Ref: Para. A30)
- (a) management’s description of the system is not presented fairly in all material respects;
 - (b) the controls are not suitably designed to provide reasonable assurance that the stated control objectives will be achieved if the controls operate effectively;
 - (c) in the case of a Type B report, the controls did not operate effectively throughout the specified period; or
 - (d) the service auditor is unable to obtain sufficient appropriate evidence,
- the service auditor’s opinion shall be modified, and the service auditor’s assurance report shall contain a clear description of all the reasons for the modification.

Other Communication Responsibilities

59. If the service auditor becomes aware of non-compliance with laws and regulations, or uncorrected errors attributable to the service organization that are not clearly trivial and may affect one or more user entities, the service auditor shall determine whether this information has been communicated appropriately to affected user entities. If the information has not been so communicated and management of the service organization is unwilling to do so, the service auditor shall take appropriate action. (Ref: Para. A31)

Application and Other Explanatory Material

Definitions (Ref: Para. 9(d))

- A1. The process referred to in the definition of “controls at the service organization” at paragraph 9(d) invariably includes aspects of user entities’ information systems maintained by the service organization, and may also include aspects of one or more of the other components of internal control. For example, it may include aspects of the service organization’s control environment, monitoring, and control activities where they relate to the services provided. It does not, however, include controls at a service organization that are not related to the achievement of the control objectives stated in the description of the system, for example controls related to the preparation of the service organization’s own financial statements.

Ethical Requirements (Ref: Para. 11)

- A2. The service auditor is subject to independence requirements of the Code. However, in performing an engagement in accordance with this ISAE, the Code does not require the service auditor to be independent from each user entity.

Acceptance and Continuance (Ref: Para. 12-13)

- A3. The requirements of paragraph 12 do not preclude a service auditor from using this ISAE where required by law or regulation to accept or continue an engagement, for example, in the public sector, if the service auditor’s assurance report is modified appropriately and clearly indicates the reason that would otherwise have caused the service auditor to decline the engagement.
- A4. A request to change the scope of the engagement may not have a reasonable justification when, for example, the request is made:
- To exclude certain aspects of controls at the service organization from the scope of the engagement because of the likelihood that the service auditor’s opinion would be modified with respect to those aspects.
 - To change the report from a Type B to a Type A because of the likelihood that the service auditor’s opinion would be modified with respect to the operating effectiveness of controls.

Assessing the Suitability of the Criteria (Ref: Para. 14-17)

A5. ISAE 3000 requires the service auditor, amongst other things, to assess the suitability of criteria, and the appropriateness of the subject matter.⁶ The subject matter is the underlying condition of interest to intended users of an assurance report. The following table identifies the subject matter and minimum criteria for each of the opinions in Type B and Type A reports.

	<i>Subject matter</i>	<i>Criteria</i>	<i>Comment</i>	
<i>Opinion about the fair presentation of the description of the system (Type A and Type B reports)</i>	The system that is relevant to services covered by the service auditor’s assurance report.	The description is fairly presented if it: (a) presents how the service organization’s system made available to user entities has been designed and implemented to process relevant transactions including the matters identified in paragraph 15(a); and (b) does not omit or distort information relevant to the scope of the service organization’s system being described, while acknowledging that the description is presented to meet the common needs of a broad range of user entities and may not, therefore, include every aspect of the service organization’s system that each individual user entity may consider important in its own particular environment.	The specific wording of the criteria for this opinion may need to be tailored to be consistent with criteria established by, for example, law or regulation, user groups, or a professional body. Examples of criteria for this opinion are provided in the illustrative assertion in Appendix 1. Paragraphs A11-A14 offer further guidance on determining whether these criteria are met. (In terms of the requirements of ISAE 3000, the subject matter information ⁷ for this opinion is the description of the system and the service organization’s assertion that the description is presented fairly.)	
<i>Opinion about suitability of design, and operating effectiveness (Type B reports)</i>	The design and operating effectiveness of those controls that are necessary to achieve the stated control objectives	The controls are suitably designed and operating effectively if: (a) the risks that threaten achievement of the control objectives stated in the description have been identified; (b) the identified controls would, if operated as described, provide reasonable assurance that those risks do not prevent the stated	When the criteria for this opinion are met, controls will have provided reasonable assurance that the related control objectives were achieved throughout the specified period. (In terms of the requirements of ISAE	The control objectives, which are stated in the description, are part of the criteria for these opinions. The stated control objectives will differ from engagement to engagement. If, as part of forming the opinion on the

⁶ ISAE 3000, paragraphs 18-19.

⁷ The “subject matter information” is the outcome of the evaluation or measurement of the subject matter that results from applying the criteria to the subject matter.

	<i>Subject matter</i>	<i>Criteria</i>	<i>Comment</i>	
	relevant to services covered by the service auditor's assurance report.	control objectives from being achieved; and (c) those controls necessary for achieving the relevant control objectives were consistently applied as designed. This includes whether manual controls were applied by individuals who have the appropriate competence and authority.	3000, the subject matter information for this opinion is the service organization's assertion that controls are suitably designed and that they are operating effectively.)	description, the auditor concludes the stated control objectives are not fairly presented then those control objectives would not be suitable as part of the criteria for forming an opinion on either the design or operating effectiveness of controls.
<i>Opinion about suitability of design (Type A reports)</i>	The suitability of the design of those controls that are necessary to achieve the stated control objectives relevant to services covered by the service auditor's assurance report.	The controls are suitably designed if: (a) the risks that threaten achievement of the control objectives stated in the description have been identified; and (b) the identified controls would, if operated as described, provide reasonable assurance that those risks do not prevent the stated control objectives from being achieved.	Meeting this criterion does not, of itself, provide any assurance that the related control objectives were achieved because no assurance has been obtained about the operation of controls. (In terms of the requirements of ISAE 3000, the subject matter information for this opinion is the service organization's assertion that controls are suitably designed.)	

Materiality (Ref: Para. 18)

A6. In an engagement to report on controls at a service organization, the concept of materiality relates to the information being reported on, not the financial statements of user entities. The service auditor plans and performs procedures to determine whether the service organization's description of the system is fairly stated in all material respects, whether controls at the service organization are suitably designed in all material respects and, in the case of a Type B report, whether controls at the service organization are operating effectively in all material respects. In applying the concept of materiality, the service auditor considers that the service auditor's assurance report provides information about the service organization's system to meet the common information needs of a broad range of user entities and their auditors who have an understanding of the manner in which the system is being used in a particular user entity for financial reporting by that user entity. Materiality with respect to the fair presentation of the description, and with respect to the design of controls, includes primarily the consideration of qualitative factors, for example, whether the description includes the significant aspects of

processing significant transactions, whether the description omits or distorts relevant information, and the ability of controls, as designed, to provide reasonable assurance that the stated control objectives would be achieved. Materiality with respect to the operating effectiveness of controls includes the consideration of both quantitative and qualitative factors, for example, the tolerable rate and observed rate of deviation (a quantitative matter), and the nature and cause of any observed deviation (a qualitative matter).

Using the Work of an Internal Audit Function

Obtaining an Understanding of the Internal Audit Function (Ref: Para. 19)

- A7. An internal audit function may be responsible for providing analyses, evaluations, assurances, recommendations, and other information to management and those charged with governance. An internal audit function at a service organization may perform activities related to the service organization's internal control, or activities related to the services and systems, including controls, that the service organization is providing to user entities.
- A8. The scope and objectives of an internal audit function vary widely and depend on the size and structure of the service organization and the requirements of management and those charged with governance. Internal audit function activities may include one or more of the following:
- Monitoring of the service organization's internal control or the application processing systems, including controls, provided to user entities. The internal audit function may be assigned specific responsibility for reviewing controls, monitoring their operation and recommending improvements thereto.
 - Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, measure, classify and report financial and operating information, and specific inquiry and other procedures into individual items including detailed testing of transactions, balances and procedures.
 - Evaluation of the economy, efficiency and effectiveness of operating activities including non-financial activities of a service organization.
 - Evaluation of compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

Obtaining an Understanding of the Service Organization's System (Ref: Para. 32)

- A9. Obtaining an understanding of the service organization's system, including controls, included in the scope of the engagement, assists the service auditor in:
- Identifying the boundaries of the system, and how it interfaces with other systems.
 - Assessing whether the service organization's description fairly presents the system that has been designed and implemented.
 - Determining which controls are necessary to achieve the stated control objectives included in the scope of the engagement, and whether controls were suitably designed, and, in the case of a Type B report, operating effectively.

A10. Procedures to obtain this understanding may include:

- Inquiring of management and of others within the service organization who, in the service auditor's judgment, may have relevant information.
- Observing operations and inspecting documents, reports, printed and electronic records of transaction processing.
- Inspecting a selection of agreements between the service organization and user entities to identify their common terms.

Obtaining Evidence Regarding the Description (Ref: Para. 33)

A11. Considering the following questions may assist the service auditor in determining whether those aspects of the description included in the scope of the engagement are fairly stated in all material respects:

- Does the description address the major aspects of the service provided (within the scope of the engagement) that could reasonably be expected to be relevant to the common needs of a broad range of user auditors in planning their audits of user entities' financial statements?
- Is the description presented at a level of detail that could reasonably be expected to provide a broad range of user auditors with sufficient information to obtain an understanding of internal control in accordance with ISA 315 (Redrafted)?⁸ The description need not address every aspect of the service organization's processing or the services provided to user entities, and need not be so detailed as to potentially allow a reader to compromise security or other controls at the service organization.
- Is the description prepared and presented in a manner that does not omit or distort information that may affect the common needs of a broad range of user auditors' decisions, for example, does the description contain any significant omissions or inaccuracies in processing of which the service auditor is aware?
- Have the controls identified in the description actually been implemented?
- Are complementary user entity controls, if any, adequately described? In most cases, the description of control objectives is worded such that the control objectives are capable of being achieved through effective operation of controls implemented by the service organization alone. In some cases, however, the control objectives stated in the description cannot be achieved by the service organization alone because their achievement requires particular controls to be implemented by user entities. This may be the case where, for example, the control objectives are specified by a regulatory authority. When the description does include complementary user entity controls, the description separately identifies those controls.

⁸ ISA 315 (Redrafted), "Identifying and Assessing Risks of Material Misstatement Through Understanding the Entity and Its Environment."

A12. The service auditor's procedures to evaluate the fair presentation of the description may include:

- Considering the nature of user entities and how the services provided by the service organization are likely to affect them, for example, the predominant type(s) of user entities, and whether user entities are regulated by government agencies.
- Reading standard contracts, or standard terms of contracts, (if applicable) with user entities to gain an understanding of the service organization's contractual obligations.
- Observing procedures performed by service organization personnel.
- Reviewing the service organization's policy and procedure manuals and other systems documentation, for example, flowcharts and narratives.

A13. Paragraph 33(a) requires the service auditor to evaluate whether the stated control objectives are reasonable in the circumstances. Considering the following questions may assist the service auditor in this evaluation:

- Have the stated control objectives been designated by the service organization or by outside parties such as regulatory authorities, a user group, a professional body or others?
- Where the stated control objectives have been specified by management, do they relate to the types of assertions commonly embodied in the broad range of user entities' financial statements to which controls at the service organization could reasonably be expected to relate? Although the service auditor ordinarily will not be able to determine how controls at a service organization specifically relate to the assertions embodied in individual user entities' financial statements, the service auditor's understanding of the nature of the service organization's system, including controls, and services being provided is used to identify the types of assertions to which those controls are likely to relate.
- Where the stated control objectives have been specified by management, are they complete? A complete set of control objectives can provide a broad range of user auditors with a framework to assess the effect of controls at the service organization on the assertions commonly embodied in user entities' financial statements.

A14. If the inclusive method has been used, it is important that the description adequately differentiates between controls at the service organization and controls at the subservice organization. If the carve-out method is used, it is important that the description identifies the functions that are performed by the subservice organization, but it need not describe the detailed processing or controls at the subservice organization.

Obtaining Evidence Regarding the Design of Controls (Ref: Para. 35)

A15. From the viewpoint of a *user auditor*, a control is suitably designed if individually or in combination with other controls, it would, when complied with satisfactorily, provide reasonable assurance that material misstatements, whether due to fraud or error, are prevented, or detected and corrected. A *service auditor*, however, is not aware of the

circumstances at individual user entities that would determine whether or not a misstatement resulting from a control deviation is material to those user entities. Therefore, from the viewpoint of a service auditor, a control is suitably designed if individually or in combination with other controls, it would, when complied with satisfactorily, provide reasonable assurance that stated control objectives are achieved.

- A16. A service auditor may consider using flowcharts, questionnaires, or decision tables to facilitate understanding the design of the controls.
- A17. Controls may consist of a number of integrated activities directed at the achievement of various control objectives. Consequently, where the service auditor evaluates certain activities as being ineffective in achieving a particular control objective, the existence of other activities, sometimes known as compensating controls, may nonetheless allow the service auditor to conclude that controls related to the stated control objective are suitably designed.

Obtaining Evidence Regarding the Effectiveness of Controls

Assessing Operating Effectiveness (Ref: Para. 36)

- A18. From the viewpoint of a *user auditor*, a control is operating effectively if individually or in combination with other controls, it provides reasonable assurance that material misstatements, whether due to fraud or error, are prevented, or detected and corrected. A *service auditor*, however, is not aware of the circumstances at individual user entities that would determine whether or not a misstatement resulting from a control deviation is material. Therefore, from the viewpoint of a service auditor, a control is operating effectively if individually or in combination with other controls, it provides reasonable assurance that stated control objectives are achieved. Similarly, a service auditor is not in a position to determine whether any observed control deviation would result in a material misstatement from the viewpoint of an individual user entity.
- A19. Obtaining an understanding of controls sufficient to opine on the suitability of their design is not sufficient evidence regarding their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls as they were designed and implemented. For example, obtaining information about the implementation of a manual control at a point in time does not provide evidence about operation of the control at other times. However, because of the inherent consistency of IT processing, performing procedures to determine the design of an automated control and whether it has been implemented may serve as evidence of that control's operating effectiveness, depending on the service auditor's assessment and testing of other controls, such as those over program changes.
- A20. To be useful to user auditors, a Type B report ordinarily covers a minimum period of six months. If the period is less than six months, the service auditor may consider it appropriate to describe the reasons for the shorter period in the service auditor's assurance report. Circumstances that may result in a report covering a period of less than six months include when (a) the service auditor is engaged close to the date by which the report on controls is to be issued; (b) the service organization (or a particular system or application) has been in operation for less than six months; or (c) significant changes have been made to the controls

and it is not practicable either to wait six months before issuing a report or to issue a report covering the system both before and after the changes.

- A21. Certain control procedures may not leave evidence of their operation that can be tested at a later date and accordingly, the service auditor may find it appropriate to test the operating effectiveness of such control procedures at various times throughout the reporting period.
- A22. Evidence from prior engagements about the satisfactory operation of controls in prior periods cannot provide a basis for a reduction in testing, even if it is supplemented with evidence obtained during the current period. This is because the service auditor provides an opinion on the effectiveness of controls throughout each period, therefore sufficient evidence about the operation of controls during the current period is required for the service auditor to express that opinion.

Means of Selecting Items for Testing (Ref: Para. 37(c) and 39)

A23. The means of selecting items for testing available to the service auditor are:

- (a) Selecting all items (100% examination). This may be appropriate for testing controls that are applied infrequently, for example, quarterly, or when evidence regarding application of the control makes 100% examination efficient;
- (b) Selecting specific items. This may be appropriate where 100% examination would not be efficient and attribute sampling would not be effective, such as testing controls that enforce segregation of duties, or testing controls that are not applied sufficiently frequently to render a large population for attribute sampling, for example, controls that are applied monthly; and
- (c) Attribute sampling. This may be appropriate for testing controls that are applied frequently in a uniform manner and which leave documentary evidence of their application.

A24. While selective examination of specific items will often be an efficient means of obtaining evidence, it does not constitute attribute sampling. The results of procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide evidence concerning the remainder of the population. Attribute sampling, on the other hand, is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it.

Written Representations (Ref: Para. 42)

A25. The written representations reconfirming the service organization's assertion about the effective operation of controls may be based on ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of a service organization and include regular management and supervisory activities. Internal auditors or personnel performing similar functions may contribute to the monitoring of a service organization's activities. Monitoring activities may also include using information from communications from external parties, such as customer

complaints and regulator comments, that may indicate problems or highlight areas in need of improvement.

A26. The written representations required by paragraph 42 are separate from, and in addition to, the assertion contained in the service organization's report on controls, as described in paragraph 9(j)(ii) for a Type B report, and paragraph 9(i)(ii) for a Type A report.

Preparing the Service Auditor's Assurance Report

Content of the Service Auditor's Assurance Report (Ref: Para.56)

A27. Illustrative examples of service auditors' assurance reports and related service organizations' management assertions are contained in Appendices 1 and 2.

Use of the Service Auditor's Assurance Report (Ref: Para. 56(f))

A28. ISAE 3000 requires that when the criteria used to evaluate or measure the subject matter are available only to specific intended users, or are relevant only to a specific purpose, the assurance report includes a statement restricting the use of the assurance report to those intended users or that purpose.⁹ The criteria used for engagements to report on controls at a service organization are relevant only for the purposes of providing information about the service organization's system, including controls, to those who have an understanding of how the system is used for financial reporting by user entities, and accordingly the service auditor's assurance report states that it is intended only for use by existing users and their financial statement auditors.

Description of the Service Auditor's Tests of Controls (Ref: Para. 57)

A29. In describing the nature of the service auditor's tests of controls for a Type B report, it assists readers if the service auditor's assurance report defines the types of tests performed. It also assists readers of the service auditor's assurance report if the service auditor includes:

- The results of all tests where deviations have been identified, even if compensating controls have been identified or the control tested has subsequently been removed from the description of the system.
- Information about causative factors for identified deviations, to the extent the service auditor has identified such factors.

Modified Opinions (Ref: Para. 58)

A30. Illustrative examples of elements of modified service auditor's assurance reports are contained in Appendix 3.

Other Communication Responsibilities (Ref: Para. 59)

A31. Appropriate action when the service auditor becomes aware of non-compliance with laws and regulations, or uncorrected error that has not been communicated appropriately to

⁹ ISAE 3000, paragraph 49(f).

affected user entities, and management of the service organization is unwilling to do so, may include:

- Obtaining legal advice about the consequences of different courses of action.
- Communicating with those charged with governance of the service organization.
- Communicating with third parties (for example, a regulator) when required to do so.
- Modifying the service auditor's opinion, or adding an other matters paragraph.
- Withdrawing from the engagement.

Appendix 1

(Ref. Para. A27)

Example Management Assertions

The following example management assertions are for guidance only and are not intended to be exhaustive or applicable to all situations.

Example 1: Type B Assertion for Service Organization

Management's Assertion

We have prepared the accompanying description for existing customers of our *[the type or name of]* system and their auditors who have a sufficient understanding to consider it, along with other information including information about controls operated by customers themselves, when assessing the risks of material misstatements of customers' financial statements. We confirm that:

- (a) The accompanying description at pages *[bb-cc]* of the system fairly presents *[the type or name of]* system made available to existing customers for processing their transactions throughout the period *[date]* to *[date]*. The criteria we used in making this assertion were that the accompanying description:
 - (i) Presents how the system made available to existing customers has been designed and implemented to process relevant transactions, including:
 - The classes of transactions processed.
 - The procedures, within both information technology and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, and transferred to the reports presented to existing customers.
 - The related accounting records, supporting information and specific accounts that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the reports presented to existing customers.
 - How the system captures significant events and conditions, other than transactions.
 - The process used to prepare reports presented to existing customers.
 - The stated control objectives and controls designed to achieve those objectives.
 - Other aspects of our control environment, risk assessment process, information system (including the related business processes) and communication, control activities and monitoring controls that are relevant to processing and reporting existing customers' transactions.
 - (ii) Does not omit or distort information relevant to the scope of the system being described, while acknowledging that the description is presented to meet the common needs of a broad range of existing customers and their auditors and may not, therefore, include

every aspect of the system that each individual customer may consider important in its own particular environment.

- (b) The controls related to the control objectives stated in the accompanying description were suitably designed and operated effectively throughout the period *[date]* to *[date]*. The criteria we used in making this assertion were that:
- (i) The risks that threaten achievement of the control objectives stated in the description have been identified;
 - (ii) The identified controls would, if operated as described, provide reasonable assurance that those risks do not prevent the stated control objectives from being achieved; and
 - (iii) The controls were consistently applied as designed, including that manual controls were applied by individuals who have the appropriate competence and authority.

[Management (or Those Charged With Governance)]

Example 2: Type A Assertion for Service Organization

Management's Assertion

We have prepared the accompanying description for existing customers of our *[the type or name of]* system and their auditors who have a sufficient understanding to consider it, along with other information including information about controls operated by customers themselves, when obtaining an understanding of customers' information systems relevant to financial reporting. We confirm that:

- (a) The accompanying description at pages *[bb-cc]* of the system fairly presents *[the type or name of]* system made available to existing customers for processing their transactions as at *[date]*. The criteria we used in making this assertion were that the accompanying description:
- (i) Presents how the system made available to existing customers has been designed and implemented to process relevant transactions, including:
 - The classes of transactions processed.
 - The procedures, within both information technology and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, and transferred to the reports presented to existing customers.
 - The related accounting records, supporting information and specific accounts that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the reports presented to existing customers.
 - How the system captures significant events and conditions, other than transactions.
 - The process used to prepare reports presented to existing customers.
 - The stated control objectives and controls designed to achieve those objectives.

- Other aspects of our control environment, risk assessment process, information system (including the related business processes) and communication, control activities and monitoring controls that are relevant to processing and reporting existing customers' transactions.
- (ii) Does not omit or distort information relevant to the scope of the system being described, while acknowledging that the description is presented to meet the common needs of a broad range of existing customers and their auditors and may not, therefore, include every aspect of the system that each individual customer may consider important in its own particular environment.
- (b) The controls related to the control objectives stated in the accompanying description were suitably designed as at *[date]*. The criteria we used in making this assertion were that:
- (i) The risks that threaten achievement of the control objectives stated in the description have been identified; and
 - (ii) The identified controls would, if operated as described, provide reasonable assurance that those risks do not prevent the stated control objectives from being achieved.

[Management (or Those Charged With Governance)]

Appendix 2

(Ref. Para. A27)

Example Service Auditor's Assurance Reports

The following examples of reports are for guidance only and are not intended to be exhaustive or applicable to all situations.

Example 1: Type B Service Auditor's Assurance Report

**Independent Service Auditor's Assurance Report on
the Description of Controls, their Design and Effective Operation**

To: XYZ Service Organization

Scope

We have been engaged to report on XYZ Service Organization's description at pages [bb-cc] of [the type or name of] system made available to customers for processing their transactions throughout the period [date] to [date] (the description), and on the design and operation of controls related to the control objectives stated in the description.¹⁰

Management's Responsibilities

Management of XYZ Service Organization is responsible for preparing and presenting the description and accompanying assertion at page [aa], including the completeness, accuracy and method of presentation of the description and assertion, providing the services covered by the description, stating the control objectives and identifying the risks that threaten their achievement, and designing, implementing and maintaining controls to achieve the stated control objectives.

Service Auditor's Responsibilities

Our responsibility is to express an opinion on the description, and on the design and operation of controls related to the control objectives stated in that description, based on our procedures. We conducted our engagement in accordance with International Standard on Assurance Engagements 3402, "Assurance Reports on Controls at a Third Party Service Organization" issued by the International Auditing and Assurance Standards Board. That standard requires that we comply with ethical requirements, and plan and perform our procedures to obtain reasonable assurance whether, in all material respects, the description is fairly presented and the controls are suitably designed and operating effectively.

An assurance engagement on the description, design and effective operation of controls at a service organization involves performing procedures to obtain evidence about the disclosures in the description of the system, and the design and effective operation of controls. The procedures selected depend on the service auditor's judgment, including the assessment of the risks that the description is not fairly presented, and that controls are not suitably designed or operating effectively, whether due

¹⁰ If some elements of the description are not included in the scope of the engagement, this is made clear in the assurance report.

to fraud or error. Our procedures included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the control objectives stated in the description were achieved. An assurance engagement of this type also includes evaluating the overall presentation of the description, and the suitability of the objectives stated therein.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Limitations of Internal Controls at a Service Organization

Because of their nature, controls at a service organization may not prevent or detect all errors or omissions in processing or reporting transactions. Also, the projection of any evaluation of effectiveness to future periods is subject to the risk that controls at a service organization may become inadequate or fail.

Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in management's assertion at page [aa]. In our opinion, in all material respects:

- (a) The description fairly presents the [the type or name of] system that had been designed and implemented throughout the period [date] to [date];
- (b) The controls related to the control objectives stated in the description were suitably designed throughout the period [date] to [date]; and
- (c) The controls we tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period [date] to [date].

Description of Tests of Controls

The specific controls that were tested and the nature, timing and results of those tests are listed on pages [yy-zz].

Intended Users and Purpose

This report and the description of tests of controls on pages [yy-zz] are intended only for existing customers of XYZ Service Organization's [type or name of] system, and their auditors, who have a sufficient understanding to consider it, along with other information including information about controls operated by customers themselves, when assessing the risks of material misstatements of customers' financial statements.

[Service auditor's signature]

[Date of the service auditor's assurance report]

[Service auditor's address]

Example 2: Type A Service Auditor’s Assurance Report**Independent Service Auditor’s Assurance Report on
the Description of Controls and their Design**

To: XYZ Service Organization

Scope

We have been engaged to report on XYZ Service Organization’s description at pages [bb-cc] of [the type or name of] system made available to customers for processing their transactions as at [date] (the description), and on the design of controls related to the control objectives stated in the description.¹¹

Management’s Responsibilities

Management of XYZ Service Organization is responsible for preparing and presenting the description and accompanying assertion at page [aa], including the completeness, accuracy and method of presentation of the description and the assertion, providing the services covered by the description, stating the control objectives and identifying the risks that threaten their achievement, and designing, implementing and maintaining controls to achieve the stated control objectives.

Service Auditor’s Responsibilities

Our responsibility is to express an opinion on the description, and on the design of controls related to the control objectives stated in that description, based on our procedures. We conducted our engagement in accordance with International Standard on Assurance Engagements 3402, “Assurance Reports on Controls at a Third Party Service Organization” issued by the International Auditing and Assurance Standards Board. That standard requires that we comply with ethical requirements, and plan and perform our procedures to obtain reasonable assurance whether, in all material respects, the description is fairly presented and the controls are suitably designed in all material respects.

An assurance engagement on the description and design of controls at a service organization involves performing procedures to obtain evidence about the disclosures in the description of the system, and the design of controls. The procedures selected depend on the service auditor’s judgment, including the assessment that the description is not fairly presented, and that controls are not suitable designed, whether due to fraud or error. An assurance engagement of this type also includes evaluating the overall presentation of the description, and the suitability of the objectives stated therein.

We did not perform any procedures regarding the operating effectiveness of controls included in the description, and accordingly do not express an opinion thereon.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

¹¹ If some elements of the description are not included in the scope of the engagement, this is made clear in the assurance report.

Limitations of Internal Controls at a Service Organization

Because of their nature, controls at a service organization may not prevent or detect all errors or omissions in processing or reporting transactions.

Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in management's assertion at page [aa]. In our opinion, in all material respects:

- (a) The description fairly presents the [the type or name of] system that had been designed and implemented as at [date], and
- (b) The controls related to the control objectives stated in the description were suitably designed as at [date].

Intended Users and Purpose

This report is intended only for existing customers of XYZ Service Organization's [type or name of] system, and their auditors, who have a sufficient understanding to consider it, along with other information including information about controls operated by customers themselves, when obtaining an understanding of customers' information systems relevant to financial reporting.

[Service auditor's signature]

[Date of the service auditor's assurance report]

[Service auditor's address]

Appendix 3

(Ref. Para. A30)

Example Modified Service Auditor's Assurance Reports

The following examples of modified reports are for guidance only and are not intended to be exhaustive or applicable to all situations. They are based on the examples of reports in Appendix 2.

Example 1: Qualified opinion – management's description of the system is not presented fairly in all material respects

...

Service Auditor's Responsibilities

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

The accompanying description states at page [mn] that XYZ Service Organization uses operator identification numbers and passwords to prevent unauthorized access to the system. Based on our procedures, which included inquiries of staff personnel and observation of activities, we have determined that operator identification numbers and passwords are employed in Applications A and B but not in Applications C and D.

Qualified Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in management's assertion at page [aa]. In our opinion, except for the matter described in the Basis for Qualified Opinion paragraph:

(a) ...

Example 2: Qualified opinion – the controls are not suitably designed to provide reasonable assurance that the stated control objectives will be achieved if the controls operate effectively

...

Service Auditor's Responsibilities

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

As discussed at page [mn] of the accompanying description, from time to time XYZ Service Organization makes changes in application programs to correct deficiencies or to enhance capabilities. The procedures followed in determining whether to make changes, in designing the changes and in implementing them, do not include review and approval by authorized individuals who are independent from those involved in making the changes. There are also no specified requirements to test such changes or provide test results to an authorized reviewer prior to implementing the changes.

Qualified Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in management’s assertion at page [aa]. In our opinion, except for the matter described in the Basis for Qualified Opinion paragraph:

(a) ...

Example 3: Qualified opinion – the controls did not operate effectively throughout the specified period (Type B report only)

...

Service Auditor’s Responsibilities

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

XYZ Service Organization states in its description that it has automated controls in place to reconcile loan payments received with the output generated. However, as noted at page [mn] of the description, this control was not operating effectively during the period from dd/mm/yyyy to dd/mm/yyyy due to a programming error. This resulted in the non-achievement of the control objective “Controls provide reasonable assurance that loan payments received are properly recorded” during the period from dd/mm/yyyy to dd/mm/yyyy. Management implemented a change to the program performing the calculation as of [date], and our tests indicate that it was operating effectively during the period from dd/mm/yyyy to dd/mm/yyyy.

Qualified Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in management’s assertion at page [aa]. In our opinion, except for the matter described in the Basis for Qualified Opinion paragraph:

...

Example 4: Qualified opinion – the service auditor is unable to obtain sufficient appropriate evidence

...

Service Auditor's Responsibilities

...

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

XYZ Service Organization states in its description that it has automated controls in place to reconcile loan payments received with the output generated. However, electronic records of the performance of this reconciliation for the period from *dd/mm/yyyy* to *dd/mm/yyyy* were deleted as a result of a computer processing error, and we were therefore unable to test the operation of this control for that period. Consequently, we were unable to determine whether the control objective "Controls provide reasonable assurance that loan payments received are properly recorded" operated effectively during the period from *dd/mm/yyyy* to *dd/mm/yyyy*.

Qualified Opinion

Our opinion has been formed on the basis of the matters outlined in this report. The criteria we used in forming our opinion were those described in management's assertion at page *[aa]*. In our opinion, except for the matter described in the Basis for Qualified Opinion paragraph:

(a) ...

PROPOSED CONFORMING AMENDMENT

Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services

Other International Standards

- 24a. Some International Standards identified in paragraphs 5-7 contain: objectives, requirements, application and other explanatory material, and introductory material and definitions. These terms are to be interpreted in a directly analogous way to how they are explained in the context of ISAs and financial statement audits in paragraphs 15-22.
- 24b. ~~The Other~~ International Standards identified in paragraphs 5-7 contain basic principles and essential procedures ...



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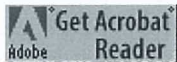
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IAASB Proposes New Standards on Service Organizations and Communicating Deficiencies in Internal Control; Makes Further Progress on Clarity of Standards

(New York/December 21, 2007) - At its recent meeting in Washington, D.C., the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board under the auspices of the International Federation of Accountants (IFAC), approved three new proposed standards: two focus on enhancing the auditors' consideration of controls at service organizations, and the third addresses the communication of deficiencies in internal control to those charged with governance. These standards reflect the importance of internal control within audited entities and at their service organizations, and of the auditor's responsibility to make significant findings available to those charged with governance. The IAASB is also releasing two exposure drafts written in accordance with the new clarity drafting conventions.

Third Party Service Organizations

Many entities outsource aspects of their businesses to organizations that provide services ranging from performing a specific task under the direction of the entity to replacing one or more of the entity's business units or functions. Frequently, services provided by such organizations are integral to the entity's information system relevant to financial reporting.

Following a risk-based approach, proposed International Standard on Auditing (ISA) 402 (Revised and Redrafted), *Audit Considerations Relating to an Entity Using a Third Party Service Organization*, deals with the auditor's responsibilities to obtain audit evidence when an entity uses one or more service organizations. This may include obtaining reports prepared by the auditors of those organizations.

Proposed International Standard on Assurance Engagements (ISAE) 3402, *Assurance Reports on Controls at a Third Party Service Organization*, is the first subject matter-

specific standard developed under the IAASB's *International Framework for Assurance Engagements*. It complements proposed ISA 402 (Revised and Redrafted) in that reports prepared in accordance with proposed ISAE 3402 will be capable of providing appropriate audit evidence under the proposed ISA. It will help to bring consistency in reporting on controls at service organizations, thereby assisting such organizations to meet the needs of clients ("user entities") and their auditors. In particular, it should ensure that reports issued in one country are likely to meet the requirements of the auditors of user entities in other countries.

"The proposed standards reflect the IAASB's recognition of the increasing use of service organizations worldwide. In revising our existing standard for the auditors of user entities, and complementing it with a new standard for the auditors of service organizations, we are proposing consistent and comprehensive guidance for this important aspect of auditing," says John Kellas, Chairman of the IAASB.

Communicating Deficiencies in Internal Control

The IAASB also seeks comments on proposed ISA 265, *Communicating Deficiencies in Internal Control*. This deals with the auditor's responsibility to communicate to management and those charged with governance deficiencies in internal control that have been identified by the auditor. It distinguishes between significant and other deficiencies in order to establish requirements to communicate to the appropriate levels within the audited entity. It also requires the former to be communicated in writing to those charged with governance.

"This new proposed standard is intended to enhance the effectiveness of the auditor's communication of deficiencies in internal control by requiring a clearer focus on what is important to those taking ultimate responsibility for control over financial reporting. The proposed standard will require these matters to be communicated in writing, and on a timely basis so that those charged with governance can take steps to strengthen internal control," explains Mr. Kellas.

New Clarity Exposure Drafts

The IAASB has also approved the following exposure drafts of proposed ISAs:

- ISA 501 (Redrafted), *Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures*; and
- ISA 520 (Redrafted), *Analytical Procedures*.

These exposure drafts form part of the

IAASB's ambitious 18-month program to redraft existing standards and to develop new and revised standards following the new clarity drafting conventions. Subject to any comments on exposure, the final standards will become effective for audits of financial statements for periods beginning on or after December 15, 2009.

How to Comment

Comments on the exposure drafts are requested as follows:

- Proposed redrafted ISAs 501 and 520 by March 31, 2008;
- Proposed ISA 402 (Revised and Redrafted) and proposed ISA 265 by April 31, 2008; and
- Proposed ISAE 3402 by May 31, 2008.

The exposure drafts may be viewed by going to <http://www.ifac.org/EDs>. Comments may be submitted by email to EDComments@ifac.org. They can also be faxed to the attention of the Executive Director, Professional Standards at +1 (212) 286-9570 or mailed to IFAC, 545 Fifth Avenue, 14th Floor, New York, NY 10017, USA. All comments will be considered a matter of public record and will ultimately be posted on IFAC's website.

About the IAASB and IFAC

The objective of the IAASB is to serve the public interest by setting high quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The Public Interest Oversight Board oversees the activities of the IAASB and, as one element of that oversight, establishes its due process and working procedures.

Founded in 1977, IFAC is the global organization for the accountancy profession dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. IFAC is comprised of 158 members and associates in 123 countries and jurisdictions, representing more than 2.5 million accountants in public practice, education, government service, industry and commerce. In addition to setting international auditing and assurance standards through the IAASB, IFAC, through its independent standard-setting boards, sets international ethics, education, and public sector accounting standards. It also issues guidance to encourage high quality performance by professional accountants in business.

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