

INTERNATIONAL STANDARD ON AUDITING 402
AUDIT CONSIDERATIONS RELATING TO ENTITIES
USING SERVICE ORGANIZATIONS

(Effective for audits of financial statements for periods
beginning on or after December 15, 2004)*

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International Standard on Auditing (ISA) 402, "Audit Considerations Relating to Entities Using Service Organizations" should be read in the context of the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the application and authority of ISAs.

* ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," ISA 330, "The Auditor's Procedures in Response to Assessed Risks," and ISA 500, "Audit Evidence" gave rise to conforming amendments to ISA 402. The conforming amendments are effective for audits of financial statements for periods beginning on or after December 15, 2004 and have been incorporated in the text of ISA 402.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance to an auditor where the entity uses a service organization. This ISA also describes the service organization auditors' reports which may be obtained by the entity's auditors.
2. **The auditor should consider how an entity's use of a service organization affects the entity's internal control so as to identify and assess the risk of material misstatement and to design and perform further audit procedures.**
3. A client may use a service organization such as one that executes transactions and maintains related accountability or records transactions and processes related data (for example, a computer systems service organization). If the entity uses a service organization, certain policies, procedures and records maintained by the service organization may be relevant to the audit of the financial statements of the client.

Considerations of the Auditor

4. A service organization may establish and execute policies and procedures that affect the entity's internal control. These policies and procedures are physically and operationally separate from the entity. When the services provided by the service organization are limited to recording and processing the entity's transactions and the entity retains authorization and maintenance of accountability, the entity may be able to implement effective policies and procedures within its organization. When the service organization executes the entity's transactions and maintains accountability, the entity may deem it necessary to rely on policies and procedures at the service organization.
5. **In obtaining an understanding of the entity and its environment, the auditor should determine the significance of service organization activities to the entity and the relevance to the audit.** In doing so, the auditor obtains an understanding of the following, as appropriate:
 - Nature of the services provided by the service organization.
 - Terms of contract and relationship between the entity and the service organization.
 - Extent to which the entity's internal control interact with the systems at the service organization.
 - The entity's internal control relevant to the service organization activities such as:
 - Those that are applied to the transactions processed by the service organization.

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- How the entity identifies and manages risks related to use of the service organization.
 - Service organization’s capability and financial strength, including the possible effect of the failure of the service organization on the entity.
 - Information about the service organization such as that reflected in user and technical manuals.
 - Information available on controls relevant to the service organization’s information systems such as general IT-controls and application controls.
6. The auditor would also consider the existence of third-party reports from service organization auditors, internal auditors, or regulatory agencies as a means of obtaining information about the internal control of the service organization and about its operation and effectiveness. When the auditor intends to use work of the internal auditor, ISA 610, “Considering the Work of Internal Auditing” provides guidance on evaluating the adequacy of the internal auditor’s work for the auditor’s purposes.
- 6a. The understanding obtained may lead the auditor to decide that the control risk assessment of the risk of material misstatement will not be affected by controls at the service organization; if so, further consideration of this ISA is unnecessary.
7. **If the auditor concludes that the activities of the service organization are significant to the entity and relevant to the audit, the auditor should obtain a sufficient understanding of the service organization and its environment, including its internal control, to identify and assess the risks of material misstatement and design further audit procedures in response to the assessed risks.** The auditor assesses the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances and disclosures.
8. If the understanding obtained is insufficient, the auditor would consider the need to request the service organization to have its auditor perform such risk assessment procedures to supply the necessary information, or the need to visit the service organization to obtain the information. An auditor wishing to visit a service organization may advise the entity to request the service organization to give the auditor access to the necessary information.
9. The auditor may be able to obtain a sufficient understanding of internal control affected by the service organization by reading the third-party report of the service organization auditor. In addition, when assessing the risks of material misstatement, for assertions affected by the service organization’s internal controls, the auditor may also use the service organization auditor’s report. **If the auditor uses the report of a service organization auditor, the auditor should consider making inquiries concerning that auditor’s professional**

competence in the context of the specific assignment undertaken by the service organization auditor.

10. The auditor obtains audit evidence about the operating effectiveness of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of the service organization's controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level. The auditor may also conclude that it would be efficient to obtain audit evidence from tests of controls. Audit evidence about the operating effectiveness of controls may be obtained by the following:
- Performing tests of the entity's controls over activities of the service organization.
 - Obtaining a service organization auditor's report that expresses an opinion as to the operating effectiveness of the service organization's internal control for the service organization activities relevant to the audit.
 - Visiting the service organization and performing tests of controls.

Service Organization Auditor's Report

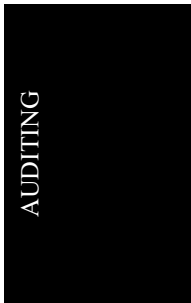
11. **When using a service organization auditor's report, the auditor should consider the nature of and content of that report.**
12. The report of the service organization auditor will ordinarily be one of two types as follows:

Type A—Report on the Design and Implementation of Internal Control

- (a) A description of the service organization's internal control, ordinarily prepared by the management of the service organization; and
- (b) An opinion by the service organization auditor that:
 - (i) The above description is accurate;
 - (ii) The internal control is suitably designed to achieve their stated objectives; and
 - (iii) The internal controls have been implemented.

Type B—Report on the Design, Implementation and Operating Effectiveness of Internal Control

- (a) A description of the service organization's internal control, ordinarily prepared by the management of the service organization; and
- (b) An opinion by the service organization auditor that:
 - (i) The above description is accurate;



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- (ii) The internal controls is suitably designed to achieve their stated objectives;
- (iii) The internal controls have been implemented; and
- (iv) The internal controls are operating effectively based on the results from the tests of controls. In addition to the opinion on operating effectiveness, the service organization auditor would identify the tests of controls performed and related results.

The report of the service organization auditor will ordinarily contain restrictions as to use (generally to management, the service organization and its customers, and the entity's auditors).

- 13. **The auditor should consider the scope of work performed by the service organization auditor and should evaluate the usefulness and appropriateness of reports issued by the service organization auditor.**
- 14. While Type A reports may be useful to the auditor in obtaining an understanding of the internal control, an auditor would not use such reports as audit evidence about the operating effectiveness of controls.
- 15. In contrast, Type B reports may provide such audit evidence since tests of control have been performed. When a Type B report is to be used as audit evidence about operating effectiveness of controls, the auditor would consider whether the controls tested by the service organization auditor are relevant to the entity's transactions, account balances, and disclosures, and related assertions, and whether the service organization auditor's tests of control and the results are adequate. With respect to the latter, two key considerations are the length of the period covered by the service organization auditor's tests and the time since the performance of those tests.
- 16. **For those specific tests of control and results that are relevant, the auditor should consider whether the nature, timing and extent of such tests provide sufficient appropriate audit evidence about the operating effectiveness of the internal control to support the auditor's assessed risks of material misstatement.**
- 17. The auditor of a service organization may be engaged to perform substantive procedures that are of use to the entity's auditor. Such engagements may involve the performance of procedures agreed upon by the entity and its auditor and by the service organization and its auditor.
- 18. **When the auditor uses a report from the auditor of a service organization, no reference should be made in the entity's auditor's report to the auditor's report on the service organization.**