

## AU-C Section 402

# ***Audit Considerations Relating to an Entity Using a Service Organization***

Source: SAS No. 122; SAS No. 128.

Effective for audits of financial statements for periods ending on or after December 15, 2012.

### **NOTE**

In October 2015, the Auditing Standards Board issued SAS No. 130, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* (sec. 940), which contains amendments to this section.

The amendments are effective for integrated audits for periods ending on or after December 15, 2016, and can be viewed in the appendix of section 940 until the effective date, when they will be applied to this section.

## **Introduction**

### **Scope of This Section**

**.01** This section addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. Specifically, it expands on how the user auditor applies section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

**.02** Many entities outsource aspects of their business activities to organizations that provide services ranging from performing a specific task under the direction of the entity to replacing entire business units or functions of the entity. Many of the services provided by such organizations are integral to the entity's business operations; however, not all of those services are relevant to the audit.

**.03** Services provided by a service organization are relevant to the audit of a user entity's financial statements when those services and the controls over them affect the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organization are likely to relate to financial reporting, other controls also may be relevant to the audit, such as controls over the safeguarding of assets. A service organization's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:

- a. The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;
- b. The procedures within both IT and manual systems by which the user entity's transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements;
- c. The related accounting records, supporting information, and specific accounts in the user entity's financial statements that are used to initiate, authorize, record, process, and report the user entity's transactions. This includes the correction of incorrect information and how information is transferred to the general ledger; the records may be in either manual or electronic form;
- d. How the user 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 user entity's financial statements, including significant accounting estimates and disclosures; and
- f. Controls surrounding journal entries, including nonstandard journal entries used to record nonrecurring, unusual transactions, or adjustments.

**.04** The nature and extent of work to be performed by the user auditor regarding the services provided by a service organization depend on the nature and significance of those services to the user entity and the relevance of those services to the audit.

**.05** This section does not apply to services that are limited to processing an entity's transactions that are specifically authorized by the entity, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker (that is, when the user entity retains responsibility for authorizing the transactions and maintaining the related accountability). In addition, this section does not apply to the audit of transactions arising from an entity that holds a proprietary financial interest in another entity, such as a partnership, corporation, or joint venture, when the partnership, corporation, or joint venture performs no processing on behalf of the entity.

## Effective Date

**.06** This section is effective for audits of financial statements for periods ending on or after December 15, 2012.

## Objectives

**.07** The objectives of the user auditor, when the user entity uses the services of a service organization, are to

- a. 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 and assess the risks of material misstatement.
- b. design and perform audit procedures responsive to those risks.

## Definitions

**.08** For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:

**Complementary user entity controls.** Controls that management of the service organization assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve the control objectives stated in management's description of the service organization's system, are identified as such in that description.

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

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

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

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

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

**Service organization.** An organization or segment of an organization that provides services to user entities that are relevant to those user entities' internal control over financial reporting.

**Service organization's system.** The policies and procedures designed, implemented, and documented by management of the service organization to provide user entities with the services covered by the service auditor's report. Management's description of the service organization's system identifies the services covered, the period to which the description relates (or in the case of a type 1 report, the date to which the description relates), the control objectives specified by management or an outside party, the party specifying the control objectives (if not specified by management), and the related controls.

**Subservice organization.** A service organization used by another service organization to perform some of the services provided to user entities that are relevant to those user entities' internal control over financial reporting. (Ref: par. .A20)

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

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

## Requirements

### Obtaining an Understanding of the Services Provided by a Service Organization, Including Internal Control

**.09** When obtaining an understanding of the user entity in accordance with section 315, the user auditor should obtain an understanding of how the user entity uses the services of a service organization in the user entity's operations, including the following:<sup>1</sup> (Ref: par. .A1–.A2)

- a. The nature of the services provided by the service organization and the significance of those services to the user entity, including their effect on the user entity's internal control (Ref: par. .A3–.A5)
- b. The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organization (Ref: par. .A6)
- c. The degree of interaction between the activities of the service organization and those of the user entity (Ref: par. .A7)
- d. The nature of the relationship between the user entity and the service organization, including the relevant contractual terms for the activities undertaken by the service organization (Ref: par. .A8–.A11)

**.10** When obtaining an understanding of internal control relevant to the audit in accordance with section 315, the user auditor should evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organization, including those that

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<sup>1</sup> Paragraph .12 of section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

are applied to the transactions processed by the service organization.<sup>2</sup> (Ref: par. .A12–.A14)

**.11** The user auditor should determine whether a sufficient 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 has been obtained to provide a basis for the identification and assessment of risks of material misstatement.

**.12** If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor should obtain that understanding from one or more of the following procedures:

- a. Obtaining and reading a type 1 or type 2 report, if available
- b. Contacting the service organization, through the user entity, to obtain specific information
- c. Visiting the service organization and performing procedures that will provide the necessary information about the relevant controls at the service organization
- d. Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organization (Ref: par. .A15–.A20)

### ***Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organization***

**.13** In determining the sufficiency and appropriateness of the audit evidence provided by a type 1 or type 2 report, the user auditor should be satisfied regarding the following:

- a. The service auditor's professional competence and independence from the service organization
- b. The adequacy of the standards under which the type 1 or type 2 report was issued (Ref: par. .A21–.A22)

**.14** If the user auditor plans to use a type 1 or type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organization, the user auditor should

- a. evaluate whether the type 1 report is as of a date, or in the case of a type 2 report, is for a period that is appropriate for the user auditor's purposes;
- b. evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal control relevant to the audit; and
- c. determine whether complementary user entity controls identified by the service organization are relevant in addressing the risks of material misstatement relating to the relevant assertions in the user entity's financial statements and, if so, obtain an understanding of whether the user entity has designed and implemented such controls. (Ref: par. .A23–.A24)

## **Responding to the Assessed Risks of Material Misstatement**

**.15** In responding to assessed risks in accordance with section 330, the user auditor should

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<sup>2</sup> Paragraph .13 of section 315.

- 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 use another auditor to perform those procedures at the service organization on the user auditor's behalf. (Ref: par. .A25–.A29)

### **Tests of Controls**

**.16** When the user auditor's risk assessment includes an expectation that controls at the service organization are operating effectively, the user auditor should obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures:

- a. Obtaining and reading a type 2 report, if available
- b. Performing appropriate tests of controls at the service organization
- c. Using another auditor to perform tests of controls at the service organization on behalf of the user auditor (Ref: par. .A30–.A31)

#### *Using a Type 2 Report as Audit Evidence That Controls at the Service Organization Are Operating Effectively*

**.17** If, in accordance with paragraph .16a, the user auditor plans to use a type 2 report as audit evidence that controls at the service organization are operating effectively, the user auditor should determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by

- a. evaluating whether the type 2 report is for a period that is appropriate for the user auditor's purposes;
- b. determining whether complementary user entity controls identified by the service organization are relevant in addressing the risks of material misstatement relating to the relevant assertions in the user entity's financial statements and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;
- c. evaluating 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
- d. evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment. (Ref: par. .A32–.A40)

### **Type 1 and Type 2 Reports That Exclude the Services of a Subservice Organization**

**.18** If the user auditor plans to use a type 1 or a type 2 report that excludes the services provided by a subservice organization and those services are relevant to the audit of the user entity's financial statements, the user auditor should apply the requirements of this section with respect to the services provided by the subservice organization. (Ref: par. .A41)

## Fraud, Noncompliance With Laws and Regulations, and Uncorrected Misstatements Related to Activities at the Service Organization

.19 The user auditor should inquire of management of the user entity about whether the service organization has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, noncompliance with laws and regulations, or uncorrected misstatements affecting the financial statements of the user entity. The user auditor should evaluate how such matters, if any, affect the nature, timing, and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report. (Ref: par. .A42)

### Reporting by the User Auditor

.20 The user auditor should modify the opinion in the user auditor's report in accordance with section 705, *Modifications to the Opinion in the Independent Auditor's Report*, if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organization relevant to the audit of the user entity's financial statements. (Ref: par. .A43)

.21 The user auditor should not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion. (Ref: par. .A44)

.22 If reference to the work of a service auditor is relevant to an understanding of a modification of the user auditor's opinion, the user auditor's report should indicate that such reference does not diminish the user auditor's responsibility for that opinion. (Ref: par. .A44)

## Application and Other Explanatory Material

### Obtaining an Understanding of the Services Provided by a Service Organization, Including Internal Control

#### *Sources of Information (Ref: par. .09)*

.A1 Information about the nature of the services provided by a service organization may be available from a wide variety of sources, such as the following:

- User manuals
- System overviews
- Technical manuals
- The contract or service level agreement between the user entity and the service organization
- Reports by service organizations, the internal audit function, or regulatory authorities on controls at the service organization
- Reports by the service auditor, if available

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2014, by SAS No. 128.]

.A2 Knowledge obtained through the user auditor's experience with the service organization—for example, through experience with other audit engagements—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.

### ***Nature of the Services Provided by the Service Organization (Ref: par. .09a)***

**.A3** A user entity may use a service organization, such as one that processes transactions and maintains the related accountability for the user entity or records transactions and processes related data. Service organizations that provide such services include, for example, bank trust departments that invest and service assets for employee benefit plans or for others, mortgage servicers that service mortgages for others, and application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions.

**.A4** Examples of services provided by service organizations that may be relevant to the audit include the following:

- Maintenance of the user entity's accounting records
- Management of the user entity's assets
- Initiating, authorizing, recording, or processing transactions as an agent of the user entity

### ***Considerations Specific to Smaller Entities***

**.A5** Smaller entities may use external bookkeeping services ranging from the processing of certain transactions (for example, payment of payroll taxes) and maintenance of their accounting records to the preparation of their financial statements. The use of such a service organization for the preparation of its financial statements does not relieve management of the smaller entity and, when appropriate, those charged with governance of their responsibilities for the financial statements.<sup>3</sup>

### ***Nature and Materiality of Transactions Processed by the Service Organization (Ref: par. .09b)***

**.A6** A service organization may establish policies and procedures (controls) that affect the user entity's internal control. These controls are at least in part physically and operationally separate from the user entity. The significance of the controls at the service organization to the user entity's internal control depends on the nature of the services provided by the service organization, including the nature and materiality of the transactions it processes for the user entity. In certain situations, the transactions processed and the accounts affected by the service organization may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of controls over the processing of those transactions is necessary in the circumstances.

### ***The Degree of Interaction Between the Activities of the Service Organization and the User Entity (Ref: par. .09c)***

**.A7** The significance of the controls at the service organization to the user entity's internal control also depends on the degree of interaction between the service organization's activities and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organization. For example, a high degree of interaction exists between the activities

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<sup>3</sup> Paragraph .05 of section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*.

of the user entity and those at the service organization when the user entity authorizes transactions and the service organization processes and accounts for those transactions. In these circumstances, it may be practicable for the user entity to implement effective controls over those transactions. On the other hand, when the service organization initiates or initially records, processes, and accounts for the user entity's transactions, a lower degree of interaction exists 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 at the user entity and may rely on controls at the service organization.

***Nature of the Relationship Between the User Entity and the Service Organization (Ref: par. .09d)***

**.A8** The contract or service level agreement between the user entity and the service organization may provide for matters such as the following:

- The information to be provided to the user entity and the responsibilities for initiating transactions relating to the activities undertaken by the service organization
- Complying with the 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 report on its controls and, if so, whether such a report will be a type 1 or type 2 report
- Whether the user auditor has rights of access to the accounting records of the user entity maintained by the service organization and other information necessary for the conduct of the audit
- Whether the agreement allows for direct communication between the user auditor and the service auditor

**.A9** A direct relationship exists between the service organization and the user entity when the user entity enters into an agreement with the service organization, and between the service organization and the service auditor when the service organization engages the service auditor. These relationships do not create a direct relationship between the user auditor and the service auditor.

**.A10** Communications between the user auditor and the service auditor usually are conducted through the user entity and the service organization. A user auditor may request through the user entity that a service auditor perform procedures for the benefit of the user auditor. For example, a service auditor may be engaged by the service organization to perform an agreed-upon procedures engagement related to testing controls at a service organization or performing procedures related to a user entity's transactions or balances maintained by the service organization. AT section 201, *Agreed-Upon Procedures Engagements*, establishes standards and provides guidance for agreed-upon procedures engagements.

*Considerations Specific to Governmental Entities*

**.A11** For governmental entities, the auditor may be required to perform audit procedures with respect to the entity's compliance with laws and regulations. Such required procedures may include obtaining an understanding of internal control over compliance, performing tests of controls over compliance, and performing tests of compliance. Consequently, auditors of governmental

entities that use a service organization may determine that it is appropriate to request, through the governmental entity, that the service auditor perform specified compliance-related audit procedures with respect to services provided by the service organization.<sup>4</sup>

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

**.A12** 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, regardless of the controls in place at the service organization. If a user entity, for example, uses a service organization to process its payroll transactions, the user entity may establish controls over the submission and receipt of payroll information that could prevent, or detect and correct, material misstatements. These controls may include the following:

- Comparing the data submitted to the service organization with reports of information received from the service organization after the data has been processed
- Recomputing a sample of the payroll amounts for clerical accuracy and reviewing the total amount of the payroll for reasonableness

**.A13** 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.

**.A14** As noted in section 315, for some risks the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.<sup>5</sup> Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions and account balances that may involve highly automated processing with little or no manual intervention. Risks related to such automated processing may be particularly present when the user entity uses a service organization. In such cases, the user entity's controls over such risks are relevant to the audit and the user auditor is required to obtain an understanding of and to evaluate such controls in accordance with paragraphs .09–.10 of this section.

### ***Further Procedures When a Sufficient Understanding Cannot Be Obtained From the User Entity (Ref: par. .12)***

**.A15** The user auditor's decision regarding which procedure, individually or in combination, in paragraph .12 to undertake in order to obtain the information necessary to provide a basis for the identification and assessment of the risks of material misstatement regarding the user entity's use of the service organization, may be influenced by such matters as the following:

- The size of both the user entity and the service organization
- The complexity of the transactions at the user entity and the complexity of the services provided by the service organization
- The location of the service organization (for example, the user auditor may decide to use another auditor to perform procedures at the service organization on the user auditor's behalf if the service organization is in a remote location)

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<sup>4</sup> Section 935, *Compliance Audits*, addresses audits of an entity's compliance.

<sup>5</sup> Paragraph .31 of section 315.

- Whether the procedure(s) is expected to effectively provide the user auditor with sufficient appropriate audit evidence
- The nature of the relationship between the user entity and the service organization

**.A16** A service organization may engage a service auditor to report on the description and design of its controls (type 1 report) or on the description and design of its controls and their operating effectiveness (type 2 report). Type 1 or type 2 reports may be issued under Statement on Standards for Attestation Engagements No. 16, *Reporting on Controls at a Service Organization* (AT sec. 801), or under standards promulgated by an authorized or recognized standards-setting organization (for example, the International Auditing and Assurance Standards Board).

**.A17** The availability of a type 1 or type 2 report generally will depend on whether the contract between the service organization and the user entity includes the provision of such a report by the service organization. A service organization may also elect, for practical reasons, to make a type 1 or type 2 report available to the user entities. However, in some cases, a type 1 or type 2 report may not be available to user entities.

**.A18** 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, finance and accounting functions, or the controllership function to one or more service organizations. As a report on controls at the service organization may not be available in these circumstances, visiting the service organization may be the most effective procedure for the user auditor to gain an understanding of controls at the service organization because there is likely to be direct interaction of management of the user entity with management of the service organization.

**.A19** Another auditor may be used to perform procedures that will provide the necessary information about the relevant controls at the service organization. If a type 1 or type 2 report has been issued, the user auditor may use the service auditor to perform these procedures as the service auditor has an existing relationship with the service organization. The user auditor using the work of another auditor may find the guidance in section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, useful as it relates to understanding another auditor (including that auditor's independence and professional competence); involvement in the work of another auditor in planning the nature, extent, and timing of such work; and in evaluating the sufficiency and appropriateness of the audit evidence obtained.<sup>6</sup>

**.A20** A user entity may use a service organization that in turn uses a subservice organization to provide some of the services provided to a user entity that are relevant to those user entities' internal control over financial reporting. 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 in which one or more subservice organizations are used, the interaction between the activities of the user entity and those of 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

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<sup>6</sup> Paragraphs .02 and .22 of section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

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. (Ref: par. .08)

### ***Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organization (Ref: par. .13–.14)***

**.A21** The user auditor may make inquiries about the service auditor to the service 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 in which different standards are followed with respect to reports on controls at a service organization. In such a situation, the user auditor may obtain information about the standards used by the service auditor from the standards-setting organization in that jurisdiction.

**.A22** Unless evidence to the contrary comes to the user auditor's attention, a service auditor's report implies that the service auditor is independent of the service organization. However, a service auditor need not be independent of the user entities.

**.A23** A type 1 or type 2 report, along with information about the user entity, may assist the user auditor in obtaining an understanding of the following:

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

A type 1 or type 2 report may assist the user auditor in obtaining a sufficient understanding to identify and assess the risks of material misstatement of the user entity's financial statements. A type 1 report, however, does not provide any evidence of the operating effectiveness of the relevant controls.

**.A24** A type 1 report that is as of a date, or a type 2 report that is for a period outside of the reporting period of a user entity, may assist the user auditor in obtaining 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 description of the service organization's system is as of a date or for a period that precedes the beginning of the period under audit, the user auditor may perform procedures to update the information in a type 1 or type 2 report, such as the following:

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

## Responding to the Assessed Risks of Material Misstatement (Ref: par. .15)

**.A25** Whether the use of a service organization increases a user entity's risk of material misstatement depends on the nature of the services provided and the controls over these services; in some cases, the use of a service organization may decrease a user entity's risk of material misstatement, particularly if the user entity itself does not possess the expertise necessary to undertake particular activities, such as initiating, processing, and recording transactions, or does not have adequate resources (for example, an IT system).

**.A26** When the service organization maintains material elements of the accounting records of the user entity, direct access to those records may be necessary for the user auditor to obtain sufficient appropriate audit evidence relating to the operations of controls over those records, to substantiate transactions and balances recorded in them, or both. Such access may involve physical inspection of records at the service organization's premises or electronic interrogation of records, or both. When direct access is achieved electronically, the user auditor may also obtain evidence concerning the adequacy of the service organization's controls over the completeness and integrity of the user entity's data for which the service organization is responsible.

**.A27** In determining the nature and extent of audit evidence to be obtained for financial statement balances representing assets held or transactions processed by a service organization for a user entity, the following procedures may be considered by the user auditor:

- a. *Inspecting records and documents held by the user entity.* The reliability of this source of evidence is determined by the nature and extent of the accounting records and supporting documentation retained by the user entity. In some cases, the user entity may not maintain independent detailed records or documentation of specific transactions undertaken on its behalf.
- b. *Inspecting records and documents held by the service organization.* The user auditor's access to the records of the service organization may be established as part of the contractual arrangements between the user entity and the service organization. The user auditor may also use another auditor, on its behalf, to gain access to the user entity's records maintained by the service organization, or ask the service organization through the user entity for access to the user entity's records maintained by the service organization.
- c. *Obtaining confirmations of balances and transactions from the service organization.* When the user entity maintains independent records of balances and transactions, confirmation from the service organization corroborating those records usually constitutes reliable audit evidence concerning the existence of the transactions and assets concerned. For example, when multiple service organizations are used, such as an investment manager and a custodian, and these service organizations maintain independent records, the user auditor may confirm balances with these organizations in order to compare this information with the independent records of the user entity. 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. Therefore, such confirmations do not, taken alone, constitute

reliable audit evidence. In these circumstances, the user auditor may consider whether 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.

**.A28** As noted in paragraph .A10, a service auditor may perform procedures under AT section 201 that are substantive in nature for the benefit of user auditors. Such an engagement may involve the performance by the service auditor of procedures agreed upon by the user entity and its user auditor and by the service organization and its service auditor. The findings resulting from the procedures performed by the service auditor are reviewed by the user auditor to determine whether they constitute sufficient appropriate audit evidence. In addition, requirements may be imposed by governmental authorities or through contractual arrangements whereby a service auditor performs designated procedures that are substantive in nature. The results of the application of the required procedures to balances and transactions processed by the service organization may be used by the user auditor as part of the evidence necessary to support the user auditor's audit opinion. In these circumstances, it may be useful for the user auditor and the service auditor to establish an understanding prior to the performance of the procedures concerning the audit documentation or means of accessing the audit documentation that will be provided to the user auditor.

**.A29** 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 in which a significant portion of the audit evidence resides at the service organization. Substantive procedures may need to be performed at the service organization by the user auditor or the service auditor on behalf of the user auditor. A service auditor may provide a type 2 report and, in addition, may perform substantive procedures on behalf of the user auditor. As noted in paragraph .A44, 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, relevant information for the user auditor to consider when determining 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.

### **Tests of Controls (Ref: par. .16)**

**.A30** The user auditor is required by section 330 to design and perform tests of controls to obtain sufficient appropriate audit evidence concerning the operating effectiveness of relevant controls in certain circumstances.<sup>7</sup> In the context of a service organization, this requirement applies when

- a. the user auditor's assessment of risks of material misstatement includes an expectation that the controls at the service organization are operating effectively (that is, the user auditor intends to

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<sup>7</sup> Paragraph .08 of section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

rely on the operating effectiveness of controls at the service organization in determining the nature, timing and extent of substantive procedures); or

- b. substantive procedures alone, or in combination with tests of the operating effectiveness of controls at the user entity, cannot provide sufficient appropriate audit evidence at the assertion level.

**.A31** If a type 2 report is not available, a user auditor may contact the service organization through the user entity to request that a service auditor be engaged to perform a type 2 engagement that includes tests of the operating effectiveness of the relevant controls or the user auditor may use another auditor to perform agreed-upon procedures at the service organization 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. The user auditor's risk assessments are based on the combined evidence provided by the service auditor's report and the user auditor's own procedures.

*Using a Type 2 Report as Audit Evidence That Controls at the Service Organization Are Operating Effectively* (Ref: par. .17)

**.A32** A type 2 report may be intended to satisfy the needs of several different user auditors; therefore, specific tests of controls and results described in a type 2 report may not be relevant to assertions that are significant in the user entity's financial statements. The relevant tests of controls and results of the tests are evaluated to determine whether the type 2 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 service auditor's work and the services and processes covered, the controls tested and the tests that were performed, and the way in which tested controls relate to the user entity's controls
- c. The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls

**.A33** For certain assertions, the shorter the period covered by a specific test and the longer the time elapsed since the performance of the test, the less audit evidence the test may provide. In comparing the period covered by the type 2 report to the user entity's financial reporting period, the user auditor may conclude that the type 2 report offers less audit evidence if little overlap exists between the period covered by the type 2 report and the period for which the user auditor intends to rely on the report. When this is the case, an additional type 2 report covering a preceding or subsequent period may provide additional audit evidence. In other cases, the user auditor may determine it is necessary to perform, or use another auditor to perform, tests of controls at the service organization in order to obtain sufficient appropriate audit evidence about the operating effectiveness of those controls.

**.A34** It may also be necessary for the user auditor to obtain additional evidence about significant changes in the relevant controls at the service organization during a period outside the period covered by the type 2 report, or to determine what additional audit procedures need to be performed (for example, when little or no overlap exists between the period covered by the type 2 report and the period covered by the user entity's financial statements). Relevant factors in determining what additional audit evidence to obtain about controls at

the service organization that were operating outside the period covered by the service auditor's report may include the following:

- 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 systems, processes, and personnel
- The degree to which audit evidence about the operating effectiveness of those controls was obtained
- The length of the remaining period
- The extent to which the user auditor intends to reduce further substantive procedures based on the reliance on controls
- The effectiveness of the control environment and monitoring controls at the user entity

**.A35** Additional audit evidence may be obtained, for example, by performing tests of controls that operated during the remaining period or testing the user entity's monitoring controls.

**.A36** If the service auditor's testing period is completely outside the user entity's financial reporting period, the user auditor will be unable to rely on such tests to conclude that the user entity's controls are operating effectively because the tests do not provide current audit period evidence of the effectiveness of the controls, unless other procedures are performed.

**.A37** In certain circumstances, a service provided by the service organization may be designed with the assumption that certain controls will be implemented by the user entity. For example, the service may be designed with the assumption that the user entity will have controls in place for authorizing transactions before they are sent to the service organization for processing. In such a situation, the description of the service organization's system may include a description of those complementary user entity controls. The user auditor considers whether those complementary user entity controls are relevant to the service provided to the user entity.

**.A38** If the user auditor believes that the service auditor's report may not provide sufficient appropriate audit evidence (for example, if a service auditor's report does not contain a description of the service auditor's tests of controls and results thereof), the user auditor may supplement his or her understanding of the service auditor's procedures and conclusions by contacting the service organization through the user entity to request a discussion with the service auditor about 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.

**.A39** The service auditor's type 2 report identifies results of tests, including deviations, and other information that could affect the user auditor's conclusions. Deviations noted by the service auditor or a modified opinion in the service auditor's report do not automatically mean that the service auditor's report will not be useful for the audit of the user entity's financial statements in assessing the risks of material misstatement. Rather, the deviations and the matter giving rise to a modified opinion in the service auditor's type 2 report are considered in the user auditor's assessment of the tests of controls performed by the service auditor. In considering the deviations and matters giving rise to

a modified opinion, the user auditor may 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.

**.A40** *Communication of significant deficiencies and material weaknesses in internal control identified during the audit.* The user auditor is required by section 265, *Communicating Internal Control Related Matters Identified in an Audit*, to communicate in writing to management and those charged with governance significant deficiencies and material weaknesses identified during the audit.<sup>8</sup> Matters related to the use of a service organization that the user auditor may identify during the audit and may communicate to management and those charged with governance of the user entity include the following:

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

The auditor also may communicate other control related matters, including deficiencies that are not significant deficiencies or material weaknesses.

## **Type 1 and Type 2 Reports That Exclude the Services of a Subservice Organization (Ref: par. .18)**

**.A41** If a service organization uses a subservice organization, the service auditor's report may either include or exclude the subservice organization's relevant control objectives and related controls in the service organization's description of its system and in the scope of the service auditor's engagement. These two methods of reporting are known as the *inclusive method* and the *carve-out method*, respectively. If the type 1 or type 2 report excludes the controls at a subservice organization and the services provided by the subservice organization are relevant to the audit of the user entity's financial statements, the user auditor is required to apply the requirements of this section with respect to the subservice organization. The nature and extent of work to be performed by the user auditor regarding the services provided by a subservice organization depend on the nature and significance of those services to the user entity and the relevance of those services to the audit. The application of the requirement in paragraph .09 assists the user auditor in determining the effect of the subservice organization and the nature and extent of work to be performed.

## **Fraud, Noncompliance With Laws and Regulations, and Uncorrected Misstatements Related to Activities at the Service Organization (Ref: par. .19)**

**.A42** A service organization may be required under the terms of the contract with user entities to disclose to affected user entities any fraud, noncompliance with laws and regulations, or uncorrected misstatements attributable

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<sup>8</sup> Paragraphs .11–.12 of section 265, *Communicating Internal Control Related Matters Identified in an Audit*.

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 request that the user entity contact the service organization to obtain the necessary information.

### **Reporting by the User Auditor (Ref: par. .20)**

**.A43** When a user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organization relevant to the audit of the user entity's financial statements, a limitation on the scope of the audit exists. This may be the case when

- the user auditor is unable to obtain a sufficient understanding of the services provided by the service organization and does not have a basis for the identification and assessment of the risks of material misstatement;
- a user auditor's risk assessment includes an expectation that controls at the service organization are operating effectively and the user auditor is unable to obtain sufficient appropriate audit evidence about the operating effectiveness of these controls; or
- sufficient appropriate audit evidence is only available from records held at the service organization, and the user auditor is unable to obtain direct access to these records.

Whether the user auditor expresses a qualified opinion or disclaims an opinion depends on the user auditor's conclusion regarding whether the possible effects on the financial statements are material, pervasive, or both.<sup>9</sup>

### **Reference to the Work of the Service Auditor (Ref: par. .21–.22)**

**.A44** The fact that a user entity uses a service organization does not alter the user auditor's responsibility to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Therefore, the user auditor does not make reference to the service auditor's 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 report, the user auditor is not precluded from referring to the service auditor's report if such reference assists in explaining the reason for the user auditor's modified opinion. In such circumstances, the user auditor need not identify the service auditor by name and may need the consent of the service auditor before making such a reference.

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<sup>9</sup> Paragraphs .07–.10 of section 705, *Modifications to the Opinion in the Independent Auditor's Report*.