

ISA (UK) 402 Audit Considerations Relating to an Entity Using a Service Organisation (Lecture A648 – 11.27 minutes)

ISA (UK) 402 outlines the auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations.

The standard acknowledges that many entities outsource aspects of their business to organisations which provide a range of services, for example payroll. A lot of these services will be integral to the entity's business operations, but not all such outsourced services will be relevant to the audit. Services provided by the service organisation are relevant to the audit when those services (and the controls over them) are part of the user-entity's information system, including related business processes, which are relevant to financial reporting.

ISA (UK) 402 defines a 'user auditor' and a 'user entity' as follows:

- *User auditor – An auditor who audits and reports on the financial statements of the user entity*
- *User entity – An entity that uses a service organization and whose financial statements are being audited*

Obtaining an understanding of the services provided by the service organisation

ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* requires the user auditor to obtain an understanding of the user entity using the services of a service organisation in the user entity's operations. This includes:

- The nature of the services that are provided by the service organisation and the significance of those services to the user entity, together with the effect those services have on the user entity's internal control;
- The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
- The degree of interaction between the activities of the service organisation and those of the user entity;
- The nature of the relationship between the user entity and the service organisation which also includes the relevant contractual terms for the activities undertaken by the service organisation; and
- If the service organisation maintains all, or part, of the user entity's accounting records, whether those arrangements impact the work which the auditor will perform to fulfil reporting responsibilities in relation to accounting records that are established in law or regulation.

The reason for the auditor having to understand these matters is so that any risk of material misstatement created by the use of a service organisation can be identified and an appropriate response planned.

The user auditor is required to obtain an understanding of the controls in place at the service organisation and must also evaluate the design and implementation of relevant controls at the user entity which relate to the services provided by the service organisation. Information should be available from the user entity to enable the understanding outlined above to be obtained, for example, via reports received from the service organisation, technical manuals and the contract between the service organisation and the user entity.

In situations where the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor must obtain that understanding by other means, which include the following:

- obtaining a type 1 or type 2 report if available (see below);
- contacting the service organisation, through the user entity, to obtain specific information;
- visiting the service organisation and performing audit procedures that will provide the necessary information about the relevant controls at the service organisation; or
- using another auditor to carry out procedures that will provide the information about the relevant controls at the service organisation.

Type 1 or type 2 reports

A type 1 report focuses on the description and design of controls, whereas a type 2 report also covers the operating effectiveness of the controls. These types of reports can provide some assurance over the controls which should have operated at the service organisation.

A 'service auditor' is defined in ISA (UK) 402 as:

'An auditor who, at the request of the service organization, provides an assurance report on the controls of a service organization.'

To determine whether a type 1 or type 2 report is required, the auditor must be satisfied as to:

- the service auditor's professional competence and independence from the service organisation; and
- the adequacy of the standards under which the type 1 or type 2 report was issued. For example, the service auditor may be practising in a country where different standards are followed in respect of reports on controls at a service organisation and the user auditor may obtain information about the standards used by the service auditor from the standard-setting organisation.

Where 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 organisation, the user auditor must:

- evaluate whether the description and design of controls at the service organisation is at a date, or for a period, that is appropriate for the user auditor's purposes;
- 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
- determine whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

Auditor's response to assessed risks of material misstatement

ISA (UK) 330 *The Auditor's Responses to Assessed Risks* requires the auditor to design appropriate responses to assessed levels of risk. In responding to risks where the use of service organisation is concerned, the auditor must:

- determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions (e.g. completeness, accuracy etc) is available from the records held at the user entity; and, if not
- perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform procedures at the service organisation on the user auditor's behalf.

Test of controls

If the user auditor expects that the controls at the service organisation are operating effectively, the user auditor obtains audit evidence concerning the operating effectiveness of those controls from one, or more, of the following procedures:

- obtaining a type 2 report, if available;
- performing tests of controls at the service organisation; or
- using another auditor to perform tests of controls at the service organisation on behalf of the user auditor.

Where the user auditor plans to use a type 2 report as audit evidence which states that controls at the service organisation are operating effectively, the user auditor must determine whether the service auditor's report provides sufficient appropriate audit evidence concerning the effectiveness of the controls by:

- evaluating whether the description, design and operating effectiveness of controls at the service organisation is at a date, or for a period, that is appropriate for the user auditor's purposes;
- determining whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtaining an understanding of

whether the user entity has designed and implemented such controls and, if so, performing tests over their operating effectiveness;

- evaluating the adequacy of the period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and
- evaluating whether the tests of controls performed by the service auditor and the results, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate evidence to support the auditor's risk assessment.

Fraud, non-compliance with laws and regulations and uncorrected misstatements in respect of activities at the service organisation

The user auditor must inquire of management of the user entity as to whether the service organisation has reported to the user entity (or whether the user entity is otherwise aware of) any fraud, non-compliance with laws and regulations or uncorrected misstatements which affect the financial statements of the user entity. The user auditor must then evaluate how such matters 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.

Reporting

If the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation, the auditor must modify their opinion as a limitation on the scope of the audit will exist. This could arise when:

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

The effect on the auditor's report (ie a qualified or disclaimer of opinion) will all depend on the auditor's conclusion as to whether the possible effects on the financial statements are material and pervasive.

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 must indicate that such reference does not diminish the user auditor's responsibility for that opinion.