

Type 1 and type 2 reports (Lecture A771 – 9.48 minutes)

ISA (UK) 402 *Audit Considerations Relating to an Entity Using a Service Organization* requires the auditor to obtain an understanding of the nature and significance of services which are provided to an audit client and the effect of these services on the entity's internal control.

Many audit clients buy-in services from external parties, such as payroll providers and HR services. The auditor is required to identify and assess the risks of material misstatement where service providers are used. In addition, ISA (UK) 402, para 7(b) requires the auditor to design and perform audit procedures which are responsive to those risks.

ISA (UK) 402 is effectively an extension of ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment* (now rebranded as *Identifying and Assessing the Risks of Material Misstatement*). This is because the auditor must obtain a thorough understanding of the client's business (including its system of internal control) in accordance with ISA (UK) 315.

In many cases, the auditor may decide it necessary to obtain a type 1 or type 2 report from the service organisation. The problem with these sorts of reports is that they are often just put on the audit file with no evidence that the auditor has actually considered the content of either report.

1.1 Type 1 report

A type 1 report is less comprehensive than a type 2 report (see below). A type 1 report describes the service entity's control objectives and controls. This is then supported by the service entity's auditor's opinion but it does not relate specifically to any period. Essentially a type 1 report focuses on the description and design of controls.

1.2 Type 2 report

A type 2 report is more comprehensive than a type 1 report and will often be more costly to prepare. A type 2 report will also cover the operating effectiveness of the controls and can provide some assurance over the controls which should have operated at the service organisation.

1.3 Review of the report

Auditors must take time to carefully review the content of the type 1 or type 2 report, paying particular attention to the service organisation's auditor's report on the controls. It may be the case that the auditor has qualified the report due to either missing controls or controls that have been deemed as inadequate. The auditor's report will also describe the effect that the missing or inadequate control(s) has on the entity.

Keep in mind that if the service organisation's auditors have qualified the type 1 or type 2 report, it is unlikely that the auditor will place any reliance on those controls that have been subject to the modification. There is little to be gained from placing reliance on any weak or ineffective internal control because this will only serve to increase the risk of material misstatement and increase audit risk. In such instances, the auditor must increase substantive testing on the relevant areas as substantive procedures are aimed at detecting misstatements at the financial statement assertion level.

File reviewers and professional bodies have frequently criticised the use of type 1 or type 2 reports. The main criticism is that there is no evidence that the auditor has actually done anything with them other than place them on the audit file. The content should be carefully reviewed and conclusions drawn by the auditor as to whether reliance can be placed on the service organisation's controls.

1.4 Bridging letters

In some cases, it may be worthwhile requesting a 'bridging letter'. This is used when the audit client's reporting date is different than the service providers. For example, the service provider may have a 31 December year end, but the client may have a 31 March year end. In some cases the auditor may need to consider whether a bridging letter should be obtained to cover the intervening period up to the 31 March year end. This letter will provide the auditor with additional information and confidence that control have operated effectively (or not as the case may be) in the intervening period.