

Auditing Guidance Statement

AGS 1042
(July 2002)

Reporting on Control Procedures at Outsourcing Entities

Prepared by the **Auditing & Assurance Standards Board** of the
Australian Accounting Research Foundation

(Notation inserted by the Auditing and Assurance Standards
Board - 14 April 2008)



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ISSN 1324-4191

AUDITING GUIDANCE STATEMENT
AGS 1042 “REPORTING ON CONTROL PROCEDURES AT
OUTSOURCING ENTITIES”

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For periods commencing on or after 1 July 2008, AGS 1042 is not applicable for reporting on control procedures at outsourcing entities which provide investment management services. GS 007 *Audit Implications of the Use of Service Organisations for Investment Management Services*, issued March 2008, provides the applicable guidance in this circumstance.

Inserted by AUASB: 14 April 2008

Introduction

- .01 The purpose of this Auditing Guidance Statement (AGS) is to provide guidance to auditors engaged to report on control procedures at outsourcing entities, and to provide guidance to auditors seeking to place reliance on such reports as part of their financial report audit. Therefore, this guidance applies to:
- (a) service entity auditors engaged to provide assurance on control procedures relating to outsourcing functions performed by the service entity; and
 - (b) user entity auditors seeking assurance on control procedures relating to an outsourced function(s) performed by a service entity.
- .02 Increasing competition and changes in technology are two important elements of the current business environment. Hence management may seek to balance the use of available resources including people, facilities, technology, application systems and data. Organisations may use a service entity because the expertise or ability to perform certain services does not exist within the organisation or because it may be cost effective to outsource the activity. The common term to describe arrangements with a service entity is “outsourcing”. A feature of these arrangements that differentiate them from basic service provision is the delegation of the day-to-day management of the outsourced activity to the service entity.
- .03 There are various types of service entities, ranging from those that perform a specific task under the direction of the user entity, to those that replace entire business units or functions of an entity. In certain circumstances outsourcing arrangements may impact on the financial report assertions of the user entity, whereas in other circumstances the outsourced area may not relate to the financial information flow involved in the preparation of the audited financial report of the user entity. However, in either situation assurance may

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be required on control procedures at an outsourcing entity. For example, when outsourcing arrangements impact on the financial report assertions of the user entity, a report on control procedures at the outsourcing entity may be required to support particular financial report assertions of the user entity. In contrast, where the outsourced area does not impact on the audited financial report of the user entity, the user entity may still seek assurance over control procedures as part of a trading agreement between the user and the service entity.

- .04 The use of a service organisation to outsource activities does not change the legal and governance responsibilities of the governing body of a user entity, including, for example, the responsibility to safeguard assets, maintain proper accounting records and prepare a financial report. The governing body and management of a user entity are responsible for ensuring that the contractual terms applicable to activities conducted by service entities are appropriate.
- .05 When a user entity outsources activities that impact the financial report assertions, the functions or processes performed by the service entity are undertaken outside the user entity’s internal control structure. Depending on the nature and extent of the outsourcing arrangement, there may be an impact on the planning and performance of the audit of the user entity. For example, certain aspects of the internal control structure and account balances to which the auditor ordinarily applies tests of control and substantive procedures, may be under the control of the service entity.
- .06 AUS 404 “Audit Implications Relating to Entities using a Service Entity” establishes standards for the auditors of a user entity on the audit evidence implications for material financial report assertions when an entity uses a service entity. In accordance with AUS 404, the auditor of a user entity may therefore determine that is necessary to obtain audit evidence from the service entity about the service entity’s internal control structure, and the effectiveness of control procedures in relation to a particular subject matter. AUS 404 describes the types of reports that a service entity auditor may issue to assist the auditor of a user entity in obtaining sufficient appropriate audit evidence concerning the transactions and balances of the user, and/or the transactions that flow through the internal control structure of a service entity. AUS 404 also applies to outsourcing arrangements.
- .07 Typical areas of outsourcing that may impact financial report assertions and related IT issues are given in Appendix 1.

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Definitions

For the purpose of this statement:

- .08 “Attest reporting engagement” means an engagement where the management of a service entity provides a written description of the internal control objectives and procedures relating to the provision of an outsourcing function and the auditor provides assurance to enhance the credibility of management’s description.
- .09 “Control procedures” means those policies and procedures, in addition to the control environment, designed to contribute to the achievement of one or more of the internal control objectives of a subject matter.
- .10 “Control weakness” means a deficiency in the design of control procedures or a deficiency in operation of a control procedure that could potentially result in risks relevant to the area of activity not being reduced to an acceptable level. Relevant risks are those that threaten achievement of the objectives relevant to the area of activity being examined.
- .11 “Direct reporting engagement” means an engagement where the management of the service entity does not make a public written assertion about the internal control structure relating to the provision of an outsourcing function, and the auditor:
- (a) provides both information and assurance about that aspect of the internal control structure; and
 - (b) when appropriate, provides relevant and reliable information about the controls in the form of facts and findings.
- .12 “Internal control objectives for a subject matter” (within a service entity) means the aim or purpose of a particular subject matter, stated in terms of one or more specified internal control objectives, such as the:
- (a) prevention and detection of error and fraud;
 - (b) safeguarding of assets;
 - (c) maintenance of reliable accounting records;
 - (d) timely preparation of reliable financial information.

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A subject matter in this context can comprise an individual system, groups of systems and/or sub-components of a system.

- .13 “Internal control structure” means the dynamic, integrated processes, effected by the governing body, management and all other staff, that are designed to provide reasonable assurance regarding the achievement of the following general objectives:
- (a) effectiveness, efficiency and economy of operations;
 - (b) reliability of management and financial reporting; and
 - (c) compliance with applicable laws and regulations and internal policies.
- Management’s strategies for achieving these general objectives are affected by the design and operation of the following components:
- (i) the control environment;
 - (ii) the information system; and
 - (iii) control procedures.
- .14 “Materiality” means the potential for knowledge of a control weakness to affect the decisions of the addressee of the auditor’s report. An example of a material control weakness may be where the weakness has the potential to lead to one or more internal control objectives not being achieved.
- .15 “Service entity” means an entity that provides an outsourcing service to user entities to record, process, execute transactions, maintain related accountability for these transactions, or any combination thereof.
- .16 “Service entity auditor” means the auditor who is engaged to provide assurance on control objectives and procedures over outsourcing functions carried out by the service entity.
- .17 “Subject matter” means that aspect(s) of the internal control structure relating to an outsourcing function(s) that is being examined by the service entity auditor.
- .18 “User entity” means an entity that outsources functions to a service entity.

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- .19 “User entity auditor” means the auditor engaged to report on the financial report of the user entity.

The User Entity Auditor

Planning the User Entity Financial Report Audit

- .20 Where an entity uses a service entity and such use has implications for material financial report assertions, the auditor refers to AUS 404 for guidance on evaluating risk and obtaining audit evidence relating to outsourcing functions. In planning the audit of the user entity, the user entity auditor requires sufficient information to:
- (a) understand those aspects of the control environment relevant to the processing of user transactions;
 - (b) determine the relevance of control objectives to the service entity, and in respect of the user organisation’s financial report assertions;
 - (c) assess the effective operation of relevant control procedures throughout the period being audited. When the service entity auditor reports on the design and existence of control procedures at a point in time, the user entity auditor considers additional procedures necessary to provide assurance over the effective operation of control procedures throughout the period; and
 - (d) understand the role of any complementary controls at the user entity.
- .21 A user entity auditor may receive assurance on control procedures over outsourcing activities at the service entity from the service entity auditor. However, engagements to report on internal control procedures over outsourcing functions at service entities are complex and affect four different parties: the user entity, the user entity auditor, the service entity and the service entity auditor. Apart from the impact of outsourcing on the financial report, the user entity may require the service entity to provide assurance over control procedures as part of an outsourcing service agreement or trading agreement. To determine whether the assurance provided by the service entity auditor comprises sufficient, appropriate audit evidence for the purpose of the user entity financial audit, the user entity auditor evaluates the scope and purpose of the assurance

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given, including reference to the user entity and/or the service entity auditor terms of engagement.

- .22 However, a service entity audit report alone is not always sufficient appropriate audit evidence to reduce control risk in a user entity to an acceptable level. The user entity auditor evaluates whether the information in the service entity auditor’s report meets the user entity’s control objectives, and when necessary carries out further work. This may include:
- (a) discussion of the user entity’s understanding of procedures, conclusions, scope, results etc. with the service entity auditor;
 - (b) a request that the service entity auditor performs further procedures eg. on an agreed-upon procedures basis;
 - (c) the user entity auditor performing such procedures as necessary at the service entity.
- .23 If the user entity auditor is not able to gain sufficient information to plan the audit there is a limitation of scope. The user entity auditor assesses the impact of that limitation of scope and considers the need to issue a qualified opinion on the user entity’s financial statements.
- .24 The user entity auditor evaluates the terms of reference used in the service entity auditor’s report by reference to this AGS to understand the nature of the examination undertaken and the level of assurance provided.

The Service Entity Auditor

Report Users and Proximity

- .25 The service entity auditor is engaged and authorised by the service entity to report on particular control procedures over outsourcing activities provided by the service entity for use by specific users, including:
- assurance to user entities in accordance with a service or trading agreement;
 - assurance to a user entity and/or the user entity auditor in respect of particular control procedures which impact on the user’s financial report.

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Terms of Engagement

- .26 AUS 204 “Terms of Audit Engagements” outlines the basic principles to be applied in agreeing the terms of audit engagements. In addition, the following specific matters are relevant in an outsourcing entity audit engagement.
- .27 The service entity auditor ensures that any engagement letter or other suitable form of agreement clearly identifies the scope, purpose and terms of the engagement. In particular, the following are to be clearly stated:
- (a) the format of the proposed report including the opinion;
 - (b) the period of time to be covered by the report;
 - (c) the information to be prepared by management and the representation management will make in relation to such information;
 - (d) a definition of “material control weakness” and a description of how the control weaknesses could effect the audit approach, including the consequences for the auditor’s report;
 - (e) the fact that due to the complex nature of internal control, the audit report may not encompass all individual control procedures possible at the service entity; and
 - (f) the report on control procedures will be prepared in response to the terms of the engagement, and will therefore not necessarily address the needs of other users not specifically identified.
- .28 Service entity auditors are engaged to report on internal control procedures over a number of identifiable subject matters (activity areas or units of activity areas) rather than the entire internal control structure of the outsourcing entity. The internal control structure is therefore described, for example, in terms of the internal control objectives of a system (or area or unit of activity) within a service entity. The internal control objectives for subject matter which relate to the provision of outsourcing functions by a service entity are unlikely to be examined as part of the service entity’s financial report audit, and therefore the internal control engagement is a separate engagement.

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- .29 The management of the service entity identifies the internal control objectives to be reported on by the service entity auditor, which are identified in the engagement letter or other suitable form of agreement. The nature of the service entity’s description of the internal control objectives and procedures for the subject matter establish the scope of the audit engagement, and are the criteria which the service entity auditor uses for engagement planning and evaluating the outcome of the work done.
- .30 The description by management of internal control objectives and procedures relating to the provision of an outsourcing function(s) is a written assertion of:
- (a) the design and existence of the internal control procedures at a point in time; or
 - (b) the design, effectiveness and continuity of the internal control procedures.

The auditor’s report on management’s assertion can either be in the form of an opinion whether:

- (i) the control procedures to achieve the internal control objectives for a subject matter are fairly stated; or
- (ii) management’s assertion is fairly stated.

An example engagement letter is provided in Appendix 2.

Scope

- .31 There are several types of engagements possible for reporting on the control procedures over outsourcing functions at a service entity. The engagement type will depend on the service entity auditor’s mandate. An engagement may involve:
- (a) an audit, a review, or agreed-upon procedures;
 - (b) attest or direct reporting (for audit and review engagements);
 - (c) reporting on the “design and existence” or the “design, operating effectiveness and continuity” of the internal control procedures of the service entity; and
 - (d) reporting at a point in time or over a period of time.

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An attest engagement is the most appropriate form of reporting for internal control engagements, as it ensures that the management of the service entity acknowledges responsibility for their internal control systems and procedures.

- .32 An audit provides a high but not absolute level of assurance about the effectiveness of control procedures. This is expressed as reasonable assurance in recognition of the fact that absolute assurance is rarely attainable due to such factors as the need for judgement, the use of testing, the inherent limitations of internal control and because much of the evidence available to the auditor is pervasive rather than conclusive in nature.
- .33 A review provides a moderate level of assurance about the effectiveness of control procedures. The level of assurance provided is less than that provided in an audit because the scope of the auditor’s work is less extensive than that of an audit, and the nature, timing and extent of the procedures performed do not provide sufficient appropriate audit evidence to enable the auditor to express a positive opinion. The objective of a review is to enable the auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor’s attention that causes the auditor to believe that the control procedures were not effective based on identified criteria (expression of negative assurance). AUS 902 “Review of Financial Reports” is to be applied to the extent practicable in an engagement to review the effectiveness of control procedures.
- .34 An agreed-upon procedures engagement does not result in the expression of any assurance by the auditor. The auditor is engaged to carry out specific procedures to meet the information needs of those parties who have agreed to the procedures to be performed. The auditor issues a report of factual findings to those parties that have agreed to the procedures. The recipients must form their own conclusions from this report because the auditor has not determined the nature, timing and extent of procedures to be able to express any assurance. The report is restricted to those parties (for example, a regulatory body) that have agreed to the procedures to be performed, since others are not aware of the reasons for the procedures and may misinterpret the results.
- .35 When the service entity auditor reports on the design and existence of control procedures at a service entity, the service entity auditor provides assurance on whether:
- (a) the control procedures were suitably designed to provide reasonable, but not absolute, assurance, that the stated

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- internal control objectives of the system would be achieved if the procedures operated as designed; and
- (b) the control procedures existed as at a point in time. It is not possible to establish the effective operation of control procedures when the examination of such procedures is limited to a point in time. Accordingly, the auditor does not provide assurance on their effective operation and refers only to their existence as at a point in time.
- .36 When the service entity auditor reports on the design, effective operation and continuity of control procedures at the service entity, the service entity auditor provides assurance on whether:
- (a) the control procedures were suitably designed to provide reasonable, but not absolute assurance, that the stated internal control objectives of a system were achieved; and
- (b) the control procedures operated effectively throughout a specified period.
- .37 Except as otherwise stated, the remainder of this AGS is directed towards audit engagements. For review engagements the auditor would apply this AGS in the context of AUS 902. For agreed-upon procedure engagements, the auditor would apply this AGS in the context of AUS 904 “Engagements to Perform Agreed-upon Procedures”.

Planning an Audit of Specified Subject Matter at a Service Entity

- .38 The requirements of AUS 806 “Performance Auditing” and AUS 808 “Planning Performance Audits” are to be applied by the service entity auditor in an audit of the control structure relating to an outsourcing function(s), together with other AUSs adapted as necessary.
- .39 The scope of an audit of the internal control structure relating to outsourcing function(s) at a service entity is identified in the terms of the engagement. When planning the engagement, the service entity auditor also considers:
- (a) identifying the criteria against which the auditor’s opinion will be formed (this will be the specific control objectives and control procedures in many engagements);
- (b) the suitability of control objectives and procedures;

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- (c) consequences of unsuitable control objectives and procedures;
 - (d) the period of time covered by the report;
 - (e) the number of locations.
- .40 In planning the engagement, the service entity auditor obtains a general understanding of the internal control structure and a more detailed understanding of the control procedures in relation to the subject matter (area of activity or unit of activity) to be examined. This includes making inquiries of appropriate personnel, inspecting documents, and observing activities and operations. The nature and extent of these procedures will vary depending on the terms of the engagement and the service entity. Factors taken into account include:
- (a) the entity’s size and complexity;
 - (b) the nature of the subject matter to be examined (being the particular outsourcing function being provided to users), including the objective(s) to which the controls are directed and the risk that those objectives will not be achieved;
 - (c) the nature and extent to which information technology is used; and
 - (d) the documentation available.

Initial Engagements

- .41 Often, in an initial engagement, the description of the control objectives and procedures will not exist at the required level of detail, or may be unsuitable in its present form, to allow the service entity auditor to express an opinion thereon. The service entity auditor may be engaged to assist the management of the outsourcing entity in developing a description which is suitable to all parties involved (ie. service entity management, users and the service entity auditor). Assistance of this nature is beyond the scope of the audit and should be regarded as a separate engagement. The audit commences after the satisfactory completion of the description of internal control objectives and control procedures.

Identification of the Subject Matter

- .42 The subject matter, being that aspect(s) of the internal control structure relating to an outsourcing function is to be clearly

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identified. For example, the subject matter considered in Appendix 5 (Example Accompanying Description of the Subject Matter and Internal Control Objectives and Procedures) is the data centre that provides on-line systems to customers.

Identification of the Criteria

- .43 The evaluation of the subject matter is carried out by reference to the achievement of control objectives and procedures relevant to the subject matter. Therefore, the control objectives, which are identified by the service entity management, become the basis, or criteria, for the service entity auditor’s examination. The criteria define the scope of the service entity auditor’s examination and provide the terms of reference for assessment and reporting. These criteria are to be suitable to enable assessment of the matters subject to audit or review in accordance with AUS 808.27-36.
- .44 The service entity auditor obtains a written statement from management identifying the internal control objectives relating to the outsourcing function to be reported on prior to commencing the audit. The service entity management is responsible for providing a comprehensive and complete description of the internal control objectives and the related control procedures to be examined. In an attest engagement, the service entity management’s description of the specified internal control objectives and procedures reported on by the service entity’s auditors are attached to the audit report. The description provided to users gives a clear explanation of activities examined to avoid any misunderstanding.

Suitable Control Objectives and Control Procedures

- .45 The service entity auditor assesses whether the internal control objectives and control procedures, identified by the service entity management, are consistent with the purpose and scope of the engagement to enable the service entity auditor to assess the effectiveness of the internal control structure being reported on. If the description of control objectives and procedures relating to an outsourcing function are unsuitable, they may adversely affect the user entity auditor’s decisions in planning the audit of the user entity’s financial report and in assessing control risk. The service entity auditor cannot be aware of all user entities’ financial report assertions that might be affected by the service entity’s control structure, and therefore does not have responsibility to identify or test control objectives and procedures which have not been included in the description of identified subject matter.

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- .46 If the service entity auditor believes the identified control objectives and procedures are unsuitable, the service entity auditor agrees on suitable control objectives and procedures with the service entity management prior to continuing with the engagement. If the service entity auditor and service entity management are unable to agree on suitable control objectives and procedures, the service entity auditor does not continue with the engagements or issues a qualified report where the auditor is required to perform the engagement under a legislative mandate.

Refer to Appendix 4 for further discussion of matters relating to the “Description of the Subject Matter, Control Objectives and Control Procedures”.

Period of Time Covered by the Report

- .47 The period of time for which a service entity audit report is applicable can range from a point in time for a “design and existence report” (ie. as at a specific date), to any defined period for a “design, and effective operation and continuity” report, but usually does not exceed twelve months.
- .48 The time period covered by the report has a significant impact on the planning of the engagement and the conduct of fieldwork. Reports which provide assurance on “design and existence” at a point in time require a concentrated effort in the timeframe immediately prior to the date reported on. When it is impractical to conduct all the fieldwork on the reporting day itself, it is necessary to conduct appropriate fieldwork in the weeks surrounding the reporting date.
- .49 Planning for an engagement to provide an opinion on design, effective operation and continuity is undertaken at the beginning of the period to be reported on, or preferably, prior to the start of the period. This ensures that sufficient audit evidence can be obtained throughout the period to support the assurance given, particularly where control procedures are being reported on which do not leave a documented audit trail as evidence that they are operating effectively (such as some general controls in a computer environment).

Number of Locations

- .50 Where the service entity operates multiple locations, the number of locations reported on by the service entity auditor is determined at the planning stage, as the expected degree of coverage affects the conduct of the examination and the scope of the report. If the

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service entity auditor is required to report on a system(s) covering all locations, consideration is given to whether all, or only a sample of locations are to be visited to perform fieldwork.

- .51 The decision to examine and report on all locations rather than a sample of locations is affected by two factors:
- (a) Centralisation of control and/or the control procedures in place are similar at each location, and considered effective in reducing control risk. Sampling is not appropriate where control is decentralised and individual control procedures differ between locations.
 - (b) The terms of the engagement may require an examination of certain locations. When the service entity auditor gives assurance on control procedures at certain locations only, the scope paragraph of the report gives details of the locations examined.

Complementary User Controls

- .52 When the service entity’s control objectives assume that certain internal control procedures are implemented by user entities (such as the use of passwords to access the service entity’s applications by remote access), the service entity’s description of the specified control objectives and procedures identifies the complementary user controls.
- .53 A service entity auditor can only report on internal controls over outsourcing functions that are the responsibility of the service entity. Generally, these are controls over the processes within the service entity, for example, between the points at which transfers of consideration (such as money, goods, services, commitments) with outside entities occur or are captured. The service entity auditor does not report on controls over processes that are outside the service entity (for example controls at the user entity) since their existence, effective operation and continuity are primarily dependent on the actions of persons other than the service entity.
- .54 In some situations the user entity is required to apply certain control procedures in order to achieve a stated control objective. When a user control is necessary to achieve a stated control objective, the service entity auditor ensures that it is clearly identified in the description of control objectives and procedures.
- .55 If management’s description of the specified objectives and procedures does not identify complementary controls at user

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entities, the service entity auditor considers adding an explanatory paragraph to the audit report to provide this information, or considers qualifying the opinion given on the fairness of the presentation of the description.

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Materiality

- .56 The service entity auditor considers materiality when:
- (a) determining the nature, timing and extent of procedures; and
 - (b) evaluating the effect of control weaknesses on the auditor’s opinion.
- .57 When assessing materiality, the service entity auditor considers the following factors:
- (a) any specific requirements of the terms of the engagement;
 - (b) the impact of a control weakness;
 - (c) the importance of a control weakness in relation to the subject matter and the entity’s overall objectives;
 - (d) whether an identified weakness (including an absence of controls) results in the risk of the internal control objective relevant to the specified subject matter not being reduced to an acceptably low level;
 - (e) the length of time an observed weakness was in existence;
 - (f) the effect of a centralised function (for example computer security, central budgeting or human resource management) on other parts of the service entity;
 - (g) public perceptions and/or interest in the subject matter; and
 - (h) the cost of alternative controls relative to their likely benefit.

The service entity auditor also considers those factors affecting materiality and risk that are identified in AUS 808.17.

The Control Environment

- .58 Management of the service entity is responsible for implementing an effective control environment. Outsourcing functions are performed within this control environment which therefore influences the design and effective operation of control procedures. For example, the control environment procedures in place to handle recruiting, training, supervision and evaluation of staff have an impact on the

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capability of staff to effectively perform their assigned functions, including specific control procedures.

- .59 The service entity auditor has a responsibility to assess the effect of the control environment on the control procedures to be reported on. The service entity auditor gains an understanding of the control environment and then assesses the design of the information system and control procedures incorporated in the subject matter to be reported on.
- .60 An evaluation of the control environment is carried out primarily by means of enquiry, observation, and review of relevant documentation. The following aspects of the control environment may be relevant to the subject matter being considered by the service entity auditor:
- (a) organisation structure and culture;
 - (b) segregation of duties;
 - (c) control consciousness of management and individuals responsible for control related activities;
 - (d) competence of personnel who have control responsibilities;
 - (e) acceptance of control procedures as an integral part of the normal duties of service entity personnel performing outsourcing functions;
 - (f) protection of assets and records;
 - (g) possibility of management override;
 - (h) effort and resources expended to implement and maintain the control procedures;
 - (i) ability of the service entity to manage change and update the necessary control structure;
 - (j) IT control infrastructure for the security of data (particularly for service providers of Value-Added Networks (VANs) or public network access);
 - (k) IT access controls both physical and logical;
 - (l) general controls over the development and maintenance of databases and programs;

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- (m) operational and procedural controls, including automated application controls; and
- (n) hardware, system software and network controls.

Timing of Audit Procedures

- .61 The timing of audit procedures depends on the type of report being issued. When the service entity auditor provides assurance on “design and existence”, the service entity auditor is not reporting on the effectiveness or continuity of control procedures. However, users may have an expectation that the control procedures reported on have not only been placed in operation, but also that no evidence exists to suggest they will not continue to operate. Therefore the service entity auditor refers to the terms of the engagement when planning the timing of audit procedures. A report on the “design and existence” of control procedures as at a point in time requires that a number of control procedures be tested in a very short time frame (for example, a day). When this is impractical, or when the service entity auditor requires assurance that controls have not been implemented by management solely for the purposes of the report, the service entity auditor tests certain control procedures during a period surrounding the actual reporting date and gains additional assurance through enquiry, observation and discussion that the procedures existed on the actual reporting date itself.
- .62 A report addressing the “design, effective operation and continuity” of control procedures will require the service entity auditor to perform tests in relation to the entire period being reported on.

Nature and Extent of Audit Procedures

- .63 After carrying out a preliminary assessment of the control environment to determine whether the control environment is effective and the description of internal control procedures is complete, the service entity auditor carries out a detailed examination and evaluation of the control procedures to assess whether the stated internal control objectives have been achieved. In performing an evaluation of internal control procedures, the service entity auditor assesses the potential for errors occurring in the processes and evaluates whether the control procedures are sufficient to reduce the risk that the objective(s) will not be achieved to a low level.

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Evaluating Design and Existence

- .64 The service entity auditor evaluates the design effectiveness of the internal control relating to the outsourcing function based on the identified control objectives and procedures. This evaluation is based on whether internal controls at the service entity have been suitably designed to reduce risk of the specified objectives not being achieved to a low level. Where the service entity auditor is unable to identify internal controls that are designed to provide reasonable assurance about the achievement of objectives, this constitutes a weakness in relation to design.
- .65 Where the “design and existence” of control procedures are to be reported on, audit procedures generally consist of enquiry, observation, review of documentation and tracing of transactions through the information system. Enquiry alone does not normally provide sufficient audit evidence to express an opinion on the existence of control procedures unless corroborated from more than one source. Usually a walkthrough of the flow of transactions through the information system is required as a minimum.
- .66 Where the service entity auditor believes a material control weakness exists, which has serious design implications, the service entity auditor considers issuing a modified report without performing any tests of operating effectiveness. In such situations, an adverse opinion is appropriate.
- .67 IT controls often consist of a number of integrated processes directed at the achievement of objectives. Some controls may have a pervasive effect on achieving many overall objectives whereas others are designed with a particular objective in mind. Due to the pervasive nature of some controls, there are often several controls that affect the risks relevant to a particular objective. Consequently, where the service entity auditor evaluates a control as being ineffective for a particular objective, the service entity auditor considers whether there are any other compensating controls before concluding that a material control weakness exists.

Testing Operating Effectiveness and Continuity

- .68 Tests of operating effectiveness are concerned with how the controls were applied, the consistency with which they were applied, and who applied them. The service entity auditor considers the period of time over which the controls were applied. These tests ordinarily include procedures such as inquiry of appropriate personnel, inspection of relevant documentation, observation of the outsourcing entity’s operations, and detailed procedures to

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substantiate the effective operation of controls. Detailed procedures include re-performance or examination and follow-up of the application of significant control procedures.

- .69 The nature and extent of the audit procedures the service entity auditor performs depends on the types of control procedures. These may be categorised as follows:
- (a) automated program and/or process monitoring to provide continuous control over individual transactions or applied periodically to a group of transactions;
 - (b) manual procedures in conjunction with IT controls (eg. follow up of exception reports or access violations) or in addition to IT controls (eg. investigation of Key Performance Indicators).
- .70 The assessment of sufficient appropriate evidence is a matter of professional judgement. For example, the service entity auditor considers:
- (a) the nature of the subject matter (area of activity or unit of activity);
 - (b) the significance of the internal control procedures in achieving the relevant objective(s);
 - (c) the nature and extent of any tests of operating effectiveness performed by the service entity (management, internal audit or other personnel) relating to the outsourcing function; and
 - (d) the likelihood that the internal control procedures will not reduce to an acceptably low level the risks relevant to the objective(s).

Management Representations

- .71 The service entity auditor obtains evidence that management acknowledges its responsibility for establishing and maintaining the service entity’s internal control structure relating to outsourcing functions. This representation may be in the form of a published assertion in an attest engagement, or for a direct reporting engagement, by obtaining relevant minutes of meetings or by obtaining a written representation from management.

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- .72 In an attest engagement, preparation of an explicit management assertion by the service entity management ensures that appropriate accountability relationships are maintained. As management is responsible for the effectiveness of the internal controls, it is reasonable for management to be held directly accountable for meeting that responsibility. The service entity auditor’s role is then to add credibility to management’s representations.

Refer to Appendix 3 for an Example Management Representation Letter, and Appendices 5 and 6 for Examples of “Description of Subject Matter, Control Objectives and Control Procedures”.

Types of Reports

- .73 Reporting on control procedures at outsourcing entities is one type of performance audit. The reporting principles outlined in AUS 806 “Performance Auditing” are therefore adopted for audit reports for these engagements.

Format of Report

- .74 The service entity auditor’s report on control procedures at a service entity is prepared in accordance with AUS 806.32. The identification of criteria in the audit report will depend on the nature of the engagement:
- (a) in direct reporting engagements, the service entity auditor’s report will include or refer to a description of the internal control objectives and the related control procedures to achieve those objectives;
 - (b) in attest reporting engagements, the service entity auditor’s report will be attached to the service entity management’s assertions in respect of the outsourcing activity which provide a description of the internal control objectives and the related control procedures to achieve those objectives.

Refer to Appendices 5 and 6 for examples of the accompanying “Description of Internal Control Objectives and Procedures”. Refer to Appendices 7 and 8 for example audit reports.

Other Reporting Matters

- .75 The service entity auditor has a responsibility to consider information obtained subsequent to the period being reported on and prior to the release of the report, to determine whether that information is of significance to users. The service entity auditor is

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under no obligation, however, to update audit procedures beyond the date of the report, unless specifically engaged to do so.

- .76 The service entity auditor also considers the impact of information which, had it been known before issuance of the report, might have affected the audit report. The service entity auditor discusses the matter with management of the service entity or, if necessary, the governing body to determine the appropriate course of action for communicating with users of the report. If these discussions or resulting actions are not satisfactory, the service entity auditor seeks legal advice in determining any further course of action.

Material Control Weakness

- .77 Where a material control weakness exists, the service entity auditor is not able to conclude that internal controls are effective. The type of report to be issued by the service entity auditor will be determined by the potential impact of the weakness. The service entity auditor's report includes a clear description of material control weaknesses including:
- (a) a description of the effect of all identified material control weaknesses on the achievement of relevant objectives; or
 - (b) if the service entity auditor is unable to reliably determine the effect of a material control weakness, a statement to that effect with reasons.

Reporting to Management

- .78 During the course of the engagement the service entity auditor may become aware of deficiencies in internal controls. The service entity auditor reports any control weakness identified in the design or operation of internal controls to an appropriate level of management at the service entity. The service entity auditor designs procedures to gather sufficient appropriate evidence to form an opinion in accordance with the terms of the engagement. In the absence of a specific requirement in the terms of engagement, the service entity auditor does not have a responsibility to design procedures to identify matters that may be appropriate to report to management. Matters brought to the attention of the service entity's management are also reported to the user entity auditor if required by the terms of the engagement.
- .79 Certain matters may be of such importance that they would be reported to the audit committee or the governing body of the service entity. If the service entity auditor discovers fraud, error, or non-

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compliance with laws and regulations, during the course of the audit, the service entity auditor refers to the guidance provided by AUS 210 “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of a Financial Report” and AUS 218 “Consideration of Laws and Regulations in an Audit of a Financial Report”. Unless stated otherwise in the terms of engagement, less important matters are reported to a level of service entity management that has the authority to take appropriate action.

Operative Date

- .80 This AGS, which incorporates amendments made by AUS/AGS Omnibus 3 “Miscellaneous Amendments to AUSs and AGSs”, is operative from July 2002. This version of AGS 1042 supersedes AGS 1042 “Reporting on control Procedures at Outsourcing Entities”, as revised in February 1999.

Compatibility with International Standards and Statements on Auditing

- .81 There is no corresponding International Standard or Statement on Auditing.

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APPENDIX I

*EXAMPLES OF OUTSOURCING SERVICES WHICH MAY IMPACT
FINANCIAL STATEMENT ASSERTIONS*

Typical areas of outsourcing that may impact financial report assertions include the outsourcing of:

- service provider of value-added networks (VANs) or public networks such as the Internet
- transaction recording and/or processing services
- inventory management
- asset management
- accounts payable/receivable
- payroll
- financial accounting function
- human resources

Information technology (IT) is likely to be a pervasive factor in any type of outsourcing function provided by another entity and will therefore be a characteristic of the service entity’s control environment (refer to Table 1).

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TABLE 1

The IT services used in an outsourcing agreement can vary in size and complexity and cover a wide array of arrangements. Control environment considerations regarding IT include:

- operation of the hardware
- implementation and control over the IT control infrastructure of VANs or public network connections
- development of specific application programs
- development of application control activities, such as logical access security maintenance
- systems operation/facilities management being provision of these services involved in the operation and management of all or a significant part of the users' information systems function under a long-term contract. This may involve the vendor providing only the personnel to run the system or processing services, where vendor provides equipment and (optionally) facilities, as well as personnel
- personal computer support
- facilities management with the user entity's staff seconded to the service entity and its assets made available on a lease basis
- buying time on a large computer owned and operated by a bureau
- buying computer time with the provision of operation control and set up functions
- facilities management involving all aspects of the day to day running of a clients computer centre
- network management and/or communications includes, communications network design, implementation, operation, management and support of both local area networks (LANs) and wide area networks (WANs)
- systems integration, integration of products and services, functional service and quality requirements. Also change management and provision of education and support services. However, unlike facilities management, system integrators do not look after the day to day running of the client's computer systems or centre.

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APPENDIX 2

EXAMPLE ENGAGEMENT LETTER

Reporting on Effective Operation of Control Procedures

To [the governing body, audit committee or the appropriate representative of senior management] of XYZ Outsourcing Entity:

Scope

You have requested that we audit control procedures in relation to [subject matter] [as at/for the period ended ...] in order to express an opinion about their effectiveness based on [specified criteria] which you will provide and which will accompany our report. We are pleased to confirm our acceptance and understanding of this engagement by means of this letter.

We will conduct our audit in accordance with Australian Auditing Standard AUS 404 “Audit Implications Relating to Entities Using Service Entities” and other Australian Auditing Standards applicable to performance audits, and with reference to AGS 1042 “Reporting on Control Procedures at Outsourcing Entities”, to provide reasonable assurance whether the control objectives in the [specified criteria] are free of material weaknesses. We will undertake such tests and procedures as we consider necessary to form an opinion whether in all material respects, the control procedures in relation to [subject matter] were adequately designed and operated effectively based on the criteria referred to above.

Management’s Description of Control Objectives and Control Procedures

We understand that you will identify the control objectives relevant to [subject matter], and the control procedures necessary to achieve those control objectives, and that you will provide us with a report giving a “Description of Control Objectives and Control Procedures relating to [subject matter]” to accompany our audit report (appropriate for attest engagements).

Audit Report

The format of the report will be in accordance with AGS 1042 and will consist of an opinion on the “Description of Control Objectives and Control Procedures relating to [subject matter]” by XYZ Outsourcing Entity management (in an attest engagement). An example of the proposed report is contained in the appendix to this letter.

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Our report will be issued [frequency] and will cover [period reported on] (paragraph is appropriate for recurring engagements).

Distribution of the Audit Report

The audit report will be incorporated in a report issued by the XYZ Outsourcing Entity containing information prepared by XYZ Outsourcing Entity management to provide “user entities” and their auditors with an overall understanding of [subject matter]. We will review the contents of the report issued by XYZ Outsourcing Entity to ensure that it is consistent with our report. The audit report will be prepared for this purpose only and we disclaim any assumption of responsibility for any reliance on our report to any person other than to the user entities, or for any purpose other than that for which it was prepared.

Material Weaknesses in Control Procedures

We will issue an audit report without modification, to provide assurance on the control procedures of [subject matter] where our audit does not disclose a material weakness(es) in the internal control objectives you have engaged us to report upon. For this purpose, a material weakness exists when prescribed control procedures, or the degree of compliance with them:

- (a) does not provide outsourcing entity management with reasonable assurance that fraud, error, or non-compliance with laws and regulations would be prevented or detected by employees in the normal course of their assigned functions; and
- (b) knowledge of that weakness would be material to users of the audit report.

If our audit discloses that there are significant weaknesses in the system of internal controls in effect during the period covered by the report, such weaknesses will be disclosed in our report even if they were corrected prior to the end of the reporting period. However, our report will indicate that such weaknesses were corrected if that is the case. If any material weaknesses disclosed in our report have been corrected subsequent to this period (or are in the process of being corrected), we will refer to this in our report.

Although the primary purpose of our audit will be to enable us to issue the above report, we will also periodically provide you with letters containing recommendations for strengthening controls if such matters are observed during the process of the audit. Although issues raised may not represent material weaknesses in the system of internal controls, recommendations will address areas where we believe controls could be improved.

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Inherent Limitations

Because of the inherent limitations of any internal control structure it is possible that fraud, error, or non-compliance with laws and regulations may occur and not be detected. Further, the internal control structure, within which the control procedures that we will audit, will not be examined [except for...]. Hence no opinion will be expressed as to the effectiveness of the internal control structure as a whole.

The work undertaken by us to form an opinion is permeated by judgement, in particular regarding the nature timing and extent of audit procedures for gathering audit evidence and the drawing of conclusions based on the audit evidence gathered. In addition to the inherent limitations in any audit, which include the use of testing, inherent limitations of any internal control structure, and the possibility of collusion, most audit evidence is pervasive rather than conclusive. As a result, an audit can only provide reasonable – not absolute – assurance that control procedures have operated effectively throughout the period.

Audit Approach

We will examine and evaluate the control objectives and control procedures for [subject matter] described above. The “Description of Control Objectives and Control Procedures relating to [subject matter]” will include details of controls which user entities should comply with. While our evaluation will include assessment of the appropriateness of the user controls, our testing will not encompass control procedures carried out by users of [subject matter].

Due to the complex nature of internal control, our audit will not encompass all individual control procedures possible at XYZ Outsourcing Entity, but will be restricted to an examination of those control procedures identified by XYZ Outsourcing Entity management in the “Description of Control Objectives and Control Procedures relating to [subject matter]” provided to us.

Audit Procedures

1. Perform a preliminary review of the control environment of XYZ Outsourcing Entity;
2. Evaluate the design of specific control procedures of the information system by:
 - identifying control areas for gathering data from significant exchange or transaction types, for processing exchange

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- data, and for safeguarding groups of valuable, movable assets in both physical and electronic form;
- documenting significant flows of information;
 - identifying and documenting controls in place over data gathering for significant exchange types, processing exchange data, and safeguarding groups of valuable, movable assets in both physical and electronic form;
 - evaluating whether each documented control in place is capable of achieving its objective.
3. Perform tests of controls to ascertain whether the degree of compliance with control procedures is sufficient for the controls to achieve their objectives.
 4. Ensure that the control procedures at XYZ Outsourcing Entity, as identified by XYZ Outsourcing Entity management, are evaluated and tested to determine whether they have achieved their objectives.
 5. Review information prepared by XYZ Outsourcing Entity management and contained in the report using procedures similar to those contained in AGS 1042 (step is appropriate where the audit report is included as part of a Company produced document).

In undertaking this audit, we shall work closely with the XYZ Outsourcing Entity internal auditing group and place reliance on their work in accordance with AUS 604 “Considering the Work of Internal Auditing” (paragraph applicable where the work of internal auditing is an integral part of the audit).

We will also request a representation letter from XYZ Outsourcing Entity, if applicable, that would confirm oral representations provided to us during the course of our work.

Fees

We look forward to full co-operation with your staff and we trust that they will make available to us whatever records, documentation and other information are requested in connection with our audit. Our fees, which will be billed as work progresses, are based on the time required by individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

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Other

This letter will be effective for future years unless it is terminated, amended or superseded.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the control procedures over your outsourcing services.

Yours faithfully,

(signed)

.....

Name and Title

Date

Acknowledged on behalf of XYZ Outsourcing Entity

(signed)

.....

Name and Title

Date

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APPENDIX 3

EXAMPLE MANAGEMENT REPRESENTATION LETTER

(Reporting on Control Procedures for a Period of Time)

ABC Partners
Local Office Address

Dear Sir

We are writing at your request to confirm our understanding that your audit of the system of internal controls of [subject matter] for the period January 1, 19X1 to December 31, 19X1 was made for the purpose of expressing an opinion on the adequacy of the control procedures for [subject matter]. In connection with your audit, we confirm to the best of our knowledge and belief the following representations made to you during your audit.

1. We are responsible for establishing, documenting and maintaining a system of internal controls that provides management with reasonable but not absolute assurance regarding the [subject matter] as to the “internal control objectives” for the (“type of outsourcing provided”).
2. The description of the Outsourcing Entity’s control procedures set forth in your report are the control procedures followed by the Outsourcing Entities during the period under review and are suitably designed to provide management with reasonable but not absolute assurance that the internal control objectives in 1. above are achieved.
3. We are not aware of a weakening of any control procedures subsequent to December 31, 19X1.
4. We have not knowingly withheld from you any information that in our judgement would be relevant to the purposes of your audit.
5. There has been no fraud, error, or non-compliance with laws and regulations involving any member of management or employees who have significant roles in the system of internal controls.

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6. There have been no significant adjustments necessary to the records relating to “type of outsourcing provided” that have not been disclosed to you.

Yours faithfully,

XYZ Outsourcing Entity

.....
Chief Executive Officer

.....
Chief Operating Officer

(responsible for system reported upon)

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APPENDIX 4

*DESCRIPTION OF THE SUBJECT MATTER, CONTROL OBJECTIVES
AND CONTROL PROCEDURES*

- .01 The service entity auditor’s report is attached to a description of the internal control objectives of the subject matter and the control procedures designed to achieve those objectives. In an attest type engagement, the description of internal control objectives and control procedures are supported by management’s written assertions in relation to the internal controls being reported on.
- .02 The level of detail of the description attached to an audit report largely depends on the needs of the users of the report, as perceived by management of the service entity, balanced by the specific representations for which management is prepared to take responsibility. It also depends on the extent to which other separate reports or documentation prepared by the management or internal auditors of the service entity address these matters.
- .03 The accompanying description also includes relevant details of the control environment within the service entity or describes the flow of transactions where necessary.

Essential Components of the Accompanying Description of the Subject Matter and Control Objectives and Procedures

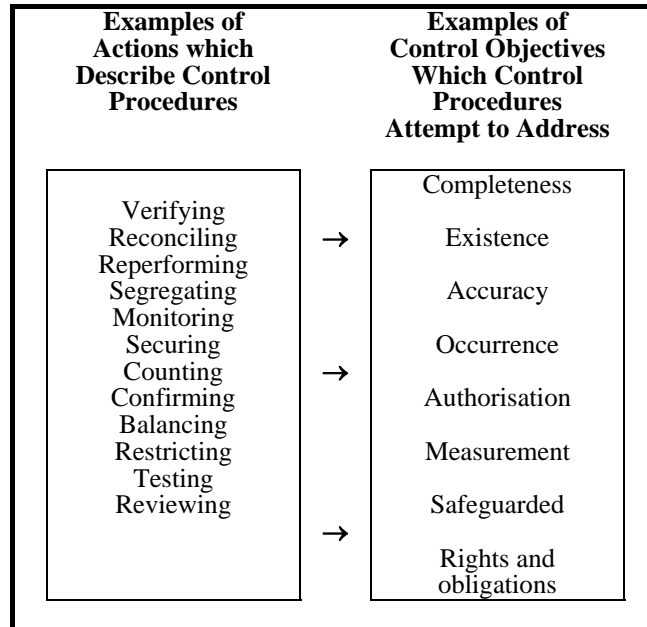
Description of Internal Control Objectives

- .04 The description of the internal control objectives is critical from the perspective of the service entity auditor as it defines a boundary for the scope of the engagement. It also provides a focus for the identification of those control procedures, which are evaluated and tested in order to determine whether the control objective is achieved.

Description of Control Procedures

- .05 The description of control procedures necessary to achieve the internal control objectives is to be both accurate and complete as it forms the basis for testing and evaluation performed by the service entity auditor, and for reliance on existence and/or effectiveness of such procedures by users of the report. A control procedure, which may be preventive or detective in nature, is generally described as an action undertaken by the service entity in order to address an assertion, as depicted below:

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- .06 The description of control procedures is at a level of detail that is meaningful to the users of the report and provides a clear scope for the audit of the specified subject matter at the service entity. However, if the description is too extensive, competitive or security concerns may arise.

User Entity Control Procedures

- .07 The description of control procedures includes references to complementary controls which are expected to be performed by users of the service entity.
- .08 The audit report includes a statement that the effectiveness of complementary control procedures performed by the user entity should be considered by users of the report in order to assess whether the internal control objectives of the system as a whole are achieved. In most cases, the user entity has a clear understanding of its responsibilities as a result of direct communication with the service entity (for example, responsibilities defined within the contract to provide services). Alternatively, an addendum prepared and distributed by service entity management details the complementary procedures to be performed at the user organisation.

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Optional Components of the Accompanying Description of the Subject Matter and Stated Control Objectives and Procedures

Description of the Control Environment

- .09 The service entity management or, in the case of direct reporting engagements, the service entity auditor, reports on the control environment where a weakness has been encountered that has a significant impact on the existence or effectiveness of the control procedures reported on. Where there is no specific reference to the control environment, users of the report assume that the control environment is adequate to support the underlying control procedures. For example, the control environmental factors relating to the competence of personnel (recruitment, training, supervision, evaluation) is not included as separate control procedure to be reported on, unless the service entity management or in direct reporting engagements, the service entity auditor, believes that these factors are deficient and could impair the proper functioning of control procedures to achieve the stated internal control objectives. In this example, the service entity management reports the deficiencies or the service entity auditor modifies the audit report accordingly.
- .10 The management process to implement, maintain and monitor the on-going effectiveness of the internal control structure is a critical part of the control environment to ensure that changes in the service entity are properly managed and controlled. Material weaknesses in this control process are likely to have a pervasive effect on control procedures reported on.
- .11 In some circumstances the terms of the engagement require that the control environment is included in the description. For example, where users of the report request that internal control objectives relating to the control environment be specifically included to supplement the report (for example, the EDP general control environment).

Description of the Flow of Transactions

- .12 A description of the flow of transactions is included in a direct audit report by a service entity auditor where a system is reported on (for example a payroll system), in contrast to a report on a particular environment (for example, a report on data processing installation). Normally a broad based description or flowchart is sufficient to provide users with an understanding of the system to which the internal control objectives and control procedures apply. Where it is necessary to establish the split of responsibilities between the user

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organisation and the service entity, a more detailed description is required.

Description of the Nature, Timing and Extent of Audit Tests Performed

- .13 The service entity direct audit report does not normally provide a detailed description of audit procedures performed by the service entity auditor.

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APPENDIX 5

*EXAMPLE ACCOMPANYING DESCRIPTION OF THE SUBJECT MATTER
AND INTERNAL CONTROL OBJECTIVES AND PROCEDURES
(SUMMARY LEVEL) AND A REPORT BY THE MANAGEMENT OF THE
OUTSOURCING ENTITY ON ITS INTERNAL CONTROLS.*

XYZ¹

Outsourcing entity

Report by the Directors Concerning Internal Controls.

As the directors of XYZ Outsourcing Entity, we are responsible for the design, implementation and maintenance of XYZ Outsourcing Entity’s internal control objectives and procedures and for the declaration and assertions in this report. In carrying out this responsibility, we have had regard to the interests of the outsourcing entity’s clients and the owners of this business, and to the general effectiveness and efficiency of the operating of XYZ Outsourcing Entity.

We set out in this report the control objectives and procedures established for the XYZ data centre of XYZ Outsourcing entity. The specific control procedures set out in the remainder of the report have been established to meet each of the control objectives. The control procedures have been in place throughout the period from to

Signed on behalf of the Board

Date

¹ [In an attest engagement, the inclusion of the Report by management of XYZ Outsourcing Entity on its internal controls should be included here]

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XYZ OUTSOURCING ENTITY

Introduction

XYZ Outsourcing Entity (XYZ) operates a data centre that provides its customers on-line computer based systems. Batch generation of reports extracted from on-line data is also available upon request.

The data centre houses computer hardware and system software and accommodates operators responsible for day-to-day operations of the network, computer systems and production scheduling, the hardware, and an operations support function responsible for disk and tape support, maintenance and back-up of data and software.

The stated internal control objective and control procedures included in this report apply to XYZ operations as they relate only to timesharing services. Specifically excluded from this report are controls within individual systems, controls executed at customer premises and other services provided by XYZ, including data conversion services, custom application development and facilities management.

The effectiveness of control procedures performed by customers of XYZ should also be considered as part of the overall system of internal control relating to processing performed at the XYZ data centre.

Internal Control Objective

The data processing environment at the XYZ data centre is secure and the integrity of processing is maintained.

Control Procedures

1. Segregation of functions exists for computer operations, systems support, hardware support, applications development and administrative functions.
2. Physical access to computer facilities, software and documentation is restricted and monitored.
3. Logical access security to prevent inadvertent or unauthorised access to systems software, application programs and data exists and is monitored.
4. System software changes and enhancements are subject to authorisation and testing prior to implementation.

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5. An environmentally controlled facility exists for the operation of data processing equipment.
6. Off-site hardware exists and file back-ups are maintained to enable execution of the disaster recovery plan.
7. Data centre operations, including the communications network, are monitored and problems identified are resolved on a timely basis.

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APPENDIX 6

*EXAMPLE DESCRIPTION OF THE SUBJECT MATTER AND INTERNAL
CONTROL OBJECTIVES AND PROCEDURES (DETAIL LEVEL) AND A
REPORT BY THE MANAGEMENT OF THE OUTSOURCING ENTITY ON
ITS INTERNAL CONTROLS*

XYZ²

Outsourcing entity

Report by the Directors Concerning Internal Controls

As the directors of XYZ Outsourcing Entity, we are responsible for the design, implementation and maintenance of XYZ Outsourcing Entity’s internal control objectives and procedures and for the declaration and assertions in this report. In carrying out this responsibility, we have had regard to the interests of the outsourcing entity’s clients and the owners of the business, and to the general effectiveness and efficiency of the operating of XYZ Outsourcing Entity.

We set out in this report the control objectives and procedures established for the XYZ data centre of XYZ Outsourcing entity. The specific control procedures set out in the remainder of the report have been established to meet each of the control objectives. The control procedures have been in place throughout the period from to

Signed on behalf of the Board

Date

² [In an attest engagement, the Report by XYZ Outsourcing Entity Management on its Internal Controls, should be inserted here]

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XYZ OUTSOURCING ENTITY

Introduction

XYZ Outsourcing Entity operates a data centre that provides its customers on-line computer based systems. Batch generation of reports extracted from on-line data is also available upon request.

The data centre houses computer hardware and system software and accommodates operators responsible for day-to-day operations of the network, computer systems and production scheduling, the hardware support function responsible for installation and maintenance of hardware, and an operations support function responsible for disk and tape support, maintenance and back-up of data and software.

The stated internal control objectives and control procedures included in this report apply to XYZ operations as they relate only to timesharing services. Specifically excluded from this report are controls within individual systems, controls executed at customer premises and other services provided by XYZ including data conversion services, custom application development and facilities management.

The effectiveness of control procedures performed by customers of XYZ should also be considered as part of the overall system of internal control relating to processing performed at the XYZ data centre.

Internal Control Objective

Effective segregation of duties exists at the XYZ data centre.

Control Procedures

- 1.1 There is a formal organisation structure for all functions at the XYZ data centre. Each functional group reports to a separate manager, who in turn reports to the Senior Manager - Data Processing Services.
- 1.2 Segregation of functions exists for computer operations, systems support, hardware support, applications development and administrative functions.

Internal Control Objective

Physical security is restricted to prevent inadvertent or unauthorised access to computer facilities, software and documentation.

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Control Procedures

- 2.1 Security guards are in attendance 24 hours per day, 7 days per week. Entrances are either manned or locked and alarmed.
- 2.2 All exterior doors are locked, alarmed and subject to visual surveillance.
- 2.3 Access to and within the data centre is restricted by a cardkey security system that provides on-line monitoring of physical access and intrusion. Procedures exist for security guards to monitor accesses and intrusions.
- 2.4 All authorised personnel are required to wear colour-coded badges that identify the individual and specify the areas to which access is allowed within the data centre.
- 2.5 Visitors must be signed in/out by an authorised individual and escorted whilst on the premises.

Internal Control Objective

Logical access is restricted to prevent inadvertent or unauthorised access to systems software, application programs and data.

Control Procedures

- 3.1 Procedures exist to ensure all accesses are authorised.
- 3.2 All authorised personnel are issued unique user identification codes and are responsible for maintaining the corresponding passwords.
- 3.3 Access control software is implemented to restrict access and report violations of logical security.
- 3.4 Access violation reports are reviewed on a timely basis and followed-up.
- 3.5 Network transmissions originate from pre-determined terminal locations. Dial-up access is restricted.
- 3.6 Utilities identified as having special capabilities are restricted in their use and usage is monitored and justified.

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Internal Control Objective

Systems software changes and enhancements are subject to authorisation and testing to maintain the integrity of the system software environment.

Control Procedures

- 4.1 Responsibilities for the support and maintenance of system software are documented.
- 4.2 Changes and enhancements to system software components are scheduled.
- 4.3 All changes and enhancements to system software are authorised by the manager responsible for system software.
- 4.4 Testing of system software changes and enhancements are subject to pre-determined test criteria. Achievement of the criteria is required prior to implementation in the production environment.
- 4.5 Documentation for system software, including all changes and enhancements, exists in libraries organised by the software support function.

Internal Control Objective

An environmentally controlled facility exists to ensure continuity of data processing operations.

Control Procedures

- 5.1 The data centre building is constructed on non-combustible materials.
- 5.2 The data centre is protected with fire, water and heat detection systems that are tested periodically. Fire suppression systems exist and are tested on a regular basis.
- 5.3 The data centre has an uninterruptible power supply (UPS) to prevent deviations in power supply to computer equipment and support facilities.
- 5.4 Preventive maintenance is carried out on a regular basis on the detection, air conditioning and fire suppression systems.

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Internal Control Objective

Back-up procedures are adequate to ensure the continuity of processing in the event of a disaster.

Control Procedures

- 6.1 A disaster recovery plan, designed to provide reasonable assurance that processing can be maintained, exists, is documented and maintained.
- 6.2 An off-site facility has been contracted for in order to execute the disaster recovery plan.
- 6.3 System software is backed up on a weekly basis and stored off-site. Application programs and data are backed up daily and stored off-site. Documentation is backed up monthly and stored off-site.
- 6.4 On-site back-ups exist to facilitate the resumption of processing operations in the event of minor interruptions in processing.
- 6.5 The disaster recover plan is tested at least once on an annual basis.

Internal Control Objective

Problems relating to data centre operations, including the communications network, are identified and resolved on a timely basis.

Control Procedures

- 7.1 Schedules establishing the operations of the data centre are pre-determined and authorised.
- 7.2 All special requests of the operations support function must be documented and authorised.
- 7.3 Performance of the data centre operations, including the communications network, is monitored on a regular basis.
- 7.4 Problems identified with computer operations are logged and the status is monitored to resolution.
- 7.5 Operations support prepares a weekly report describing major incidents and summarising system performance as compared to established performance criteria. The report is reviewed by data centre management.

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APPENDIX 7

EXAMPLE OF AN UNQUALIFIED ATTEST AUDIT REPORT

INDEPENDENT AUDIT REPORT

To The Board of Directors XYZ Outsourcing Entity

Scope

We have audited XYZ’s outsourcing entity internal controls in relation to [subject matter] for the period ended [date] in order to express an opinion about their effectiveness based on the accompanying description of the internal control objectives and control procedures of [subject matter]. The members of the governing body are responsible for maintaining an effective internal control structure including controls in relation to [subject matter]. Management’s assertion about the effectiveness of the internal controls in relation to [subject matter] is included in the accompanying report [title of report, eg. “Description of Control Objectives and Control Procedures relating to subject matter”]. We have conducted an independent audit of the internal controls identified in that report.

Our audit has been conducted in accordance with AUS 404 “Audit Implications Relating to Entities Using Service Entities” and other Australian Auditing Standards applicable to performance audits and accordingly included such tests and procedures as we considered necessary in the circumstances. These procedures have been undertaken to form an opinion whether in all material respects, the internal control procedures outlined in the accompanying description of the internal control objectives and control procedures in relation to [subject matter] were adequately designed and operated effectively based on the criteria referred to above.

Inherent Limitations

Because of inherent limitations in any internal control structure, fraud, error, or non-compliance with laws and regulations may occur and not be detected. Also projections of any evaluation of the internal controls to future periods are subject to the risk that the internal controls may become inadequate because of changes in conditions, or that the degree of compliance with the control procedures may deteriorate.

The audit opinion expressed in this report has been formed on the above basis.

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Audit Opinion*

In our opinion, XYZ Outsourcing Entity maintained, in all material respects, the control procedures identified in the accompanying description, which were suitably designed to provide reasonable, but not absolute, assurance that the internal control objectives were achieved and the control procedures operated effectively and continuously from January 1, 19X1 to December 31, 19X1 for [subject matter] based on the criteria referred to above.

Date	Firm
Address	Partner

A further section containing management’s assertions in the report by outsourcing entity management on its internal controls and an accompanying a description of the internal control objectives and internal control procedures of the [subject matter] should be attached to the audit opinion.

In addition, other separate paragraphs highlighting matters that maybe of use to users may be included.

*If the terms of the engagement requires that the auditors opinion be expressed in terms of management’s assertions, the opinion could be expressed in the following form:

“In our opinion, the assertion by the governing body that XYZ Outsourcing Entity has/has not maintained, in all material respects, the control procedures included in the accompanying description which were suitably designed to provide reasonable but not absolute assurance that the internal control objectives were achieved and the control procedures operated effectively in relation to the [subject matter] for the period ended.... based on the criteria referred to above, is fairly stated.”

(This would require consequent changes to the scope section).

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APPENDIX 8

EXAMPLE OF AN UNQUALIFIED DIRECT AUDIT REPORT

INDEPENDENT AUDIT REPORT

To The Board of Directors XYZ Outsourcing Entity

Scope

We have audited XYZ’s outsourcing entity internal controls in relation to [subject matter] for the period ended [date] in order to express an opinion about their effectiveness based on the accompanying description of the internal control objectives and control procedures of [subject matter]. The members of the governing body are responsible for maintaining an effective internal control structure including controls in relation to [subject matter].

Our audit has been conducted in accordance with AUS 404 “Audit Implications Relating to Entities Using Service Entities” and other Australian Auditing Standards applicable to performance audits and accordingly included such tests and procedures as we considered necessary in the circumstances. These procedures have been undertaken to form an opinion whether in all material respects, the internal controls in relation to [subject matter] were adequately designed and operated effectively based on the criteria referred to above.

Inherent Limitations

Because of inherent limitations in any internal control structure, fraud, error, or non-compliance with laws and regulations may occur and not be detected. Also, projections of any evaluation of the internal controls to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the control procedures may deteriorate.

The audit opinion expressed in this report has been formed on the above basis.

Audit Opinion

In our opinion, XYZ outsourcing entity maintained in all material respects the control procedures included in the accompanying description, which were suitably designed to provide reasonable, but not absolute, assurance that the internal control objectives were achieved and the control procedures operated

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effectively and continuously from January 1, 19X1 to December 31 19X1 for [subject matter] based on the criteria referred to above.

Date	Firm
Address	Partner

A further section containing a description of the internal control objectives and internal control procedures of [subject matter] should be attached to the audit opinion.

In addition, other separate paragraphs highlighting matters that may be of use to users may be included.