

EXPOSURE DRAFT

ED 16/05
(October 2005)

**Proposed Auditing Standard:
Audit Considerations
Relating to Entities Using
Service Organisations
(Re-issuance of AUS 404)**

Prepared and Issued by the **Auditing and Assurance Standards Board**



Australian Government

Auditing and Assurance Standards Board

Commenting on this Exposure Draft

Comments on this Exposure Draft should be forwarded so as to arrive by 15 December 2005. Comments should be addressed to:

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A copy of all non-confidential submissions will be placed on public record on the AUASB website: www.auasb.gov.au.

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PREFACE

Reasons for Issuing ED 16/05

The Auditing and Assurance Standards Board (AUASB) is proposing to re-issue Auditing Standard (AUS 404) *Audit Considerations Relating to Entities Using Service Organisations* due to the requirements of the legislative provisions explained below.

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (the CLERP 9 Act) established the AUASB as an independent statutory body under section 227A of the *Australian Securities and Investments Commission Act 2001*, as from 1 July 2004. Under section 336 of the *Corporations Act 2001*, the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards will be legislative instruments under the *Legislative Instruments Act 2003*.

Main Proposals

This proposed Auditing Standard provides mandatory requirements and explanatory guidance to an auditor where the entity uses a service organisation relevant to the audit.

Proposed Operative Date

It is intended that this proposed Auditing Standard will be operative for financial reporting periods commencing on or after 1 July 2006.

Main changes from existing AUS 404 (July 2002)

The main differences between this proposed Auditing Standard and the Auditing Standard issued by the former Auditing & Assurance Standards Board of the AARF that it supersedes, AUS 404 (July 2002), is that in this proposed Auditing Standard:

1. the word 'shall', in the **bold-type** paragraphs, is the terminology used to describe an auditor's mandatory requirements, whereas an auditor's degree of responsibility was previously described by the word 'should';
2. the explanatory paragraphs provide guidance and illustrative examples to assist the auditor in fulfilling the mandatory requirements, previously some obligations were implied within certain explanatory paragraphs. Accordingly, such paragraphs have been redrafted to clarify that the matter forms part of the explanatory guidance;
3. the following additional mandatory requirements (and related explanatory guidance) are included:
 - (a) in obtaining an understanding of the entity and its environment, the auditor shall determine the significance of service organisation activities to the entity and the relevance to the audit (paragraph 9);
 - (b) if the auditor concludes that the activities of the service organisation are significant to the entity and relevant to the audit, the auditor shall obtain a sufficient understanding of the entity and its environment, including its internal control, to identify and assess the risks of material misstatement and design further audit procedures in response to the assessed risk (paragraph 13);
 - (c) if the auditor uses the report of a service organisation auditor, the auditor shall consider the professional competence of that auditor in the context of the specific assignment undertaken by the service organisation auditor (paragraph 17);
 - (d) when using a service organisation auditor's report, the auditor shall consider the nature of and content of that report (paragraph 19); and

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- (e) when the auditor uses a report from the auditor of a service organisation, no reference shall be made in the entity's auditor's report to the auditor's report on the service organisation (paragraph 27).
4. the following basic principles and essential procedures, previously included in AUS 404, have been included in or superseded by other mandatory requirements contained within this proposed Auditing Standard or other proposed Auditing Standards:
- (a) in accordance with AUS 402, the user auditor should obtain audit evidence through the performance of tests of controls to support any assessment of control risk which is less than high (paragraph 21 in AUS 402);
 - (b) the user auditor should obtain sufficient appropriate audit evidence regarding the adequacy and appropriateness of the financial information obtained from the service entity (paragraph 25 in AUS 402); and
 - (c) when using the work of the service entity auditor, the user auditor should refer to AUS 602 "Using the Work of Another Auditor" (paragraph 30 in AUS 402); and
5. the terminology and overall concepts have been aligned to the Audit Risk Standards.

A Table of Proposed Changes is provided as an attachment to this Exposure Draft.

Request for Comments

Comments are invited on this Exposure Draft of the proposed re-issuance of Auditing Standard (AUS 404) *Audit Considerations Relating to Entities Using Service Organisations* by 15 December 2005. The AUASB would prefer that respondents express a clear overall opinion on whether the proposed Auditing Standard, as a whole, is supported and that this opinion be supplemented by detailed comments, whether supportive or critical, on any matter. The AUASB regards both critical and supportive comments as essential to a balanced review of the proposed Auditing Standard.

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AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) makes Auditing Standard << >> *Audit Considerations Relating to Entities Using Service Organisations* as set out in paragraphs 1 to 28, pursuant to section 227B of the *Australian Securities and Investment Commission Act 2001* and section 336 of the *Corporations Act 2001*.

This Auditing Standard is to be read in conjunction with the *Preamble to AUASB Standards*, which sets out the AUASB's intentions on how the Auditing Standards are to be understood, interpreted and applied.

The mandatory requirements of this Auditing Standard are set out in **bold-type** paragraphs.

AUDITING STANDARD

Audit Considerations Relating to Entities Using Service Organisations

Application

- 1 **This Auditing Standard applies to:**
 - (a) **an audit of a financial report for a financial year, or an audit of a financial report for a half-year, in accordance with Part 2M.3 of the *Corporations Act 2001*; and**
 - (b) **an audit of a financial report for any other purpose.**
- 2 This Auditing Standard also applies, as appropriate, to an audit of other financial information.

Operative Date

- 3 **This Auditing Standard is operative for financial reporting periods commencing on or after 1 July 2006.**

Introduction

- 4 The purpose of this Auditing Standard is to establish mandatory requirements and to provide explanatory guidance to an auditor where the entity uses a service organisation. This Auditing Standard also describes the service organisation auditor's reports which may be obtained by the entity's auditors.
- 5 **The auditor shall consider how an entity's use of a service organisation affects the entity's internal control so as to identify and assess the risk of material misstatement and to design and perform further audit procedures.**
- 6 An entity may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data (for example, a computer systems service organisation). If the entity uses a service organisation, certain policies, procedures and records maintained by the service organisation may be relevant to the audit of the financial report of the entity.

Considerations of the Auditor

- 7 A service organisation may establish and execute policies and procedures that affect the entity's internal control. These policies and procedures are physically and operationally separate from the entity. When the services provided by the service organisation are limited to recording and processing the entity's transactions and the entity retains authorisation and maintenance of accountability, the entity may be able to implement effective policies and procedures within its organisation. When the service organisation executes the entity's transactions and maintains accountability, the entity may deem it necessary to rely on policies and procedures at the service organisation.
- 8 An auditor appointed to provide an opinion on an entity's financial report may also have additional statutory or regulatory responsibilities, which may be affected by the entity's use of a service organisation. For example, sections 307(c) and 307(d) of the *Corporations Act 2001* require the auditor to form an opinion on whether the entity has kept proper financial records, and other records and registers as required by that Act.
- 9 **In obtaining an understanding of the entity and its environment, the auditor shall determine the significance of service organisation activities to the entity and the relevance to the audit.**
- 10 In doing so, the auditor ordinarily obtains an understanding of the following, as appropriate:
- Nature of the services provided by the service organisation.
 - Terms of contract and relationship between the entity and the service organisation.
 - Extent to which the entity's internal control interacts with the systems at the service organisation.
 - The entity's internal control relevant to the service organisation activities such as:
 - (i) Those that are applied to the transactions processed by the service organisation.
 - (ii) How the entity identifies and manages risks related to use of the service organisation.

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- Service organisation’s capability and financial strength, including the possible effect of the failure of the service organisation on the entity.
 - Information about the service organisation such as that reflected in user and technical manuals.
 - Information available on controls relevant to the service organisation’s information systems such as general ITcontrols and application controls.
- 11 The auditor would ordinarily consider the existence of third-party reports from service organisation auditors, internal auditors, or regulatory agencies as a means of obtaining information about the internal control of the service organisation and about its operation and effectiveness. When the auditor intends to use work of the internal auditor, AUS 604, “Considering the Work of Internal Auditing”, provides mandatory requirements and explanatory guidance on evaluating the adequacy of the internal auditor’s work for the auditor’s purposes. Similarly, AUS 602, “Using the Work of Another Auditor”, provides mandatory requirements and explanatory guidance when an auditor uses the work of another auditor.
- 12 The understanding obtained may lead the auditor to decide that the control risk assessment of the risk of material misstatement will not be affected by controls at the service organisation; if so, further consideration of this Auditing Standard is unnecessary.
- 13 **If the auditor concludes that the activities of the service organisation are significant to the entity and relevant to the audit, the auditor shall obtain a sufficient understanding of the entity and its environment, including its internal control, to identify and assess the risks of material misstatement and design further audit procedures in response to the assessed risk.**
- 14 Pursuant to AUS 402, the auditor is required to assess the risk of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances and disclosures.
- 15 If the understanding of the entity and its environment obtained is insufficient to identify and assess risks and design further audit procedures, the auditor ordinarily considers the need to request the service organisation to have its auditor perform such risk assessment procedures to supply the necessary information, or the need to visit the service organisation to obtain the information. An auditor

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wishing to visit a service organisation may advise the entity to request the service organisation to give the auditor access to the necessary information.

- 16 The auditor may be able to obtain a sufficient understanding of internal control affected by the service organisation by reading the third-party report of the service organisation auditor. In addition, when assessing the risks of material misstatement, for assertions affected by the service organisation's internal controls, the auditor may also use the service organisation auditor's report.
- 17 **If the auditor uses the report of a service organisation auditor, the auditor shall consider the professional competence of that auditor in the context of the specific assignment undertaken by the service organisation auditor.**
- 18 Pursuant to AUS 406, the auditor is required to obtain audit evidence about the operating effectiveness of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of the service organisation's controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level. The auditor may also conclude that it would be efficient to obtain audit evidence from tests of controls. Audit evidence about the operating effectiveness of controls may be obtained by the following:
- Performing tests of the entity's controls over activities of the service organisation.
 - Obtaining a service organisation auditor's report that expresses an opinion as to the operating effectiveness of the service organisation's internal control for the service organisation activities relevant to the audit.
 - Visiting the service organisation and performing tests of controls.

Service Organisation Auditor's Reports

- 19 **When using a service organisation auditor's report, the auditor shall consider the nature of and content of that report.**
- 20 The report of the service organisation auditor will ordinarily be one of two types as follows:

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

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

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

- (a) A description of the service organisation's internal control, ordinarily prepared by the management of the service organisation; and
- (b) An opinion by the service organisation auditor that:
 - (i) The above description is accurate;
 - (ii) The internal controls are suitably designed to achieve their stated objectives;
 - (iii) The internal controls have been implemented; and
 - (iv) The internal controls are operating effectively based on the results from the tests of controls. In addition to the opinion on operating effectiveness, the service organisation auditor would ordinarily identify the tests of controls performed and related results.

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

- 21 The auditor shall consider the scope of work performed by the service organisation auditor and shall evaluate the usefulness and appropriateness of reports issued by the service organisation auditor.**

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- 22 While Type A reports may be useful to the auditor in obtaining an understanding of the internal control, however, pursuant to paragraph 21 of this Auditing Standard, the auditor is required to disregard such reports as audit evidence about the operating effectiveness of controls.
- 23 In contrast, Type B reports may provide such audit evidence since tests of control have been performed. When a Type B report is to be used as audit evidence about operating effectiveness of controls, pursuant to paragraph 21 of this Auditing Standard, the auditor is required to consider whether the controls tested by the service organisation auditor are relevant to the entity's transactions, account balances, and disclosures, and related assertions, and whether the service organisation auditor's tests of control and the results are adequate (for example, the auditor considers the length of the period covered by the service organisation auditor's tests and the time since the performance of those tests).
- 24 For those specific tests of control and results that are relevant, the auditor shall consider whether the nature, timing and extent of such tests provide sufficient appropriate audit evidence about the operating effectiveness of the internal control to support the auditor's assessed risks of material misstatement.**
- 25 In circumstances where the auditor concludes that the work of the service organisation auditor cannot be used, and the auditor has been unable to obtain sufficient appropriate audit evidence about the operating effectiveness of the internal control to support the auditor's assessed risks of material misstatement, the auditor may conclude that a limitation on the scope of the auditor's work exists. AUS 701, "Modifications to the Independent Auditor's Report", provides mandatory requirements and explanatory guidance in relation to circumstances where a limitation on the scope of the auditor's work exists.
- 26 The auditor of a service organisation may be engaged to perform substantive procedures that are of use to the entity's auditor. Such engagements may involve the performance of procedures agreed upon by the entity and its auditor and by the service organisation and its auditor.
- 27 When the auditor uses a report from the auditor of a service organisation, no reference shall be made in the entity's auditor's report to the auditor's report on the service organisation.**

Conformity with International Standards on Auditing

28 Except as noted below, this Auditing Standard conforms with International Standard on Auditing ISA 402, “Audit Considerations Relating to Entities Using Service Organisations”, issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants. The differences between this Auditing Standard and ISA 402 are:

- This Auditing Standard contains a mandatory requirement for the auditor to consider the professional competence of the service organisation auditor, where the auditor uses the report of that auditor, in the context of the specific assignment undertaken by the service organisation auditor. Where the auditor uses the report of a service organisation auditor, ISA 402 requires the auditor to consider making inquiries concerning the auditor’s professional competence in the context of the specific assignment undertaken by the service organisation auditor (paragraph 17); and
- This Auditing Standard contains explanatory guidance relating to circumstances where the auditor concludes that the work of the service organisation cannot be used, and the auditor has been unable to obtain sufficient appropriate audit evidence about the operating effectiveness of the internal control to support the auditor’s assessed risks of material misstatement, whereas, ISA 402 does not (paragraph 25).

Compliance with this Auditing Standard enables compliance with ISA 402.

Table of Proposed Changes from AUS 404 *Audit Considerations Relating to Entities Using Service Organisation*

Base Standard

ISA 402, “Audit Considerations Relating to Entities Using Service Organisations”, was used as the base standard when drafting this proposed Auditing Standard.

Main differences between the Base Standard and the existing AUS 404

The main differences between ISA 402 and the existing AUS 404 are:

1. ISA 210 contains the following mandatory requirements, whereas the existing AUS 204 does not:
 - a. in obtaining an understanding of the entity and its environment, the auditor shall determine the significance of service organisation activities to the entity and the relevance to the audit (paragraph 9);
 - b. if the auditor concludes that the activities of the service organisation are significant to the entity and relevant to the audit, the auditor shall obtain a sufficient understanding of the entity and its environment, including its internal control, to identify and assess the risks of material misstatement and design further audit procedures in response to the assessed risk (paragraph 13);
 - c. if the auditor uses the report of a service organisation auditor, the auditor shall consider making inquiries concerning the auditor’s professional competence in the context of the specific assignment undertaken by the service organisation auditor (paragraph 17)¹;
 - d. when using a service organisation auditor’s report, the auditor shall consider the nature of and content of that report (paragraph 19); and
 - e. when the auditor uses a report from the auditor of a service organisation, no reference shall be made in the entity’s auditor’s report to the auditor’s report on the service organisation (paragraph 27).
2. certain mandatory requirements, previously included in AUS 404, are not specifically contained in ISA 402, although are typically included in or superseded by other mandatory requirements contained within ISA 402 or other proposed Auditing Standards:
 - a. in accordance with AUS 402, the user auditor should obtain audit evidence through the performance of tests of controls to support any assessment of control risk which is less than high (paragraph 21 in AUS 402);
 - b. the user auditor should obtain sufficient appropriate audit evidence regarding the adequacy and appropriateness of the financial information obtained from the service entity (paragraph 25 in AUS 402); and
 - c. when using the work of the service entity auditor, the user auditor should refer to AUS 602 “Using the Work of Another Auditor” (paragraph 30 in AUS 402).
3. the terminology and overall concepts have been aligned to the Audit Risk Standards.

¹ Refer also to the proposed change to this mandatory requirement outlined in the table below.

Table of proposed changes from the Base Standard

The table below details the proposed changes from the base standard, ISA 402 (excluding changes to reflect Australian terminology and references to Australian Auditing Standards).

Paragraph No. in Proposed Exposure Draft	Status (Requirement, Guidance, Footnote or Appendix)	Description of Proposed Change(s)
1, 2	Requirement / Guidance	New Application paragraph.
3	Requirement	Insert Operative Date paragraph.
5, 9, 13, 17, 19, 21, 24, 27	Requirement	Replace “should” with “shall”.
10, 11, 15,	Guidance	Insert “ordinarily” to clarify implied obligations.
14, 18, 22, 23	Guidance	Insert “pursuant to...the auditor is required to...” to clarify implied obligations.
8	Guidance	Insert reference to section 307(c) and (d) relating to forming an opinion on whether the entity has kept proper financial records, and other records and registers as required by the Corporations Act 2001. A similar paragraph is contained in the existing AUS 404.
11	Guidance	Insert reference to AUS 602, “Using the Work of Another Auditor.”
17	Requirement	Re-word: “if the auditor uses the report of a service organisation auditor, the auditor shall consider making inquiries concerning that auditor’s professional competence in the context of the specific assignment undertaken by the service organisation” As: “if the auditor uses the report of a service organisation auditor, the auditor shall consider the professional competence of that auditor making inquiries concerning that auditor’s professional competence in the context of the specific assignment undertaken by the service organisation auditor”.

Paragraph No. in Proposed Exposure Draft	Status (Requirement, Guidance, Footnote or Appendix)	Description of Proposed Change(s)
25	Guidance	Insert explanatory guidance relating to circumstances where the auditor concludes that the work of the service organisation cannot be used, and the auditor has been unable to obtain sufficient appropriate audit evidence about the operating effectiveness of the internal control to support the auditor's assessed risks of material misstatement.