



Organización Internacional de Comisiones de Valores
International Organisation of Securities Commissions
Organisation internationale des commissions de valeurs
Organizaçào Internacional das Comissões de Valore

August 11, 2008

Mr. James M. Sylph
Executive Director, Professional Standards
International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
New York, NY 10017

Email Edcomments@ifac.org

Re: Proposed Revised and Redrafted International Standard on Auditing ISA 402, Audit Considerations Relating to an Entity Using a Third Party Service Organization (ISA 402)

Dear Mr. Sylph:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (SC 1) appreciates the opportunity to comment on the Exposure Draft of proposed ISA 402 and certain closely-related portions of ISAE 3402. As an international organization of securities regulators representing the public interest, IOSCO is committed to enhancing the integrity of international markets through promotion of high quality accounting, auditing, and professional standards.

Members of SC 1 seek to further IOSCO's mission through thoughtful consideration of accounting, auditing and disclosure concerns and pursuit of improved global financial reporting. As we review proposed auditing standards, our concerns focus on whether the standards are sufficient in scope and adequately cover all relevant aspects of the area of audit being addressed, whether the standards are clear and understandable, and whether the standards are written in such a way as to be enforceable. Our comments in this letter reflect those matters on which we have achieved a consensus among the members of SC 1; however, they are not intended to include all comments that might be provided by individual members on behalf of their respective jurisdictions.

We welcome the Board's effort to revise and redraft ISA 402 and to provide a context for this ISA through the creation of ISAE 3402 to specify requirements and guidance for auditors of service organizations. Outsourcing of both financial and operational functions has grown to be quite prevalent in the global marketplace, and additional auditing challenges exist for both user auditors and service auditors when significant portions of an audited entity's financial functions are performed by others.

We believe that ISA 402 and ISAE 3402 have the potential to enhance the consistency of auditor performance in an audit of financial statements, but we have a number of concerns regarding matters where we believe further coverage is needed. We believe there is a need to clarify some of the requirements and provide additional guidance, particularly in regard to how user auditors should assess and respond to the risks of material misstatement, including the use of substantive procedures in addition to relying on a service auditor's report. We outline our questions and concerns in the letter that follows. In the attached appendix A, we also provide a

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response to the IAASB's request for specific comments, and provide additional detail concerning some clarifications we believe are needed.

We also reviewed proposed ISAE 3402, *Assurance Reports on Controls at a Third Party Service Organization*, to understand the impact that it could have on user auditors. As a result of this review, we identified a few suggestions related to proposed ISAE 3402 that generally complement comments we have on ISA 402. These suggestions are included in the Appendix of our letter.

Scope of this ISA

We agree that the overall scope is appropriate and recommend that additional content be added regarding the aspect of designing and performing further audit procedures in response to assessed risk.

However, the proposed ISA contains conflicting information and guidance as to when a service organization's services are part of an entity's information system relevant to financial reporting. For example, paragraph 5 indicates that the ISA "does not apply to services provided by an organization, such as a financial institution, *that are limited to processing an entity's transactions that are specifically authorized by the entity*, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker" (emphasis added). This suggests that any third-party organization that processes transactions specifically authorized by the entity would not be within the scope of the ISA, unless the third-party organization also performed other services for the entity. However, the Appendix indicates that transfer agents, who "process purchases, sales and other shareholder activity for investment companies" are service organizations.

We believe paragraph 5 should be modified to avoid the implication that ISA 402 does not apply to any service organization that processes transactions that are specifically authorized by an entity. Additionally, we suggest the Board review the guidance throughout the ISA, with particular focus on paragraphs 3, 5, and the Appendix, to ensure it provides clear guidance on when a service organization's services are part of an entity's information system relevant to financial reporting.

The objective

The objective adequately emphasizes that the auditor has to obtain an understanding of how the user entity uses a service organization; however, this objective does not provide sufficient coverage of the obligation for the user auditor to obtain sufficient appropriate audit evidence to ensure they have responded appropriately to the risks of material misstatement arising from the user entity's use of service organizations. This is an important objective and, nonetheless, the requirements contained in ISA 402 seem to address this additional obligation. Accordingly, to align the objective in ISA 402 with the outcome that will be achieved by applying its requirements, we recommend that the objective be modified as follows:

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

- (a) Obtain an understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's internal control relevant to the audit sufficient to identify, assess, and respond to the risks of material misstatement; and**
- (b) Obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.**

Emphasis of the requirements

Our impression from ISA 402 is that there is an undue emphasis on how the auditor should use an assurance report from a service auditor and insufficient emphasis on the user auditor's own work in assessing risk and performing substantive procedures in response to assessed risk. We also note that the user auditor may not need to obtain an assurance report from a service auditor in some audit engagements, for example, if a user entity's controls and procedures adequately address the risk of material misstatement.

We therefore believe there needs to be more obvious emphasis in ISA 402 on how the auditor should assess and respond to the risks of material misstatement. Whether the auditor would request a service auditor's report from the third party service organization would depend on the auditor's assessment of the risks of material misstatement and the nature of other audit evidence that the user auditor is able to obtain through the testing of internal controls or other substantive audit evidence. It would not always be necessary for understanding an entity and assessing the risks of material misstatement that the auditor should obtain evidence in some way directly from the service organization (e.g. via a service auditor's report).

Additionally, we are concerned that the requirements in paragraph 11 on obtaining an understanding of the services provided by a service organization also seem to reflect the work that would be done in response to the assessed risks of material misstatement. Therefore, we suggest the last sentence of paragraph 11 be modified as follows:

If the user auditor is unable to obtain that understanding from information on the service organization available at the user entity, the user auditor shall obtain audit evidence **necessary to obtain that understanding** from one or more of the following procedures:

We believe this wording will clarify that the procedures in paragraph 11 are intended to be performed for the purposes of obtaining a sufficient understanding of the user entity's internal control relevant to that audit.

Assurance reports on service entities

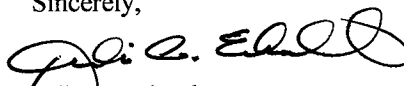
ISA 402 does not include a prominent and direct statement that, on its own, neither a Type A nor Type B report constitutes sufficient appropriate audit evidence for user auditors where the account balances or transactions covered by the reports have a material impact on the financial statements of the user entity. In addition, we believe the distinction between Type A and Type B control reports, and the evidence they provide, should be more prominent. Otherwise it is possible that auditors could inappropriately rely on a Type A report for assessing operating effectiveness.

We therefore suggest that both of these aspects be emphasized by including such statements in the introduction or application material.

In addition to the comments that we have provided above, Appendix A to this letter outlines our responses to the IAASB's request for specific comments on ISA 402 and provides additional matters for the Board's consideration.

We appreciate the Board's thoughtful consideration of the points raised in this letter. If you have any questions or need additional information about the comments that we have provided, please do not hesitate to contact me or Susan Koski-Grafer at 202-551-5300 or contact any member of the SC 1 Auditing Subcommittee.

Sincerely,



Julie A. Erhardt
Chair

IOSCO Standing Committee No. 1

Appendix A

ISA 402, Audit Considerations Relating to an Entity Using a Third Party Service Organization (ISA 402)

Question 1: Is the ISA capable of being adapted to situations where an entity uses a shared service center which provides services to a group of related entities?

We are aware of the growth in the use of shared service centers in large groups. Therefore we would welcome the use of this ISA to assist in audits where there are shared service centers.

However, the IAASB then also needs to review what further issues should be addressed and included in the ISA as we are not convinced that the contents of ISA 402 would be sufficient. As a suggestion, two additional issues that occur to us are:

- Identifying where audit work carried out on one group member might be used as assurance across the whole group; and
- The need to consider inter group entity control mechanisms

Further, we are not clear on whether the guidance is directed to group auditors, auditors of component entities within a consolidated group, or auditors of unconsolidated related entities. We suggest the IAASB clarify how the ISA may be “adapted in the circumstances” in these situations.

Similarly, paragraph 2 of ISAE 3402 indicates that the standard focuses on controls at a third party service organization relevant to financial reporting, but “it may also be applied, *adapted as necessary in the circumstances* of the engagement” (emphasis added) to other engagements. ISAE 3402 however does not provide application guidance on how the standard may be “adapted as necessary in the circumstances” for these engagements. We suggest the IAASB provide this guidance in ISAE 3402.

Question 2: Is the objective appropriate and are the proposed requirements appropriate responses to the objective?

Please see the covering letter for our comment on the objective.

For our comment on the emphasis of the requirements, please see the covering letter. We note below our comments on the content of the requirements and other comments we have about clarification of the application and other explanatory material and other aspects of ISA 402.

Content of the requirements

Paragraph 11 - We suggest the following amendments to clarify that the auditor would be obtaining an understanding of more than the role of internal controls. We suggest redrafting as per the bold text below.

“...a sufficient understanding of the **nature and significance of the services provided by the service organization and their effect on the** user entity’s internal control relevant to the audit...”

Paragraph 14 states that “if the user auditor plans to use a Type B report as audit evidence that controls at the service organization are operating effectively, the user auditor shall evaluate the *sufficiency* and appropriateness of the evidence provided about the effectiveness of controls for the relevant assertions” (emphasis added). It is unclear as to how the auditor can evaluate the sufficiency of the evidence provided when service auditor reports, including those prepared in accordance with proposed ISAE 3402, do not disclose the sample sizes used by the service auditor unless deviations are observed. It is unclear what information the user auditor could use to evaluate the sufficiency of evidence when sample sizes are not disclosed. It is also unclear how the auditor should evaluate the sufficiency of evidence in other circumstances. For example, proposed ISAE 3402 requires a service auditor to report sample sizes when deviations are observed, “even if, on the basis of tests performed, the service auditor has concluded that the related control objective has been achieved” (e.g., if compensating controls

have been identified or the control tested). We suggest aligning the reporting requirements of ISAE 3402 with the information that user auditors will need in order to evaluate the sufficiency of evidence provided by Type B reports and providing application guidance to clarify how the user auditor should perform the required evaluation.

Paragraph 15 - We note the reference to “shall be satisfied as to the service auditor's professional reputation, competence and independence” when determining the sufficiency and appropriateness of the audit evidence provided by a Type A or Type B report. We believe the phrase “be satisfied”, which is used to describe the user auditor's obligations, sets an imprecise obligation for the user auditor. We therefore believe the use of more direct language, such as ‘The auditor shall evaluate...’ would make the obligation clearer and enhance appropriate translation of the requirement.¹

Additionally, we noted that the requirement in paragraph 15 for the user auditor to be satisfied with the service auditor's “professional reputation, competence and independence” was similar but not entirely consistent with the requirement in paragraph 9 of ISA 620 that requires an auditor to evaluate an auditor's expert's “capabilities, competence, and objectivity.” We are unclear whether the Board intended for the evaluation of a service auditor's professional reputation to be equivalent to the evaluation of an auditor's expert's competence or whether the intention was for the auditor to consider different items when evaluating a service organization versus an auditor's expert. If the Board intended for the evaluation to be equivalent, we suggest the Board conform the language between the two ISAs. Alternatively, we suggest the Board provide additional guidance about how the evaluation of a service organization's professional reputation should be made and how that differs from evaluating an auditor's expert's competency.

Paragraph A19 provides guidance when a Type A report is as of a date outside the user entity's reporting period and specifically addresses situations when the report is as of a date that precedes the beginning of the period under audit. An auditor is responsible for understanding internal control for the period under audit and therefore we believe ISA 315 would require a user auditor to update their understanding of the design and implementation of controls any time the service auditor's report is as of a date that is different from the user entity's reporting period. Therefore, we suggest this paragraph be modified to clarify that the identified procedures are relevant whenever a difference exists between the user entity's reporting period and the “as of” date in the service auditors' report. In addition, since performance of additional procedures would be necessary in this circumstance, we suggest this guidance be elevated to a requirement.

Paragraph A24 indicates an auditor is unable to rely on tests performed by a service auditor when the testing period is completely outside the user entity's financial reporting period, “unless other procedures are performed.” We disagree with the notion that a user auditor would be able to perform “other procedures” that would enable reliance on tests performed by a service auditor during a period that is completely outside the user entity's financial reporting period. When there is no overlap between the period covered by the service auditor's tests and the user entity's financial reporting period, we believe a user auditor needs to perform other procedures, such as those in paragraph 11 (c) and (d), to test the controls of the service organization during the financial reporting period in order to conclude that the user entity's controls are operating effectively. Therefore, we suggest the Board establish a requirement that directs a user auditor to not rely on a Type B report covering a period completely outside the user entity's financial reporting period and to perform other procedures to conclude on the operating effectiveness of the user entity's controls during the financial reporting period in this circumstance.

Paragraph A29 states in part, “The service auditor may be practicing in a jurisdiction where different standards are followed in respect of reports on controls at a service organization. In such a situation, the user auditor may inquire about the adequacy of those standards.” We believe that in this situation, a user auditor should have an obligation to evaluate whether the standards used by the service auditor are adequate for the user auditor's purpose of placing reliance on the report of the service auditor. Providing guidance to a user auditor that suggests inquiring about the adequacy of the standards without placing an obligation on the user auditor to evaluate the adequacy of those standards diminishes the quality of the ISA because a user auditor may be able to justify reliance on a service auditor's report when the service auditor's services were conducted under an inappropriate

¹ The use of “shall evaluate” would be consistent with paragraph 9 of proposed ISA 620, which describes the auditor's obligations related to an auditor's expert.

set of attestation standards. Therefore, we suggest the Board add a requirement to paragraphs 13 and 14 that directs a user auditor to evaluate whether the standards used by a service auditor are adequate for the user auditor's purpose. We further suggest the Board add application guidance that provides auditors with factors to consider when performing this evaluation.

Application and Other Explanatory Material

Communication of Deficiencies in Internal Control Identified during the Audit

Paragraph A28 links this ISA with the requirement contained in proposed ISA 265 that the auditor communicates to management deficiencies in internal control identified during the audit. Proposed ISA 265 requires deficiencies, other than those considered to be "clearly trivial" to be communicated to management. However, ISA 402 requires all deficiencies to be communicated to management. Therefore, we suggest this paragraph be modified to require all deficiencies other than those deemed "clearly trivial" to be communicated to management in order to be consistent with proposed ISA 265. Further, we believe the three items that are identified as "matters that the user auditor *may wish* to communicate" (emphasis added) represent non-trivial deficiencies that would be communicated to management in all cases and those charged with governance, if significant, under ISA 265. Therefore, we suggest the Board clarify the language in paragraph A28 to indicate the listed items represent non-trivial matters the auditor would communicate to management in all cases and to those charged with governance, if significant.

Paragraph A33 of the application material covers the types of audit procedure which an auditor would use in responding to the risks of material misstatement (e.g. inspecting records; obtaining confirmations). However we note that the introduction in paragraph A33 states that the "following procedures *may be considered* by the user auditor" (emphasis added). We are concerned this language implies that all of the procedures listed were optional. We would suggest that the introduction for paragraph A33 could be reworded as follows:

"In determining the nature and extent of audit evidence..... **the auditor considers the following procedures...**"

Other aspects of ISA 402

References in ISA 315 & ISA 330

ISAs 315 and 330 contain little guidance on service organizations², and therefore, we believe the relationship between the risk assessment considerations applicable to service organizations and the separate standard on service organizations can be improved through an acknowledgement in ISA 315 and 330 that an entity's internal control relevant to financial reporting may include activities that occur outside of the entity and a cross-reference to ISA 402. ISA 402 should then contain all of the relevant requirements and guidance necessary for an auditor to address the audit implications of using a service organization. Accordingly, we suggest conforming amendments to ISAs 315 and 330 to direct the auditor to ISA 402 for service organization considerations.

Interaction of ISA 402 with ISA 620

ISA 402 paragraph 3(e) states that a service organization's services are part of an entity's information system relevant to financial reporting if they affect "the financial reporting process used to prepare the entity's financial statements, including *significant accounting estimates and disclosures*" (emphasis added).

Various firms provide actuarial, pricing, and other services to entities. We are unclear whether these firms are a third party service organization that would fall within the scope of proposed ISA 402 or whether it would be a "management's expert," which is addressed in proposed ISA 620's conforming amendments to ISA 500.

² Paragraph A57 of ISA 315 (Redrafted) identifies "The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations." as one of the factors relevant to the auditor's judgment about whether a control is relevant to the audit.

We are concerned that without additional guidance, parties intended to be management experts under ISA 500 may be considered service organizations under ISA 402. Therefore, we suggest the Board provide additional guidance to clarify when a third party organization is a service organization for which an auditor would apply ISA 402 or a management expert for which an auditor would apply ISA 500. We further suggest that ISA 500 then reference such guidance in ISA 402. We believe a differentiating factor to consider whether a third party entity is a service organization or a management expert is whether that entity processes or records transactions for the entity. We suggest the Board consider whether incorporating these concepts into the ISA 402 scope provides useful information to assist auditors in making the distinction between a service organization and a management expert.

Determining if a service organization is part of an entity's information system relevant to financial reporting

Proposed ISA 402 does not contain a requirement for an auditor to determine whether a service organization is part of an entity's information system relevant to financial reporting. Paragraphs 3 and 5 and the Appendix provide guidance and examples for determining when a service organization's services are part of an entity's information system relevant to financial reporting. The extent of this guidance is appropriate given the complexity and subjectivity associated with making this determination. Since the nature, timing, and extent of audit procedures to be performed varies greatly depending upon whether a service organization's services are relevant to an entity's information system, we believe the ISA should contain a requirement that the auditor, in connection with the risk assessment procedures performed under paragraph 18 of ISA 315 (Redrafted), determine whether the entity uses services provided by a third party organization that are part of the entity's information system relevant to financial reporting³.

Information systems relevant to financial reporting

Paragraph 3 of proposed ISA 402 describes when a service organization's services are part of an entity's information system relevant to financial reporting and the Appendix provides examples of service organizations which perform services that are part of an entity's information system relevant to financial reporting. Paragraph 5 describes services provided by organizations that are not within the scope of the ISA. We believe paragraphs 3 and 5 and the Appendix should be clarified to address the following:

Business processes – Paragraph 3 addresses when a service organization's services are part of an entity's information system, *including related business processes*, (emphasis added) relevant to financial reporting. This language is consistent with the language in paragraph 18 of ISA 315. We believe most people would conclude that "related business processes" is already captured by the definition of "information system relevant to financial reporting" contained in the ISA Glossary. Therefore, we question whether the Board intended to distinguish between information systems relevant to financial reporting that contain related businesses processes with those that do not. We suggest the Board clarify its intentions.

Definition - Control objectives

The term "control objectives" is used throughout the ISA (see paragraphs 8(a), 8(g)(i)-(ii), 8(h)(i)-(ii), and A18) but this term has not been previously defined in the ISAs. Paragraph 4(c) of ISA 315 (Redrafted) refers to "an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations" and paragraph 20 of ISA 315 describes "control activities relevant to the audit". We recommend the Board either define the term "control objectives" in the ISAs or use consistent terminology throughout all ISAs.

Other aspects of ISAE 3402

As described in the main body of our letter, we reviewed proposed ISAE 3402 to understand the impact that it could have on user auditors. As a result of this review, we also identified the following issues.

³ Paragraph 18 of ISA 315 (Redrafted) includes six areas where the "auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting."

Link with ISAs – We agree with the IAASB’s view that it is not appropriate to require all ISAs to be applied, adapted as necessary in the circumstances of the engagement, because to do so would not result in sufficient clarity as to which requirements of the ISAs should be applied or how they ought to be adapted. However, in reviewing ISAE 3402 for purposes of evaluating its impact on user auditors, we noted the following with respect to the requirements of ISAE 3402:

- ISAE 3402 includes many of the relevant ISA requirements, but does not appear to address all of the relevant requirements. For example, ISAE 3402 does not contain requirements and application guidance for the service auditor to consider fraud (ISA 240) and laws and regulations (ISA 250) or to determine the need for a service auditor’s expert (ISA 620).
- Certain of the ISA requirements included in ISAE 3402 have not been included in their entirety or are written differently, which suggests a different performance obligation exists for a user auditor and a service auditor. For example, paragraph 19 of ISAE 3402 provides direction to the service auditor in obtaining an understanding of the internal audit function. This requirement is similar to the requirement in paragraph 7 of ISA 610, but does not include the ISA 610 requirement for a service auditor to understand the organizational status of the internal audit function and the scope of the internal audit function’s responsibilities.
- ISAE 3402 does not always contain all of the related ISA application guidance when it includes an ISA requirement. For example, ISAE 3402 includes guidance related to attribute sampling in paragraphs 39 and A23-A24 that is similar to that included in ISA 530, but no guidance is provided in ISAE 3402 related to factors the service auditor may consider in determining sample sizes and selecting items for testing, which is addressed in paragraphs A9-A12 and Appendices 2 and 4 of ISA 530.

We therefore suggest the IAASB review each of the individual requirements of the ISAs and determine which should be adapted in the context of these engagements to ensure that all relevant ISA requirements are addressed in ISAE 3402. We also suggest the IAASB review the wording of the relevant ISA requirements and application guidance in ISAE 3402 to ensure consistency with the ISAs and inclusion of complete guidance.

Scope – Paragraph 1 of ISAE 3402 indicates that the standard deals with engagements undertaken by a “professional accountant” and paragraph 10 requires a service auditor to comply with ISAE 3000. However, paragraph 1 of ISAE 3000 indicates the purpose of that standard is to provide guidance to “professional accountants in public practice.” These two terms are not synonymous in the IFAC Code of Ethics for Professional Accountants. We believe engagements conducted under ISAE 3402 should be performed by professional accountants in public practice and therefore suggest paragraph 1 of ISAE 3402 be aligned with ISAE 3000 to indicate that the standard deals with assurance engagements undertaken by a “professional accountant in public practice.”

Definitions – Certain terms in the ISAs are used in ISAE 3402 that either have not been defined in ISAE 3402 or have been defined slightly differently (e.g. criteria, internal audit function, tests of controls, sampling risk, tolerable rate of deviation). Different definitions for the same terms may imply there is a different performance obligation and therefore, we suggest consistent definitions should be used within the ISAs and ISAE 3402 and that all terms defined within the ISAs that are used in ISAE 3402 should also be defined in ISAE 3402.

Paragraph 35 – When assessing whether controls are suitably designed, we believe that auditors should consider the competency and authority of the person performing the control. However, paragraph 35 of ISAE 3402, which describes procedures the service auditor should perform to assess the design of controls, does not require such an evaluation. In order to allow user auditors to maximize their potential reliance on Type A or Type B reports, we suggest ISAE 3402 be modified to require service auditors to consider these factors when assessing whether controls are suitably designed.

Appendix 1 and 2 – The example management assertions and service auditor’s assurance reports contained in Appendix 1 and 2 have numerous references to “existing” customers, which suggests the assertions and reports are only relevant when the report is provided to an existing customer of the service organization. We believe both former and prospective customers and/or their auditors may also desire to obtain and rely upon a service auditor’s report and therefore suggest the reference to “existing” customers be removed throughout the Appendices.