

## SA 402 "AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING SO"

### Scope of SA 402

- (i) Many entities outsource aspects of their business to organizations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity's entire business units or functions, such as the tax compliance function. however, not all those services are relevant to the audit.
- (ii) **Relevant to financial reporting** = Relevant to the audit
- (iii) A SO's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:-
  - The classes of transactions that are significant to FS.
  - The procedures by which the user entity's transactions are initiated, recorded, processed (bookkeeping)
  - The related accounting records that are used to report the transactions
  - How the user entity's information system captures events and conditions, that are significant to the financial statements (estimates)
  - The financial reporting process used to prepare the user entity's financial statements
  - Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

### Auditor's Objective

- To obtain an understanding of **nature and significance of service** provided by the SO and their effect on the user's entity internal control relevant to the audit, sufficient to identify and assess the risk of material misstatement (ROMM)
- To design and perform audit procedures responsive to those risks (Response)

### Meaning of terms used in SAs

**(a) User Entity**

An entity that uses a SO and whose financial statements are being audited.

**(b) User Auditor**

An Auditor who audits and reports on the financial statements of a user entity.

**(c) SO**

A third-party organisation that provides services to user entities that are part of those entities information systems relevant to financial reporting.

**(d) Service Auditor**

An Auditor who provides an assurance report on the controls of a SO. (SAE-3402 me padhenge)

### (Step-1) Obtaining understanding of services provided by SO

The user auditor shall obtain an understanding of how user entity uses the services of a SO in the user entity operation, including:

- Nature and significance of **service** provided by the SO

- Nature and materiality of the **transactions** processed or financial reporting processes affected by SOs.
- Nature of relationship between user entity and the SO including the relevant contractual terms for the activities undertaken by the SO.
- The degree of interaction between activities of SOs and those of the user entity.

**(Step-2) Obtaining an understanding of Internal control at User entity (related to SO)**

The user auditor shall evaluate the DIM of relevant controls of user entity that relate to the services provided by SO.

**(Step-3) Determine whether step1 & step2 provided sufficient understanding for assessment of ROMM**

The user auditor shall determine whether a sufficient understanding of nature and significance of services provided by SO and their effect on the user entity internal control relevant to the audit has been obtained, to provide basis for identification and assessment of risk of Material Misstatement. (Objective)

**(Step-4) Specific audit procedure to obtain sufficient understanding**

If user auditor is **unable** to obtain a sufficient understanding from the user entity, the auditor shall obtain that understanding from one or more of the following procedures:

- Obtaining a Type 1 or Type 2 Report, if available.
- Contacting the SO, through the user entity, to obtain the sufficient information.
- Using another auditor to perform procedures at the SO.
- Visiting the SO.

**Type 1 & Type 2 Reports**

**(a) Type I Report**

Report on the **description and design of internal controls at a SO**. This report comprises of:

- (1) A description prepared by management of the SO, of
  - ✓ The SO’s system,
  - ✓ Control objectives
  - ✓ Related controls
 that have been designed and implemented as at a **specified date**
- (2) A report by the service auditor with the objective of conveying reasonable assurance that includes
  - The service auditor’s opinion on the description of the SO’s system, control objectives and related controls.

**(b) Type II Report**

Report on the **description, design and operating effectiveness of controls at a SO**. This report comprises of:

- (3) A description prepared by management of the SO, of
  - ✓ The SO’s system,

- ✓ Control objectives
- ✓ Related controls and
- ✓ Operating effectiveness of the control

that have been designed and implemented as at a **specified date or throughout a specified period**

- (4) A report by the service auditor with the objective of conveying reasonable assurance that includes:
- The service auditor's opinion on the description of the SO's system, control objectives and related controls and the **operating effectiveness** of the control
  - A description of the service auditor's **tests of the controls** and the **results** thereof.

### Using Type 1 or Type 2 Report

- (i) In determining the sufficiency and appropriateness of the audit evidence provided by a Type 1 or Type 2 report, the user auditor shall be satisfied as to:
- The service auditor's professional competence (except where the service auditor is a member of the ICAI) and independence from the SO; and
  - The adequacy of the standards under which the Type 1 or Type 2 report was issued.
- (ii) If the user auditor plans to use a Type 1 or Type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the SO, the user auditor shall:
- Evaluate whether the description and design of controls at the SO is at a date or for a period that is appropriate for the user auditor's purposes;
  - Evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal control relevant to the audit; and
  - Determine whether complementary user entity controls identified by SO are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.
- (iii) Complementary user entity controls refer to controls that the SO assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of its system.

### Responding to Assessed Risk of Material Misstatement

Determine whether Sufficient Appropriate Audit Evidence w.r.t. F.S. assertions are available from records held at User Entity. If Not:

- Perform further audit procedures to obtain SAAE; (overall level, assertion level)
- Use another auditor to perform those procedures at SO.

### Tests of Controls

When the user auditor's risk assessment includes an expectation that controls at the SO are operating effectively, the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures:

- Obtaining a Type 2 report, if available; (savadhannn)

- Performing appropriate tests of controls at the SO; or
- Using another auditor to perform tests of controls at the SO on behalf of the user auditor.

#### **Using a Type 2 report as audit evidence that controls at the SO are operating effectively**

If, the user auditor plans to use a Type 2 report as audit evidence that controls at the SO are operating effectively, he shall determine whether the service auditor’s report provides SAAE about the effectiveness of the controls to support the user auditor’s risk assessment by:

- Evaluating whether the description, design and operating effectiveness of controls at the SO is at a date or for a period that is appropriate for the user auditor’s purposes;
- Determining whether complementary user entity controls identified by the SO are relevant to the user entity and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;
- Evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and
- Evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor’s report, are relevant to the assertions in the user entity’s F.S. and provide SAAE to support the user auditor’s risk assessment.

#### **Audit Procedures in case of Fraud or Non-Compliance**

- Inquire of User Entity Management whether the SO has reported instances of any Fraud, Non-compliance with Law and Regulations or Uncorrected Misstatement affecting F.S. of User Entity.
- Evaluate impact on Nature, timing and extent of further audit procedures, Including Auditor’s Conclusions and Audit report.

#### **Reporting by User Auditor**

- The User Auditor shall modify opinion if he is unable to obtain SAAE, regarding the services provided by SO, relevant to audit of User Entity F.S.

#### **Reference to Service auditor in user entity’s audit report (Rachit’s Special)**

- The User Auditor shall not refer to report of Service auditor unless required by Law and Regulation.
- If such reference is required by law or regulation, the user auditor’s report shall indicate that the reference does not diminish the user auditor’s responsibility for the audit opinion.
- If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion.

## SAE 3402 "ASSURANCE REPORTS ON CONTROLS AT A SO"

### Scope of SAE 3402

- SAE 3402 deals with assurance engagements undertaken by a professional accountant (CA/Auditor use nahi karne ka) in public practice to provide a **report on the controls at a SO** for use by user entities and their auditors.
- Reports prepared in accordance with this SAE are capable of providing appropriate evidence under SA 402.

### Meaning of Terms used in SAE

(a) Service Auditor

(b) SO (SO)

(c) User Auditor

(d) User Entity

(e) Type I Report

(f) Type II Report

(g) Controls at SO

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- Controls over the achievement of a control objective that is covered by the service auditor's assurance report.
- Such controls may include aspects of a SO's – control environment, monitoring and control activities related to the services provided.

### Importance of controls of a SO (SO) to user entity's internal controls relating to financial reporting

- Controls related to a SO operations and compliance objectives may be relevant to a user entity's internal control as it relates to financial reporting. Such controls may pertain to assertions about presentation and disclosure relating to account balances, classes of transactions, or disclosures, or may pertain to evidence that the user auditor evaluates or uses in applying auditing procedures.
- **Example:** A company has outsourced its payroll processing functions to a SO. SO is responsible for the accurate preparation of payrolls and timely remittance of statutory dues to government authorities on behalf of the company. Payroll processing SO controls related to the timely remittance of payroll deductions to government authorities may be relevant to the company (user entity) as late remittances could result in interest & penalties resulting in liabilities for the user entity.

### Objective

- **To obtain reasonable assurance** about whether, in all material respects, based on **suitable criteria:** (COBIT)
  - (1) SO description of its system **fairly presents** the system as designed and implemented throughout the specified period (or as at a specified date, in case of Type 1 report);
  - (2) Control Objectives stated in the SO description of its system were achieved throughout the specified period.

- (3) Controls related to the control objectives stated in SO description of its system were suitably designed throughout the specified period (or as at a specified date, in case of Type 1 report);
- **To report** on the matters stated above in accordance with the findings.

### **Compliance of Ethical Requirements**

Service auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to assurance engagements.

### **Determination Of Management and TCWG**

Service auditor shall determine the appropriate person(s) within the SO's management or governance structure with whom to interact.

### **Agreeing the terms of Engagement**

#### **(a) Acceptance and Continuance**

Before agreeing to accept or continue, an engagement service auditor shall determine whether:

- He has the capabilities and competence to perform the engagement;
- Criteria to be applied by SO to prepare the description of its system will be suitable and available to user entities and their auditors; and
- Scope of the engagement and the SO description of its system will not be so limited that they are unlikely to be useful to user entities and their auditors.

#### **(b) Changes in terms of engagement**

If the So requests a change in the scope of the engagement before the completion of the engagement, service auditor shall be satisfied that there is a reasonable justification for the change.

### **Assessing the suitability of Criteria**

Service auditor shall assess whether the SO has used suitable criteria in preparing the description of its system, in evaluating whether controls are suitably designed, and, in the case of a type 2 reports, in evaluating whether controls are operating effectively

**Definition of Criteria :** Benchmarks used to evaluate or measure a subject matter including, where relevant, benchmarks for presentation and disclosure.

### **Consideration of Materiality**

When planning and performing the engagement, the service auditor shall consider materiality with respect to the fair presentation of the description, the suitability of the design of controls and, in the case of a type 2 report, the operating effectiveness of controls.

### **Obtaining an Understanding**

Service auditor shall obtain an understanding of the SO System, including controls that are included in the scope of the engagement.

### **Collection of Evidences**

#### **(a) Regarding Description**

Service auditor shall obtain and read the SO's description of its system, and shall evaluate whether those aspects of the description included in the scope of the engagement are fairly presented.

**(b) Regarding Design of Controls**

Service auditor shall determine which of the controls at the SO are necessary to achieve the control objectives stated in the SO's description of its system, and shall assess whether those controls were suitably designed.

**(c) Regarding operating Effectiveness of Controls**

When providing a type 2 report, the service auditor shall test those controls that he has determined are necessary to achieve the control objectives stated in the SO's description of its system and assess the operating effectiveness throughout the period.

**(d) Evaluation of Internal Audit Function**

If SO has an internal audit function, the service auditor shall obtain an understanding of the nature of the responsibilities of the internal audit function and of the activities performed in order to determine whether the internal audit function is likely to be relevant to the engagement in order for the service auditor to use specific work of the internal auditors.

**(e) Obtaining Written Representation**

Service auditor shall request SO to provide written representations:

- That reaffirm the assertion accompanying the description of the system;
- That it has provided the service auditor with all relevant information and access agreed to; and
- That it has disclosed to the service auditor any of the following of which it is aware:
  - (1) Non-compliance with laws and regulations, fraud, or uncorrected deviations attributable to the SO that may affect one or more user entities;
  - (2) Design deficiencies in controls;
  - (3) Instances where controls have not operated as described; and
  - (4) Any events subsequent to the period covered by organization's description of its system up to the date of the service auditor's assurance report that could have a significant effect on the service auditor's assurance report.

**(f) Subsequent Events**

Service auditor shall inquire whether SO is aware of any events subsequent to the period covered by the SO description of its system up to the date of the service auditor's assurance report that could have a significant effect on the service auditor's assurance report.

**Documentation**

The service auditor shall prepare documentation that is sufficient to enable an experienced service auditor, having no previous connection with the engagement to understand:

- The NTE of the procedures performed to comply with this SAE and applicable legal and regulatory requirements;
- The results of the procedures performed, and the evidence obtained; and
- Significant matters arising during the engagement, and the conclusions reached thereon and significant professional judgments made in reaching those conclusions.

## Elements of Assurance Report

- A title that clearly indicates the report is an independent service auditor's assurance report.
- An addressee.
- Identification of:
  - (1) SO description of its system, and the SO's assertion.
  - (2) Those parts of the SO description of its system, if any, that are not covered by the service auditor's opinion.
  - (3) If the description refers to the need for complementary user entity controls, a statement that the service auditor has not evaluated the suitability of design or operating effectiveness of complementary user entity controls.
  - (4) If services are performed by a subSO, the nature of activities performed by the subSO as described in the SO description of its system.
- Identification of the criteria, and the party specifying the control objectives.
- A statement that the report is intended only for user entities and their auditors.
- A statement that the SO is responsible for:
  - (1) Preparing the description of its system, including the completeness, accuracy and method of presentation of that description;
  - (2) Providing the services covered by the SO description of its system;
  - (3) Stating the control objectives; and
  - (4) Designing and implementing controls to achieve the control objectives stated in the SO description of its system.
- A statement that the service auditor's responsibility is to express an opinion on the SO description, on the design of controls related to the control objectives stated in that description and, in the case of a type 2 report, on the operating effectiveness of those controls, based on the service auditor's procedures.
- A statement that the engagement was performed in accordance with SAE 3402.
- A summary of the service auditor's procedures to obtain reasonable assurance and a statement of the service auditor's belief that the evidence obtained is sufficient and appropriate to provide a basis for the service auditor's opinion, and, in the case of a type 1 report, a statement that the service auditor has not performed any procedures regarding the operating effectiveness of controls and therefore no opinion is expressed thereon.
- A Statement of the limitations of controls.
- The service auditor's opinion, expressed in the positive form, on whether, in all material respects, based on suitable criteria:
  - (1) In the case of a type 2 report:
    - (i) The description fairly presents the SO system that had been designed and implemented throughout the specified period;
    - (ii) The controls related to the control objectives stated in the SO description of its system were suitably designed throughout the specified period; and
    - (iii) The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the specified period.
  - (2) In the case of a type 1 report:

- (i) The description fairly presents the SO system that had been designed and implemented as at the specified date; and
  - (ii) The controls related to the control objectives stated in the SO description of its system were suitably designed as at the specified date.
- The date of the service auditor’s assurance report, which shall be no earlier than the date on which the service auditor has obtained sufficient appropriate evidence on which to base the opinion.
  - Practitioner’s Signature: Report should be signed by the practitioner.
  - Place of signature: Report should name specific location, which is ordinarily the city where the report is signed.

**Additional matters requiring reporting in type 2 report**

- In the case of a type 2 report, service auditor’s assurance report shall include a separate section after the opinion, or an attachment, that describes the tests of controls that were performed and the results of those tests.
- In describing the tests of controls, the service auditor shall clearly state which controls were tested, identify whether the items tested represent all or a selection of the items in the population, and indicate the nature of the tests in sufficient detail to enable user auditors to determine the effect of such tests on their risk assessments.
- If deviations have been identified, the service auditor shall include the extent of testing performed that led to identification of the deviations (including the sample size where sampling has been used), and the number and nature of the deviations noted.
- The service auditor shall report deviations even if, on the basis of tests performed, the service auditor has concluded that the related control objective was achieved.

<b>Modified Opinion</b>
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A modified opinion is required to be expressed if auditor concludes that:

- The SO description does not fairly present, in all material respects, the system as Designed and implemented;
- The controls related to the control objectives stated in the description were not suitably designed, in all material respects;
- In the case of a type 2 report, the controls tested, which were those necessary to reasonable assurance that the control objectives stated in the SO description of its system were achieved, did not operate effectively, in all material respects; or
- The service auditor is unable to obtain sufficient appropriate evidence, the service auditor’s opinion shall be modified, and the service auditor’s assurance report shall contain a clear description of all the reasons for the modification.