NAVIGATING AUDITS WITH SERVICE ORGANISATIONS **FROM RISK TO ASSERTION**

When your client outsources business functions such as payroll processing and cloud-based accounting to a service organisation, your responsibility as an auditor doesn't disappear. You must still obtain sufficient evidence to support your audit opinion. The key to a successful audit in this environment is a clear, linked path from your initial risk assessment to your final audit approach, with a constant focus on financial statement assertions.

START WITH RISK

What assertions are at stake?

Your first step is to understand how the service organisation's services affect the user entity's (your audit client) internal control system. You need to identify which significant classes of transactions, account balances or disclosures are being managed or affected by the service organisation.

For example, if the service organisation processes all payroll transactions, the assertions of occurrence (did the payroll actually take place?) and accuracy (were the amounts correct?) are directly affected. Your risk assessment must clearly document which assertions are impacted by the outsourced service to ensure your audit procedures are properly targeted.

EVALUATE INTERNAL CONTROLS

Where do they live?

Once you understand the risks, the controls must be evaluated for mitigation. These controls usually exist in three different 'locations':

- **At the user entity (your audit client)** – These are often complementary user entity controls – controls the service organisation expects your audit client to perform to achieve the overall control objectives.
- **At the service organisation** – These are controls designed and implemented by the service organisation to process your audit client's data securely and accurately, with no checking or controls at the audit client's site.
- **A hybrid approach** – Often, your audit client will use information provided by the service organisation to exercise their own controls.

DETERMINE YOUR AUDIT APPROACH

Your approach depends entirely on whether controls exist at your audit client's site, the service organisation, or both.

Scenario A: Controls at the entity

If there is a high degree of interaction, your audit client may have strong controls over the information sent to and received from the service organisation.

- **Example procedure** – If the service organisation processes payroll, the audit client might compare the data they submitted to the service organisation to reports received back after processing.
- **Audit action** – You can assess these client-side controls to see if they are operating effectively for the relevant assertions (such as accuracy).

Scenario B: Controls only at the service organisation

If the service organisation initiates and processes transactions with little interaction from your audit client, you may find that no effective controls exist at the user entity (your audit client) level. In such cases, you must look at the service organisation's controls.

- **Audit action** – To obtain evidence, you will typically need a report from the service organisation's auditor:
  - Type 1 report – Confirms the controls were described and designed properly by a specific date

- Type 2 report – Confirms the controls were operating effectively over a period of time

- **Linking to assertions** – When using a Type 2 report, you must specifically evaluate whether the tests performed by the service auditor are relevant to the assertions in your audit client's financial statements. If the report doesn't cover the specific assertion you are concerned about, you may need to perform further procedures, such as visiting the service organisation yourself, or asking another auditor to perform tests on your behalf. Further, Type 1 and Type 2 reports often cover periods that do not align with the entity's financial year. In such cases, you need to perform bridge procedures, such as requesting a bridging report, performing roll-forward testing or performing additional control inquiries.

MANAGING AGENTS

If a managing agent acts as a service organisation that effectively operates the audit client's information system by initiating and recording transactions: because the agent prepares the very records being audited, it is the subject of the audit, rather than an independent source. The auditor cannot rely solely on the managing agent's self-compiled records or confirmation letters, as these do not adequately enhance the level of assurance.

To address this independence gap, the auditor must perform further procedures to obtain sufficient appropriate audit evidence. This includes obtaining direct bank confirmations from the financial institution holding the trust accounts. The auditor may also need to perform procedures at the managing agent's office, such as substantive testing of original source documents or evaluating a Type 2 service auditor's report to confirm the operating effectiveness of the managing agent's internal controls.

SUMMARY FOR THE AUDIT FILE

To ensure your audit is robust, your audit documentation should show a 'golden thread' throughout:

1 Risk assessment – Identify the assertion (for example accuracy of expenses).

2 Control evaluation – Document controls and determine whether the control is at the audit client's site (for example reviewing service organisation reports), the service organisation (such as automated processing controls) or both.

3 Audit approach – Decide whether to assess the audit client's review process or obtain a Type 1 or Type 2 report from the service organisation to verify the design and operating effectiveness of their internal processes.

CONCLUSION

As outsourcing and technology reliance continue to expand, robust and well-documented consideration of service organisations remains fundamental to audit quality. By keeping the assertions at the centre of your planning, you ensure that no matter where the data goes, your audit remains on track.

REFERENCES

ISA 402, Audit considerations relating to an entity using a service organisation.

ISAE 3402, Assurance reports on controls at a service organisation.

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