



# *Introduction to ISAE 3402*

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*Service Organizations overview*

## Introduction to ISAE 3402 standard

### Introduction

The business choice to outsource portions of internal processes has become a normal and strategic consideration for companies and multinational players in particular.

Outsourcing is referred to any task, operation, job or process that could be performed by employees within a service organization, but is instead agreed to a third party ("service organization") for a period of time. Outsourcing (often) means costs reduction and efficiencies in the operation.

Outsourcing requires that organization better manages the risks associated with the outsourced services: the user organization must be assured that the service organization has and maintains a well-established internal control, effectively operated..

### Service organization

The International Standard on Audit n. 402 ("*Audit Considerations relating to an entity using a Service Organization*") defines the Service Organization as "*a third party organization – or segment of a third-party organization – that provides services to user entities that are part of those entities' information systems relevant to financial reporting*".

Accordingly to this definition, a service organization is a third party organization which manages the risks related to a specific process of an entity (hereinafter only "user organization").



Service organizations, therefore, means services as *payroll* providers, external *IT management*, third party *bookkeeping* service, etc..

### ISAE 3402

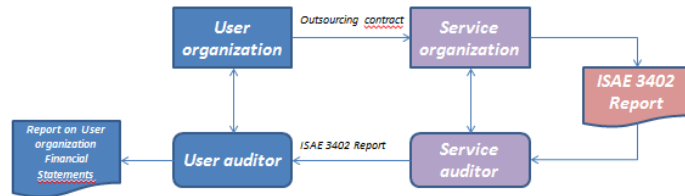
The International Standard on Assurance Engagement (ISAE) n. 3402 ("*Assurance Reports on controls at Service Organization*") deals on assurance engagements performed by an external auditor to provide a report for the use by user entities and their auditors on the controls at service organization level that are relevant to user entities' internal control as it relates to financial reporting.

The ISAE 3402 Standard provides to auditors a guidelines to evaluate the controls at service organization and catch up a reasonable assurance on control objective at service organization level for user organization financial reporting controls.

Thanks to ISAE 3402 standard the user organization can obtain an independent certification of the outsourced processes. Additionally, through the ISAE 3402 report, the user organization can be reasonable assured that no threats are in place regarding the integrity and validity of data processed for its financial reporting.

The third party which reviews the control objective at service organization level (the service auditor) should obtain evidence and, consequently, certify that the service organization put in place an internal control system to reduce to risk of material misstatements on the integrity and validity of data processed for user entity financial reporting.

ISAE 3402 provides to service organizations a competitive advantage, due to the fact that it is a method to distinguishing a service organization from its competitors.



### Type I vs. Type II

The ISAE 3402 standard regulates two kinds of assurance for the service auditor:

- an assurance on controls put in place at service organization level and their design; this kind of involvement of service auditor regulates the issue of an assurance report named *Type I*.
- An assurance on controls put in place at service organization level and their design and their operating effectiveness for a period of time; this kind of assurance report is called *Type II*.

In both cases, the ISAE 3402 standard does not ask to the service auditor just to perform a test of control identified by the management as overseeing the control objectives on service organization outsourcing service. It requires the service auditor evaluates if any risk are in place, not identified by the service organization management, which impairs the outsourcing service and consequently the integrity and validity of processed financial data.

Following table summarizes the main differences between the two kind of assurance report:

	<i>Type I</i>	<i>Type II</i>
<b>Content of the report</b>	Report on controls put in place at service organization level and their design	Report on controls put in place at service organization level, their design and their operating effectiveness
<b>Report primary purpose</b>	To provide information to customers about AWS' control environment that may be relevant to their internal controls over financial reporting.	To provide information to customers and their auditors for their assessment and opinion of the effectiveness of internal controls over financial reporting (ICOFR)
<b>Primary report audience</b>	Customers and their financial reporting auditors	Customers and their financial reporting auditors
<b>Period covered</b>	Specific data	At least six months

### The service organization responsibility

The role of service organization management in the ISAE 3402 audit process is really. The management of the service organization has the role of control objectives implementation (based on a specific risk assessment) and formalize the description of the processes/procedures included into the review of the service auditor. It means, also, that Service Organization Management has responsibility to design and implement appropriate

control activities which address the abovementioned control objectives and be sure that they are in operation at service organization staff level.

The responsibility of the internal control model implementation is on head of the service organization management and must not be on head of the service auditor or the user organization management. This assumption means, also, that the management of a service organization should build a model of controls around the company and the service provided which assures the user entity management on data processed; a strong control environment, a periodical risk assessment process, a monitoring of control procedure effective, are only some of components to implement for a strong internal control model at service organization level.

A useful tool to implement a model of internal control system may be the CoSO report and the ERM (CoSO 2) process to implement it (one of the purposes of the internal control system identified by the CoSO report is the financial reporting).

This role of the service organization management is attested by the “*Management Assertion*” that is released to the service auditor during the audit of a service organization controls. Through the management attestation, the service organization management attests that the control are implemented and the information provided on the service auditor are fairly presented and furnished to user organization for its financial reporting purposes.

#### Service auditor’s responsibility

The responsibility of the service auditor is not to identify or implement controls at service organization level, but to obtain the reasonable assurance that those control objectives are addressed by specific control activities and no other risks may impair the accuracy and integrity of service organization data for user organization financial reporting.

The responsibilities of the service auditor might be different from a report Type I and a report Type II. In the first kind of assurance report, the service auditor has to evaluate if the control objectives implemented at service organization level are addressed by the control activities and those are effectively implemented without any uncovered risk.

The Type II include in the abovereported evaluation of the service auditor, the test of operating effectiveness of controls for the period under review (usually six months or an year).

#### ISAE 3402 Assurance Report

The ISAE Assurance Report should provide to the user management and its auditors a clear and complete vision about the control objectives, the related control activities and the test performed by the service auditor. In particular, the user organization management and its auditors should understand, through the opinion of the service auditor if reasonable assurance is in place on the service provided and integrity and validity of data.

The service organization management should furnish to the report addressees a fairly presentation of control objectives and related controls and give to the “stakeholders” a clear vision about the service provided and the internal control system at service organization level.

Based on this assumptions, the assurance report should include the opinion of the service auditor, the management assertion of control objectives, the description of control objectives and related control activities in place and the test of operating effectiveness of controls the service auditor (this information only for Type II Reports) and/or any other information that may be useful for the receiver of the report to understand the results obtained.



#### The role of Internal Audit Department

The internal audit department of the service organization has not a specific role regulated by the ISAE 3402. Nevertheless, the internal audit of the service organization should execute the role of facilitator of the process, based on the fact that the service organization management might not have the skills or the

experience to put in place the appropriate control objectives and related controls.

The internal audit should support the management to evaluate if any not mitigated risk is in place in the process to review; based on this, may support the management to understand the purposes of the review of the service organization auditor and help the staff to implement the controls (in adherence to independence principles!).

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