



**BDO Dunwoody LLP**  
Chartered Accountants  
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*Newsflash*

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## **Audit Evidence Considerations when an Entity Uses a Service Organization**

Entities that outsource some of their functions to service organizations should be aware of developments in auditing standards regarding the procedures required for financial statement auditors to render an opinion under Generally Accepted Auditing Standards (GAAS).

Under the new standards, the financial statement auditor will be required, at a minimum, to document the entity's systems and assess the design and implementation of financial reporting controls over the entity's business cycles. In some cases, the financial statement auditors will want to rely on the operating effectiveness of the entity's controls when conducting their audit. The new requirements are expected to be met no later than for December 2006 year ends.

For the past few years, entities have increasingly outsourced business processes which either can't be performed in-house or can be carried out more cost-effectively by others. As a result of this growing trend, any services outsourced that impact how the entity's financial transactions are captured, recorded, processed or reported in the financial statements may need to be audited.

This includes many common services such as:

- payroll processing
- application service providers that host accounting software applications or technology environments such as servers or storage systems
- invoice distribution and collection services
- clearing and settlement services performed by investment brokers
- sales orders captured by Internet service providers
- application development companies who develop or maintain custom-written accounting applications

Under this new requirement, the entity's financial statement auditors must satisfy themselves as to the design and implementation of controls at these service organizations, either by reviewing the service auditors' reports issued by the service organizations' auditors under CICA Section 5970, or by direct testing of the service organizations' system. The entity who hires these service organizations is responsible for either obtaining these service auditors' reports from the service organizations or for making arrangements for the financial statement auditors to examine controls at these service organizations. Since the latter will often be impractical from the service organizations' viewpoint given that they provide services to many entities, the most efficient route would be to request the service organizations to engage service auditors to prepare Section 5970 reports.

If the auditor is unable to obtain the necessary service auditors' reports or perform procedures directly at the service organizations, then the auditor may not be able to render an unqualified opinion on the financial statements. Therefore, entities are strongly encouraged to evaluate any services outsourced as soon as practical. If it appears that the outsourcer's processes may need to be audited, they should talk to their service providers to determine if a Section 5970 report already exists and if not, they should request that the service provider get one.

Similarly, if you are a service provider and your customers are requesting Section 5970 reports, you should contact your BDO advisor immediately as the lead-time for preparing service auditors' reports on service organizations' controls can be lengthy.