

# PKF PERSPECTIVES

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## SAS 70: SERVICE ORGANIZATIONS

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Statement on Auditing Standards No. 70 (SAS 70), **Service Organizations**, was issued by the American Institute of Certified Public Accountants (AICPA) in 1992 and amended in 2001. SAS 70 defines the professional standards used by a service auditor to assess the internal controls of an organization and issue a service auditor's report.

An "SAS 70 audit" is conducted by an independent auditor on an organization ("service organization") which provides services to a customer ("user organization"). The services provided by a service organization have an impact on the user organization's internal control as transactions that affect the user organization's financial statements may be subject to controls that are, at least in part, physically and operationally separate from the user organization.

SAS 70, as amended, provides authoritative guidance allowing the service organization – through its service auditor – to disclose its control activities and processes to its customers and its customers' auditors in a uniform reporting format.

### SERVICE ORGANIZATIONS

Service organizations are typically those that provide outsourcing services which impact the control environment of their customers. Some examples of service organizations could include:

- Bank trust departments that invest and service assets for employee benefit plans or for others
- Mortgage bankers that service mortgages for others
- Service providers that provide packaged software applications
- Organizations that develop, provide and maintain software used by client organizations
- Payroll processing companies
- Third-party service providers administering participant 401K plans and other defined contribution plans

According to AU §324, ¶ .03, SAS 70 is

*not intended to apply to situations in which services provided are limited to executing client organization transactions that are specifically authorized by the client, such as the processing of checking account transactions by a bank or the execution of securities transactions by a broker.*

### TYPES OF SAS 70 REPORTS

Traditionally, a service auditor's report is primarily used as an "auditor-to-auditor" communication. The report is designed to provide information and assurance to auditors of the financial statements of user organizations to enable those auditors to obtain an understanding of the service organization's internal control. The auditor of a user organization in planning its audit of the financial statements is required to obtain an understanding of the entity's internal control as well as that of the service organization(s) whose services are part of the entity's information system.

Such knowledge can be used to:

- Identify types of potential misstatements
- Consider factors that affect the risk of material misstatement
- Design tests of controls, where applicable
- Design substantive tests

There are two types of service auditor's reports:

**Type I:** This report will express an opinion on whether a service organization's description of the controls present fairly, in all material respects, the relevant aspects of the service organization's controls that had been placed in operation as of a specified date, and whether such controls were suitably designed to achieve specific control objectives.

**Type II:** In addition to the above, this report would include whether the controls that were tested

were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

With the introduction of the Sarbanes-Oxley Act (SOX) of 2002, the use of an SAS 70 audit report by a publicly-registered user organization and its auditor (“user auditors”) has become even more important to the process of reporting on the effectiveness of internal control over financial reporting and in obtaining third-party assurance regarding the controls at a service organization.

In July 2007, the Securities and Exchange Commission (SEC) approved the Public Company Accounting Oversight Board’s (PCAOB) Auditing Standard No. 5 (AS 5), ***An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements***. AS 5 is designed to focus auditors on the “most important matters” by eliminating procedures that the PCAOB believes are unnecessary to an effective audit of internal control. Under AS 5, SAS 70 audit reports continue to play an important role in allowing management and auditor to evaluate the operating effectiveness of controls at a service organization.

## **ADVANTAGES OF SAS 70 REPORTS**

### ***To Service Organization:***

- Builds trust with customers by having controls and operations independently verified
- Can be sent to many customers, instead of having individual audits performed for each specific customer
- In the case of a Type II report, can show weaknesses or areas that can be improved

### ***To User Organization:***

- Can assess a service organization’s controls and safeguards
- Will not have to send its auditor (and incur additional costs) to perform procedures at the service organization

## **USER AUDITOR CONSIDERATIONS**

In evaluating whether the service auditor’s report is satisfactory for purposes of the user organization’s audit, the user auditor should, as appropriate:

- make inquiries concerning the service auditor’s professional reputation
- consider whether the service auditor’s report is sufficient and, if not, the user auditor may:
  - supplement his/her understanding of the service auditor’s procedures and conclusions by discussions with the service auditor; or
  - contact the service organization, through the user organization, to have the service organization’s auditor perform additional agreed-upon procedures or to have such procedures performed by the user auditor

***SAS 70 reports are important documents for both your auditor and your company. The 2007 edition of the AICPA’s Audit Guide Service Organizations: Applying SAS No. 70, as Amended is expected to be available in September 2007.***

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