

# CorporateGovernor

Providing vision and advice for management, boards of directors and audit committees Summer 2010

## Boardroom awareness: Service organization reports in transition to new U.S. and international standards

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New U.S. and international service organization standards are set to replace SAS 70 by mid-2011. Is your organization prepared?

The dependence of U.S. corporations on outside companies is on the rise. The global economy is driving up the use of outsourcing arrangements as corporations seek to offload more and more business functions to outside affiliates. Core and ancillary business functions now being outsourced include payroll, benefits administration, IT data center hosting, back-office accounting, specialized processing and physical security services.

Those responsible for corporate governance — including management, boards of directors and audit committee members — must confront a host of potential new risks related to their increased use of external agents. Monitoring risk exposure from these third-party business relationships is a fiduciary priority due to the strict legal and regulatory requirements around corporate governance of U.S. companies.

The issuance of new U.S. and international service organization standards affects companies with domestic and international outsourcing relationships (user organizations) as well as the organizations that provide these services (service organizations). While third-party arrangements offer the chance to offload business processes or operations, they also open the door for additional risk that those services are not being performed on behalf of a company in a properly controlled fashion. Inadequate controls at the service organization could lead to financial exposure at the user organization.



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With the release of the new standards, corporate governance professionals of service organizations face the risk of being unprepared for them and therefore at risk of receiving an unfavorable service auditor report. For service organizations, an unfavorable report might result in a breach of customer contracts. For user organizations, especially U.S. public companies, an unfavorable report might mean that management and the organization's external auditors will be forced to perform additional control testing to evaluate the internal controls that support management's assertion, including those related to Section 404 of the Sarbanes-Oxley Act.

Those responsible for corporate governance at both user and service organizations are charged with making sure the service organization has a plan to transition to the new standards. By ensuring that management understands the implications of transitioning to the new standards and the actions required to do so, those charged with governance can minimize the risk of receiving an unfavorable report.

### New standards to become effective in June 2011

For almost 20 years, user and service organizations have relied upon U.S. Statement on Auditing Standards No. 70 (SAS 70) to report on controls at a service organization. The increasing importance of internal controls and related reporting, combined with the fact that many countries do not have their own standards for reporting on internal control over financial reporting at service organizations, generated a need to develop an international standard and align the U.S. standard with it.

In December 2009, the International Auditing and Assurance Standards Board (IAASB) issued International Standard on Assurance Engagements 3402, *Assurance Reports on Controls at a Service Organization* (ISAE 3402). Shortly afterwards in April 2010, the American Institute of Certified Public Accountants (AICPA) issued Statement on Standards for Attestation Engagements No. 16, *Reporting on Controls at a Service Organization* (SSAE 16).

By June 2011, the new U.S. and international standards will take effect. The differences between the new U.S. and international standards are minimal as a result of efforts to converge the U.S. standard with the international one. Where differences do occur, the U.S. standard is generally more conservative.

### The differences between SAS 70 and the new standards

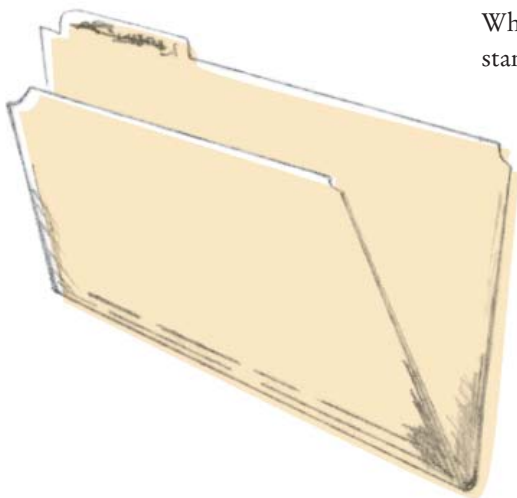
There are three major differences between SAS 70 and the new standards:

1. Management of service organizations must provide a written assertion that includes the suitable criteria used for the assessment. Management's written assertion will now accompany the service auditor's report.
2. If a service organization uses subservice organizations and elects to include them within the report, the assertion of each subservice organization must accompany the service auditor's report.
3. For Type II reports, the opinion on fair presentation of the system and suitability of design is for the period covered by the report.

Corporate governance personnel are charged with making sure their organization is up to speed with these changes and determining how they impact the process for either obtaining or evaluating the results of a service auditor's report. To this end, management should be able to:

- provide the board of directors and audit committee members with a synopsis of what the transition to the new standards will mean for the organization,
- identify the standard(s) that is most applicable to the organization, and
- define how the organization is adjusting its processes to support its service auditor's adoption of the new standards.

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### Making a smooth transition

There are 10 steps that management of a service organization can take to smooth the transition to the new U.S. and international standards:

- 1. Work with an experienced and knowledgeable accounting firm (service auditor) to better understand the implications of transitioning to SSAE 16 and ISAE 3402.**
- 2. Work with the service auditor to determine whether multiple service auditor reports will be necessary.** Service auditors in most countries will be required to follow the local (country) audit standards. This means that U.S. CPA firms will be required by AICPA standards to follow SSAE 16. However, service organizations that have global operations or a global customer base may also wish to receive a service auditor's report under ISAE 3402. A service organization should discuss with its service auditor whether multiple reports under different standards will be beneficial to or required by its customer base.
- 3. Discuss with the service auditor whether the service auditor plans to early adopt the new standards.** Service auditors can adopt the new standards prior to the effective date of June 15, 2011. Whether or not the service auditor adopts the new standards early will affect the lead time a service organization has to prepare for the transition.
- 4. Review your company's existing monitoring and/or testing processes to determine if they are sufficient to support the written management assertion required by SSAE 16 and ISAE 3402.** Management of the service organization will be required to provide a written assertion to accompany the service auditor's report. This written assertion must be based upon suitable criteria.
- 5. Select and document the criteria that management would use to support its written management assertion.** Management will need to review the description of its system to ensure that it includes sufficient information to allow a reader to understand why management believes its assertion is based upon suitable criteria.
- 6. Identify the risks that threaten the achievement of control objectives.** In its description of the system, the service organization will need to identify the risks to achieving the control objectives.
- 7. Determine whether a written assertion from the subservice organization is necessary.** If a service organization uses a subservice organization and elects to use the inclusive method, the subservice organization's assertion also accompanies the service auditor's report.
- 8. Review the existing SAS 70 description of controls and make necessary enhancements to include missing components to fully describe the system.** Management must provide a description of the service organization's system throughout the period covered by the report, including:
  - a description of the services provided,
  - a description of the procedures by which services are provided,
  - a description of the process used to prepare reports provided to customers,
  - other aspects of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) internal control framework relevant to user entities, and
  - any changes that occur during the audit period.
- 9. Develop a communication plan regarding the new standards for customers and customer-facing employees, such as sales and contract teams.** Internal and external communication is necessary to make sure customers not only understand the transition to the new standards, but also the path management intends to take in order to get there.
- 10. Review existing customer contracts and contract templates to determine the revisions necessary to transition to the new standards.**

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### The impact will vary

At both user organizations and service organizations, corporate governance efforts related to the new standards should focus on ensuring that management understands the new guidance and is prepared to adapt to the new standards and standard reporting formats. The impact of additional responsibilities required by the new standards will differ from company to company. However, it is anticipated that larger, more complex service organizations will need more time than single-location service providers to make any necessary process changes to transition to the new standards.

The ease of an organization's transition to the new standards will depend in part on what processes the service organization already has in place and whether the primary recipients of the reports reside in the United States or internationally. Service organizations that have obtained SAS 70 reports in the past — and have detailed descriptions of systems, services and controls — will transition to the new standards more easily than organizations that have never obtained a SAS 70 report. Yet all organizations can prepare for a smooth transition by making prudent use of the time leading up to June 15, 2011. •

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### Key corporate governance considerations

The following questions can help guide a discussion between board members and managers responsible for the transition to the new standards:

- What is being done to understand the impact of the new standard(s)?
- Will multiple service auditor reports under the U.S. standard SSAE 16 and the international standard ISAE 3402 be necessary?
- What is the plan for working with the audit firm to transition to the new standard(s)?
- What is the auditor's timeline for adopting the new standard(s)?
- What is the service auditor's timeline for adopting the new standard(s)?
- What are the additional internal and external costs of transitioning to the new standard(s)?

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