

Select Auditing Considerations for the 2016 Audit Cycle for Brokers and Dealers

We are pleased to release our *Select Auditing Considerations for the 2016 Audit Cycle for Brokers and Dealers* (the 2016 CAQ Brokers and Dealers Alert), our second annual alert. This alert is intended to provide certain auditing considerations that may be relevant for audit and attestation engagements for brokers and dealers registered with the U.S. Securities and Exchange Commission (SEC) in the 2016 audit cycle and is one example of the profession's commitment to continuously strengthening audit quality. The 2016 CAQ Brokers and Dealers Alert discusses some of the more judgmental or complex audit areas, including those that have recently been the subject of attention and focus by the Public Company Accounting Oversight Board (PCAOB or the Board) in its inspection process. While the 2016 CAQ Brokers and Dealers Alert highlights certain areas for consideration, it should not be relied upon as definitive or all-inclusive, and should be read in conjunction with the applicable rules, standards, and guidance in their entirety, including the PCAOB [Staff Guidance for Auditors of SEC-Registered Brokers and Dealers](#).

Under the interim program of inspection related to audits of brokers and dealers, the PCAOB evaluates the firm's performance of engagements, issuance of audit and attestation reports, and related matters involving brokers and dealers. Rule 4020T, *Interim Inspection Program Related to Audits of Brokers and Dealers* requires the PCAOB to publish an annual report describing the progress of the interim program and any significant observations. The PCAOB does not issue firm-specific inspection reports under the interim program, but summarizes the findings of all of its inspections of brokers and dealers.¹

The 2016 CAQ Brokers and Dealers Alert highlights certain results from 2015 PCAOB inspections and addresses certain related focus areas identified for the 2016 inspections, including those described in:

- ▶ PCAOB Release No. 2016-004, [Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers](#) (the 2016 PCAOB Brokers and Dealers Annual Report);
- ▶ PCAOB [Staff Inspection Brief 2016-02](#), *Preview of Observations from 2015 Inspections of Auditors of Brokers and Dealers* (PCOAB Inspection Brief 2016-02); and
- ▶ PCAOB [Staff Inspection Brief 2016-04](#), *Information about 2016 Inspections of Auditors of Brokers and Dealers* (PCAOB Inspection Brief 2016-04).

¹ The 2016 PCAOB Brokers and Dealers Annual Report indicates that "the PCAOB staff is currently working to develop a rule proposal for the Board to consider during 2016 to establish a permanent inspection program, which will address, among other things, the scope of such a program, including whether to exempt any category of firm from any such inspection program."

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Our members may also wish to refer to Appendix C of the 2016 PCAOB Brokers and Dealers Annual Report mentioned above. Appendix C- *References to Certain Releases for Standards and Rules Related to Brokers and Dealers and Their Auditors*, provides:

- ▶ a list of PCAOB releases and guidance that describe requirements applicable to audits of brokers and dealers; and
- ▶ SEC releases and staff guidance that describe the amendments to the reporting requirements for brokers and dealers under Rule 17a-5 and the SEC's financial responsibility rules, including Rules 15c3-1 and 15c3-3.

As part of the profession's commitment to remaining proactive and advancing audit quality, we recommend that our members read these publications in their entirety and consider whether the procedures described herein may help improve the quality of the audits and attestation engagements they currently perform. We at the CAQ are developing additional tools that will be distributed in the future to support our membership in executing quality audits of brokers and dealers.

We also remind our member firms that information, presented in the following CAQ Alerts published in 2015, continue to apply to the 2016 audit cycle:

- ▶ CAQ Alert No. 2015-07, [Select Auditing Considerations for the 2015 Audit Cycle](#); and
- ▶ CAQ Alert No. 2015-07, [Select Considerations for the 2015 Audit Cycle for Brokers and Dealers](#).

CAQ ALERT NO. 2016-01, SELECT AUDITING CONSIDERATIONS FOR THE 2016 AUDIT CYCLE

A separate CAQ publication, [Select Auditing Considerations for the 2016 Audit Cycle](#) (the 2016 CAQ Alert) contains a number of auditing considerations, including planned focus areas of PCAOB inspections in the 2016 audit cycle, some of which are applicable to audits of brokers and dealers. The most applicable topics in the 2016 alert include:

- ▶ improper alteration of audit documentation;
- ▶ assessing and responding to risks of material misstatement;
- ▶ effective communication with audit committees (or equivalent);
- ▶ cybersecurity; and
- ▶ auditor independence.

Revenue Recognition

Brokers and dealers generate revenue from a variety of securities-related lines of business. Revenue is an important driver of a company's operating results and often involves significant estimates and judgements. As such, the auditor should always begin by performing a risk assessment in accordance with Auditing Standards Nos. 8-15.² Once the risk assessment is performed, we remind our members that, when testing revenue, the auditor should evaluate if he or she, among other things:

- ▶ has obtained sufficient evidence that the controls selected for testing to support the assessment of control risk at less than maximum operated effectively in order to support the nature, timing, and extent of planned substantive procedures over revenue, based on that assessment;³
- ▶ has designed and performed sufficient audit procedures with respect to revenue in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure;⁴ and

² AS 1101, AS 2101, AS 1201, AS 2105, AS 2110, AS 2301, AS 2810, AS 1105, as reorganized.

³ AS 2301.16.

⁴ AS 2301.08.

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- ▶ has performed sufficient testing for material classes of revenue transactions, including commission revenue, trading gains and losses, and advisory fees.⁵

Depending on the results of the risk assessment, the testing strategy selected, and other facts and circumstances, the auditor may consider whether he or she:

- ▶ performed sufficient procedures to obtain evidence about the accuracy and completeness of information such as trade blotters, various customer or broker or dealer statements, or population data produced by service organizations that the auditor used in the audit; or information produced by the broker or dealer, such as trade blotters, account statements, and schedules or spreadsheets, that was used as audit evidence;
- ▶ designed and performed substantive analytical procedures in accordance with [Auditing Standard \(AS\) 2305](#) (currently AU Sec. 329), *Substantive Analytical Procedures* (AS 2305) to provide the intended level of assurance, where the auditor should:
 - ▶ establish that there was a plausible and predictable relationship between the current year and prior year balances⁶ (for example, testing interest income by comparing monthly interest income recorded in current year to the monthly interest income recorded in the prior year without establishing the plausibility and predictability of the relationship between current and prior year interest income alone is not sufficient);
 - ▶ develop expectations that are sufficiently precise to identify material misstatements⁷ (for example, comparing total revenue for the current year to the prior year as a primary test of significant revenue accounts alone is not sufficient);
 - ▶ evaluate the reliability of the data from which the auditors' expectations were developed⁸ (for example, developing an expectation based on unaudited data provided by a broker without testing the accuracy or completeness of the data alone is not sufficient); and
 - ▶ determine an amount of difference from the expectation that could be accepted without further investigation.⁹
- ▶ appropriately designed and sufficiently performed sampling procedures to test revenue transactions where the auditor is required to adequately consider the relationship of the sample to the: relevant audit objective, tolerable misstatement, allowable risk of incorrect acceptance, and the characteristics of the population to appropriately select a sufficient sample size.¹⁰

Many brokers and dealers use the services of other brokers and dealers to perform trade processing and related back-office functions, primarily in the clearing and settling of customer transactions. When a broker dealer entity uses a service organization in its operations the auditor should refer to [AS 2601](#) (currently AU Sec. 324), *Consideration of an Entity's Use of a Service Organization* (AS 2601). When the auditor is using information produced by a service organization or a service auditor's report as audit evidence, the auditor should refer to both AS 2601 and [AS 1105](#) (currently AS No. 15), *Audit Evidence* (AS 1105).

AS 1105 requires that when an auditor uses information produced by the company as audit evidence, the auditor should evaluate whether such information obtained is both sufficient and appropriate for purposes of the audit. Audit procedures include: (1) testing the accuracy and completeness of the information, or testing the controls over the accuracy and completeness of that information; and (2) evaluating whether the information is sufficiently precise and detailed for purposes of the audit. PCAOB auditing standards also require the auditor to obtain an understanding of the company's IT systems relevant to financial reporting and take IT considerations into account in assessing the risks of material misstatement.¹¹

5 See page 10 of the 2016 PCAOB Brokers and Dealers Annual Report.

6 AS 2305.13–14.

7 AS 2305.17–19.

8 AS 2305.16.

9 AS 2305.20–21.

10 See paragraph 16 of AS 2315 (currently AU Sec. 350), *Audit Sampling* (AS 2315).

11 See AS 2110 (currently AS No. 12), *Identifying and Assessing Risks of Material Misstatement*.

Auditors are encouraged to read PCAOB Staff Audit [Practice Alert No. 12](#), *Matters Related to Auditing Revenue in an Audit of Financial Statements* (Practice Alert No. 12). Practice Alert No. 12 discusses the application of certain requirements in PCAOB auditing standards that auditors should be mindful of when auditing revenue. While directed toward the financial statement audit and audit of internal control over financial reporting, the Practice Alert No. 12 may also inform the audits of brokers and dealers.

Assessing and Responding to Risks of Material Misstatement Due to Fraud

Assessing and responding to risks of material misstatement due to fraud is a critical component of an audit or attestation engagement. To address the risk of material misstatement due to fraud, including improper revenue recognition and management override of controls, the auditor should refer to:

- ▶ [AS 2110](#) (currently AS No. 12), *Identifying and Assessing Risks of Material Misstatement*, which outlines the following procedures, among others:
 - ▶ inquire of the audit committee or equivalent, management, or others within the company about the risks of material misstatement;
 - ▶ obtain sufficient understanding of the aspects of internal control over financial reporting, including evaluating the design of the controls intended to address fraud risks;
- ▶ [AS 2301](#) (currently AS No. 13), *The Auditor's Responses to the Risks of Material Misstatement (AS 2301)*, which outlines substantive tests of details specifically responsive to fraud risk assessment; and
- ▶ [AS 2401](#) (currently AU Sec. 316), *Consideration of Fraud in a Financial Statement Audit*, which outlines the following procedures, among others:
 - ▶ assess improper revenue recognition as a potential fraud risk and provide documentation or other persuasive evidence indicating how the auditor overcame the presumption that improper revenue recognition is a fraud risk; and
 - ▶ appropriately execute auditing procedures related to journal entries testing, such as:
 - obtain a sufficient understanding of the entity's reporting process and the controls over journal entries and other adjustments,
 - determine appropriate timing of testing,
 - inquire about inappropriate or unusual activity, and
 - select appropriate journals for testing.

AS 2401 also indicates that the auditor should perform audit procedures to specifically address the risk of management override of controls¹² including:

- ▶ examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, as addressed by paragraphs 58–62 of AS 2401;
- ▶ reviewing accounting estimates for biases that could result in material misstatement due to fraud, as addressed by paragraphs 63–65 of AS 2401; and
- ▶ evaluating whether the business purpose (or lack thereof) indicates that the significant unusual transaction may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets ("significant unusual transactions"), as addressed by paragraphs 66–67A of AS 2401.

¹² The auditor's identification of fraud risks should include the risk of management override of controls, as required by AS 2110.69.

Paragraphs 12–13 of AS 2301 state that the audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected. In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks. If the auditor selects certain controls intended to address the assessed fraud risks for testing in accordance with paragraphs 16–17 of AS 2301, the auditor should perform tests of those controls. In addition, PCAOB Staff Audit Practice Alerts Nos. 7–12 provide guidance on the application of provisions of AS 2110 and AS 2301.

We also encourage our members to consider additional information identified in [Staff Guidance for Auditors of SEC-Registered Brokers and Dealers](#) and the PCAOB [Release No. 2015-007](#), *Inspection Observations Related to PCAOB “Risk Assessment” Auditing Standards (No. 8 through No. 15)*.

Financial Statement Presentation and Disclosures

The work performed by the auditor should include procedures to evaluate whether financial statement presentation and related disclosures are in conformity with generally accepted accounting principles. This will include assessment of the audit procedures performed to evaluate the completeness and accuracy of disclosures.¹³

Auditors would ordinarily develop an expectation about the appropriate disclosures required to be included in the financial statements as part of obtaining an understanding of the company and its environment. The auditor is required to evaluate “as part of obtaining an understanding of the company’s selection and application of accounting principles, including related disclosures...whether the company’s selection and application of accounting principles are appropriate for its business and consistent with the applicable financial reporting framework and accounting principles used in the relevant industry. Also, to identify and assess risks of material misstatement related to omitted, incomplete, or inaccurate disclosures, the auditor should develop expectations about the disclosures that are necessary for the company’s financial statements to be presented fairly in conformity with the applicable financial reporting framework.”¹⁴

Certain PCAOB inspections conducted in 2015 identified instances where the auditor did not identify required financial statements disclosures or notes thereto. In light of these findings, and in an effort to strengthen overall audit quality, we remind our members to evaluate whether the financial statements and disclosures:

- ▶ are presented in conformity with generally accepted accounting principles and compliant with requirements of Rule 17a-5(d) (2)(i), which requires the financial statements of registered brokers and dealers to be presented in a format that is consistent with Form X-17A-5 Part II or Part IIA;
- ▶ are complete with respect to disclosed accounting policies (policies for revenue recognition, related parties, or related party transactions are all required disclosures);
- ▶ include appropriate description of the financial statement line items;
- ▶ present accurate and consistent amounts in the financial statements and notes to the financial statements; and
- ▶ include proper classification of fair value measurements of certain assets and liabilities within the hierarchy required by Financial Accounting Standards Board Accounting Standards Codification Topic 820, *Fair Value Measurement* (ASC 820), including the appropriate classification of securities disclosed as Level 1, Level 2, or Level 3 based on the inputs used by the broker or dealer to measure fair value.

¹³ AS 2810.31.

¹⁴ AS 2110.12.

Paragraph 13 of AS 2110 provides that the following matters, if present, are relevant to the necessary understanding of the company's selection and application of accounting principles, including related disclosures:

- ▶ “Significant changes in the company's accounting principles, financial reporting policies, or disclosures and the reasons for such changes;
- ▶ The financial reporting competencies of personnel involved in selecting and applying significant new or complex accounting principles;
- ▶ The accounts or disclosures for which judgment is used in the application of significant accounting principles, especially in determining management's estimates and assumptions;
- ▶ The effect of significant accounting principles in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- ▶ The methods the company uses to account for significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature; and
- ▶ Financial reporting standards and laws and regulations that are new to the company, including when and how the company will adopt such requirements.”

Paragraph 31 of [AS 2810](#) (currently AS No. 14), *Evaluating Audit Results* provides: “as part of the evaluation of the presentation of the financial statements, the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework. Evaluation of the information disclosed in the financial statements includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.”

Auditor Independence

PCAOB and SEC rules prohibit the provision of bookkeeping services to audit and attest clients, including preparing financial statements; maintaining or preparing clients' accounting records; preparing or originating source data underlying the audit client's financial statements. These restrictions also apply to assisting audit clients in the preparation of the brokers or dealers exemption reports. CAQ Alert No. 2014-11, [SEC/PCAOB Independence Rules for Non-Issuer Audit and Attestation Engagements](#) (the 2014 CAQ Alert) provides audit firms with an overview of the independence rules of the SEC and PCAOB applicable to financial statement audit and attestation engagements for brokers and dealers and other covered entities. The 2014 CAQ Alert addresses:

- ▶ applicability of SEC independence rules;
- ▶ bookkeeping services, including financial statement preparation;
- ▶ applicability of PCAOB independence rules; and
- ▶ other engagements subject to SEC or PCAOB independence rules.

We also remind our members that PCAOB [Rule 3526](#), *Communications with Audit Committees Concerning Independence*, requires the auditor to communicate annually, in writing, to the audit committee of the brokers or dealers, or their equivalent, that the audit firm is independent of the broker or dealer in compliance with PCAOB [Rule 3520](#) *Auditor Independence*. If no such committee or board of directors (or equivalent body) exists with respect to the broker or dealer, then the communication should be addressed to the person(s) who oversee the accounting and financial reporting process of the company and audits of the financial statements of the company.¹⁵

¹⁵ See Rule 3501 *Definitions of Terms Employed in Section 3, Part 5 of the Rules*, (a)(v) Audit Committee and footnote 12 of the 2016 PCAOB Brokers and Dealers Annual Report.

Related Party Transactions

Related parties could play a significant role in the operations of brokers and dealers, including, for example, through direct participation in the activities of the brokers and dealers by principals or affiliates under shared service agreements. [AS 2410](#) (currently AS No. 18), *Related Parties* (AS 2410), establishes requirements for the auditor to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements.

The auditor should perform procedures to obtain an understanding of the company’s relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with AS 2110. The procedures performed to obtain an understanding of the company’s relationships and transactions with its related parties include:

- ▶ obtaining an understanding of the company’s process for: “(a) identifying related parties and relationships and transactions with related parties; (b) authorizing and approving transactions with related parties; and (c) accounting for and disclosing relationships and transactions with related parties in the financial statements;”¹⁶
- ▶ performing inquiries of management regarding: “(a) the names of the company’s related parties during the period under audit, including changes from the prior period; (b) background information concerning the related parties (for example, physical location, industry, size, and extent of operations); (c) the nature of any relationships, including ownership structure, between the company and its related parties; (d) the transactions entered into, modified, or terminated, with its related parties during the period under audit and the terms and business purposes (or the lack thereof) of such transactions; (e) the business purpose for entering into a transaction with a related party versus an unrelated party; (f) any related party transactions that have not been authorized and approved in accordance with the company’s established policies or procedures regarding the authorization and approval of transactions with related parties; and (g) any related party transactions for which exceptions to the company’s established policies or procedures were granted and the reasons for granting those exceptions;”¹⁷
- ▶ performing inquiries of others within the company regarding their knowledge of the matters in accordance with paragraph 5 of AS 2410. “The auditor should identify others within the company to whom inquiries should be directed, and determine the extent of such inquiries, by considering whether such individuals are likely to have knowledge regarding: (a) the company’s related parties or relationships or transactions with related parties; (b) the company’s controls over relationships or transactions with related parties; and (c) the existence of related parties or relationships or transactions with related parties previously undisclosed to the auditor;”¹⁸
- ▶ inquiring of the audit committee or its chair, regarding: “(a) the audit committee’s understanding of the company’s relationships and transactions with related parties that are significant to the company; and (b) whether any member of the audit committee has concerns regarding relationships or transactions with related parties and, if so, the substance of those concerns;”¹⁹ and
- ▶ communicating “to engagement team members relevant information about related parties, including the names of the related parties and the nature of the company’s relationships and transactions with those related parties.”²⁰ “If the auditor is using the work of another auditor, the auditor should communicate to the other auditor relevant information about related parties, including the names of the company’s related parties and the nature of the company’s relationships and transactions with those related parties. The auditor also should inquire of the other auditor regarding the other auditor’s knowledge of any related parties or relationships or transactions with related parties that were not included in the auditor’s communications.”²¹

AS 2410 provides certain procedures the auditor should perform to address the identified and assessed risks of material misstatement

¹⁶ AS 2410.04

¹⁷ AS 2410.05

¹⁸ AS 2410.06

¹⁹ AS 2410.07

²⁰ AS 2410.08

²¹ AS 2410.09

for each related party transaction that is either required to be disclosed in the financial statements or determined to be a significant risk (these could potentially include service agreements, fee arrangements, or intercompany balances). For instance, where related party revenue and expenses are based on allocations between the broker or dealer and its parent or affiliates, the auditor should test amounts allocated to the brokers or dealers, or test the basis for the allocations and the computation of the allocated amounts. Further, the auditor should not limit its procedures to reading the allocation agreement and tracing the amounts disclosed in the financial statements to a list of intercompany payments, but should also test the reasonableness of the allocated expenses or whether the expenses are allocated in accordance with the terms of the allocation agreement.²² The auditor also should perform procedures on intercompany account balances as of concurrent dates, even if fiscal years of the respective companies differ.²³

The auditor should communicate to the audit committee the auditor's evaluation of the company's identification of, accounting for, and disclosure of its relationships and transactions with related parties. The auditor also should communicate other significant matters arising from the audit regarding the company's relationships and transactions with related parties.²⁴

Supplemental Information Accompanying Financial Statements

The supplemental information brokers and dealers are required to include in their annual reports relates to their compliance with certain SEC rules regarding maintaining minimum net capital and reserves,²⁵ specifically those governing the safeguarding of customer assets.

Certain PCAOB inspections identified instances where the auditors did not perform sufficient testing of the components of the net capital computation; completeness and accuracy of significant components of the customer reserve computation; and compliance with the possession or control requirements under Rule 15c3-3. Auditor's procedures related to the supporting schedules may need to address the following:

- ▶ Components of the net capital calculation, such as whether assets were properly classified as allowable and non-allowable assets, and whether haircuts on securities' values were appropriately determined.
- ▶ Components of the customer reserve computation in order to evaluate whether they were reported in accordance with Exchange Act Rule 15c3-3, such as the accuracy and completeness of customer credit and debit balances and the accuracy and completeness of customer's cash and margin account information obtained from a service organization report.²⁶
- ▶ Reported information related to compliance with the possession or control requirements under Rule 15c3-3, such as whether the broker or dealer maintained control of customer fully-paid and excess margin securities and whether the broker or dealer promptly obtained and maintained physical possession or control of fully-paid and excess margin customer securities carried by the broker or dealer for customer accounts.

The auditor's report on the supporting schedules accompanying audited financial statements should be prepared in accordance with provisions of [AS 2701 \(currently AS No. 17\)](#), *Auditing Supplemental Information Accompanying Audited Financial Statements* (AS 2701). Generally, under the provision of Rule 17a-5, brokers and dealers are required to file with the SEC a financial report containing financial statements and supporting schedules. The auditor's report should cover both, the financial statements and supporting schedules. The auditor's report on the supporting schedules should include an opinion on whether the supplemental information is fairly stated, in all material respects, in relation to the financial statements taken as a whole.²⁷ In addition, the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the auditor's opinion on the financial statements and on the supplemental information in relation to the financial statements as a whole.²⁸

22 See pages 16-17 of the 2016 PCAOB Brokers and Dealers Annual Report for a full discussion of inspection findings.

23 AS 2410.12-.13.

24 AS 2410.19.

25 See paragraph (d)(2) of SEC Rule 17a-5.

26 Refer to relevant provisions of AS 1105 and AS 2601 when using information produced by a service organization or a service auditor's report as audit evidence.

27 AS 2701.03.

28 AS 2701.12 and AS 3110.01 (Currently AU Sec. 530), *Dating of the Independent Auditor's Report*.

The following provisions of Rule 15c3-1 may need to be considered with respect to audit procedures performed to evaluate the compliance with applicable rules, such as:

- ▶ whether a broker's or dealer's required minimum net capital is the greater of:
 - ▶ one of a number of fixed-dollar amounts prescribed in Rule 15c3-1(a)(2) applicable to the broker or dealer relative to its line(s) of business, or
 - ▶ an amount computed using one of two financial ratios, as prescribed in the Rule 15c3-1(a)(1);
- ▶ whether the appropriate haircut percentages were applied by the broker or dealer to its securities,²⁹ including evaluating the relevant characteristics of the securities, and testing accuracy and completeness of the reported securities position upon which haircuts were applied;
- ▶ whether, under Rule 15c3-1(a)(1), net worth is adjusted by certain items, such as discretionary liabilities, certain capital contributions and distributions, and certain deferred taxes, in the determination of net capital;³⁰
- ▶ whether, under Rule 15c3-1(c)(2), assets not readily convertible into cash (non-allowable assets) are deducted from equity when computing net capital;
- ▶ whether commissions receivable pursuant to the Investment Company Act of 1940 Rule 12b-1 are allowable assets under Rule 15c3-1. Rule 15c3-1 permits brokers and dealers to offset certain receivables and payables when specific conditions are met,³¹ and
- ▶ whether, when computing net capital, brokers and dealers deducted amounts related to operational charges, such as aged fail to deliver balances,³² and other deductions, such as excess fidelity bond coverage,³³ as required by Rule 15c3-1 and whether the reported amounts of operational charges and other deductions from the broker or dealer's net capital include all required charges.

Engagement Quality Review

[AS 1220](#) (currently AS No. 7), *Engagement Quality Review* (AS 1220) requires an engagement quality review to be performed by a qualified reviewer³⁴ for audits as well as attestation engagements performed pursuant to [Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers](#) (AT No. 1) and PCAOB [Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers](#) (AT No. 2). In addition to other required procedures, the engagement quality reviewer should review the engagement completion document³⁵ prepared for an audit as well as an attestation engagement (these could be included in one document), which should include actions taken to address significant findings or issues, including risks requiring special consideration by the auditor.

29 Haircuts on securities are based on the percentages applicable to the categories of securities and marketability pursuant to Rule 15c3-1(c)(2)(vi) and Rule 15c3-1(c)(2)(vii).

30 Auditors should also evaluate the compliance with approvals of the Financial Industry Regulatory Authority (FINRA).

31 See rule 15c3-1 (c)(2)(iv)(c).

32 See Rule 15c3-1(c)(2)(ix).

33 See Rule 15c3-1(c)(2)(xiv).

34 See AS 1220.03-.04.

35 See AS 1215.13, *Audit Documentation* (currently AS No. 3).

Examination Engagements

AT No. 1 establishes requirements that apply when an auditor is engaged to perform an examination of certain statements made by a broker or dealer in a compliance report prepared pursuant to Rule 17a-5. The auditor's objective is to express an opinion regarding whether the assertions made by the broker or dealer in its compliance report are fairly stated, in all material respects.

Among other things, paragraphs 9–10 of AT No. 1 require the auditor to (a) identify and evaluate the design and implementation of relevant controls over compliance; (b) assess the risks associated with related parties that were relevant to compliance and controls over compliance; (c) obtain an understanding of the nature and frequency of customer complaints; or (d) assess the risk of fraud, including the risk of misappropriation of customer assets.

Paragraphs 11–13 of AT No. 1 provide relevant requirements for testing controls over compliance. These include:

- ▶ testing those controls that are important to the auditor's conclusion about whether the broker or dealer maintained effective Internal Control Over Compliance (ICOC) for each financial responsibility rule during the fiscal year and as of the end of the fiscal year.
- ▶ obtaining evidence that the controls over compliance selected for testing are designed effectively and operated effectively during the fiscal year and as of the fiscal year end.
- ▶ obtaining, for each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control.

These paragraphs of AT No. 1 also include factors that affect the risk associated with the control.

In addition, paragraphs 21–23 of AT No. 1 provide requirements for the auditor's procedures to evaluate whether the broker or dealer maintained compliance with the net capital rule and reserve requirements rule.³⁶

Review Engagements

AT No. 2 establishes the requirements for auditor review of the statements in the exemption reports of brokers and dealers, including review procedures to identify exceptions to the exemption provisions of Rule 15c3-3 and assessment of risk factors associated with exemption compliance.

Auditors may need to evaluate procedures they perform to identify exceptions to the exemption provisions and consideration of risk factors associated with exemption compliance. This evaluation may include whether auditors made all required inquiries, including those which involve obtaining an understanding of management's controls and monitoring activities in place to comply with the claimed exemption provisions, and performed the required procedures. In addition, auditors may assess whether they sufficiently evaluated whether the evidence obtained and the results of the procedures performed supported their conclusions regarding the statements in the exemption report.

Paragraphs 10(a) through 10(h) of AT No. 2 provide relevant procedures with respect to conducting all required inquiries. The auditor should evaluate if identified exceptions are in compliance with exemption provisions and should evaluate if required information obtained from the audit of the financial statements and supplemental schedules corroborates or contradicts assertions regarding compliance with the exemption provisions.

The auditor should also evaluate if the date of the auditor's review report is in compliance with AT No. 2.³⁷ The auditor should date the review report no earlier than the date on which the auditor has completed his or her review procedures. Because of the coordination

³⁶ See Rules 15c3-1 and 15c3-3(e).

³⁷ See paragraph 18 of AT No. 2.

between the review engagement and the audit of the financial statements and the audit procedures performed on supplemental information, the date of the review report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

Finally, the auditor should report that the broker's or dealer's exemption report had not identified (or identified incorrectly) the exemption claimed by the broker or dealer under Rule 15c3-3.³⁸ Paragraph 15 of AT No. 2 also requires the auditor to communicate to management and to the audit committee any exceptions to the exemption provisions identified by the auditor and information that causes the broker's or dealer's assertions about the exemption provisions not to be fairly stated, in all material respects.

SIPC Rule 600, Rules Relating to Supplemental report of SIPC Membership

In March 2016, the SEC approved [SIPC Rule 600, Rules Relating to Supplemental Report of SIPC Membership \(SIPC Rule 600\)](#). These rules now prescribe the form and content of the SIPC supplemental report and require that registered brokers and dealers must file a report with SIPC, and no longer with the SEC. The SIPC supplemental report is required to include a report of an independent public accountant engaged to perform certain agreed-upon procedures, outlined in SIPC Rule 600. For registered brokers and dealers exempt from SIPC membership, these agreed-upon procedures include a requirement to provide a comparison of the income or loss reported in the audited financial statements required by the SEC with Form SIPC-3. The SIPC maintains [Member FAQs](#) where member firms and their auditors can find information regarding SIPC forms, membership, and how and where to file reports.

Paragraph (b)(3) of SIPC Rule 600 provides that the public accountant engaged to perform the agreed-upon procedures specified in Rule 600 must be independent in accordance with the provisions of Rule 2-01, *Qualifications of Accountants* of Regulation S-X.³⁹ Further, the auditor must perform these agreed-upon procedures in accordance with PCAOB standards.

PCAOB Rules 3210 and 3211

In May of 2016, the SEC approved PCAOB [Rule 3210, Amendments \(Rule 3210\) and Rule 3211, Auditor Reporting of Certain Audit Participants](#) (Rule 3211). Rule 3211 requires registered public accounting firms to file with the PCAOB a new form, Form AP, *Auditor Reporting of Certain Audit Participants*. The PCAOB is not extending the Form AP requirements to audits of brokers and dealers pursuant to Rule 17a-5 under the Securities Exchange Act of 1934, as amended ("Exchange Act"). However, if a broker or dealer is an issuer required to file audited financial statements under Section 13 or 15(d) of the Exchange Act, the requirements would apply.⁴⁰ The 2016 CAQ Alert provides additional information about Rule 3211.

³⁸ See paragraph 19 of AT No. 2.

³⁹ Codified within the Code of Federal Regulations (CFR) 17 CFR Part 210 - Regulation S-X.

⁴⁰ PCAOB Release No. 2015-008, *Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*, page 3, footnote 4.