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Audit Planning Alert for Auditors of Brokers and Dealers

Introduction

The Center for Audit Quality (CAQ) is pleased to release our *Audit Planning Alert for Auditors of Brokers and Dealers* (the Planning Alert). The Planning Alert is an example of the profession's commitment to continuously strengthening audit quality and presents questions for auditors of brokers and dealers to consider as they plan both their audit and attestation engagements. We have organized the questions in this alert by focusing on certain complex areas of both the audit and attestation engagements. The Planning Alert also presents common examples of audit deficiencies the Public Company Accounting Oversight Board (PCAOB) has described in their *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers*.[1]

The questions posed in this Planning Alert are a mixture of (1) questions applicable to all audits of brokers and dealers and (2) questions that may require further action if certain circumstances are present at the broker or dealer. While auditors should consider every question included, the list of questions should not be relied upon as definitive guidance or all-inclusive. The appendices to this alert provide auditors of brokers and dealers with additional reminders and resources that may be useful as they plan their audits of brokers and dealers.

Risk Assessment Procedures

A potential root cause of audit deficiencies is when the auditor does not obtain a sufficient understanding of the risk—and thus does not design audit procedures responsive to that risk. An insufficient understanding of risk may also involve, among other things, not identifying systems, reports, or third parties that could have an impact on the risk assessment and audit approach. To design procedures to obtain sufficient appropriate audit evidence, the auditor is required to obtain a sufficient understanding of each component of internal control over financial reporting to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatements, and (c) design further audit procedures.[2]

For auditors developing a risk-based audit approach, the following are several (but not all) of the applicable PCAOB standards:

1 As of the date of this publication, the most recent annual interim inspection report was published by the PCAOB on August 18, 2016.
2 See AS 2110.18.

- Auditing Standard 2110, *Identifying and Assessing Risks of Material Misstatement* (AS 2110), provides that auditors should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to fraud or error, and designing further audit procedures.[3]

- Auditing Standard 2301, *The Auditor's Responses to the Risks of Material Misstatement* (AS 2301) establishes the requirements for developing and applying overall responses and audit procedures that address the assessed risk of material misstatement.

- Auditing Standard 1001, *Responsibilities and Functions of the Independent Auditor* (AS 1001) states, "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[4] Auditing Standard 2401, *Consideration of Fraud in a Financial Statement Audit* (AS 2401), establishes requirements and provides direction relevant to fulfilling that responsibility, as it relates to fraud, in an audit of financial statements.

It is important to note that risk assessment procedures should be applied continuously throughout the audit. Auditors should recognize that facts and circumstances change as evidence is gathered during the audit.[5]

Changes in the overall market, at the broker or dealer entity itself, and the results of the audit procedures performed, can have an impact on the risks identified and potentially create new risks to be assessed. The auditing standards that establish the requirements for evaluating audit results require that the auditor evaluate the appropriateness of their risk assessments, and whether audit procedures need to be adjusted because of changes in the risk assessments.[6]

Auditor Communication Requirements

PCAOB Auditing Standard 1301 and PCAOB Auditing Standard 1305 establish the requirements for the auditor's communication with the broker's or dealer's audit committee (or equivalent body) when performing an audit of the financial statements. The standards require certain communications as part of planning and completing the audit. As discussed in Appendix 1 of this document, PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*, establishes communication requirements with the audit committee (or equivalent body) regarding independence. It may be helpful for auditors to discuss with their client what their protocol will be regarding required communications. Securities and Exchange Commission (SEC) Rule 17a-5(h) provides notification requirements of both the broker or dealer and the independent accountant when there are certain instances of non-compliance or material weakness in internal control over compliance. These notification requirements may require the broker or dealer and/or the independent accountant to notify the SEC directly within a certain time frame, which is why it is important to consider establishing a protocol for communication in regards to these matters during planning. In addition to the SEC's notification requirements, there are also communication requirements in PCAOB Attestation Standards that auditors of brokers and dealers should consider as they establish their communication protocol.[7]

Revenue Recognition

Brokers and dealers may generate revenue from a variety of the services they perform in the securities industry. Brokers facilitate the purchase and sale of securities for their clients and typically will earn a commission, or mark-up, on the transactions. Dealers or traders will buy and sell for their own accounts, generating a profit or loss based on their trading activity. Some companies act in both capacities. Brokers and dealers are of various sizes and business models and may

3 See AS 2110.04.
4 See AS 1001.02.
5 "As part of the evaluation of whether sufficient appropriate audit evidence has been obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate and whether the audit procedures need to be modified or additional procedures need to be performed as a result of any changes in the risk assessments. For example, the re-evaluation of the auditor's risk assessments could result in the identification of relevant assertions or significant risks that were not identified previously and for which the auditor should perform additional audit procedures." (PCAOB Auditing Standard 2810, paragraph .36).
6 Ibid 2.
7 See PCAOB AT No. 1.34-35 and PCAOB AT No. 2.15.

generate revenues beyond those previously described. Auditors need to gain an understanding of how brokers and dealers generate and record revenue transactions throughout the transaction lifecycle.

- Consider the following questions when obtaining an understanding of the revenue cycle to develop an audit approach:
    - What are the broker's or dealer's sources of revenues?
    - Has the PCAOB's Staff Audit Practice Alert No. 12 been considered?
    - Are the sources of revenues consistent with the broker's or dealer's registration with its regulators?
    - Have homogeneous and nonhomogenous revenue transactions been identified?
    - How are revenue transactions initiated, calculated, recorded, and monitored?
    - Have parties involved in the revenue transaction process been identified (e.g., related parties, customers, brokers and dealers, registered clearing agencies, and transfer agents), and have their roles and data been provided to and from each party involved in the transaction process?
    - What are the broker's or dealer's processes and controls for maintaining their books and records?
    - Are reconciliations performed to ensure completeness of transactions?
    - What systems and reports are utilized in initiating, calculating, and recording revenue?
    - Has the SEC's new rule to shorten the standard settlement cycle for most broker and dealer transactions from trade date + 3 business days (T+3) to trade date + 2 business days (T+2) had an impact on their procedures for recording trade activity?[8]
    - Are service organizations utilized in the revenue recognition process? Has a sufficient understanding of what the service organization does and the controls at that service organization been obtained?[9]
    - Are there revenue calculations? Who performs the calculations? Are there contractual agreements to review and evaluate (e.g., accuracy of commission rates)? [10]
    - How are fair value measurements determined? How are the completeness of the assets and/or cutoff of the assets requiring fair value treatment considered?
    - What are the controls over these processes? Does the audit approach contemplate a plan to rely on controls?
    - Are any of the controls to be tested considered management review controls? Has the PCAOB's Staff Audit Practice Alert No. 11[11] been considered?[12]
    - Has the use of an IT specialist during the audit been considered?
    - How will the financial statement audit team coordinate and supervise the IT specialist's work?

8 See SEC Release No. 34-80295.
9 Please see the section of this Planning Alert, *Auditing Information Produced by a Service Organization*, for more considerations relative to the use of a service organization.
10 Consider whether the commission rates are based on a commission table, or are discretionary.
11 While Staff Audit Practice Alert No. 11 applies to audits of internal control over financial reporting, there are still concepts described in this alert that may be helpful when auditors of brokers or dealers plan and perform tests of internal control.
12 See pages 19-25 of the PCAOB's *Staff Audit Practice Alert No. 11 - Consideration for Audits of Internal Control Over Financial Reporting.*

- What reports will be used in the revenue cycle audit procedures? How are those reports generated? How has the completeness and accuracy of the information in those reports been considered? Have you considered the PCAOB's Staff Audit Practice Alert No. 11?[13]

- Below are some common examples of audit deficiencies that have been identified in previous PCAOB inspections related to auditing revenue:[14]

    - The auditor incorrectly assumes that a population of revenue transactions is homogenous. Thus, the samples tested are not representative of all the significant revenue types.[15]

    - The auditor does not sufficiently understand the components of a revenue financial statement line item, and thus fails to test a material class of revenue transactions.

    - The auditor reduces the extent of substantive testing based upon reliance on controls without sufficiently testing the design and operating effectiveness of controls to support the planned controls reliance strategy.

    - The auditor uses reports (trade blotters, account statements, or reports from clearing brokers) or information (schedules or spread sheets) from the client, or third parties, including service organizations without obtaining sufficient and appropriate evidence about the accuracy and completeness of that report or information.[16]

    - The auditor did not adequately test the relevant assertions for revenue as a result of not doing all or some of the following:

        - Evaluating whether the terms of underlying contractual arrangements were appropriately considered in recognizing revenue.

        - Testing whether the values used for assets under management to calculate fees were accurate and complete.

        - Determining whether the commission rates used to calculate commission revenue were consistent with the underlying agreements.

        - Evaluating the effect on the financial statements of recognizing commission revenue on trade date rather than on a settlement date basis.[17]

        - Evaluating whether revenue recognition policies were in accordance with US Generally Accepted Accounting Principles (GAAP).

As a reminder, Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers* (Topic 606) will be effective for calendar year end public companies on January 1, 2018.[18] Brokers or dealers that are registered with the SEC meet the Financial Accounting Standards Board (FASB) Master Glossary definition of public business entities, and therefore the effective date for the ASU will be the same as public companies.[19] Please see the CAQ's publication, *Preparing for the New Revenue Recognition Standard: A Tool for Audit Committees*, for more information on preparing for the implementation of the ASU. Additionally, consider the American Institute of CPAs (AICPA) Brokers and Dealers in Securities Revenue Recognition Task Force's resource page, which identifies current broker and dealer revenue recognition implementation issues and helpful tips and illustrative examples.

13 See pages 26-27 of the PCAOB's *Staff Audit Practice Alert No. 11 - Consideration for Audits of Internal Control Over Financial Reporting.*
14 See pages 10-14 of the PCAOB's *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers.*
15 See PCAOB Auditing Standard No. 2315, *Audit Sampling* (AS 2315).
16 See PCAOB Auditing Standard No. 2601, *Consideration of an Entity's Use of a Service Organization* (AS 2601), and PCAOB Auditing Standard No. 1105, *Audit Evidence* (AS 1105).
17 See FASB Accounting Standards Codification (ASC) Topic 940, *Financial Services – Broker Dealers*.
18 In May 2014, FASB and the International Accounting Standards Board (IASB) (collectively, the boards) jointly issued a converged standard, Accounting Standards Update (ASU) *No. 2014-09, Revenue from Contracts with Customers* (Topic 606).
19 See FASB ASU No. 2013-12, *Definition of a Public Business Entity*.

Related Party Transactions

PCAOB Auditing Standard 2410, *Related Parties,* establishes requirements regarding the auditor's evaluation of a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties. Related party transactions are common in broker and dealer entities. Brokers and dealers may enter into expense-sharing or revenue-sharing agreements with a parent company or other affiliates (at times with cost plus mark-up type of arrangements). As described in more detail in the *Risk Assessment Procedures* section of this Planning Alert, for auditors to design procedures to obtain sufficient appropriate audit evidence, they should obtain a sufficient understanding of each component of internal control over financial reporting. As part of risk assessment procedures, the auditor should obtain an understanding of the broker's or dealer's related party relationships and transactions that might reasonably be expected to affect the risks of material misstatement of the financial statements.[20]

- Consider the following questions when obtaining an understanding of a client's related party transactions to design an audit approach:
    - What agreements are in place with the related party and what is the purpose of the agreements? How often are those agreements executed, evaluated, and updated? What is the approval process for related party transactions?
    - How are the revenues and expenses allocated and recorded? What are the inputs to the allocation? How often do those inputs change? Who is responsible for the revenue and/or expense allocation process? Who authorizes changes to the allocation process?
    - What are the relevant inputs in calculating allocated expenses or revenues? How are those inputs determined? What is the nature and extent of the planned procedures to test those inputs? For example, if expenses are allocated based upon expenses incurred at the parent level, what will be the nature and extent of the procedures to test those parent level expenses?
    - Have there been errors in the allocation process in the past?
    - What are the processes and controls in place related to the completeness and accuracy of related party disclosure(s) in the financial statements?
    - If the broker or dealer management asserts and discloses in the financial statements that the related party transactions are at arm's length, how has the company concluded that the related party transactions are arm's length? How has the company ensured completeness of an arms-length related party transaction? Is there contrary evidence as to whether the transaction is truly arm's length?[21]
    - How does the broker or dealer determine or document that their expense allocation is reasonable in the context of the Notice to Members NASD 03-63 (net capital)?[22]
    - How are the intercompany balances settled with the parent company or affiliate?
    - Has management's treatment of related party receivable or payable balances in the net capital computation been considered?[23] Are any of the receivable or payable amounts netted between affiliates? Have procedures been designed to test that the netting is in accordance with US GAAP?

20 See PCAOB Staff Guidance for Auditors of SEC Registered Brokers and Dealers.
21 If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion (See PCAOB AS 2410.18).
22 On July 11, 2003, the SEC Division of Market Regulation issued a letter (Notice to Members 03-63) to clarify its position regarding the treatment of broker and dealer expenses and liabilities.
23 See 17 CFR 240.15c3-1 – Net capital requirements for brokers or dealers.

- Below are some common examples of audit deficiencies that have been identified in previous PCAOB inspections related to auditing related party transactions:[24]

  - The auditor did not test the amounts allocated to the broker or dealer, or test the basis for the allocation and the computation of the allocated amount.

  - The auditor's procedures to test allocated expenses from a parent company were limited to reading the intercompany agreement, and tracing the amounts disclosed in the financial statements to a list of intercompany payments.

  - The auditor did not evaluate the reasonableness of whether the allocated revenues or expenses were in accordance with the terms of the intercompany agreement.

Auditing Information Produced by a Service Organization

Brokers and dealers may use service organizations to process certain transactions as part of their financial reporting system. Brokers and dealers may also use service organizations to perform trade processing and other back-office functions. Obtaining a sufficient understanding of how information is produced by a service organization can sometimes be challenging because these systems and controls are outside the broker or dealer entity. PCAOB Auditing Standard 2601, *Consideration of an Entity's Use of a Service Organization* (AS 2601), establishes the auditing requirements for when a company uses the services of a service organization that affect the broker's or dealer's accounting records and financial reporting processes.

- Consider the following questions when developing an understanding of how a broker or dealer uses a service organization to develop the audit approach:

  - Does the broker or dealer use the services of a service organization that affect the broker's or dealer's accounting records and financial reporting processes? Consider how the broker or dealer views the transfer of data and how they maintain their own books and records.

  - Is a service auditor's report available for the service organization?

  - Is the broker or dealer an intended user of the service auditor's report?

  - What is the period covered by the service auditor's report in relation to the period under audit of the broker or dealer?[25]

  - Is the opinion unqualified or qualified? Have they identified any exceptions?

  - What services are not covered by the opinion?

  - Is there a subservice organization not covered by the service auditor's report? Are those services applicable to the audit? How has the engagement team addressed services performed by the subservice organization?

  - How will changes to the processes and controls at the service organization for the period not covered by the service auditor's report be identified and evaluated?

  - Are there key reports produced by the service organization being utilized by the broker or dealer and, if yes, are these key reports within the service auditor's report? If the key reports are not included in the service auditor's report, what procedures will be performed to test the completeness and accuracy of the reports?

24 See pages 15-17 of the PCAOB's *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers.*
25 See PCAOB AS 2601.15.

  - Are all relevant assertions addressed by controls in the service auditor's report? Is the service auditor's testing of the control(s) appropriate? Have they identified any exceptions?

  - Which relevant complementary user entity controls at the client are required to achieve the stated control objectives in the service auditor's report? Are they designed and operating effectively?

- Below are some common examples of audit deficiencies that have been identified in previous PCAOB inspections related to auditing information produced by a service organization:[26]

  - The auditor obtains the service auditor's report but does not evaluate the report or consider whether the report provides sufficient evidence about the design and operating effectiveness of the controls relied on in the report.

  - The auditor does not test the operating effectiveness of necessary user organization controls that are specified in the service auditor's report.

  - The auditor does not evaluate whether the scope of the service auditor's report included testing the design and operating effectiveness of controls over information used by the auditor as audit evidence (e.g., the auditor relies on a report produced by the service organization that is being used by the broker or dealer that has not been tested for completeness or accuracy).

  - The auditor does not obtain evidence about the effectiveness of necessary controls in place at subservice organizations specified in the service auditor's report.

  - The auditor does not evaluate the period covered by the service auditor's report and may not adequately address any gap between that period and the financial statement period under audit.

Supplemental Information Accompanying the Financial Statements

Brokers and dealers will present supplemental information in their annual reports to meet regulatory compliance requirements. Under the provisions of SEC Rule 17a-5(d), brokers and dealers are required to file with the SEC, among other things, a financial report containing financial statements, and supplementary information. Thus, the auditor's opinion, covering the financial report, addresses both the financial statement and supplemental information. PCAOB Auditing Standard 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements* (AS 2701), provides, among other things, the requirements for obtaining sufficient audit evidence to report on the accompanying supplemental information.

Auditors of brokers and dealers should also consider whether the entity is dually registered as an introducing broker or futures commission merchant with the U.S. Commodity Futures Trading Corporation (CFTC), which would have an impact on the regulatory and financial reporting requirements of the broker or dealer, including the supplemental information the broker and dealer is required to include with its annual financial statements.[27] Additionally, it is important to consider which audit, attestation, and independence requirements are applicable to the audit based upon whether the broker or dealer is registered with the SEC and/or CFTC. Please see the following resource, "AICPA Stockbrokerage and Investment Banking Expert Panel: Applicable Audit, Attestation, and Independence Standards," for a summary of the applicable standards to the various types of audits of brokers and dealers. In addition to the questions below, the auditor should also consider the information and questions in the *Examination and Review Engagements* section below when planning their audit of the supplemental information.

- Consider the following questions when planning the audit approach over the supplemental information accompanying the financial statements:

26 See pages 12-13 and 22-23 of the PCAOB's *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers.*
27 See the AICPA's publication, *Regulatory Considerations for Entities Registered with the Commodity Futures Trading Commission*, for more information.

- How is the supplemental information prepared? Who is responsible for preparing and reviewing the supplemental information? Have there been changes in the personnel responsible for preparing and reviewing the supplemental information?
- What controls do management have in place to prepare and review the supplemental information?
- What systems are used to prepare the supplemental information? Does the audit plan contemplate the use of information or reports from service organizations to test the supplemental information? Has the completeness and accuracy of that information been considered?
- How does the company determine its required minimum net capital? How do they determine the appropriate haircut percentages that need to be applied to the broker's or dealer's securities?
- How do they determine other components to the net capital computation?
- Are there changes in the business that would have an impact on the supplemental information the broker or dealer prepares?
- Is the same materiality being used to plan, perform, and evaluate the results of the audit of the supplemental information as is used for the audit of the financial statements?[28]
- Have the Financial Industry Regulatory Authority (FINRA), the SEC, or other regulators examined the broker or dealer recently? Are there exams in process with the regulator?
- Has all of the broker's or dealer's correspondence with regulators been requested and obtained? Has the correspondence been evaluated for the impact that any matters raised by regulators could have on the audits of the financial statements and supplemental information?

- Below are common examples of audit deficiencies that have been identified in previous PCAOB inspections related to auditing the supplemental information accompanying the financial statements:[29]
    - The auditor does not test whether components of the net capital computation are in accordance with the appropriate regulatory requirements.
    - The auditor does not test the classification of allowable and non-allowable assets in the net capital computation.
    - The auditor does not evaluate whether the appropriate haircut percentages have been applied by the broker or dealer to its securities or does not appropriately assess the systems used to calculate haircuts.
    - The auditor does not sufficiently understand and test the completeness and accuracy of the customer debits and customer credits in the customer reserve computation.
    - The auditor does not perform sufficient procedures to test the broker's or dealer's information relating to possession or control requirements (as an example not sufficiently testing the classification of good control locations).

Examination Engagements

PCAOB Attestation Standard 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* (AT 1) establishes requirements that apply when an auditor is engaged to perform an examination of certain statements made by a broker or dealer with respect to specific financial responsibility rules (i.e., Rule 15c3-1, Rule 15c3-3, Rule 17a-13, and the

28 See PCAOB AS 2701.03(b).
29 See pages 23-28 of the PCAOB's *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers.*

Account Statement Rule) in a compliance report prepared pursuant to SEC Rule 17a-5(d). As further explained in Appendix 1, PCAOB Auditing Standard 1220, *Engagement Quality Review*, applies to attestation engagements conducted pursuant to AT 1. See the *Engagement Quality Review* section of Appendix 1 for more details.

- Consider the following questions when planning the examination engagement:
  - What are the nature of instances of non-compliance with the financial responsibility rules and deficiencies in internal control over compliance identified during previous examination engagements?
  - What control deficiencies (including those resulting from errors) have been identified in the past? Is management aware of control deficiencies during the current period?
  - What are the broker's or dealer's processes, including relevant controls, regarding compliance with the financial responsibility rules?
  - Have there been changes to the controls since the last examination?
  - What reports or information are used by the broker or dealer to perform its financial responsibility controls? How has the completeness and accuracy of those reports or information been considered? How are those reports generated? How has the completeness and accuracy of the information in that report been considered? Has the PCAOB's Staff Audit Practice Alert No. 11 been considered?[30]
  - Where has the auditor considered opportunities to coordinate the examination engagements with the audits of the broker's or dealer's financial statements, including supplemental schedules?
  - Do any of the controls to be tested include management review controls? Has the PCAOB's Staff Audit Practice Alert No. 11 been considered?[31]
  - What is management's level of competence regarding the relevant rules and regulations?
  - Are there related parties that are investment advisors or entities that are relevant to compliance with the financial responsibility rules and internal controls over compliance with which the broker or dealer has a custodial or clearing relationship?
  - Have the Financial and Operational Combined Uniform Single Reports (FOCUS Reports) filed by the broker or dealer been obtained and read? What are the reasons for resubmissions, if any?
  - Are there internal audit reports available that are relevant to the broker's or dealer's assertions related to compliance?
  - Are there open regulatory examinations, or correspondence with the SEC or the broker's or dealer's Designated Examining Authority (DEA) that are relevant to the broker's or dealer's assertions?
  - Is there correspondence and/or notifications regarding non-compliance that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA that are relevant to the broker's or dealer's assertions?
  - What is the nature and frequency of customer complaints that are relevant to compliance with the financial responsibility rules?
  - How has materiality been determined for purposes of identifying the controls management has in place to prevent or detect a non-compliance with the financial responsibility rules, as well as evaluating whether control

30 See pages 26-27 of the PCAOB's *Staff Audit Practice Alert No. 11 - Consideration for Audits of Internal Control Over Financial Reporting.*
31 See pages 19-26 of the PCAOB's *Staff Audit Practice Alert No. 11 - Consideration for Audits of Internal Control Over Financial Reporting.*

deficiencies represent a non-compliance with the financial responsibility rules? Have alternative approaches to determining materiality been considered?

- What controls does management have in place to prevent or detect non-compliance with SEC Rules 15c3-1 and 15c3-3(e); detect non-compliance to a material extent with 15c3-3, except paragraph (e); 17a-13, and the Account Statement Rule?[32] What evidence is available to test those controls? Does the broker or dealer rely on a service organization?

- Possession or control: What is management's process to review agreements with custodians/mutual funds with regard to possession or control and has consideration been given to regulatory findings in determination of good control locations?

- SEC Rule 15c3-3: Has an understanding of how management has assessed that the stock record allocation hierarchy was performed in accordance with Rule 15c3-3 been obtained in order to test whether the allocation was performed as designed?

- Account Statement Rule: Does the auditor have an understanding of the rule or rules of the DEA of the broker or dealer that is disclosed in management's assertions in its compliance report (e.g. NASD Rule 2340)?

  - Has an understanding of the account statement process been obtained? What is the broker's or dealer's process for maintaining compliance with the account statement rules?

- Has the auditor identified sufficient appropriate tests of compliance on the schedules used by the broker or dealer to determine compliance?[33]

- Below are examples of examination deficiencies in examination engagements that have been identified in previous PCAOB inspections:[34]

  - The auditor does not identify and evaluate the design and implementation of relevant controls over compliance.

  - The auditor does not identify or test the operating effectiveness of any compliance controls.

  - The auditor tests review controls without gaining an understanding of management's process for setting expectations and investigating differences. Thus, the auditor does not sufficiently test the control.

  - The auditor does not test the completeness and accuracy of underlying information or reports upon which the design and operating effectiveness of the compliance control depends.

  - The auditor does not obtain an understanding of the nature and frequency of customer complaints. (Note: The examination standard includes a requirement for the auditor to obtain an understanding of the nature and frequency of customer complaints that are relevant to compliance with the financial responsibility rules, which can provide evidence relevant to the assessment of fraud risks, especially if there is a high incidence of customer complaints, thematic issues in the complaints that indicate the potential for misappropriation of customer assets, or specific allegation of fraud or misfeasance by the broker's or dealer's customers.)[35]

  - The auditor does not assess the risks associated with the related parties that were relevant to compliance and controls over compliance.

  - The auditor does not assess the risk of fraud including risk of misappropriation of customer assets.

32 See PCAOB AT No. 1.A4.

33 PCAOB AT No. 1.21 requires auditors to perform procedures on the schedules the broker or dealer used to determine compliance and PCAOB. AT No. 1.22 requires the auditor to plan and perform compliance tests that are responsive to the risks, including fraud risks, associated with non- compliance with the net capital rule and the reserve requirements rule.

34 See pages 34-36 and pages 39-41of the PCAOB's *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers.*

35 See paragraph 9.j. of PCAOB AT 1; also see chapter 3 of *Staff Guidance for Auditors of SEC-Registered Brokers and Dealers*.

Review Engagements

PCAOB Attestation Standard 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* (AT 2) establishes the requirements for auditor review of the statements in the exemption reports of certain brokers and dealers, including review procedures to identify exceptions to the exemption provisions of SEC Rule 15c3-3 and assessment of risk factors associated with exemption compliance. As further explained in Appendix 1, PCAOB Auditing Standard 1220, *Engagement Quality Review*, applies to attestation engagements conducted pursuant to AT 2. See the *Engagement Quality Review* section of Appendix 1 for more details.

- Consider the following questions when planning the review engagement:
    - Under what provision(s) does the broker or dealer claim exemption from SEC Rule 15c3-3, and why is this exemption(s) being elected?
    - To whom will inquiries be directed to further understand the conditions under which the broker or dealer is claiming an exemption, and the processes and controls the broker or dealer has in place to maintain compliance with the exemption?[36]
    - What if the broker or dealer has not held customer securities or funds during the fiscal year, but does not fit into one of the exemptive provisions?[37]
    - Has the nature of the broker or dealer business changed since the last review? (Exemption needs to address all types of businesses of the broker or dealer)
    - What is management's process for identifying and reporting exceptions?
    - Have there been exceptions to the broker's or dealer's compliance with the claimed exemption during the period?
    - Are there opportunities to coordinate the review engagements with the audits of the broker's or dealer's financial statements?
- Below is an example of a review deficiency in a review engagement that has been identified in previous PCAOB inspections:[38]
    - The auditor does not perform all required inquiries, including those required to obtain an understanding of management's controls and monitoring activities in place to comply with the claimed exemption provisions.

36 See PCAOB AT No. 2.5(b) and AT No. 2.10(c)(1).
37 See Question and Answer number six of the SEC's release *Frequently Asked Questions Concerning the July 30, 2013 Amendments to the Broker-Dealer Financial Reporting Rule.*
38 See pages 36-39 and pages 41-43 of the PCAOB's *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers Auditors.*

Appendix 1: Additional Reminders

Independence

As a reminder, PCAOB and SEC rules prohibit providing 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 broker's or dealer's compliance and 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 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 auditors of brokers and dealers that PCAOB Rule 3526, *Communications with Audit Committees Concerning Independence*, requires, among other things, the auditor to describe, in writing, to the audit committee of the brokers or dealers, or their equivalent, all relationships between the registered public accounting firm or any affiliates of the firm and the broker or dealer or persons in financial reporting oversight roles at the broker or dealer that, as of the date of the communication, may reasonably be thought to bear on independence 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.[39]

Engagement Quality Review

PCAOB Auditing Standard 1220, *Engagement Quality Review*, (AS 1220) requires an engagement quality review and concurring approval of issuance are required for the following engagements conducted pursuant to the standards of the PCAOB: (a) an audit engagement; (b) a review of interim financial information; and (c) an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*. AS 1220 requires that a qualified engagement quality reviewer perform an evaluation of the significant judgments made by the engagement team, and the related conclusions reached in forming the overall conclusion on the engagement. Please see AS 1220 for specific requirements.

Financial Statement Presentation and Disclosure

During planning, auditors would 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

39 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.

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."[40]

PCAOB Standard Setting Update

INTERIM INSPECTION PROGRAM

The PCAOB's current inspection program of the audits of brokers and dealers operates in accordance with PCAOB Rule 4020T, *Interim Inspection Program Related to Audits of Brokers and Dealers*. This rule requires that the PCAOB publish an annual report describing the progress of the interim program and any significant observations. According to the PCAOB's most recent annual report on the interim inspection program related to audits of brokers dealers that was issued in August 2016, the PCAOB staff is currently working to develop a rule proposal for the Board to consider 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 firms from any such inspection program.

PCAOB RULES 3210 AND 3211

In May 2016, the SEC approved PCAOB Rule 3210*, Amendments* (Rule 3210) and PCAOB 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.

AUDITOR'S REPORTING MODEL

In May 2016, the PCAOB re-proposed an auditing standard, *The Auditor's Report on an Audit of the Financial Statements When the Auditor Expresses an Unqualified Opinion,* which would supersede portions of PCAOB Auditing Standard 3101, *Reports on Audited Financial Statements*, and related amendments to PCAOB standards. The re-proposed standard would retain the pass/fail model of the existing auditor's report but would provide additional information in the report, such as the communication of critical audit matters (CAMs) arising from the audit and new elements related to auditor independence and auditor tenure. The re-proposed CAM requirements would not apply to audits of brokers and dealers reporting under the SEC Rule 17a-5.

40 See PCAOB Standard No. 2110.12.

Appendix 2: PCAOB Broker and Dealer Audit Forums

Visit https://pcaobus.org/News/Events/Pages/default.aspx for upcoming PCAOB events, including PCAOB Broker and Dealer Audit Forums.

Here are links to materials from 2016 PCAOB Broker and Dealer Audit Forums:

https://pcaobus.org/News/Events/Documents/2016%20Forums/2016-Las-Vegas-Broker-Dealer-Slides.pdf

https://pcaobus.org/News/Events/Documents/12132016-Webinar/12132016-Broker-Dealer-Auditor-Webinar-Slides.pdf

https://pcaobus.org/News/Events/Pages/12132016-broker-dealer-auditor-webinar.aspx

Appendix 3: Additional Resources

Below are links to some of the rules and regulations related to brokers or dealers that may be useful while planning the audit of a broker or dealer.

17 CFR 240.15c3-1 - Net capital requirements for brokers or dealers
https://www.law.cornell.edu/cfr/text/17/240.15c3-1

17 CFR 240.15c3-3 - Customer protection - reserves and custody of securities
https://www.law.cornell.edu/cfr/text/17/240.15c3-3

AICPA: Expert Panel - Stockbrokerage and Investment Banking
https://www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Stockbrokerage_and_Investment_Banking.aspx

FINRA Regulatory and Examination Priorities Letter
http://www.finra.org/sites/default/files/2017-regulatory-and-examination-priorities-letter.pdf

PCAOB Auditing Standards
https://pcaobus.org/Standards/Auditing/Pages/default.aspx

PCAOB Auditing Standards (Reorganized and Pre-Reorganized Numbering)
https://pcaobus.org/Standards/Auditing/Documents/ReorganizedandPreReorganizedNumbering.pdf

SEC 2017 Examination Priorities
https://www.sec.gov/news/pressrelease/2017-7.html