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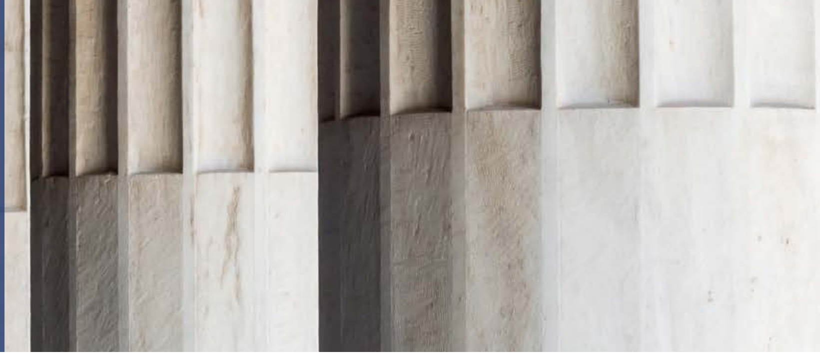

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Select Auditing Considerations for the 2017 Audit Cycle for Brokers and Dealers

Introduction

The Center for Audit Quality (CAQ) is pleased to release our *Select Auditing Considerations for the 2017 Audit Cycle for Brokers and Dealers* (the 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 US Securities and Exchange Commission (SEC). The development and issuance of this alert is an example of the profession's commitment to continuously seek to strengthening audit quality and presents questions for auditors of brokers and dealers to consider as they plan and execute both their audit and attestation engagements. The alert discusses some of the more judgmental or complex areas of the audit and attestation engagements, including some of those identified by the Public Company Accounting Oversight Board (PCAOB).[1] While the alert highlights certain areas and questions for consideration, it should not be relied upon as definitive or all-inclusive, and should be read in conjunction with applicable rules, standards, and guidance in their entirety. The questions posed in this 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.

The areas highlighted also include those where inspections staff continue to find deficiencies in the audits and attestation engagements covered by the inspections of auditors of brokers and dealers.[2]

The alert focuses on the following topics:

- Auditor Independence
- Risk of Material Misstatement Due to Fraud
- Revenue Recognition
- Financial Statement Presentation and Disclosure
- Related Party Transactions
- Auditing Information Produced by a Service Organization
- Supplemental Information
- Examination Engagements

1 See PCAOB Staff Inspection Brief: *Information about 2017 Inspection of Auditors of Brokers and Dealers*

2 See PCAOB Staff Inspection Brief: *Preview of Observations from 2016 Inspections of Auditors of Brokers and Dealers.*

- Review Engagements
- Engagement Quality Reviews
- The Securities Investor Protection Corporation (SIPC) Rule 600, Rules Relating to Supplemental Report of SIPC Membership

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Auditor Independence

As a reminder, PCAOB and SEC rules prohibit providing bookkeeping services to an audit client,[3] including preparing financial statements; maintaining or preparing clients' accounting records; and 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* provides 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.

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 audit client, or their equivalent,[4] 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. 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.[5]

Risks of Material Misstatement Due to Fraud

Assessing and responding to risks of material misstatement due to error or fraud is a critical component of an audit or attestation engagement. Auditors must have an appropriate response to their assessed risks of material misstatement due to fraud related to management override of controls, including examining journal entries for evidence of possible material misstatement due to fraud. The two types of material misstatements due to fraud can be the result of fraudulent financial reporting or misappropriation of assets, including customer assets.[6]

The auditor should refer to the following resources.

- AS 2110, *Identifying and Assessing Risks of Material Misstatement* (AS 2110) outlines the following procedures, among others:

    - Inquire of audit committee or equivalent, management, or others within the company about the risks of material misstatement

    - Obtain a sufficient understanding of the aspects of internal control over financial reporting, including evaluating the design of the controls intended to address fraud risks

3 SEC Rule 2-01(f) of S-X and PCAOB Rule 3501 *Definitions of Termed Employed in Section 3, Part 5 of the Rules,* (a)(iv) define "audit client" as the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client.

4 See Rule 3501 *Definitions of Termed 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.

5 Ibid.

6 See AS 2401.06.

- Obtain a sufficient understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement[7]

- Obtain an understanding of industry, regulatory, and other external factors[8]

- AS 2301, *The Auditor's Responses to the Risks of Material Misstatement* (AS 2301) outlines ways in which planned audit procedures may be modified to address assessed fraud risks.[9]

- AS 2401, *Consideration of Fraud in a Financial Statement Audit* (AS 2401) outlines the following procedures, among others:

  - Assess improper revenue recognition as a potential fraud risk or 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:

    - obtaining a sufficient understanding of the entity's reporting process and the controls over journal entries and other adjustments,

    - determining appropriate timing of testing,

    - inquiring about inappropriate or unusual activity, and

    - selecting appropriate journal entries for testing.

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

    - examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, as addressed by paragraphs 58–62;

    - reviewing accounting estimates for biases that could result in material misstatement due to fraud, as addressed by paragraphs 63–65; 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.

Consider the following questions when developing and performing audit procedures to address the risks of material misstatement due to fraud:

- Has the auditor assessed the risk of improper revenue recognition as a potential fraud risk?

- If the auditor has concluded that the risk of fraud through improper revenue recognition as a fraud risk has been overcome, are those conclusions documented?

- Do the substantive procedures, planned or performed, include a response to address the risk of fraud in revenue?

- Has the auditor obtained an understanding of the process to record journal entries? As a result of the understanding, has the auditor planned or performed procedures to test journal entries that represent a risk of material misstatement from fraud or error? How have the procedures planned or performed considered the completeness of the journal entry population?

7 See AS 2110.07.

8 See AS 2110.07a.

9 See AS 2301.14.

- Has the auditor (1) selected specific journal entries for testing to address fraud risk and (2) obtained sufficient appropriate evidence to support the conclusions reached? Has the auditor considered journal entries recorded based on transactions occurring in back-office brokerage system(s)?

The following are examples of audit deficiencies that have been identified in previous PCAOB inspections related to this area:[10]

- Auditors did not identify improper revenue recognition as a potential fraud risk, or if they have concluded it is not a fraud risk, they did not document their reasons supporting that conclusion.[11]
- Auditors did not perform substantive procedures, including tests of details, specifically responsive to this risk.
- Auditors did not identify and test, or sufficiently test, journal entries.
- Auditors did not test the completeness of the population of journal entries from which they selected a sample for testing.
- Auditors did not test journal entries to address the risk of management override of controls.

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

Consider the following questions when developing and performing procedures to test revenue:

- Has the auditor identified and obtained a sufficient understanding of the sources of the broker's or dealer's revenues? Has the auditor identified homogeneous and nonhomogeneous revenue transactions? As part of this process, has the auditor considered:
    - How are revenue transactions initiated, authorized, processed, recorded, and reported?
    - Have parties involved in the revenue transaction process been identified (e.g., related parties, customers, brokers and dealers, registered clearing agencies, and transfer agents)? Have their roles and data been provided to and from each party involved in the transaction process?
    - What systems and reports are utilized in initiating, calculating, and recording revenue?
    - Are service organizations utilized in the revenue recognition process, and if so has a sufficient understanding of what the service organization does and the controls at that service organization been obtained?
    - Are there revenue calculations? Who performs the calculations? Are there contractual agreements to review and evaluate (e.g., accuracy of commission rates)?
    - Are reconciliations performed to ensure completeness of transactions?
    - How are fair value measurements determined? How are the completeness of the assets and/or cutoff of the assets requiring fair value treatment considered?

10 As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on [August 18, 2017](#).

11 See AS 2401.83.

- Do the auditor's procedures planned or performed align with the auditor's understanding of internal control and risk assessment?

- Does the audit response contemplate a reliance on internal controls? If so, have those controls been tested? Are the results of the control testing sufficient to support the planned reliance on internal controls?

- Are any of the controls tested considered management review controls? Has the PCAOB's Staff Audit Practice Alert No. 11 been considered in this context?

- What reports were used in the revenue cycle audit procedures? How were those reports generated?

- How have the completeness and accuracy of the information in those reports been considered? Has the PCAOB's Staff Audit Practice Alert No. 11 been considered in this context?

The following are examples of audit deficiencies that have been identified in PCAOB inspections related to auditing revenue:[12]

- Auditors did not perform, or sufficiently perform, risk assessment procedures for revenue, including obtaining a sufficient understanding of the aspects of internal control over financial reporting relevant to revenue and evaluating the design of the controls intended to address fraud risks, which contributed to deficiencies in testing revenue.[13]

- The auditor incorrectly assumed that a population of revenue transactions is homogeneous. Thus, the samples tested were not representative of all the significant revenue types.[14]

- Auditors did not perform sufficient procedures for material classes of revenue transactions, including instances in which auditors did not design and perform sufficient sampling procedures.[15]

- 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.

- Substantive analytical procedures performed by auditors did not provide the necessary level of assurance.[16]

- Auditors did not perform procedures to obtain sufficient appropriate evidence about the accuracy and completeness of information produced by the broker or dealer or a service organization that the auditor used in its auditing procedures.[17]

- The auditor uses reports (trade blotters, account statements, or reports from clearing brokers) or information (schedules or spread sheets) from the client, including service organizations without obtaining sufficient and appropriate evidence about the accuracy and completeness of that report or information.[18]

- 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

12 As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

13 See AS 2110.

14 See AS 2315, *Audit Sampling* (AS 2315).

15 Ibid.

16 See AS 2305, *Substantive Analytical Procedures* (AS 2305).

17 See AS 2601, *Consideration of an Entity's Use of a Service Organization* (AS 2601), and AS 1105, *Audit Evidence* (AS 1105).

18 Ibid.

- 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[19]

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

As a reminder, Accounting Standards Codification 606, *Revenue from Contract with Customers* (the new revenue recognition standard) will be effective for calendar year end public companies on January 1, 2018. 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 new revenue recognition standard will be the same as public companies.[20] In October 2017, the PCAOB published Staff Audit Practice Alert No. 15, *Matters Related to Auditing Revenue from Contracts with Customers* (Practice Alert No. 15), which highlights PCAOB requirements and other considerations for audits of a company's implementation of the new revenue accounting standard. Practice Alert No. 15 discusses (a) auditing management's transition disclosures in the notes to the financial statements, (b) auditing transition adjustments, (c) considering internal control over financial reporting, (d) identifying and assessing fraud risks, (e) evaluating whether revenue is recognized in conformity with the applicable financial reporting framework, and (f) evaluating whether the financial statements include the required disclosures regarding revenue.[21]

Financial Statement Presentation and Disclosure

During performance of risk assessment procedures, auditors 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."[22]

Consider the following questions when developing and performing procedures in this area:

- Did the auditor develop an expectation of the required disclosures to be included in the broker's or dealer's financial statements?

- Has the auditor evaluated if the disclosures they would expect to be included are included? Was a disclosure check list completed by the auditor?

- Did the auditor consider the financial statement presentation disclosure requirements of SEC Rule 17A-5 applicable to the broker's or dealer's financial statements?

The following are examples of audit deficiencies that have been identified in previous PCAOB inspections related to this area:[23]

- The auditor did not identify that required disclosures were missing from the broker's or dealer's financial statements or notes.[24]

19 See FASB Accounting Standards Codification (ASC) Topic 940, *Financial Services – Broker Dealers*.

20 See FASB ASU No. 2013-12, *Definition of a Public Business Entity*.

21 Practice Alert No. 15, page 2.

22 See AS 2110.12.

23 As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

24 See AS 3101.41-.44.

- The auditors did not perform sufficient procedures to evaluate whether the broker's or dealer's financial statements were presented fairly in conformity with GAAP.[25]

- The auditors did not identify and appropriately address instances in which the broker's or dealer's financial statements were inconsistent with the requirements of SEC Form X-17A-5.[26]

- The auditor did not evaluate the broker's or dealer's classification of fair value measurements of certain assets and liabilities within the hierarchy required by FASB ASC Topic 820, *Fair Value Measurement*.

Related Party Transactions

AS 2410, *Related Parties* (AS 2410), 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).

Consider the following questions when developing and performing audit procedures to test related party transactions:

- Did the auditor obtain a sufficient understanding of the broker's or dealer's related party transactions to perform procedures responsive to the risks of material misstatement?
    - 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?
    - Have there been errors in the allocation process in the past?
    - How are the intercompany balances settled with the parent company or affiliate?
    - What are the processes and controls in place related to the completeness and accuracy of related party disclosure(s) in the financial statements?
    - How does the broker or dealer determine or document that its expense allocation is reasonable in the context of the Notice to Members NASD 03-63 (net capital)?
    - Have all unconsolidated related parties been considered?
    - Are there investment banking fees earned from the parent?
- Does the auditor's response to the risks of material misstatement in related party transactions contemplate testing inputs to the related party transaction calculation? For example, if expenses are allocated based upon expenses incurred at the parent level, what was the nature and extent of the procedures to test those parent level expenses?
- Has management's treatment of related party receivable or payable balances in the net capital computation been considered? Are any of the receivable or payable amounts netted between affiliates? Have procedures been designed or

25 See AS 2810.30-.31.

26 See *Reports to Be Made by Certain Brokers and Dealers,* SEC Rule 17a-5.

performed to test that the netting is in accordance with US GAAP?

The following are examples of audit deficiencies that have been identified in previous PCAOB inspections related to this area:[27]

- Auditors did not perform sufficient risk assessment procedures to obtain an understanding of relationships and transactions with related parties.
- Auditors did not perform sufficient procedures to test the related party transactions.
  - The auditor did not test the revenue or expense 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. AS 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 and performing procedures to audit information produced by a service organization:

- 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 ensures the completeness and accuracy of 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?[28]
- Is the opinion unqualified or qualified? Does the report identify 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?

27 As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

28 See AS 2601.15.

- 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?

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

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

The following are examples of deficiencies that have been identified in previous PCAOB inspections related to this area:[29]

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

- The auditor did 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

Brokers and dealers 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 supplemental information. Thus, the auditor's opinion, covering the financial report, addresses both the financial statements and supplemental information.[30] AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements* (AS 2701), provides, among other things, the requirements for obtaining sufficient and appropriate 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 US Commodity Futures Trading Commission (CFTC), which would have an impact on the regulatory and financial reporting requirements of the broker or dealer, including the supplemental information the broker or dealer is required to include with its annual financial statements. Additionally, it is important to consider which audit, attestation, and independence requirements are applicable to the engagement based upon whether the broker or dealer is registered with the SEC and/or the 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 engagements with brokers and dealers. In addition to the questions below, the auditor should also consider the information and questions in the *Examination and Review Engagements* sections below when planning and executing their procedures over the supplemental information.

Consider the following questions when developing and performing audit procedures to test supplemental information:

29 As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

30 See AS 2701.11.

- Has the auditor obtained a sufficient understanding of how the supplemental information is prepared in order to develop procedures responsive to the risk of material misstatement identified?
    - 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 methods and processes does 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 of the net capital computation?
    - How did they determine they were in compliance with the customer protection rule?
    - Are there changes in the business that would have an impact on the supplemental information the broker or dealer prepares?
- Was the same materiality used to plan, perform, and evaluate the results of the audit of the supplemental information as was used for the audit of the financial statements?
- Has 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?

The following are examples of audit deficiencies that have been identified in previous PCAOB inspections related to this area:[31]

- Net Capital - Auditors did not perform sufficient procedures (any one or more of the following) to:
    - Test whether components of the net capital computation are in accordance with the appropriate regulatory requirements
    - Test the broker's or dealer's classification of allowable and non-allowable assets
    - Evaluate the completeness of the reported amounts of operational charges and other deductions to arrive at the broker's or dealer's net capital, because they did not evaluate whether a deduction from net worth was necessary
    - Evaluate whether haircuts on securities' values were determined in accordance with the Net Capital Rule
- Customer Protection Rule - Auditors did not:
    - Obtain an understanding of the methods used by the broker or dealer to prepare the supporting schedule that included information relating to possession or control requirements, evaluate the appropriateness of those methods, and determine whether those methods had changed from the methods used in the prior period

31 As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

- Perform sufficient procedures to determine whether the amounts in the supplemental schedules reconcile to the broker's or dealer's underlying accounting and other records or to the financial statements, as applicable

- Perform sufficient procedures to test the information presented in the customer reserve supporting schedule, including obtaining sufficient evidence about the accuracy and completeness of information that the auditor relied upon, which was produced by a broker's or dealer's service organization, to support adjustments to the customer reserve computation

- 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 Account Statement Rule) in a compliance report prepared pursuant to SEC Rule 17a-5(d).

Consider the following questions when planning and performing the examination engagement:

- Has the auditor obtained a sufficient understanding of the relevant controls over compliance with the financial responsibility rules?
    - What controls does management have in place to prevent or detect noncompliance with SEC Rules 15c3-1 and 15c3-3(e); detect noncompliance to a material extent with 15c3-3, except paragraph (e), 17a-13, and the Account Statement Rule?[32]
    - What are the nature of instances of noncompliance 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 pieces of information are used by the broker or dealer to perform their financial responsibility controls? How are those reports generated? How has the completeness and accuracy of the information in those reports been considered? Has the PCAOB's Staff Audit Practice Alert No. 11 been considered?[33]
- 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?
- 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?

32 See PCAOB AT No. 1.A4.

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

- 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 noncompliance 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 are 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 risks of noncompliance and associated controls management has in place to prevent or detect a noncompliance with the financial responsibility rules, as well as evaluating whether control deficiencies represent a noncompliance with the financial responsibility rules? What approaches to determining materiality have been considered?
- Has sufficient evidence been obtained to test the compliance controls? Does the broker or dealer rely on a service organization? Are any of the controls tested management review controls? Has the PCAOB's Staff Audit Practice Alert No. 11 been considered?[34]
- 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 and tested to conclude 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?[35]
    - If the broker or dealer makes statements available in accordance with FINRA notice 98-3, do they have controls to comply with the relevant requirements?
    - Has the auditor planned or performed sufficient tests on the accuracy of customer statements and feeds from source systems?

The following are examples of deficiencies that have been identified in previous PCAOB inspections related to this area:[36]

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34 See pages 19-25 of the PCAOB's *Staff Audit Practice Alert No. 11 - Consideration for Audits of Internal Control Over Financial Reporting.*

35 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.

36 As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

- Auditors did not sufficiently plan and perform the examination because the auditors did not (any one or more of the following):
  - identify and evaluate the design and implementation of relevant controls over compliance
  - assess the risks associated with related parties that were relevant to compliance and controls over compliance
  - obtain an understanding of the nature and frequency of customer complaints
  - assess the risk of fraud, including the risk of misappropriation of customer assets
- Auditor did not identify or test the operating effectiveness of any compliance controls. [37]
- Auditor tested review controls without gaining an understanding of management's process for setting expectations and investigating differences. Thus, the auditor did not sufficiently test the control.
- Auditor did not perform compliance tests to support their conclusions regarding whether the broker or dealer was in compliance with the Net Capital Rule or the reserve requirements.
- Auditor did not test whether the special reserve account maintained by the broker or dealer for the exclusive benefit of its customers is in accordance with the requirements of the Customer Protection Rule.[38]
- The auditor did not test the completeness and accuracy of underlying information or reports upon which the design and operating effectiveness of the compliance control depends.

Review Engagements

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. AS 1220, *Engagement Quality Review* (AS 1220) also applies to attestation engagements conducted pursuant to AT 2.

Consider the following questions when planning and performing 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?[39] Were those inquiries performed and documented?
- 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? How has this been reflected?[40]
- 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.)

37 AT No. 1 requires the auditor to identify and test controls that are important to the auditor's conclusion about whether the broker or dealer maintained effective internal control over compliance with the financial responsibility rules throughout the fiscal year and at fiscal year-end.

38 See Rule 15c3-3(f).

39 See PCAOB AT No. 2.5(b) and AT No. 2.10(c)(1).

40 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.*

- 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?

The following are examples of deficiencies that have been identified in previous PCAOB inspections related to this area:[41]

- Auditor did not gain an understanding of the broker's or dealer's exemption conditions and did not consider certain risk factors in performing necessary inquiries and other review procedures.
- Auditor did not make all required inquiries as described by paragraphs 10(c) and 10(d) of AT No. 2. [42]
- Auditor did not consider the broker's or dealer's history of instances of noncompliance with the exemption provisions and perform other procedures as necessary.[43]
- Inspections staff also had observations related to the auditors' review reports, such as the following:
  - The report did not identify or incorrectly identified the provision in paragraph (k) of Rule 15c3-3 that the broker or dealer claimed as the basis for its exemption from Rule 15c3-3.
  - The report indicated that the broker or dealer met the identified exemption provisions throughout the period without exception, when the broker or dealer listed in its exemption report exceptions it had during the period.
- Auditor did not evaluate whether information had come to their attention during the audit that caused them to believe that one or more of the broker's or dealer's assertions are not fairly stated.

Engagement Quality Review

Engagement quality reviews can serve as safeguards against insufficiently supported audit opinions or inappropriate conclusions expressed in an attestation report because they can identify and correct engagement deficiencies before the auditor's reports are issued. 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*.[44] 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 prior to the issuance of the auditor's reports. Please see AS 1220 for specific requirements.

The following are examples of deficiencies that have been identified in previous PCAOB inspections related to this area:

- Engagement quality reviews were not performed prior to the issuance of the related audit and review reports.
- Engagement quality reviewer did not sufficiently evaluate the significant judgments and conclusions reached by the engagement team.

41 As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

42 AT No. 2 requires that the auditor's procedures related to the broker's or dealer's statements in the exemption report should include inquiries of individuals responsible for the broker or dealer complying with applicable rules, and other procedures sufficient to obtain moderate assurance about whether the statements made by the brokers and dealers in their exemption reports are fairly stated, in all material respects.

43 See paragraph 10(h) of AT No. 2.

44 See AS 1220.01.

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

SIPC Rule 600, Rules Relating to Supplemental Report of SIPC Membership (SIPC Rule 600) prescribes the form and content of the SIPC supplemental report and require that registered brokers and dealers must file a report with SIPC.[45] 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, Q*ualifications of Accountants* of Regulation S-X.[46] Further, the auditor must perform these agreed-upon procedures in accordance with PCAOB standards.[47]

Effective September 1, 2017, firms that currently file annual reports separately with FINRA and SIPC will now file once using FINRA's existing reporting portal. The portal will provide access to both FINRA and SIPC, which will allow brokers or dealers to meet the regulatory reporting requirements of both agencies with one filing.[48]

On June 20, 2017, SIPC sent a letter to its members that communicated a reduction in the member assessment rate effective retroactively as of January 1, 2017. The letter includes instructions for those situations where its members can file Form SIPC 7-B, and have the member's independent public accountant perform agreed upon procedures.[49]

If you are interested in joining the CAQ's mailing list for future broker dealer alerts and resources, please sign up at the following link. http://caq.informz.net/CAQ/pages/CAQ_Subscribe.

45 These rules were approved in March 2016. Registered brokers and dealers must file a report with SIPC, and no longer the SEC.

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

47 See SIPC Rule 600 - Rules Related to Supplemental Report on SIPC Membership.

48 See SIPC and FINRA Streamline Reporting Process Broker Dealers.

49 For more information, see SIPC Letter to Members (June 20, 2017).