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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. It is important to keep in mind that the planning of the attestation engagements for brokers and dealers should be done in coordination with the planning of the financial statement audit.¹

The Planning Alert focuses on five areas: (1) auditing revenue, (2) auditing related party transactions, (3) auditing the supplemental information, (4) performing examination engagements, and (5) performing review engagements. We have selected revenue, related party transactions, and supplemental information as the focus of the Planning Alert as they are often the more complex areas of audit and attestation engagements that may require significant auditor judgment.²

The questions posed in this Planning Alert are a mixture of:

1. questions applicable to all audits, examinations, and reviews 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.

Types of Brokers and Dealers

There are many types of brokers and dealers, and a clear understanding of the type of broker or dealer that is being audited, examined, or reviewed can often determine the most appropriate procedures to perform when planning and performing the audit. Brokers and dealers can vary widely in the activities they perform. Mutual fund distributors, introducing, clearing, carrying, and prime brokers or dealers are common types of brokers and dealers.

¹ See AT1.08, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* (AT 1) and AT2.07, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* (AT 2).

² See the PCAOB's *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers* for a more extensive list of topics. As of the date of this publication, the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

- ▶ **Mutual fund distributors** sell shares of mutual funds either directly to customers or through other brokers and dealers.
- ▶ **Introducing brokers and dealers** accept customer orders but clear the orders through another broker called a clearing broker or dealer.
- ▶ **Clearing brokers and dealers** execute customers' orders, creates the trade confirmations, settles the payments, and manages the booking of entries and physical movement of the securities.
- ▶ **Carrying brokers** hold customer accounts for introducing brokers and dealers and can also function as their clearing broker or dealer. Carrying brokers perform the customer reserve computations as well as the possession and control requirements of Securities and Exchange Commission (SEC) Rule 15c3-3.
- ▶ **Prime brokers and dealers** often cater to hedge funds and other sophisticated investors. They clear and finance customer trades completed by executing broker-dealers at the direction of the customer.

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 and the business function(s) they are approved to perform. 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. While this alert focuses on audits of SEC registered brokers and dealers, it may also be helpful to the planning of audits of brokers and dealers not registered with the SEC.

Revenue Recognition

Brokers and dealers may generate revenue from a variety of services they perform within 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 or dealers acting as a mutual fund distributor will be compensated for selling shares of investment companies to investors. In some arrangements, the fee may be paid upfront, over time (e.g., 12b-1 fees) based on a contractual rate applied to market value of the fund (monthly or quarterly), or upon the investor's exit from the fund, or a combination of these arrangements. Brokers and dealers are of various sizes and business models and may generate revenues beyond those described above. It is important for auditors to gain an understanding of the end-to-end process for generating and recording revenue transactions for each broker and dealer audit.

Accounting Standards Codification 606, *Revenue from Contracts with Customers* (the new revenue recognition standard) is effective for calendar year-end public business entities with annual reporting periods beginning after December 15, 2017. All SEC-registered brokers or dealers meet the Financial Accounting Standards Board (FASB) Master Glossary definition of public business entities because they are required by SEC Rule 17a-5 to file financial statements with the SEC, and therefore the effective date for the new revenue recognition standard is the same as public companies.³ In October 2017, the Public Company Accounting Oversight Board (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 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.⁴ Please see the American Institute of CPAs (AICPA) [Brokers](#)

³ See FASB ASU No. 2013-12, *Definition of a Public Business Entity*

⁴ PCAOB Staff Practice Alert No. 15, page 2.

and Dealers in Securities Revenue Recognition Task Force page for helpful hints and illustrative examples for how to apply the new revenue recognition standard to broker or dealer revenue streams.

RISK ASSESSMENT PROCEDURES – REVENUE

It is important for the auditor to gain a sufficient understanding of the sources of the broker’s or dealer’s revenue. Obtaining a sufficient understanding of the risks of material misstatement and designing audit procedures responsive to those risks are critical components of applying the required risk assessment standards to auditing revenue. An insufficient understanding of risk may result in, among other things, not identifying systems, reports, related parties, or third parties that could have an impact on the risk assessment and audit approach related to revenue. The auditor should 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.⁵

As described above, there are different types of brokers and dealers that carry out different types of functions. These different business models, and brokerage operations may introduce different nuances to consider when obtaining an understanding of the broker or dealer and its revenue transactions. For example, introducing brokers will typically trade through a clearing broker, which could result in another party being involved in the processing and calculation of revenue. The CAQ has developed the following questions for auditors to consider when planning the audit of a broker or dealer that relate to some of the audit deficiencies identified in previous PCAOB inspection reports in this area:

Questions	Example Deficiencies ⁶
<p>Has the auditor considered:</p> <ul style="list-style-type: none"> ▶ How revenue transactions are initiated, authorized, processed, recorded, and reported? ▶ Have the relevant inputs for determining revenue that need to be tested for the relevant assertions been identified? ▶ Whether parties involved in the revenue transaction process have 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? ▶ Whether there 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? ▶ Whether there are revenue calculations? Who performs the calculations? Are there contractual agreements to review and evaluate (e.g., accuracy of commission rates)? ▶ Whether there are reconciliations performed to evaluate completeness of transactions? ▶ The extent to which potential fraud schemes could be perpetrated with respect to revenue stream? 	<p>Auditor 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.⁷</p>

⁵ See paragraph .18 of AS 2110, *Identifying and Assessing Risks of Material Misstatement* (AS 2110).
⁶ The example deficiencies have been derived from the PCAOB’s *Annual Reports on the Interim Inspection Program Related to Audits of Brokers and Dealers*. As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.
⁷ See AS 2110.

EXTENT OF REVENUE TESTING

The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.⁸ The objective of the auditor is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor’s report.⁹ To the extent that a specific audit procedure involves sampling, the auditor should consider the specific audit objective to be achieved and should determine that the audit procedure, or combination of procedures, to be applied will achieve that objective. The auditor should determine that the population from which he or she draws the sample is appropriate for the specific audit objective.¹⁰ Sample items should be selected in a way that the sample can be expected to be representative of the population (i.e., all items in the population should have an opportunity to be selected).¹¹

The CAQ has developed the following questions for auditors to consider when planning the audit of a broker or dealer that relate to some of the audit deficiencies identified in previous PCAOB inspection reports in this area:

Questions	Example Deficiencies ¹²
Do the auditor’s procedures align with the auditor’s risk assessment and understanding of internal control?	The auditor reduced 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 did not appropriately design and perform sampling procedures to test revenue transactions in accordance with AS 2315.
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 ¹³ been considered in this context?	
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?	The auditor incorrectly assumed that a population of revenue transactions is relatively homogeneous. Thus, the samples tested were not representative of the population tested. 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
Have substantive analytics been designed with the appropriate level of precision responsive to the risk of material misstatement?	Substantive analytical procedures performed by auditors did not provide the necessary level of assurance. ¹⁶

AUDITING INFORMATION PRODUCED BY SERVICE ORGANIZATIONS AND/OR THE BROKER OR DEALER

Brokers and dealers may 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 and 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. A clearing broker used by an introducing broker may be considered a service organization.

⁸ See paragraph .08 of AS 2301, *The Auditor’s Responses to the Risks of Material Misstatement* (AS 2301).

⁹ See paragraph .03 of AS 1105, *Audit Evidence* (AS 1105).

¹⁰ See paragraph .17 of AS 2315, *Audit Sampling* (AS 2315).

¹¹ See AS 2315.24.

¹² The example deficiencies have been derived from the PCAOB’s *Annual Reports on the Interim Inspection Program Related to Audits of Brokers and Dealers*.

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

¹³ While Staff Audit Practice Alert No. 11 applies to audits of internal control over financial reporting, there are concepts described in this alert that may be helpful when auditors of brokers or dealers plan and perform tests of internal control.

¹⁴ See AS 2315.

¹⁵ Ibid.

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

Brokers and dealers may also produce information used by auditors as evidence when auditing revenue, such as reports, trade blotters, order tickets, schedules, or spreadsheets. Auditors are required to test the completeness and accuracy of the information produced by the broker or dealer that was used as audit evidence,¹⁷ so the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to: (1) test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information;¹⁸ and (2) evaluate whether the information is sufficiently precise and detailed for purposes of the audit.¹⁹

The CAQ has developed the following questions for auditors to consider when planning the audit of a broker or dealer that relate to some of the audit deficiencies identified in previous PCAOB inspection reports in this area

Questions	Example Deficiencies ²⁰
<p>What reports were used in the revenue cycle audit procedures? How were those reports generated? (Note: This does not only relate to substantive audit testing that uses reports, but also to the extent that reports from service organizations are used by management in their controls that are relevant to the process as part of the auditor’s assessment of the design and implementation of such controls.)</p> <p>When using reports from service organizations it is important to understand:</p> <ul style="list-style-type: none"> ▶ the intended user of the report,²¹ ▶ the testing of key reports by the service auditor,²² and ▶ to evaluate relevant deficiencies noted by the service auditor.²³ <p>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?</p>	<p>The auditor used reports (trade blotters, account statements, or reports from clearing brokers) or information (schedules or spreadsheets) from the client, including service organizations without obtaining sufficient and appropriate evidence about the accuracy and completeness of that report and/or information produced by the broker or dealer or a service organization that the auditor used in its auditing procedures.²⁴</p>

Related Party Transactions

AS 2410, *Related Parties* (AS 2410), establishes requirement for the auditor to obtain sufficient appropriate audit evidence to determine whether the related parties, relationships, and transactions have been properly identified, accounted for, and disclosed in the financial statements. To design procedures to obtain sufficient 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.²⁵

Related party transactions are common in broker and dealer entities. Related parties often play a significant role in the operations of brokers and dealers, for example. This can occur, through direct participation in the activities of the broker or dealer by principals or affiliates under shared-service agreements or expense-sharing agreements. Related party transactions could be used to manipulate the reported financial position or results of operations. For example, transactions with related parties, including owners or affiliates, may be improperly used by brokers and dealers in certain scenarios. These may include overpaying for goods or services and disguising capital withdrawals, avoiding the imposition of higher capital requirements

¹⁷ Auditors should also consider whether reports from service organizations used as audit evidence require audit testing for completeness and accuracy.

¹⁸ See AS 2601.13-14.

¹⁹ See AS 1105.10.

²⁰ The example deficiencies have been derived from the PCAOB’s *Annual Reports on the Interim Inspection Program Related to Audits of Brokers and Dealers*.

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

²¹ See AS 2601.

²² *Ibid*.

²³ *Ibid*.

²⁴ See AS 2601 and AS 1105.

²⁵ See AS 2110.18.

and various capital charges, structuring a broker’s or dealer’s business to avoid certain rules, and transferring customer assets to parties that are not approved custodians.

Often companies enter expense sharing or revenue sharing agreements with a parent company or other affiliates. The auditor should perform procedures to obtain an understanding of a company’s relationships and transactions with its related parties that might reasonably be expected to affect the risks of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with AS 2110.²⁶ Financial Industry Regulatory Authority (FINRA) [Notice 03-63](#) provides guidance on the booking and recording of expenses and liabilities by brokers and dealers.²⁷

RISK ASSESSMENT PROCEDURES – RELATED PARTY TRANSACTIONS

AS 2410 requires that the auditor perform procedures to obtain an understanding of the broker’s or dealer’s relationships and transactions with its related parties that might reasonably be expected to affect the risk of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with AS 2110.²⁸ Additionally, the auditor should identify and assess the risks of material misstatement at the financial statement level and assertion level associated with the related party relationships and transactions, including whether the broker or dealer has properly identified, accounted for, and disclosed its related party relationships and transactions.²⁹

The CAQ has developed the following questions for auditors to consider when planning the audit of a broker or dealer that relate to some of the audit deficiencies identified in previous PCAOB inspection reports in this area:

Questions	Example Deficiencies ³⁰
Did the auditor obtain a sufficient understanding of the broker’s or dealer’s relationships and transactions with related party transactions to perform procedures responsive to the risks of material misstatement?	Auditor did not perform sufficient risk assessment procedures to obtain an understanding of relationships and transactions with related parties and, as a result, failed to perform procedures to obtain sufficient audit evidence 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?	
Have there been errors in the revenue and/or expense 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?	
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 performed to test that the netting is in accordance with US Generally Accepted Accounting Principles (GAAP)?	
Have all unconsolidated related parties been considered?	
How has the completeness of related parties been established, including identification of related parties that are not consolidated entities?	

²⁶ See AS 2410.03.

²⁷ 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.

²⁸ See AS 2410.03.

²⁹ See AS 2410.10.

³⁰ The example deficiencies have been derived from the PCAOB’s *Annual Reports on the Interim Inspection Program Related to Audits of Brokers and Dealers*. As of the date of this publication, the most recent annual interim inspection report was published by the PCAOB on [August 18, 2017](#).

<p>How are the revenues and expenses allocated and recorded?</p> <ul style="list-style-type: none"> ▶ 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? 	<p>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.</p>
<p>Has the auditor performed procedures to identify and assess the risks of material misstatement at the financial statement and assertion level associated with related parties and relationships and transactions with related parties?</p>	<p>Auditor did not perform procedures to identify and assess the risks of material misstatement at the financial statement and assertion level associated with related parties and relationships and transactions with related parties.</p>
<p>Has the auditor identified a significant and unusual transaction with a related party as part of its risk assessment? If so, has the significant and unusual transaction been communicated to the audit committee, or equivalent?</p>	<p>Auditor failed to identify a significant and unusual transaction with a related party as part of their risk assessment and, as a result, failed to provide communications about such transactions to the audit committee, or equivalent.</p>
<p>Has a sufficient understanding of related party relationships and transactions been obtained for the auditor to plan and perform procedures responsive to the risks of material misstatement associated with related party transactions?</p>	<p>Auditor did not perform procedures, or did not design and perform procedures, in a manner that addressed the risks of material misstatement associated with related parties and relationships and transactions with related parties.</p>

RESPONDING TO RISKS OF MATERIAL MISSTATEMENT

The auditor must design and implement audit responses that address the identified and assessed risks of material misstatement. This includes designing and performing audit procedures in a manner that addresses the risks of material misstatement associated with related parties and relationships and transactions with related parties.³¹

The CAQ has developed the following questions for auditors to consider when planning the audit of a broker or dealer that relate to some of the audit deficiencies identified in previous PCAOB inspection reports in this area:

Questions	Example Deficiencies ³²
<p>What are the relevant inputs in calculating allocated expenses or revenues?</p> <ul style="list-style-type: none"> ▶ How are those inputs determined? ▶ Is there a strategy of how to test pre-allocated expenses from which the allocated expenses are derived? 	<p>The auditor did not test or sufficiently 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.</p>
<p>How does the broker or dealer determine or document that its expense allocation is reasonable? (Note: Reasonableness can mean both ensuring allocation is computed in accordance with the agreement, or ensuring allocation is reasonable in the context of FINRA Notice 03-63.</p>	<p>The auditor did not evaluate the reasonableness of whether the allocated revenues or expenses were in accordance with the terms of the intercompany agreement.</p>

³¹ See AS 2410.11.

³² The example deficiencies have been derived from the PCAOB's *Annual Reports on the Interim Inspection Program Related to Audits of Brokers and Dealers*. As of the date of this publication, the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

Auditing the 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)(2), brokers and dealers are required to file with the SEC, among other things, a financial report containing financial statements, and supporting schedules. Thus, the auditor’s report covering the financial report, addresses both the financial statements and supporting schedules.³³ 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. Among others, the auditor’s responsibilities under AS 2701 include (1) performing procedures to test the completeness and accuracy of the information presented in the supplemental information to the extent that it was not tested as part of the audit of the financial statements and (2) evaluating whether the supplemental information, including its form and content, complies with relevant regulatory requirements or other applicable criteria, if any.³⁴ In addition to the questions below, the auditor should also consider the information and questions in the “Examination Engagements” and “Review Engagements” sections below.

The CAQ has developed the following questions for auditors to consider when planning the audit of a broker or dealer that relate to some of the audit deficiencies identified in previous PCAOB inspection reports in this area:

Questions	Example Deficiencies ³⁵
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?	Auditor did not obtain a sufficient understanding of the supporting schedules to design and perform procedures responsive to the risks of material misstatement in the supporting schedules.
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? <ul style="list-style-type: none"> ▶ 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? 	
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? ³⁶	
Has FINRA, the SEC, or another regulator examined the broker or dealer recently? Are there exams in process with the regulator?	
Has access to all of the broker’s or dealer’s correspondence with regulators been requested and obtained? <ul style="list-style-type: none"> ▶ 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? This is important for both the nature, timing, and extent of testing and, for AT 1 examination engagements, to the evaluation of deficiencies in controls for internal control over compliance (ICOC). 	
Are there changes in the business that would have an impact on the supplemental information the broker or dealer prepares?	

³³ See AS 2701.11.

³⁴ See AS 2701.04(e) and (f).

³⁵ The example deficiencies have been derived from the PCAOB’s *Annual Reports on the Interim Inspection Program Related to Audits of Brokers and Dealers*. As of the date of this publication, the most recent annual interim inspection report was published by the PCAOB on [August 18, 2017](#).

³⁶ See note to AS 2701.03(b)

<p>How does the company determine its required minimum net capital?</p> <p>How does management determine the appropriate haircut percentages that need to be applied to the broker's or dealer's securities?</p>	<p>The auditor did not perform sufficient procedures to (any one or more of the following):</p> <ul style="list-style-type: none"> ▶ Test whether components of the net capital computation are in accordance with the appropriate regulatory requirements ▶ Test or sufficiently 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 Rules ▶ 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
<p>How does the company determine other components of the net capital computation?</p>	
<p>How did the company determine it was in compliance with the customer protection rule? ³⁷</p>	<p>Customer Protection Rule - Auditor did not:</p> <ul style="list-style-type: none"> ▶ 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 ▶ 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)

³⁷ Also, see Frequently Asked Questions Regarding Rule 15a-6 and Foreign Broker-Dealers.

Examination Engagements

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).

PLANNING THE EXAMINATION

The auditor is required to plan the examination engagement to perform procedures that are sufficient to provide a reasonable basis for determining whether the broker’s or dealer’s assertions are fairly stated, in all material respects.³⁸

The CAQ has developed the following questions for auditors to consider when planning the audit of a broker or dealer that relate to some of the audit deficiencies identified in previous PCAOB inspection reports in this area:

Questions	Example Deficiencies ³⁹
<p>Does management have controls in place to detect noncompliance with the financial responsibility rules?</p> <p>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?⁴⁰</p> <p>Has the risk of fraud been assessed, including the risk of misappropriation of customer assets?</p> <p>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?</p>	<p>Auditor did not sufficiently plan the examination procedures over certain of the financial responsibility rules:</p> <ul style="list-style-type: none"> ▶ The auditor did not obtain an understanding, or a sufficient understanding, of the broker or dealer’s processes, including relevant controls, regarding compliance with the financial responsibility rules. ▶ The auditor did not assess the risk of fraud, including the risk of misappropriation of customer assets.
<p>What are the broker’s or dealer’s processes, including relevant controls, regarding compliance with the financial responsibility rules?</p> <ul style="list-style-type: none"> ▶ What control deficiencies (including those resulting from errors) have been identified in the past? ▶ What control deficiencies were identified during the financial statement audit (including IT and Service Organization Controls Report 1 deficiencies) and what is their impact for the examination? ▶ Is management aware of control deficiencies during the current period? ▶ Is compliance dependent on key systems and were they adequately tested? 	<p>Auditor did not identify and evaluate the design and implementation of relevant controls over compliance.</p>

³⁸ See AT1.09-.10.

³⁹ The example deficiencies have been derived from the PCAOB’s *Annual Reports on the Interim Inspection Program Related to Audits of Brokers and Dealers*. As of the date of this publication, the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

⁴⁰ See PCAOB AT 1.A4.

<p>What is the nature and frequency of customer complaints that are relevant to compliance with the financial responsibility rules?</p>	<p>Auditor did not obtain an understanding of the nature and frequency of customer complaints that were relevant to the financial responsibility rules.</p>
<p>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? This is important for the nature, timing, and extent of testing and in the evaluation of deficiencies in controls for ICOC.</p>	<p>Auditor did not inquire of management, or other individuals at the broker or dealer who have relevant knowledge regarding regulatory examinations and correspondence between the broker or dealer and regulatory agencies relevant to the broker's or dealer's assertions.</p>

TESTING CONTROLS OVER COMPLIANCE

The auditor must test those controls that are important to the auditor's conclusion about whether the broker or dealer maintained effective ICOC for each financial responsibility rule during the fiscal year and as of the end of the fiscal year. The auditor must obtain evidence that the controls over compliance selected for testing are designed effectively and operated effectively during the fiscal year and as of the fiscal year end. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the persuasiveness of the evidence that the auditor should obtain also increases.⁴¹

The CAQ has developed the following questions for auditors to consider when planning the audit of a broker or dealer that relate to some of the audit deficiencies identified in previous PCAOB inspection reports in this area:

Questions	Example Deficiencies ⁴²
<p>What reports or pieces of information are used by the broker or dealer to perform their financial responsibility controls?</p> <ul style="list-style-type: none"> ▶ 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?⁴³ 	<p>Auditor did not test controls, or sufficiently test controls, over the accuracy and completeness of underlying information, produced by either the broker or dealer, or the broker's or dealer's service organizations, upon which the design and operating effectiveness of the control depended.</p>
<p>Has sufficient evidence been obtained to test the compliance controls?</p> <ul style="list-style-type: none"> ▶ 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?⁴⁴ 	<p>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.</p>

⁴¹ See AT 1.11-.12

⁴² The example deficiencies have been derived from the PCAOB's *Annual Reports on the Interim Inspection Program Related to Audits of Brokers and Dealers*. As of the date of this publication, the most recent annual interim inspection report was published by the PCAOB on [August 18, 2017](#).

⁴³ See pages 26-27 of the PCAOB's Staff Audit Practice Alert No. 11 - Consideration for Audits of Internal Control Over Financial Reporting.

⁴⁴ See pages 19-25 of the PCAOB's Staff Audit Practice Alert No. 11 - Consideration for Audits of Internal Control Over Financial Reporting.

<p>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?</p>	
<p>How has materiality been determined for purposes of identifying risks of noncompliance and associated controls management has in place to prevent or detect:</p> <ul style="list-style-type: none"> ▶ a noncompliance with 15c3-1 and 15c3-3(e); ▶ a material noncompliance with the other financial responsibility rules; or ▶ a material weakness with ICOC? <p>What approaches to determining materiality have been considered?</p>	
<p>What is management’s process to review agreements with custodians/mutual funds regarding possession or control? Has consideration been given to regulatory findings in determination of good control locations?</p>	<p>Auditor did not test or sufficiently test, the operating effectiveness of compliance controls.⁴⁵ Auditor did not sufficiently test the effectiveness of IT controls, such as logical access, change management, and computer operations controls.</p>
<p>Has an understanding been obtained of how management has designed controls to maintain compliance with the Rule 17a-13 requirement to perform a quarterly security count? Has the auditor tested to conclude whether the count operated as designed?⁴⁶</p> <p>Has the impact of aged items been considered in terms of net capital charges and reserve calculations?</p>	
<p>Has an understanding been obtained of how management has assessed that the stock record allocation hierarchy was performed in accordance with SEC Rule 15c3-3? Has the auditor tested to conclude whether the allocation was performed as designed?</p>	
<p>Does the auditor have an understanding of the account statement 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)?</p> <ul style="list-style-type: none"> ▶ 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?⁴⁷ ▶ 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? <p>Has the auditor planned or performed sufficient tests on the accuracy of customer statements and feeds from source systems?</p>	<p>Auditors did not test or sufficiently test:</p> <ul style="list-style-type: none"> ▶ controls designed to evaluate all customers received account statements either electronically or by mail, ▶ or controls designed to evaluate the account statement included complete and accurate information.

45 AT 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.

46 Note: If there are differences between the actual amounts held and the amounts that records indicate should be held, the broker or dealer may be required to take capital charges until the differences are resolved.

47 PCAOB AT 1.21 requires auditors to perform procedures on the schedules the broker or dealer used to determine compliance, and PCAOB AT 1.22 requires the auditor to plan and perform compliance tests that are responsive to the risks, including fraud risks, associated with noncompliance with the net capital rule and the reserve requirements rule.

PERFORMING COMPLIANCE TESTS

The auditor must perform procedures that are sufficient to support the auditor’s conclusions regarding whether the broker or dealer was in compliance with the net capital rule and reserve requirements rule as of the end of its most recent fiscal year.⁴⁸ In addition to the questions posed below, also refer to the *Auditing the Supplemental Information* above.

The CAQ has developed the following questions for auditors to consider when planning the audit of a broker or dealer that relate to some of the audit deficiencies identified in previous PCAOB inspection reports in this area:

Questions	Example Deficiencies ⁴⁹
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?	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.
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 communications/correspondence with the SEC or the broker’s or dealer’s DEA, that are relevant to the broker’s or dealer’s assertions?	
Are there communications/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?	
Does the broker or dealer maintain a special reserve bank account for the exclusive benefit of its customers? Has the account agreement been obtained and reviewed? Are the provisions that need to be met to qualify for a special reserve bank account present?	Auditor obtained written bank notification letter regarding the account the broker or dealer used to hold its customer reserve funds, but did not perform procedures to further evaluate if the provisions had been met to qualify as a special reserve account.

Review Engagements

AT 2 establishes the requirements for auditor review of the statements in the exemption reports of brokers and dealers, including review procedures to identify exceptions to the exemption provisions of SEC Rule 15c3-3 and assessment of risk factors associated with exemption compliance.

GAINING AN UNDERSTANDING OF EXEMPTION CONDITIONS AND CONSIDERATION OF RISK FACTORS

The auditor must plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance about whether one or more conditions exist that would cause one or more of the broker’s or dealer’s assertions not to be fairly stated, in all material respects.⁵⁰ An auditor who performs a review engagement must, among other things, obtain

⁴⁸ See AT 1.21.

⁴⁹ The example deficiencies have been derived from the PCAOB’s *Annual Reports on the Interim Inspection Program Related to Audits of Brokers and Dealers*. As of the date of this publication, the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

⁵⁰ See AT 2.4.

an understanding of the broker’s or dealer’s exemption conditions and other rules and regulations that are relevant to the broker’s or dealer’s assertions.⁵¹

The CAQ has developed the following questions for auditors to consider when planning the audit of a broker or dealer that relate to some of the audit deficiencies identified in previous PCAOB inspection reports in this area:

Questions	Example Deficiencies ⁵²
<p>Has the FINRA, the SEC, or another regulator examined the broker or dealer recently? Are there examinations in process with the regulator?</p> <p>Under what provision(s) does the broker or dealer claim exemption from SEC Rule 15c3-3, and why is this exemption(s) being claimed?</p>	<p>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.⁵³</p>
<p>Which exemptive provision(s) will be identified in the auditor’s review report?</p>	<p>The auditor’s review report did not identify or incorrectly identified the provision(s) in paragraph (k) of Rule 15c3-3 that the broker or dealer claimed as the basis for its exemption from Rule 15c3-3.</p>
<p>Have you inquired with management (or individuals that have relevant knowledge of compliance) if there have been exemption report exceptions identified during the period? Are the exceptions within the report consistent with management’s assertions?</p>	<p>The auditor’s review 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.</p>

MAKING REQUIRED INQUIRIES AND PERFORMING OTHER REVIEW PROCEDURES

AT 2.10(b)-10(d) outlines inquiries to be performed by the auditor to identify exceptions to the exemption provisions. Auditors should perform inquiries and other procedures as necessary to obtain moderate assurance regarding whether a material modification should be made to the broker’s or dealer’s assertions for the assertions to be fairly stated, in all material respects.⁵⁴

The CAQ has developed the following questions for auditors to consider when planning the audit of a broker or dealer that relate to some of the audit deficiencies identified in previous PCAOB inspection reports in this area:

Questions	Example Deficiencies ⁵⁵
<p>To whom inquiries will be made to further understand:</p> <ul style="list-style-type: none"> ▶ The conditions under which the broker or dealer is claiming an exemption, ▶ The processes and controls the broker or dealer has in place to maintain compliance with the exemption and provisions.⁵⁶ ▶ Were those inquiries performed and documented? 	<p>Auditor did not make all required inquiries as described by paragraphs 10(b), 10(c), and 10(d) of AT No. 2.⁵⁷</p>

⁵¹ See AT 2.5(b)

⁵² The example deficiencies have been derived from the PCAOB’s *Annual Reports on the Interim Inspection Program Related to Audits of Brokers and Dealers*. As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

⁵³ See AT 2.10(h).

⁵⁴ See AT 2.10(h).

⁵⁵ The example deficiencies have been derived from the PCAOB’s *Annual Reports on the Interim Inspection Program Related to Audits of Brokers and Dealers*. As of the date of this publication, the most recent annual interim inspection report was published by the PCAOB on August 18, 2017.

⁵⁶ See AT 2.5(b) and AT2.10(c)(1).

⁵⁷ AT 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.

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? ⁵⁸	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.
Has the nature of the broker or dealer business changed since the last review? (Claimed exemption needs to address all types of businesses of the broker or dealer.)	
What is management's process for identifying and reporting exceptions? ⁵⁹	
<p>Have there been exceptions to the broker's or dealer's compliance with the claimed exemption provisions during the period?</p> <p>Has the broker or dealer identified exceptions in meeting the provisions in SEC rule 15c3-3(k) under which it claimed an exemption?</p>	

Conclusion

This Planning Alert focuses on five areas— (1) auditing revenue, (2) auditing related party transactions, (3) auditing the supplemental information, (4) performing examination engagements, and (5) performing review engagements—that are often the more complex areas of audit and attestation engagements that may require significant auditor judgment.

We encourage auditors of brokers and dealers also to reference the CAQ's dedicated resource page, www.thecaq.org/brokerdealers. This page provides additional resources including a series of alerts on additional topical areas of relevance to planning and performing audits of brokers and dealers.

⁵⁸ 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](#).

⁵⁹ Note: Some Broker and Dealers may use regulatory notices that allow for regulatory relief. In those circumstances, it is important to understand the prerequisites and qualifications for relying on those rules to evaluate compliance.

Please note that this publication is intended as general information and should not be relied upon as being definitive or all-inclusive. As with all other CAQ resources, this is not authoritative and readers are urged to refer to relevant rules and standards. If legal advice or other expert assistance is required, the services of a competent professional should be sought. The CAQ makes no representations, warranties, or guarantees about, and assumes no responsibility for, the content or application of the material contained herein and expressly disclaims all liability for any damages arising out of the use of, reference to, or reliance on such material. This publication does not represent an official position of the CAQ, its board or its members.

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