

December 2017

B/D Alert #3: Examination Engagements

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 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.

Please see previously issued CAQ Alert #2017-05, *Select Auditing Considerations for the 2017 Audit Cycle for Brokers and Dealers* where additional areas of the audit and attestation engagements are highlighted for consideration.²

Developing and Performing Attestation Procedures

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).

¹ See PCAOB Staff Inspection Brief: *Information about 2017 Inspection of Auditors of Brokers and Dealers* and PCAOB Staff Inspection Brief: *Preview of Observations from 2016 Inspections of Auditors of Brokers and Dealers*.

² CAQ Alert #2017-05 is available at <http://www.thecaq.org/caq-alert-2017-05-select-auditing-considerations-2017-audit-cycle-brokers-and-dealers>.

Questions to Consider

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?³
 - 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?⁴
- 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?
- 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?

³ See PCAOB AT No. 1.A4.

⁴ See pages 26-27 of the PCAOB's [Staff Audit Practice Alert No. 11 - Consideration for Audits of Internal Control Over Financial Reporting](#).

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- 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?⁵
- 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?⁶
 - 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?

⁵ See pages 19-25 of the PCAOB's [Staff Audit Practice Alert No. 11 - Consideration for Audits of Internal Control Over Financial Reporting](#).

⁶ 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.

Example Deficiencies

The following are examples of deficiencies that have been identified in previous PCAOB inspections related to this area:⁷

- Auditor 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.⁸
- 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.⁹
- 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.

⁷ As of the date of this publication the most recent annual interim inspection report was published by the PCAOB on [August 18, 2017](#).

⁸ 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.

⁹ See Rule 15c3-3(f).