CAQ Alert:

Audit Planning Alert for Auditors of Brokers and Dealers

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Contents

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INTRODUCTION

The Center for Audit Quality (CAQ) is pleased to release our *Audit Planning Alert for Auditors of Brokers and Dealers* (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 six areas: (1) auditing revenue, (2) audit evidence produced by service organizations and/or the broker or dealer, (3) auditing related party transactions, (4) auditing the supplemental information, (5) performing examination engagements, and (6) performing review engagements.

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

+ questions applicable to all audits, examinations, and reviews of brokers and dealers; and
+ 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.

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).

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 assist the auditor in determining the most appropriate procedures to perform when planning and performing the audit. Brokers and dealers can vary widely in the activities they perform, and in many instances, there are firms that act as both a broker and a dealer. Mutual fund distributors, introducing, clearing, carrying, and prime brokers or dealers are common types of brokers and dealers. Common services brokers and dealers may engage in include:[2]

+ Underwriting publicly offered securities
+ Assisting in the private placement of securities
+ Providing investment research and advice
+ Developing new financial products, including derivative products
+ Providing a source of market liquidity (market makers and designated market makers) and creating a secondary market for many products
+ Providing loans and financings, including equity loans and mortgage loans
+ Providing the means for companies to hedge foreign currency, interest rate, credit risk, and other risks
+ Accommodating international investing, including US investments in foreign markets and the investment activity of foreign investors in the US markets
+ Extending credit to customers who have bought securities on margin and to business entities that need financing for mergers, acquisitions, or leveraged buyouts
+ Acting as a depository for securities owned by customers; disbursing to customers dividends and interest received; and informing customers about calls, tenders, and other reorganization activities pertaining to their securities
+ Serving in an advisory capacity for public and corporate finance activities (such as mergers and acquisitions and leveraged buyouts) and providing investment and management advisory services to individual and institutional investors (for example, mutual funds, insurance companies, and pensions)
+ Offering access to cash sweep products (such as money market funds or Federal Deposit Insurance Corporation (FDIC)-insured bank deposit programs)
+ Providing many other financial services (such as credit cards, checking accounts, and insurance products)

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),[3] 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

2 AICPA Accounting Guide *Brokers and Dealers in Securities* (2020).

3 Note that there are situations where the broker or dealer can also be registered as a SEC security-based swap dealer or CFTC swap dealer.

to the engagement based upon whether the broker or dealer is registered with the Securities and Exchange Commission (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.

FASB ASC TOPIC 606[4]

FASB ASC Topic 606, Revenue from Contracts with Customers, became effective for annual periods beginning after December 15, 2017. FASB ASC Topic 606 replaced most industry-specific revenue recognition guidance, including broker or dealer guidance, with a five-step model. Under the model, an entity should:

1. Identify the contract(s) with a customer;

2. Identify the performance obligations in the contract;

3. Determine the transaction price;

4. Allocate the transaction price to the performance obligations in the contract; and

5. Recognize revenue when (or as) each performance obligation is satisfied

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), upon the investor's exit from the fund, or a combination of these arrangements. Certain brokers or dealers earn a fee for performing services such as asset management fees or investment banking advisory fees. 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.

SEC-registered brokers and dealers meet the Financial Accounting Standards Board (FASB) Master Glossary[5] definition of public business entities because they are required by SEC Rule 17a-5 to file financial statements with the SEC. 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 revenue accounting standard. Post implementation, Practice Alert No. 15 remains a relevant resource as it discusses considering internal control over financial reporting, identifying and assessing fraud risks, evaluating whether revenue is recognized in conformity with the applicable financial reporting framework, and evaluating whether the financial statements include the required disclosures regarding revenue.[6] Please see the American Institute of CPAs (AICPA) *Brokers and Dealers in Securities - Accounting Guide* for an illustrative example of a revenue recognition policy.

4 FASB ASC Topic 606-10-05-4.
5 FASB ASC Master Glossary.
6 PCAOB Staff Practice Alert No. 15, page 2.

PCAOB'S DEFICIENCY FOCUS - REVENUE – RESPONDING TO RISKS OF MATERIAL MISSTATEMENT*

Many deficiencies in the revenue area relate to the response to the risks of material misstatement for each relevant assertion of revenue (and related receivable) accounts (AS 2301.08). In most of these cases, firms either identify a fraud risk related to revenue or do not rebut the presumption of revenue recognition as a fraud risk. Firms should address the risk of material misstatement through appropriate substantive procedures that included tests of details.

Where do firms fall short in responding to risks associated with revenue?

Past deficiencies in this area include instances of firms that did not perform any procedures for one or more significant revenue accounts or did not perform procedures to address the assessed risks of material misstatement for one or more relevant assertions for revenue (and related receivables). More specifically, the following are deficiencies related to auditing common sources of broker dealer revenue:

1. For commissions, firms did not sufficiently test whether the commission recorded by the broker or dealer was accurate based on the terms of the securities trade (including price and quantity) and the applicable commission or commission rate.

2. For trading gains and losses, firms did not sufficiently test data from the broker or dealer's proprietary trades, including acquisition cost and sales proceeds.

3. For investment banking fees, firms did not sufficiently test whether the investment banking transactions had occurred, and whether the recorded revenue was consistent with final transaction terms and the agreement between the broker or dealer and its customer.

4. For investment and other advisory fees, firms did not sufficiently test the accuracy of related balances (for example, assets under management), and whether fee rates were consistent with the terms of the broker or dealer's contract with its customer.

5. For success fees, firms did not sufficiently test final deal terms (including transaction values), applicable rates, and whether the related merger or acquisition successfully closed.

*Content derived from the PCAOB's *2020 Interim Inspection Report for Program Related to Audits of Brokers and Dealers*

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.[7]

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

7 See paragraph .18 of AS 2110, *Identifying and Assessing Risks of Material Misstatement* (AS 2110).

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:

Example Deficiencies[8]	Questions
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.[9]	Has the auditor considered: + 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? (e.g., contractual rates and asset values) + Whether there are different types of revenue transactions with varying risk profiles? + 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 (and related IT controls) are utilized in initiating, calculating, and recording revenue? + The extent to which potential fraud schemes could be perpetrated with respect to a revenue stream? + 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?

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.[10] 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.[11] 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 the sample is drawn is appropriate for the specific audit objective.[12] Sample items should

8 The example deficiencies throughout this publication have been derived from the PCAOB's Annual Reports on the Interim Inspection Program Related to Audits of Brokers and Dealers.
9 See generally AS 2110.
10 See paragraph .08 of AS 2301, *The Auditor's Responses to the Risks of Material Misstatement* (AS 2301).
11 See paragraph .03 of AS 1105, *Audit Evidence* (AS 1105).
12 See paragraph .17 of AS 2315, *Audit Sampling* (AS 2315).

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).[13]

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:

Example Deficiencies	Questions
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.	Are the planned audit procedures responsive to the identified risk of material misstatement? Has the auditor tested material classes of revenue transactions, including selecting a sample of revenue transactions for testing that was representative of the underlying population; and adequately supported their conclusion about reported revenues, based on the sampling approach applied? Has the auditor sufficiently evaluated (for each revenue stream): + the effect of specific terms and provisions in material contractual arrangements on the recognition of revenue, + tested whether revenue was recorded in the correct period, + determined whether assets under management used to calculate fees were complete and accurate, + determined whether the commission rates used to calculate commission revenue were consistent with the underlying agreements, and; + evaluated whether revenue recognition policies were in conformity with Generally Accepted Accounting Principles (GAAP)? Does the audit response contemplate a reliance on internal controls? If so, have those controls been tested? Are the results of the control testing, including IT General Controls, sufficient to support the planned reliance on internal controls? Are any relevant controls automated? Has the auditor obtained a sufficient understanding of the automated controls to determine an appropriate testing strategy? 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? (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.)

13 See AS 2315.24.

Example Deficiencies	Questions
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]	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? Has the auditor tested the classification as reported of each material class of revenue? Has the auditor identified every transaction subject to sampling for the population being sampled? Has the auditor considered whether the population sample requires disaggregation?
Substantive analytical procedures performed by auditors did not provide the necessary level of assurance.[16]	Have substantive analytics been designed with the appropriate level of precision responsive to the risk of material misstatement? Has the auditor evaluated whether underlying revenue assumptions identified have a plausible and predictable relationship with the data? Has the auditor evaluated the data used to develop the expectation for availability and reliability?

14 See AS 2315.24.
15 Ibid.
16 See AS 2305, *Substantive Analytical Procedures* (AS 2305).

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."[17]

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:

Example Deficiencies	Questions
The auditors did not identify that required disclosures were missing from the broker's or dealer's financial statements or notes.[18]	Did the auditor develop an expectation of the required disclosures to be included in the broker's or dealer's financial statements?
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.[19]	Has the auditor evaluated if the disclosures they would expect to be included are included? Was a disclosure check list completed by the auditor?
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.[20]	Did the auditor consider the financial statement presentation requirements of SEC Rule 17a-5 applicable to the broker's or dealer's financial statements?
The auditors 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.	Has the auditor considered fair value measurements disclosure guidance, including price discovery points, contrary audit evidence, determination of acceptable price ranges and testing fair value hierarchy disclosures?

17 See AS 2110.12.
18 See AS 3105.24-.27.
19 See AS 2810.30 -.31.
20 See Reports to Be Made by Certain Brokers and Dealers, SEC Rule 17a-5.

AUDIT EVIDENCE 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 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. This section includes a decision tree and associated information designed to assist auditors of SEC-registered brokers and dealers in developing their audit approach on audit and attestation engagements of a broker or dealer that uses a service organization.

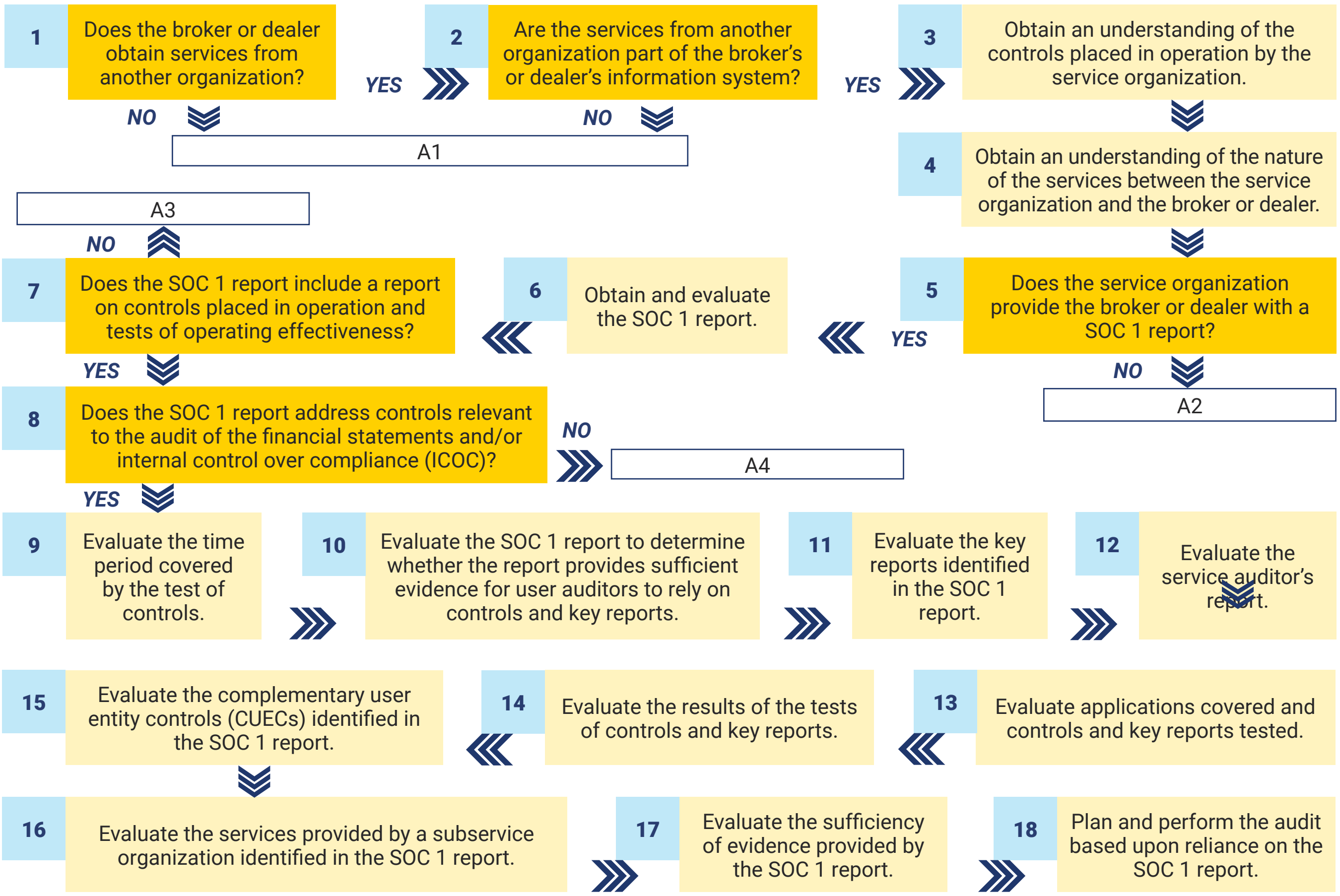
Use of a Service Organization Decision Tree

There is no one-size-fits-all approach to how a broker or dealer may use a service organization. Auditors should carefully design and execute their audit approach based upon their understanding of the broker's or dealer's transactions, related risks, the relevant controls at the broker or dealer, and the controls performed at the service organization that are part of the broker's or dealer's information system.

Auditors should document their considerations with respect to the significance of the service organization's activities to the broker or dealer and the relevance of those activities to the audit. It is important to obtain and document a sufficient understanding of the services provided by the service organization (e.g., Thomson Reuters BETA Systems), including obtaining an understanding of the service organization's internal control, to identify and assess the risk of material misstatement and design further audit procedures to respond to those assessed risks. Additionally, as necessary, auditors should appropriately design, perform and document procedures related to user entity control considerations.

The decision tree has been prepared to assist user auditors in applying the professional standards when obtaining a sufficient understanding of the broker's or dealer's use of a service organization, as well as designing auditing and attestation procedures that address the broker's or dealer's use of a service organization. The decision points are grounded in the PCAOB auditing standards. For more information, please see our stand-alone publication *Broker's and Dealer's Use of a Service Organization* which includes definitions on key terms and in-depth notes for each step in the decision tree.

Use of a Service Organization Decision Tree



DECISION TREE KEY

A1: The broker or dealer does not obtain services from another organization, and/or the broker or dealer does not obtain services from another organization that are part of the broker or dealer's information system. As a result, this decision tree would not be applicable.

A2: The service organization does not provide the broker or dealer with a SOC 1 report or the broker or dealer is not an intended user. Additional considerations not contemplated in this decision tree will be necessary. The user auditor should determine how they will obtain a sufficient understanding of the controls occurring at the service organization as part of planning and performing their audit and attestation engagement.

A3: Additional considerations not contemplated in this decision tree will be necessary. A Type 1, SOC 1 report does not provide evidence of the effectiveness of controls and therefore can only be used to assist in performing risk assessment and planning procedures.

A4: Additional considerations not contemplated in this decision tree will be necessary. If the SOC 1 report does not address controls relevant to the audit of the financial statements and supplemental information and/or internal control over compliance (ICOC) then the SOC 1 should only be used to assist in performing risk assessment and planning procedures.

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:

Example Deficiencies	Questions
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.	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? Is the opinion unqualified or qualified? Does the report identify any exceptions[21] or scope limitations?[22] When using reports from service organizations it is important to: + understand the intended user of the report,[23] + understand the scope of key reports tested by the service auditor, and + to understand and evaluate relevant deficiencies noted by the service auditor. Does the broker or dealer rely on information produced by the service organization? Does the service auditor's report explicitly cover the completeness and accuracy of the information being relied on? Does the service auditor's report cover the applications being used by the broker or dealer? Has the auditor considered possible limitations of the service auditors report as it relates to the broker or dealer? Has the auditor identified if complementary user organization controls are required for controls reliance? If so, has the auditor mapped them to controls at the broker or dealer and tested the design effectiveness and reliability? Does the service auditor's report list information or controls that the broker or dealer considers key? What is the period covered by the service auditor's report in relation to the period under audit of the broker or dealer?[24] When it is concluded that it is necessary to obtain additional audit evidence about relevant controls at the service organization that were operating outside of the period addressed by the service auditors' report, auditors may consider performing additional procedures at the service organization directly or request the service organization's auditors to perform additional procedures during the gap period.

21 See AS 2601.44(f).
22 See AS 2601.10.
23 See AS 2601.18-.21.
24 See AS 2601.15.

Information used by the Broker or Dealer

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, which would include consideration as to whether reports from service organizations used as audit evidence require audit testing for completeness and accuracy. 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; and (2) evaluate whether the information is sufficiently precise and detailed for purposes of the audit.[25]

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:

Example Deficiencies	Questions
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.[26]	What reports were used in connection with the performance of 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.) Has the PCAOB's Staff Audit Practice Alert No. 11 been considered in the context of reports being used in controls? How have the completeness and accuracy of the reports being used in control testing and substantive audit procedures been considered and tested?

RELATED PARTY TRANSACTIONS

AS 2410, *Related Parties* (AS 2410), establishes requirements for the auditor to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements. 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.[27]

Related party transactions are common in broker and dealer entities. For example related parties often play a significant role in the operations of brokers and dealers. 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

25 See AS 1105.10.
26 See AS 1105.
27 See AS 2110.18.

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 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.[28] Financial Industry Regulatory Authority (FINRA) Notice to Members 03-63 provides guidance on the booking and recording of expenses and liabilities by brokers and dealers.[29]

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.[30] 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.[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:

Example Deficiencies	Questions
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.	Did the auditor obtain a sufficient understanding of the broker's or dealer's relationships and transactions with related parties? Did the auditor perform procedures responsive to the risks of material misstatement? Has the auditor contemplated the fraud risks for the broker or dealer specific to related party transactions? Has the broker or dealer disclosed any arms-length transactions with related parties? What are the processes and controls in place related to the completeness and accuracy of related party disclosure(s) in the financial statements? 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 recognition and/or expense allocation process in the past? How are the intercompany balances settled with the parent company or affiliate?

28 See AS 2410.03.
29 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.
30 See AS 2410.03.
31 See AS 2410.10.

Example Deficiencies	Questions
(cont. from previous page)	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 GAAP? How has the completeness of related parties (including identification of unconsolidated related parties) been established?
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.	How are the revenues and expenses allocated and recorded? Are expenses allocated by a central group? What controls does the broker or dealer have in place over the allocation of revenues and expenses? + 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?
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.	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?
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.	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?
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.	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?

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.[32]

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:

Example Deficiencies	Questions
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.	What are the relevant inputs in calculating allocated expenses or revenues? + How are those inputs determined? Have you considered the completeness of the expense or revenue inputs? + Is there a strategy of how to test allocated expenses from which the expenses are derived? Are expenses tested at the parent or an affiliate company under a different materiality threshold that might require evaluation of whether the differing materiality threshold is appropriate for the BD audit? Has the auditor identified any related parties not previously identified by the broker or dealer that require further consideration and/or disclosure?
The auditor did not evaluate the reasonableness of whether the allocated revenues or expenses were in accordance with the terms of the intercompany agreement.	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 to Members 03-63. What is the frequency of updates to the current expense or revenue allocation methodology? Is the methodology consistent with the nature of the broker or dealer and its relationship with the related party?

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. AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements* (AS 2701), provides the requirements for obtaining sufficient and appropriate audit evidence to report on the accompanying supplemental information. 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.[33]

32 See AS 2410.11.
33 See AS 2701.04(e) and (f).

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:

Example Deficiencies	Questions
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.	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? 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?[34] Has FINRA, the SEC, other regulators, or internal audit examined the broker or dealer recently? Are there exams in process with another group or regulatory body? Has access to 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? This is important for the nature, timing, and extent of testing. + Has the auditor obtained and evaluated the annual compliance certification made by the broker or dealer CEO (FINRA Rules 3120 and 3130)? + Has the auditor looked up the broker or dealer in FINRA's Broker Check to corroborate the understanding of current details relevant to the broker or dealer including, types of business, disclosure of regulatory events, etc.? + Has the auditor obtained any contrary evidence or developed any concerns as a result of inquires?

34 See note to AS 2701.03(b).

<table>
<tr><th>Example Deficiencies</th><th>Questions</th></tr>
<tr><td>The auditor did not perform sufficient procedures to (any one or more of the following):
+ 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</td><td>Are there changes in the business (including new rules or regulations) that would have an impact on the supplemental information the broker or dealer prepares?
How does the company determine its required minimum net capital?
How does management determine the appropriate haircut percentages that need to be applied to the broker’s or dealer’s securities?
How does the company determine other components of the net capital computation?
Have the components of the net capital computation (including both information and systems producing information) been subjected to audit procedures?
Does the broker or dealer’s general ledger allow for identification of allowable or nonallowable balances?
Has the auditor determined if any balances deemed allowable are not readily convertible to cash?
Does the broker or dealer have policies and/or controls to monitor moment-to-moment requirements?</td></tr>
</table>

<table>
<tr><th>Example Deficiencies</th><th>Questions</th></tr>
<tr><td>Customer Protection Rule - Auditor 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
+ 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)</td><td>How did the company determine it was in compliance with the customer protection rule?[35]
Does the broker or dealer receive or hold customer funds or securities?
Does the broker or dealer perform daily or weekly computations?
Has the auditor identified any changes to the allocation hierarchy?
Has the auditor identified significant adjustments to the reserve formula from the initial balance? If so, has the auditor determined the nature of these adjustments?
Has the auditor sufficiently tested completeness, accuracy and appropriateness of customer credits or customer debits (including the stock record allocation) included in the customer reserve computation?
Does the broker or dealer use information from a service organization to prepare the supplemental schedules?
Has the auditor identified any new special reserve bank account for the exclusive benefit of customers opened during the year under audit? If so, do the accounts meet the requirements of the Customer Protection Rule?
Has auditor verified the existence of special reserve bank accounts for the exclusive benefit of customers? If so, has the auditor verified that these accounts were designated for the exclusive benefit of customers and that these agreements contain the restrictive provisions required to maintain a customer reserve bank account?
Has the auditor identified margin loans to customers? Has the auditor identified segregation requirements for full securities and excess margin securities?
If applicable, has auditor identified and tested controls that sufficiently address the completeness and accuracy of customer information inputs (i.e., security settlement position, security description, and customer details including money balances) to the segregation requirement calculation and the segregation instructions communicated from the segregation requirement system to the stock record?
If applicable, has the auditor identified if the broker or dealer has procedures for monitoring segregation deficits?
Has the broker or dealer identified any rule violations during the year? Were any rule violations reported to the SEC, FINRA, or the CFTC?</td></tr>
</table>

35 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.[36]

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

Example Deficiencies	Questions
Auditor did not sufficiently plan the examination procedures over certain of the financial responsibility rules: + 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.	Does management have controls in place to prevent or detect non-compliance with the financial responsibility rules? Does the broker or dealer have a listing of controls mapped to relevant regulations or rules? What controls does management have in place to prevent or detect non-compliance with SEC Rules 15c3-1 and 15c3-3(e); detect non-compliance to a material extent with 15c3-3, except paragraph (e); 17a-13, and the Account Statement Rule?[37] Has auditor evaluated if the frequency of internal controls over compliance was appropriate to effectively prevent or detect instances of non-compliance? If applicable, has auditor identified and tested important controls over the completeness and accuracy of the supporting schedules used in the operation of the reserve computation review control? Has the risk of fraud been assessed, including the risk of misappropriation of customer assets? What is the nature of any instances of non-compliance with the financial responsibility rules and deficiencies in internal control over compliance identified during previous examination engagements?

36 See AT1.09.
37 See AT 1.A4.

Example Deficiencies	Questions
Auditor did not identify and evaluate the design and implementation of important controls that are relevant to the auditor's conclusion over compliance.	What are the broker or dealer's processes, including important controls that are relevant to the auditor's conclusion, regarding compliance with the financial responsibility rules? 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?
Auditor did not obtain an understanding of the nature and frequency of customer complaints that were relevant to the financial responsibility rules.	What is the nature and frequency of customer complaints that are relevant to compliance with the financial responsibility rules?
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.	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.

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.[38]

38 See AT 1.11-.12.

PCAOB'S DEFICIENCY FOCUS - TESTING CONTROLS OVER COMPLIANCE*

Many examination engagement deficiencies relate to testing important controls over compliance with broker or dealer financial responsibility rules. Deficiencies are commonly based on the requirements for auditors to obtain evidence that important controls are designed effectively and operated effectively during the broker's or dealer's fiscal year and as of the fiscal year end. (AT No. 1.11, .14, and .16)

Where do firms fall short in testing ICOC?

In some cases, firms have not tested ICOC for one or more financial responsibility rules, or do not test, or sufficiently test, important controls. These important controls can include information technology and automated application controls, controls over the accuracy and completeness of information produced by the broker or dealer upon which the design and operating effectiveness of ICOC depended, and management review controls.

More specifically, the following are past deficiencies related to four aspects of the financial responsibility rules:

1. For the Reserve Requirements Rule, firms did not test, or sufficiently test, controls over determination of credit and debit balances reported within the customer reserve computation pursuant to Exhibit A of the Customer Protection Rule.

2. For the possession or control requirements of the Customer Protection Rule, firms did not test, or sufficiently test, controls over consideration of customers' related accounts when determining excess margin and segregation requirements. Firms also did not sufficiently test controls over identification and resolution of deficits requiring action within the required timeframe; and maintenance of accounts free of any right, charge, security interest, lien, or claim, including acknowledgement letters for mutual fund custody accounts.

3. For the Account Statement Rule, firms did not test, or sufficiently test, controls over the production and delivery of complete and accurate account statements, either electronically or by mail, to all customers.

4. For the Quarterly Security Counts Rule, firms did not test, or sufficiently test, controls over accounting for all securities subject to the broker or dealer's control or direction, but not in its physical possession, including a firm that did not sufficiently test the assignment of broker dealer personnel to make or supervise quarterly security counts.

*Content derived from the PCAOB's: *2020 Interim Inspection Report for Program Related to Audits of Brokers and Dealers*

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:

Example Deficiencies	Questions
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.	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?[39]
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.	Has sufficient evidence been obtained to test the compliance controls? + Does the broker or dealer rely on a service organization? Are any services outsourced that are relevant to controls over compliance? + Are any of the controls tested management review controls? + Has the PCAOB's Staff Audit Practice Alert No. 11 been considered?[40]
Auditor did not test or sufficiently test, the operating effectiveness of compliance controls.[41] Auditor did not sufficiently test the effectiveness of important controls, such as logical access, change management, and computer operations controls.	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? How has materiality been determined for purposes of identifying risks of non-compliance and associated controls management has in place to prevent or detect: + a non-compliance with 15c3-1 and 15c3-3(e); + non-compliance to a material extent with the other financial responsibility rules; or + a material weakness with ICOC? What approaches to determining materiality have been considered? 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?

39 See pages 26-27 of the PCAOB's Staff Audit Practice Alert No. 11 - Consideration for Audits of Internal Control Over Financial Reporting.
40 See pages 19-25 of the PCAOB's Staff Audit Practice Alert No. 11 - Consideration for Audits of Internal Control Over Financial Reporting.
41 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.

Example Deficiencies	**Questions**
(cont. from previous page)	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?[42] Has the impact of aged items been considered in terms of net capital charges and reserve calculations? Has an understanding been obtained of how management has assessed that the stock record allocation was performed in accordance with SEC Rule 15c3-3? Has the auditor tested to conclude whether the allocation was performed as designed and is operating effectively?
Auditors did not test or sufficiently test: + 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.	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., FINRA Rule 2231)? + 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? + Are schedules used by the broker or dealer to determine compliance? If so, has the auditor identified sufficient appropriate tests of compliance on the schedules?[43] + If the broker or dealer makes statements available in accordance with FINRA Notice to Members 98-03, do they have controls to comply with the relevant requirements? + Has the broker or dealer satisfied the principles in FINRA notice to Members 98-03 for its electronic delivery notifications? If applicable, has the auditor planned or performed sufficient tests on the accuracy of customer statements and feeds from source systems?

42 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.

43 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 non-compliance 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.[44] 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:

Example Deficiencies	Questions
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.	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 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 non-compliance that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA that are relevant to the broker's or dealer's assertions? What are the nature and frequency of customer complaints that are relevant to compliance with the financial responsibility rules?
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 bank account for the exclusive benefit of customers.	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 for the exclusive benefit of customers present?

44 See AT 1.21.

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.[45] An auditor who performs a review engagement must, among other things, obtain 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.[46]

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

Example Deficiencies	Questions
Auditor did not consider the broker's or dealer's history of instances of non-compliance with the exemption provisions and perform other procedures as necessary.	Has FINRA, the SEC, or another regulator examined the broker or dealer recently? Are there examinations in process with the regulator? Under what provision(s) does the broker or dealer claim exemption from SEC Rule 15c3-3, and why is this exemption(s) being claimed? Has the auditor assessed the relevant activities at the broker or dealer within the context of exemption(s) being claimed? Is the broker or dealer covered by Footnote 74 of the 2013 Release adopting amendments to Rule 17a-5 (FN74)?[47] If so, has the auditor determined that the business descriptions disclosed in the exemption report are appropriate and complete? Has the auditor appropriately concluded whether or not material modifications should be made to management's exemption report assertions as it relates to its description of the nature of the exceptions to meeting the exemption provisions? Has the auditor performed additional procedures in response to exceptions (incremental to what management identified) to meeting the exemption provisions?
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.	Which exemptive provision(s) will be identified in the auditor's review report? Has the auditor obtained and inspected a copy of the broker-dealer's correspondence from its Designated Examining Authority specifying the exemption conditions in Rule 15c3-3 under which the broker-dealer has been approved to operate? Does the exemptive provision align with observations on the operations of the broker or dealer? Does the exemptive provision align to the FINRA membership agreement and FOCUS report?

45 See AT 2.4.
46 See AT 2.5(b).
47 See Question 8 of the SEC FAQs.

Example Deficiencies	Questions
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.	Has the auditor 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? Is the auditor's report in conformity with AT No. 2 paragraph 17 and is that report language aligned with the exemption reports?

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.[48]

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:

Example Deficiencies	Questions
Auditor did not make all required inquiries as described by paragraphs 10(b), 10(c), and 10(d) of AT No. 2.[49]	To whom inquiries will be made to further understand: + 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.[50] + Were those inquiries performed and documented?
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.	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?[51] 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?[52] Have there been exceptions to the broker's or dealer's compliance with the claimed exemption provisions during the period? Has the broker or dealer identified each and every exception in the context of the exemption(s) being claimed (e.g., FN-74, SEC rule 15c3-3(k))?

48 See AT 2.10.
49 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.
50 See AT 2.5(b) and AT2.10(c)(1).
51 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.
52 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.

CONCLUSION

This Planning Alert focuses on six areas— (1) auditing revenue, (2) audit evidence produced by service organizations and/or the broker or dealer, (3) auditing related party transactions, (4) auditing the supplemental information, (5) performing examination engagements, and (6) performing review engagements —that are often the more complex areas of audit and attestation engagements that may require significant auditor judgment.

Appendix A: Examples of Effective Procedures and Good Practices

In the PCAOB's *2018*, *2019*, and *2020*, *Annual Interim Inspection Reports for Program Related to Audits of Brokers and Dealers*, the PCAOB provided examples of effective procedures and good practices which we have highlighted within this appendix.[53]

Topic (Year)	Example of Effective Procedures and Good Practices
Testing of ICOC (2018)	A broker-dealer relied on an automated securities movement and control system to identify segregation deficits by security CUSIP number. The auditor tested whether that system was programmed to properly calculate deficits pursuant to the Customer Protection Rule and tested the relevant information technology general controls. These procedures are not contemplated in isolation but rather in combination with other relevant procedures over the account or disclosure.
Testing of ICOC (2019)	The auditor considered management's review of its monthly net capital computation an important control and one that the auditor was required to test. The auditor inquired of the control owner regarding the nature of the review, information used, expectations, thresholds for variances requiring investigation, and resolution of variances. In addition, the auditor inquired about the nature of errors in applying the Net Capital Rule identified through the review during the year. The auditor selected a sample of monthly net capital computations and inspected evidence of management's review, including evidence that variances exceeding the threshold were resolved. The auditor determined that the control owner used a securities borrowed and loaned report to determine the appropriate net capital charge, and that the control owner also verified that amounts from the report were accurately captured and included in the computation. The auditor separately tested controls over the accuracy and completeness of the information included in the securities borrowed and loaned report.
Testing of ICOC (2019)	All of a broker-dealer's customers elect to access their customer account statement in electronic form and decline receipt of a paper statement. A broker-dealer relied on an internally developed application to create account statements that included securities positions, money balances, and account activity as required by the Account Statement Rule. The auditor tested controls over the production of the statements and controls over the accuracy and completeness of information included in the statements. The controls tested included automated application controls, manual controls, and relevant information technology controls. The auditor also tested controls related to electronic delivery of statements.

53 The PCAOB has highlighted effective procedures that describe brief scenarios and possible procedures that may be effective to address that scenario. These effective procedures are provided as examples and do not modify or establish auditing or attestation standards. Auditors should consider the specific facts and circumstances of their engagements when designing audit procedures.

Topic (Year)	Example of Effective Procedures and Good Practices
Testing of ICOC (2020)	Possession or Control Scenario: The auditor considered management's daily deficit review control an important control for addressing the possession or control requirements of the Customer Protection Rule. The auditor determined that the control owner used a deficit report that detailed deficits by security to perform the review. Good Practices: + The auditor inquired of the control owner regarding the nature of the review, information used during the review, types of deficits identified and associated timeframes for resolution, and actions taken to resolve possession or control deficits of customer securities. + The auditor tested controls over the accuracy and completeness of information in the deficit report, including controls over segregation instructions and control locations, and relevant information technology controls over the system that generated the deficit report. The auditor selected a sample of deficit reports from throughout the year and inspected evidence of management's review. The auditor also obtained evidence that management took action to resolve the deficits within the timeframes required by the Customer Protection Rule.
Testing of ICOC (2020)	Scenario: The auditor considered management's periodic review of security position reconciliations between the broker-dealer's stock record and its security custodians, an important control for addressing the requirements of the Quarterly Security Counts Rule to account for securities subject to its control or direction but not in its physical possession. The auditor determined that the control owner used a reconciliation report that detailed position variances between the broker-dealer and its custodians to perform the review. Good Practices: + The auditor inquired of the control owner regarding the nature of the review, information used during the review, and procedures to resolve differences. The auditor assessed whether the control owner had other responsibilities for securities recordkeeping that might be incompatible with the review responsibilities. + The auditor tested controls over the accuracy and completeness of information in the reconciliation report, including the position information on the stock record and custodian statements. The auditor selected a sample of reconciliations from throughout the year and inspected evidence of management's review. Note: The auditor also tested controls over compliance with the securities verification requirements of the Quarterly Security Counts Rule.
Tests for Compliance (2018)	An important control used by a broker-dealer for the Quarterly Security Count Rule was management's review of reconciliations of securities held by its custodians. For this control, an auditor obtained an understanding and tested the operating effectiveness of the review process through inquiry of management regarding their expectations for securities differences and procedures performed to account for and verify differences in accordance with the rule. The auditor also inspected documentation of management's review of the reconciliations and the verification procedures performed for the differences.

Topic (Year)	Example of Effective Procedures and Good Practices
Tests for Compliance (2018)	A broker-dealer maintained a special reserve bank account for the exclusive benefit of customers. When performing tests of compliance with the Reserve Requirements Rule, the auditor reviewed a letter issued by the bank and determined that the letter indicated that, among other terms, cash and qualified securities in this bank account were not subject to any right, charge, security interest, lien or claim of any kind in favor of the bank or any person claiming through the bank.
Tests for Compliance (2019)	A broker-dealer used an internal system to allocate securities positions according to the broker-dealer's identified allocation pairings for determining balances in its customer reserve computation. As part of the audit of the financial statements, the auditor performed valuation, confirmation, and securities position reconciliation procedures to determine whether the broker-dealer's fiscal year-end stock record was complete and accurate. As part of its compliance tests over the customer reserve, the auditor selected a sample of securities from the stock record and re-performed the allocation to determine whether the broker-dealer allocated the securities in accordance with its identified allocation pairings. The auditor also reviewed the broker-dealer's allocation pairings hierarchy and compared it to the requirements of Exhibit A of the Customer Protection Rule.
Performing Review Procedures (2018)	Auditors should make the inquiries required by AT No. 2 to identify exceptions to the exemption provisions. For a broker-dealer with branch locations where customer funds could be received, the auditor inquired of management regarding the broker-dealer's controls over prompt transmittal of customer funds and securities received at the head office and branch locations. The auditor documented its understanding of the design of those controls and how the controls sufficiently addressed risks associated with prompt transmittal.
Performing Review Procedures (2018)	During its audit of revenue, the auditor obtained evidence that the broker-dealer, in addition to its business of introducing customers to its clearing broker, sold mutual fund shares to customers directly from the funds and not through a clearing broker. This mutual fund business did not fall within the exemption claimed by the broker-dealer under paragraph (k)(2)(ii) of the Customer Protection Rule, as stated in the broker-dealer's exemption report. The auditor, therefore, performed additional review procedures to address this evidence that indicated the broker-dealer's exemption report may not be fairly stated.
Performing Review Procedures (2019)	Inquiries of Management Auditors should make the inquiries required by AT No. 2 to identify exceptions to the exemption provisions. The auditor inquired of the broker or dealer's Finance and Operations Principal (FINOP) and the Chief Compliance Officer regarding findings the broker-dealer received in a regulatory examination report from its designated examining authority. The findings indicated the broker-dealer's written supervisory procedures related to prompt transmittal of customer funds were deficient. The auditor inquired of the FINOP regarding how those deficiencies were taken into account when preparing the statement in the broker-dealer's exemption report that identifies each exception to the identified exemption provision. The auditor also inspected documentation that corroborated the FINOP's response.

Topic (Year)	Example of Effective Procedures and Good Practices
Performing Review Procedures (2020)	Scenario: A broker-dealer stated in its exemption report that it complied with the exemption provisions of paragraph (k)(2)(ii) of the Customer Protection Rule. The broker-dealer also stated in its exemption report that it engaged in other business activities that were limited to proprietary trading and receiving transaction-based compensation for identifying potential merger and acquisition opportunities for clients. Good Practices: + The auditor, in planning and performing the audit of the broker-dealer's financial statements, obtained an understanding of the broker-dealer's business activities, including the nature of its arrangements with clearing brokers. The auditor took into account this understanding when assessing whether the broker-dealer conducted other business activities that should have caused the broker-dealer to either claim an additional exemption or provide disclosures related to its additional business activities in its exemption report.
Evaluating the Results of the Review Procedures (2018)	Auditors should perform additional procedures in response to information that indicates exceptions to the exemption provisions might exist, beyond those disclosed in the exemption report. The broker-dealer stated in its exemption report that it complied with the exemption provisions of paragraph (k)(2)(ii) of the Customer Protection Rule throughout the year without exception. The auditor, through inquiry of the individual at the broker-dealer responsible for forwarding customer funds received to the clearing broker, learned that customer funds are forwarded by noon of the next business day, unless this individual is not working on that day. The auditor inspected the broker-dealer's record of funds received and determined that several exceptions to the prompt transmittal requirements occurred during the year. The auditor informed management of the broker-dealer of the exceptions identified. Management of the broker-dealer confirmed these were exceptions and revised the broker-dealer's exemption report to include them.
Evaluating the Results of the Review Procedures (2019)	The auditor should evaluate whether information has come to the auditor's attention that causes the auditor to believe that one or more of the broker-dealer's assertions are not fairly stated, in all material respects. A broker-dealer stated in its exemption report that it complied with the exemption provisions of paragraph (k)(2)(ii) of the Customer Protection Rule throughout the year without exception. During its audit of the broker-dealer's financial statements, the auditor obtained information that the broker-dealer did not have an arrangement with a clearing broker-dealer at any point during the year, and that the broker-dealer's revenue was earned primarily from private placements. The auditor took into account this evidence from the audit of the financial statements and modified its review report to indicate the broker-dealer's assertion regarding the exemption claimed was not fairly stated in all material respects because it did not reflect the nature of the broker-dealer's private placement services.
Net Capital Rule (2018)	Auditors should evaluate whether supplemental information complied with relevant regulatory requirements. A broker-dealer earned commissions for the sale of annuity products and classified as allowable assets the commissions receivable that were outstanding 30 days or less. To evaluate the classification of these receivables, the auditor obtained a report with commissions information generated by the broker-dealer's internally developed sales system. The auditor tested the completeness and accuracy of the report by selecting samples of sales transactions from the sales system and from the receivables report and determining whether they were properly included in, or excluded from, the receivables report. The auditor also tested the accuracy of the aging of the commissions receivable by recalculating the number of days outstanding for the transactions in its samples.

Topic (Year)	Example of Effective Procedures and Good Practices
Net Capital Rule (2020)	Scenario: A broker-dealer reported a commission receivable from the sale of mutual funds and a related commission payable to its sales representatives in its Statement of Financial Condition. The broker-dealer classified the receivable as an allowable asset in its net capital computation. Good Practices: + The auditor performed procedures to test the relevant assertions of the receivable and payable as part of the financial statement audit. + To determine whether the classification of the receivable as allowable was in accordance with the Net Capital Rule, the auditor reviewed the language in written contracts between the broker-dealer and its sales representatives regarding payment of the commission to the sales representatives and assessed whether that language met the requirements of the Net Capital Rule.
Customer Protection Rule (2018)	Auditors should evaluate whether supplemental information complied with relevant regulatory requirements. A broker-dealer carried margin accounts for customers and used an unsecured debits report to prepare its customer reserve computation. The auditor tested the completeness and accuracy of the broker-dealer's unsecured debits report by selecting samples of customer margin accounts from the broker-dealer's customer ledger and the unsecured debits report and determining whether, based on the value of the long positions included in the customer's account, the debit balance was properly included in, or excluded from, the unsecured debits report and when included, whether the amount was accurate.
Responses to Significant Risks, Including Fraud Risks (2019)	For significant risks, auditors should perform substantive procedures, including tests of details, that are specifically responsive to the assessed risks. A broker-dealer advises clients on mergers and acquisitions and is compensated through a combination of retainer and success fees. The auditor identified a fraud risk related to the occurrence of success fees for private transactions. The auditor selected recorded success fees from private transactions throughout the year and subsequent to year-end. In addition to vouching cash receipts and requesting confirmation of related receivables, the auditor requested confirmation of key transaction terms, including closing date, from the broker-dealer's customers. The auditor also inspected closing documents to corroborate the information obtained through the confirmation process.
Revenue (2018)	When sampling, auditors should make selections that can be expected to be representative of the entire population, and provide all items an opportunity to be selected. A broker-dealer earns a spread for underwriting securities offerings and also advises clients on mergers and acquisitions. Both sources of revenue are material. The auditor tested all individually significant underwriting transactions and a sample from the remaining population of underwriting transactions using a statistically valid sampling technique. The auditor also selected a representative sample from the population of advisory fee transactions using a random number generator.
Revenue (2018)	When performing substantive analytical procedures, auditors should develop an expectation that is sufficiently precise to identify misstatements. A broker-dealer earns commissions selling a variety of securities and insurance products. Commission rates vary widely by product. The auditor established expectations for commissions earned at each product level that took into consideration the differences in commission rates by product and resulted in the auditor using a range of expected differences sufficiently precise for detecting misstatements.

Topic (Year)	Example of Effective Procedures and Good Practices
Revenue (2018)	A broker-dealer uses information from a clearing broker for financial reporting. The auditor relied on controls at the broker-dealer's clearing broker in order to modify the nature, timing, and extent of its substantive procedures for commissions revenue. A service auditor's report provided information about the operating effectiveness of controls at the clearing broker for the first seven months of the broker-dealer's fiscal year. The auditor performed sufficient, appropriate procedures on the information included in the service auditor's report. In addition, the auditor reviewed information from the clearing broker regarding changes in its controls since the date of the service auditor's report. The auditor also identified controls at the broker-dealer over commissions revenue and tested those controls throughout the year.
Revenue (2018)	Auditors should perform procedures to assess whether revenue has been reported at the proper amount. A broker-dealer earns asset management fees based on the value of each customer's account holdings. After assessing the risks of material misstatement, the auditor performed procedures to test the occurrence and completeness of revenue transactions. The auditor also performed procedures to test the valuation of revenue by testing the completeness and accuracy of customer account holdings and the accuracy of the management fee rates that the broker-dealer used to determine the amount of revenue reported.
Revenue (2019)	Auditors should perform procedures to address the risks of material misstatement related to improper revenue recognition. A broker-dealer advises clients on mergers and acquisitions. The broker-dealer's contracts with its customers are nonstandard but generally include success fees and compensation for other services. The broker-dealer asserted that its contracts contain multiple performance obligations. The auditor tested management's assertion by inspecting a sample of contracts, and assessing the nature of the promises based on the contract terms. The auditor determined that each selected contract included a success fee (a percentage of the merger or acquisition price) and fixed fees for providing a fairness opinion in connection with the sale. The auditor tested that management determined the transaction price, allocated the transaction price to the performance obligations, and recognized revenue when (or as) the separate performance obligations were satisfied in accordance with FASB ASC Topic 606.
Revenue (2020)	Scenario: A broker-dealer earned commissions on customer trades it introduced to a clearing broker. The auditor identified a fraud risk related to improper revenue recognition for commissions. The auditor did not test the operating effectiveness of controls over commissions and accordingly assessed control risk at maximum and planned to perform substantive procedures including tests of details. Good Practices: + The auditor evaluated the design of the broker-dealer's controls to ensure that revenue was recognized on a trade date basis and in amounts that were consistent with the terms of the broker-dealer's agreements with its customers, and whether those controls had been implemented. + The auditor obtained a detail of customer trades and related commissions for the year and tested its completeness by comparing total commissions per the detail to total commissions per the broker-dealer's general ledger. + The auditor selected a sample of customer trades and tested the accuracy of the security price and quantity associated with the customer trade for each selection. The auditor also compared the commission or commission rate charged to the customer to the commission or commission rate applicable at the time of the trade per the terms of the broker-dealer's agreement with its customer.

Topic (Year)	Example of Effective Procedures and Good Practices
Related Party Relationships and Transactions (2018)	Auditors must design and implement audit responses that address the identified risks of material misstatement associated with related parties and relationships and transactions with related parties. The auditor identified a risk of material misstatement for the broker-dealer's operating expenses that were allocated to the broker-dealer from affiliated companies under the terms of an expense sharing agreement. The expenses were allocated based on factors such as office space or headcount. The auditor performed detail testing to determine whether expenses were allocated to the broker-dealer in a manner consistent with the terms of the agreement.
Confirmation Procedures (2019)	When the auditor has not received replies to positive confirmation requests, the auditor should apply alternative procedures to the nonresponses to obtain the evidence necessary to reduce audit risk to an acceptably low level. A broker-dealer recorded receivables from customers in its financial statements. The auditor assessed the risk of material misstatement and sent positive confirmation requests to a sample of customers. The auditor performed alternative procedures for the nonresponses to the confirmation requests, which included inspecting the customer statements used in the confirmation process, performing tests of detail of customer activity that affected the receivable balance (e.g., securities purchases and sales, cash deposits and withdrawals, and dividends and interest), and performing tests of detail of customer activity in the period subsequent to the financial statement date.
Financial Statement Presentation and Disclosures (2018)	A broker-dealer experienced operating losses and negative cash flow from operations for three consecutive years. The broker-dealer's owner, in addition to making capital contributions, had plans to reduce expenses until the revenue outlook for the broker-dealer improved. Management of the broker-dealer concluded that substantial doubt existed regarding the broker-dealer's ability to continue as a going concern and that its plans would mitigate the substantial doubt. To assess the likelihood that management's plans would be effective, the auditor assessed their feasibility and mitigating effects, including the capability of the owner to make capital contributions. The auditor verified that the broker-dealer's disclosures included the conditions and events that caused management to conclude that substantial doubt existed, the possible effects of those conditions and events, and information about management's plans to mitigate the substantial doubt.
Supplemental Information (2019)	The supplemental information required by Exchange Act Rule 17a-5(d)(2)(ii) consists of supporting schedules that present the net capital computation under the Net Capital Rule, the reserve requirement computations under Exhibit A of the Customer Protection Rule, and information relating to the requirement for possession or control of customer securities under the Customer Protection Rule. The reserve requirement computations include the customer reserve computation and the Proprietary Securities Account of a Broker-Dealer (PAB) account reserve computation.
Securities Haircuts (2019)	A broker-dealer held long positions in government securities in inventory, and used a report from an internal application that included issuer, maturity, and fair value information for each security to determine the haircuts on those securities to report in its computation of net capital. The auditor tested the completeness of the haircut report by reconciling the government securities included on the report to the broker-dealer's securities inventory, which was tested during the financial statement audit. The auditor tested the accuracy of the haircut report by selecting a sample of government securities from the report and comparing the maturity dates to the securities inventory, recalculating the days to maturity, obtaining the applicable haircut percentages from the Net Capital Rule, and recalculating the haircuts per the report for the securities selected.

Topic (Year)	Example of Effective Procedures and Good Practices
Possession or Control (2019)	A broker-dealer reported no reportable items in the possession or control schedule included in its financial statements. The auditor tested the completeness and accuracy of the broker-dealer's stock record and customer balances during the financial statement audit. To test the schedule, the auditor obtained a deficit report generated by the broker-dealer's internal system. The auditor tested that the system was programmed to properly calculate deficits pursuant to the Customer Protection Rule, and tested the relevant information technology controls over the system. The auditor tested completeness of the deficit report by reviewing the report logic to determine that it was configured to properly report all deficits. The auditor tested the accuracy of the report by selecting securities deficits from the stock record and the deficit report and inspecting evidence that these securities were subject to segregation, both instructed and accomplished.
Engagement Quality Review (2019)	Engagement quality reviewers should evaluate audit responses to significant risks identified by the engagement team, including fraud risks. The engagement team assessed a fraud risk related to the improper timing of underwriting revenue recognition. The engagement quality reviewer evaluated the engagement team's judgments and conclusions regarding the identified fraud risk by reviewing the substantive testing of underwriting revenue and holding discussions with the engagement team.

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