



1666 K Street, N.W.  
Washington, DC 20006  
Telephone: (202) 207-9100  
Facsimile: (202) 862-8430  
[www.pcaobus.org](http://www.pcaobus.org)

**THIRD REPORT ON THE PROGRESS  
OF THE INTERIM INSPECTION PROGRAM  
RELATED TO AUDITS OF BROKERS AND DEALERS**

**PCAOB Release No. 2014-003  
August 18, 2014**

## **Executive Summary**

The Public Company Accounting Oversight Board (the "PCAOB" or the "Board") is issuing this third report on the progress of its interim inspection program for auditors of brokers and dealers registered with the Securities and Exchange Commission ("SEC" or the "Commission"). This report describes observations noted during inspections performed during 2013; summarizes the observations from inspections performed under the interim inspection program since inception through December 31, 2013; and describes actions needed by registered public accounting firms and next steps of the interim inspection program. The Board issued its first progress report on August 20, 2012 (the "First Progress Report") and its second report on August 19, 2013 (the "Second Progress Report").

The observations discussed in this report are not necessarily indicative of the population of firms or of audits of brokers and dealers because the selection of firms and of audits of brokers and dealers for inspection is not necessarily representative of these populations.

### **Inspections of Registered Public Accounting Firms During 2013**

This report describes audit deficiencies and independence findings, collectively referred to as "observations," noted in the Board's inspections during 2013 of 60 firms, covering portions of 90 audits. At the time of the inspections, 25 of the 60 firms were subject to regular inspection as they also audited issuers, generally referred to as public companies. Inspections staff identified observations in 56 of the 60 firms whose audits were selected for inspection. The four firms with no observations in the portions of audits inspected were firms that also audited issuers. One of these firms audited more than 100 brokers and dealers.

### **Failure to Satisfy Independence Requirements**

In 21 of the 90 audits selected for inspection, it appeared to Inspections staff, that contrary to the requirements of SEC independence rules, auditors were involved in the preparation of the financial statements they audited. This conduct was observed in 19, or approximately 48 percent, of the 40 audits selected for inspection that were performed by firms that did not also audit issuers. Further, independence findings were observed in two, or four percent, of the 50 audits selected for inspection that were performed by firms that also audited issuers. Apparent independence violations have been, and will continue to be, reported to the SEC as such violations may have

implications to the broker's or dealer's compliance with the requirements of Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5 ("Rule 17a-5").

### **Audit Deficiencies**

Inspections staff identified audit deficiencies in portions of 70 of the 90 audits selected for inspection, which represents approximately 78 percent of these audits. The 20 audits where Inspections staff did not identify any audit deficiencies in the portions of audits inspected were performed by 13 firms, of which 11 also audited issuers.

The most frequent audit deficiencies were noted in the following areas: the report on material inadequacies, the net capital rule, the risk of material misstatement due to fraud, revenue recognition, and reliance on records and reports.

### **Summary of Inspections Since Inception of the Interim Inspection Program**

Since the inception of the interim inspection program through the end of 2013, the Board has inspected 101 firms, covering portions of 173 audits. Nine firms have been inspected more than once. At the time of the inspections, 35 of the 101 firms were subject to regular inspection as they also audited issuers. These firms performed 95 of the 173 audits selected for inspection.

Observations were identified in portions of 151, or approximately 87 percent, of the 173 audits selected for inspection. The 22 audits where Inspections staff did not identify observations in the portions of audits inspected were performed by 12 firms, of which 11 also audited issuers.

Inspections staff identified observations in a high percentage of the audits and areas inspected. Observations were identified across various stratifications of firm characteristics, such as whether or not the firm audited issuers and the number of broker or dealer audits performed by the firm. Firms that did not also audit issuers were noted to have a higher percentage of observations than the firms that also audited issuers. Firms that audited 100 or fewer brokers and dealers had a higher percentage of observations than firms that audited more than 100 brokers and dealers.

Observations were identified in portions of selected audits across the spectrum of brokers and dealers in terms of their characteristics, such as reported actual net capital, revenues, and assets. Except for lower percentages noted for the selected audits of brokers and dealers with the largest amounts of reported actual net capital, revenues, or assets, there did not appear to be a discernible relationship between the percentage of observations and these broker and dealer characteristics. In addition, the percentage of observations for audits of brokers or dealers that did not claim an exemption under

Exchange Act Rule 15c3-3 ("Rule 15c3-3" or the "Customer Protection Rule") was lower than for audits of brokers or dealers that claimed an exemption under Rule 15c3-3.

The percentage of observations in the audits and areas inspected in 2013 was lower than that from the inspections performed during the interim inspection program through the end of 2012. For the nine firms that were inspected more than once during the interim inspection program, Inspections staff noted a lower percentage of observations when comparing inspections performed during 2013 to inspections performed through 2012. Nevertheless, the percentage of observations remained high.

### **Actions Needed by Firms and Next Steps of the Interim Inspection Program**

The Board is concerned by the nature and number of these audit deficiencies and independence findings. Many of the observations in this report and the two previous progress reports are similar in nature and relate to fundamental auditing principles. The Board emphasizes the need for firms to improve the quality of their broker and dealer audits to achieve compliance with applicable standards and rules.

The Board reminds firms that information obtained through the interim inspection program may lead the Board to commence an investigation or disciplinary proceeding concerning the conduct of a firm or associated persons of such firms. In addition, when it comes to the Board's attention that the financial statements appear not to be fairly stated, in all material respects, in conformity with generally accepted accounting principles ("GAAP"), or there are possible violations of laws, rules, or regulations, the Board's practice is to report that information to the SEC and designated examining authorities.

### **Actions Needed by Firms**

In light of the observations that continue to be identified by Inspections staff, combined with the need to adapt to amended SEC rules and to follow PCAOB standards, the Board urges registered public accounting firms that audit brokers and dealers to re-examine their audit approaches.

All registered public accounting firms that audit brokers and dealers, and other interested parties, should read this report in its entirety and consider whether the audit deficiencies and independence findings described in this report might be present in audits they currently perform, and take appropriate action to prevent or correct any such audit deficiencies and independence findings.

The Board also encourages registered public accounting firms that audit brokers and dealers to review the [Staff Guidance for Auditors of SEC-Registered Brokers and](#)

[Dealers](#) issued on June 26, 2014, and to attend the Board's periodic Forums on Auditing Smaller Broker-Dealers.

### **Next Steps of the Interim Inspection Program**

The Board will continue to conduct inspections of registered public accounting firms that audit brokers and dealers under the interim inspection program until rules for a permanent inspection program take effect. During 2014, the Board plans to select approximately 60 firms and inspect portions of approximately 100 audits. The firms the Board selects will primarily include firms not previously inspected, but will also include some firms previously inspected under the interim inspection program. In addition, the Board may inspect audits of brokers or dealers whose past audits were previously inspected. In that context, the Board may evaluate whether, or how, firms addressed audit deficiencies or independence findings identified in previous inspections.

The Board is continuing to take a careful and informed approach in establishing a permanent inspection program. The Board continues to obtain available information to evaluate the risk of loss to customers. The PCAOB staff is currently working to develop a rule proposal for the Board to issue during 2016 to establish a permanent inspection program and its scope, which will address whether to exempt any category of registered public accounting firm.

The Board will continue its efforts to protect the interests of investors and further the public interest in informative, accurate, and independent audit reports for brokers and dealers. Such efforts will continue to include issuing future progress reports that will describe significant observations from inspections, issuing guidance for audits of brokers and dealers, conducting forums, and participating in various other outreach initiatives. In addition, the Board will use information obtained from the interim inspection program and other research and outreach efforts to inform its future standards-setting activities relevant to the audits of brokers and dealers.

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## Background

The PCAOB is issuing this third report on the progress of its interim inspection program<sup>1</sup> for auditors of brokers and dealers registered with the SEC.<sup>2</sup>

Under the interim inspection program the Board conducts inspections of registered public accounting firms in connection with their performance of audits, issuance of audit reports, and related matters involving brokers and dealers registered with the Commission<sup>3</sup> to assess compliance with the professional standards, rules of the Commission and the Board, and the Sarbanes-Oxley Act of 2002 (the "Act").

The interim inspection program also helps to inform the Board's eventual determinations about the scope and elements of a permanent inspection program, including whether and how to differentiate among classes of brokers and dealers, whether to exempt any categories of registered public accounting firms, and the establishment of minimum inspection frequency schedules.

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<sup>1</sup> On June 14, 2011, the Board adopted Rule 4020T to establish an interim inspection program related to the audits of brokers and dealers. See PCAOB Release No. 2011-001 (June 14, 2011). The SEC approved this rule on August 18, 2011. See Exchange Act Release No. 65163 (August 18, 2011).

<sup>2</sup> The Board issued its First Progress Report on August 20, 2012 and its Second Progress Report on August 19, 2013, both of which are available on the PCAOB website at: <http://pcaobus.org/Inspections/Pages/PublicReports.aspx>.

<sup>3</sup> Under Section 15 of the Exchange Act, most brokers and dealers must register with the SEC and join a self-regulatory organization, such as the Financial Industry Regulatory Authority ("FINRA"). Hereinafter, the use of the terms "broker(s) and dealer(s)" or "broker(s) or dealer(s)" refers to brokers and dealers registered with the SEC.

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The Board's inspections of auditors under the interim inspection program assess the auditor's compliance with the requirements that govern the conduct of the audit. All of the audits selected for inspection discussed in this report relate to fiscal years that ended on or before June 30, 2013. Those audits were conducted before certain changes to applicable SEC rules took effect, including changes that now require audits of brokers and dealers to be performed in accordance with PCAOB standards.<sup>4</sup> See the Appendix for references to certain releases issued by the SEC or PCAOB related to standards and rules for brokers and dealers and their auditors.

The audits selected for inspection were evaluated against the standards and rules applicable at the time of the audit, and this report's discussion of those audits refers to those standards and rules. For all audits selected for inspection discussed in this report, Rule 17a-5 generally required brokers and dealers to file with the SEC and other regulators, among other things, (1) annual financial statements, (2) supporting schedules related to the computation of net capital and the customer reserve, and (3) an accountant's supplemental report on material inadequacies. Refer to the Appendix of the Second Progress Report for an overview of net capital, customer protection, and annual reporting requirements for SEC-registered brokers and dealers.

This report contains three parts: Part I describes the inspections of registered public accounting firms, audits selected and observations identified by Inspections staff for inspections performed during 2013; Part II provides a summary of inspections performed under the interim inspection program since its inception through December 31, 2013; and Part III describes actions needed by registered public accounting firms and next steps of the interim inspection program of the PCAOB.

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<sup>4</sup> On July 30, 2013, the SEC adopted amendments to its net capital, customer protection, books and records, and notification rules for brokers and dealers under the Exchange Act, see Exchange Act Release No. 70072 (July 30, 2013), and adopted amendments to Exchange Act Rule 17a-5, *Reports to be Made by Certain Brokers and Dealers* (see Exchange Act Rule 17 C.F.R. § 240.17a-5), and Exchange Act Rule 17a-11, *Notification Provisions for Brokers and Dealers* ("Rule 17a-11," 17 C.F.R. § 240.17a-11), see Exchange Act Release No. 70073 (July 30, 2013). Among other things, the amendments to Rule 17a-5 require that audits of brokers and dealers be performed in accordance with PCAOB standards, effective beginning with audits for fiscal years ended on or after June 1, 2014. With respect to audits for earlier fiscal years, such as those discussed in this report, Rule 17a-5, required that the audits be performed in accordance with generally accepted auditing standards ("GAAS"), which are promulgated by the American Institute of Certified Public Accountants ("AICPA").

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**Part I: Inspections of Registered Public Accounting Firms During 2013**

The following section describes registered public accounting firms that audit brokers and dealers, the selection of audits inspected during 2013, and independence findings and audit deficiencies identified by Inspections staff.

**Firms that Audit Brokers and Dealers**

For fiscal periods ended during the period from July 1, 2012 through June 30, 2013, there were 790 registered public accounting firms that issued audit reports on the financial statements of brokers and dealers that were filed with the SEC. Many of the registered public accounting firms audited as few as one broker or dealer, while several firms audited more than 100 brokers and dealers.

Number of Broker or Dealer Audits per Firm	Number of Firms <sup>5</sup>	Percentage of Firms
1	367	46%
2 to 20 <sup>6</sup>	385	49%
21 to 50	24	3%
51 to 100	8	1%
More than 100	6	1%
Total	790	100%

There were 4,302 brokers and dealers that filed audited annual financial statements with the SEC for fiscal years ended during the period from July 1, 2012 through June 30, 2013. The following table expands on the information above to provide further information on which firms also audited issuers and the number of their broker and dealer audits:<sup>7</sup>

<sup>5</sup> Information about the number of firms that audited brokers and dealers and their broker or dealer audits is based on financial statements filed with the SEC through May 27, 2014, for fiscal years ended during the period from July 1, 2012 through June 30, 2013. These firms were registered with the PCAOB at the time the audit reports were issued.

<sup>6</sup> There were 294 firms that audited 2 to 5 brokers and dealers that represented approximately 37 percent of the total firms that audit brokers and dealers.

<sup>7</sup> Information about the firms that audit issuers is derived from data obtained from the most recently submitted annual reports on Form 2 filed through July 15, 2014. PCAOB Rule 2201 requires each registered public accounting firm to file an annual

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Number of Broker or Dealer Audits Per Firm	Also Audited Issuers		Did Not Audit Issuers	
	Number of Firms	Number of Brokers and Dealers	Number of Firms	Number of Brokers and Dealers
1	110	110	257	257
2 to 20 <sup>8</sup>	157	883	228	897
21 to 50	10	290	14	395
51 to 100	4	270	4	278
More than 100	6	922	-	-
Total	287	2,475	503	1,827

**Selection of Firms and Audits**

During 2013, the Board inspected 60 firms and portions of 90 audits of brokers and dealers. The 90 audits selected for inspection had financial statement periods ended on June 30, 2012 through June 30, 2013. The selection of firms for inspection took into consideration the number of broker or dealer audits performed by the firms, whether they also issued audit reports for issuers and, thus, were subject to regular inspection by the PCAOB, as well as other characteristics, to obtain a cross section of firms that audit brokers and dealers. This approach for the selection of firms has been consistent since the inception of the interim inspection program. The selection of firms and audits of brokers and dealers is not necessarily representative of the population of firms or of audits of brokers and dealers. Further, the populations of firms and brokers and dealers are not homogenous. Therefore, the observations presented are not necessarily indicative of the population of firms or of audits of brokers and dealers.

The following table presents the number of firms inspected by the number of broker or dealer audits per firm as determined at the time of inspection:

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report on Form 2 by June 30 of each year. The report covers the twelve-month period ending March 31. Information about the number of firms that audited brokers and dealers and the number of their broker or dealer audits is based on financial statements filed with the SEC through May 27, 2014, for fiscal years ended during the period from July 1, 2012 through June 30, 2013. These firms were registered with the PCAOB at the time the audit reports were issued.

<sup>8</sup> There were 309 brokers and dealers audited by 99 firms, which also audited issuers and audited 2 to 5 brokers and dealers. There were 562 brokers and dealers audited by 195 firms, which did not audit issuers and audited 2 to 5 brokers and dealers.

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Number of Broker or Dealer Audits per Firm	Number of Firms Inspected	Number of Audits Selected
1	11	11
2 to 20	31	34
21 to 50	10	21
51 to 100	3	6
More than 100	5	18
Total	60	90

At the time of the inspections, 25 of the 60 firms were subject to regular inspection as they also audited issuers.<sup>9</sup> The remaining 35 firms did not audit issuers and were not subject to inspection other than under the interim inspection program.

Registered Public Accounting Firms	Number of Firms Inspected	Number of Audits Selected
Also audited issuers	25	50
Did not audit issuers	35	40
Total	60	90

The selection of audits of brokers and dealers considered various characteristics of brokers and dealers, such as the broker's or dealer's minimum net capital requirement and reported actual net capital under Exchange Act Rule 15c3-1 ("Rule 15c3-1" or the "Net Capital Rule")<sup>10</sup> and whether or not the broker or dealer maintained a Special Reserve Bank Account<sup>11</sup> under Rule 15c3-3. The Board did not exclude any registered public accounting firms or any audits of brokers or dealers from being eligible for selection.

The 90 audits of brokers or dealers selected for inspection included 21 brokers and dealers that maintained a Special Reserve Bank Account and 69 brokers and dealers that did not. The following table presents the minimum net capital requirements and actual net capital reported for these brokers and dealers:

<sup>9</sup> Of these, nine firms selected for inspection audited more than 100 issuers and 16 firms selected for inspection audited 100 or fewer issuers.

<sup>10</sup> 17 C.F.R. § 240.15c3-1.

<sup>11</sup> Brokers and dealers who do not claim an exemption under Rule 15c3-3, 17 C.F.R. § 240.15c3-3, are generally required to maintain a bank account for the exclusive benefit of customers. At the time of the audits discussed here, Rule 15c3-3 referred to a "Special Reserve Bank Account for the Exclusive Benefit of Customers," referred to in this report as "Special Reserve Bank Account." Effective March 3, 2014, Rule 15c3-3 refers to the relevant account as the "Customer Reserve Bank Account."

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	Number of Audits Selected	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End
Special Reserve Bank Account	21	\$250,000 - \$600,000,000	\$390,000-\$6,250,000,000
No Special Reserve Bank Account	69	\$5,000 - \$1,230,000	\$8,000 - \$2,340,000,000

As indicated in the Board's release related to the adoption of Rule 4020T, the decision to include certain auditors in the scope of the interim inspection program should not be construed as a decision on the likely scope of a permanent inspection program or suggest that every auditor of a broker or dealer will be inspected as part of the interim inspection program. In addition, the criteria that were considered in making selections for the interim inspection program are not necessarily representative of any decision that the Board will make in its determination of the scope of a permanent inspection program.

**Independence Findings and Audit Deficiencies from Inspections**

The inspections focused on portions of 90 audits performed pursuant to Rule 17a-5 that related to audit procedures on certain aspects of the financial statements and compliance with the Net Capital Rule and the Customer Protection Rule.

The following tables present a summary of the independence findings and audit deficiencies in the order they are discussed in this report:

Independence Findings	Number of Audits with Findings	Number of Applicable Audits	Percentage of Audits with Findings
<b>Failure to Satisfy Independence Requirements</b>	21	90	23%

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Audit Deficiencies	Number of Audits with Deficiencies	Number of Applicable Audits	Percentage of Audits with Deficiencies
<b>Related to Customer Protection and Net Capital Rules:</b>			
Report on Material Inadequacies	38	78	49%
Customer Protection Rule	5	21	24%
Net Capital Rule	26	73	36%
<b>Related to the Financial Statement Audit:</b>			
Risks of Material Misstatement Due to Fraud	36	90	40%
Related Party Transactions	15	90	17%
Revenue Recognition	53	90	59%
Reliance on Records and Reports	40	90	44%
Financial Statement Presentation and Disclosures	27	90	30%
Fair Value Estimates	8	32	25%
Evaluation of Internal Control Deficiencies	6	90	7%
Auditor's Report	5	90	6%

The term "audit deficiencies," as used in this report, refers to failures by firms to perform, or perform sufficiently, certain required audit procedures. Audit deficiencies that exceeded a certain level of significance were communicated to the firms in writing. This report summarizes those audit deficiencies that Inspections staff determined were important to convey within this report based on their nature, severity, or frequency. The term "observations," as used in this report, refers to audit deficiencies and independence findings, collectively.

Observations described in this report were identified in 56 of the 60 firms whose audits were selected for inspection and in portions of 71 of the 90 audits selected for inspection. This includes audit deficiencies identified by Inspections staff in 55 of the 60 firms inspected and in portions of 70 of the 90 audits selected for inspection, as well as one firm, which did not audit issuers, where Inspections staff identified an independence violation but did not identify an audit deficiency in the portions of the audits inspected.

The 19 audits with no observations in the portions of audits inspected were performed by 12 firms, of which 11 also audited issuers. For 8 of these 12 firms, more than one audit was selected for inspection and Inspections staff identified observations in one or more of the other audits.

The four firms with no observations in the portions of audits inspected were firms that also audited issuers. One of these firms audited more than 100 brokers and dealers.

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**Failure to Satisfy Independence Requirements**

The independence of the registered public accounting firm is required under SEC rules and plays an important role in fostering high quality audits. SEC rules require auditors of brokers and dealers to comply with SEC independence requirements,<sup>12</sup> which differ from AICPA independence requirements. SEC rules provide, among other things, that an accountant is not independent if the accountant provides bookkeeping or other services related to the accounting records or financial statements of the audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures performed by the accountant during an audit of the client's financial statements.<sup>13</sup>

Inspections staff identified independence findings in 21 of the 90 audits selected for inspection and communicated these to the firms in writing. Independence findings were identified in two of the audits selected for inspection performed by firms that audited brokers and dealers and also issued audit reports for 100 or fewer issuers. In contrast, independence findings were identified in 19 of the audits selected for inspection that were performed by 18 firms that audited brokers and dealers but did not audit issuers.

Inspections staff observed 21 audits, by 20 firms, where the firms performed bookkeeping or other services related to the accounting records or financial statements of the brokers or dealers. All of these firms prepared, or assisted in the preparation of, the financial statements or supporting schedules required by Rule 17a-5. In addition, some of these firms also prepared journal entries or source data underlying the financial statements of the brokers or dealers, each of which is prohibited under the SEC independence rules.

**Audit Deficiencies Related to Customer Protection and Net Capital Rules**

Accountant's Supplemental Report on Material Inadequacies

At the time of the audits discussed here, Rule 17a-5(g)(1) required the scope of the audit and review of the accounting system, the internal accounting controls, procedures for safeguarding securities, and the practices and procedures in making the periodic computations of aggregate indebtedness, net capital, and the customer reserve to be sufficient to provide reasonable assurance that any material inadequacies existing

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<sup>12</sup> Rule 17a-5 provides that the auditor must be independent in accordance with Rule 2-01 of SEC Regulation S-X. At the time of the audits discussed here, that requirement had been articulated since 1972 in Rule 17a-5(f)(3). It is now articulated in Rule 17a-5(f)(1).

<sup>13</sup> See Rule 2-01(c)(4)(i) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(4)(i).

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at the date of the examination are disclosed in the accountant's supplemental report on material inadequacies.<sup>14</sup>

Inspections staff identified deficiencies in 38 of the 78 audits selected for inspection where one or more of the requirements of the accountant's supplemental report on material inadequacies was inspected. In 4 of the 78 audits, Inspections staff identified deficiencies in both categories set forth in the table below:

Deficiencies Related to:	Number of Audits	Number of Audits Inspected
Exemption claimed under Rule 15c3-3	31	69 <sup>15</sup>
Other procedures to test the accountant's supplemental report on material inadequacies	11	20 <sup>16</sup>

At the time of the audits discussed here, when a broker or dealer claimed an exemption under the Customer Protection Rule, auditors were required under Rule 17a-5(g)(2) to ascertain whether the conditions of the exemption were complied with as of the examination date, and whether facts came to the auditor's attention to indicate that the broker or dealer was not in compliance with the exemption during the period since the last examination. In 31 of the 69 audits of brokers and dealers that claimed an exemption from the requirement to maintain a Special Reserve Bank Account, Inspections staff found that firms failed to comply with this requirement. In several instances, Inspections staff found that firms failed to perform any procedures to ascertain that the broker or dealer complied with the conditions of the exemption. In

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<sup>14</sup> Effective for fiscal years ending on or after June 1, 2014, Rule 17a-5(g) requires an examination by an auditor of the financial statements and supporting schedules of the broker or dealer and, depending on the report filed by the broker or dealer, an examination of the compliance report or a review of the exemption report.

<sup>15</sup> This area was inspected for the 69 audits of brokers and dealers that claimed an exemption from the requirement to maintain a Special Reserve Bank Account.

<sup>16</sup> One or more requirements of this area were inspected for 20 audits of brokers and dealers based on certain characteristics, including whether the broker or dealer was required to maintain a Special Reserve Bank Account or whether errors or deficiencies were identified that could have been considered indicators of a material inadequacy. Of the 20 audits, 11 brokers or dealers claimed an exemption under Rule 15c3-3 and 9 did not.

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other instances, the firms limited their procedures to inquiry alone and did not perform sufficient other inquiries or other procedures related to the exemption claimed by the broker or dealer under the Customer Protection Rule.

In addition to the deficiencies noted above, Inspections staff observed that in 11 audits, firms failed to perform sufficient audit procedures with respect to the accountant's supplemental report on material inadequacies. In five audits, firms did not perform sufficient procedures to obtain reasonable assurance that any material inadequacies existing at the date of the examination would be disclosed. Inspections staff noted some of these firms did not sufficiently test controls related to the broker's or dealer's practices and procedures in making the periodic computations of aggregate indebtedness, net capital, or the customer reserve. Inspections staff also found that in seven audits,<sup>17</sup> firms identified errors or deficiencies during other audit procedures but did not sufficiently assess whether these errors or deficiencies indicated the existence of a material inadequacy.

Procedures Regarding Compliance with the Customer Protection Rule

Rule 17a-5(g) states that brokers and dealers shall include supporting schedules with the financial statements that present the customer reserve computation and information relating to requirements for possession or control of securities. Rule 17a-5(g) also states that the audit shall include all procedures necessary under the circumstances to enable the independent public accountant to express an opinion on, among other things, the customer reserve computation and information relating to the possession or control requirements under Rule 15c3-3. AU-C sec. 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. In order to opine on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should perform certain procedures using the same materiality level used in the audit of the financial statements.<sup>18</sup>

Inspections staff identified one or more deficiencies in 5 of 21 audits selected for inspection where brokers or dealers did not claim an exemption from the requirement to maintain a Special Reserve Bank Account. In three of the five audits with deficiencies related to the Customer Protection Rule, Inspections staff identified more than one deficiency in the categories set forth in the table below:

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<sup>17</sup> One audit was included in the previous example of five audits.

<sup>18</sup> See Paragraphs .05 and .07 of AU-C sec. 725. For audits conducted under pre-clarified AICPA standards, see Paragraphs .05 and .07 of AU sec. 551, *Supplementary Information in Relation to the Financial Statements as a Whole*.

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Deficiencies Related to:	Number of Audits
Completeness and accuracy of customer debits or credits	3
Special Reserve Bank Account	2
Possession or control requirements	3

*Completeness and Accuracy of Customer Debits or Credits*

In 3 of the 21 audits, Inspections staff noted that firms failed to sufficiently test the completeness and accuracy of customer debits or credits included in the customer reserve computation. Inspections staff observed that these firms limited their procedures to agreeing the amounts reported in the computation to schedules prepared by the broker or dealer and did not perform procedures to determine whether customer debits or credits were consistent with Exhibit A of Rule 15c3-3.

*Special Reserve Bank Account*

Rule 15c3-3(f) requires a broker or dealer that maintains a Special Reserve Bank Account to obtain and preserve written notification from each bank that all cash and/or qualified securities on deposit are being held by the bank for the exclusive benefit of customers, are kept separate from the broker's or dealer's other bank accounts, and assets in the account may not be used by the bank as collateral nor may the bank attach any claim to the account.

Inspections staff observed in 2 of the 21 audits, firms failed to verify the existence of a Special Reserve Bank Account or failed to determine whether the account agreements contained the required restrictive provisions of Rule 15c3-3(f).

*Possession or Control Requirements*

Rule 15c3-3(b)(1) requires a broker or dealer to promptly obtain and maintain the physical possession or control<sup>19</sup> of all fully-paid securities<sup>20</sup> and excess margin securities<sup>21</sup> carried by the broker or dealer for the accounts of customers.

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<sup>19</sup> Generally, "possession" of securities means the securities are physically located at the broker or dealer and "control" of securities means the securities are located at an approved "control" location, such as a clearing corporation or depository.

<sup>20</sup> Generally, fully-paid securities are securities that are purchased in transactions for which the customer has made full payment. See Rule 15c3-3(a)(3).

<sup>21</sup> Generally, excess margin securities in a customer account are those securities with a market value greater than 140 percent of the customer's debit balance. See Rule 15c3-3(a)(5).

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Inspections staff observed in 3 of the 21 audits, firms failed to perform sufficient procedures to test compliance with the possession or control requirements. Inspections staff noted that firms did not perform sufficient procedures to test the stock record, determine whether instructions were timely to reduce items to possession or control, or sufficiently test whether securities were located at an approved control location.

Procedures Regarding Compliance with the Net Capital Rule

Rule 17a-5(g) states that brokers and dealers shall include a supporting schedule to the financial statements that presents the computation of net capital. Net capital is also generally disclosed in the notes to the financial statements. Similar to the procedures regarding compliance with the Customer Protection Rule noted above, Rule 17a-5(g) and AU-C sec. 725 were applicable to audits described in this section.

Inspections staff identified one or more deficiencies in 26 of the 73 audits selected where one or more components of the net capital computation was selected for inspection. In 10 of the 26 audits with deficiencies related to the Net Capital Rule, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Minimum net capital requirements	10
Additions to net worth	1
Allowable assets	19
Haircuts	6
Operational charges	2

*Minimum net capital requirements*

Generally, a broker's or dealer's required minimum net capital is the greater of (1) one of a number of fixed-dollar amounts prescribed in Rule 15c3-1 applicable to the broker or dealer relative to its line(s) of business,<sup>22</sup> or (2) an amount computed using one of two financial ratios.<sup>23</sup> In 9 of the 10 audits, Inspections staff found that firms failed to assess the nature of the broker's or dealer's operations in relation to the required minimum net capital amounts in accordance with Rule 15c3-1. In 3 of the 10<sup>24</sup> audits, Inspections staff found that firms failed to sufficiently test whether aggregated

<sup>22</sup> See Rule 15c3-1(a)(2).

<sup>23</sup> See Rule 15c3-1(a)(1).

<sup>24</sup> This number includes two audits referenced in the previous sentence.

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indebtedness was calculated in accordance with Rule 15c3-1(c)(1)(i), and therefore, failed to evaluate whether the calculated minimum net capital was in accordance with Rule 15c3-1(a).

*Additions to Net Worth*

Under Rule 15c3-1, as interpreted by SEC staff, certain discretionary liabilities are allowed to be added back to net worth in the determination of net capital.<sup>25</sup> In one audit, Inspections staff found that the firm failed to test whether the amount of the liability for employee bonuses that was added to net worth in the determination of net capital was payable solely at the discretion of the broker or dealer, in accordance with Rule 15c3-1.

*Allowable assets*

Rule 15c3-1 requires that assets not readily convertible into cash ("non-allowable assets") be deducted from equity when computing net capital.<sup>26</sup> Inspections staff observed 19 audits where firms did not perform sufficient procedures to test the broker's or dealer's classification of allowable and non-allowable assets when computing net capital.

Under Rule 15c3-1, as interpreted by SEC staff, brokers and dealers are permitted to offset certain receivables and payables when specific conditions are met. In 5 of the 19 audits, Inspections staff observed that firms failed to perform sufficient procedures to verify that the conditions necessary for the right of offset of certain receivables by related payables were met in accordance with the applicable sections of Rule 15c3-1. For example, in three of these audits, firms failed to test whether commissions receivable pursuant to Exchange Act Rule 12b-1 ("Rule 12b-1")<sup>27</sup> were allowable assets under Rule 15c3-1. As Rule 15c3-1 is interpreted by SEC staff, Rule 12b-1 commissions receivable can be classified as an allowable asset only to the extent the receivables are offset by Rule 12b-1 commissions payable to sales representatives. Among other things, the sales representatives must sign a written agreement with the broker or dealer waiving payment of their commissions until the broker or dealer is in receipt of the Rule 12b-1 commissions.<sup>28</sup>

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<sup>25</sup> See Interpretation 15c3-1(c)(2)/02. This citation form refers to a compilation of the substance of certain SEC staff interpretations available at <http://www.finra.org/industry/regulation/guidance/for/>. The interpretation referred to here is identified as number /02 associated with Rule 15c3-1(c)(2) in that compilation.

<sup>26</sup> See Rule 15c3-1(c)(2)(iv).

<sup>27</sup> 17 C.F.R. § 270.12b-1.

<sup>28</sup> See Interpretation 15c3-1(c)(2)(iv)(C)/09.

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When a broker or dealer has its proprietary assets and clearing deposit in a proprietary account held by a clearing broker, Rule 15c3-1, as interpreted by SEC staff, permits these assets to be classified as allowable assets in the net capital computation provided certain conditions are met.<sup>29</sup> In 6 of the 19 audits, Inspections staff observed that brokers and dealers reported assets held by a clearing broker as allowable assets, but the firms failed to test whether these assets met the requirements of an allowable asset under Rule 15c3-1(c)(2)(iv)(E).

Rule 15c3-1(c)(2)(iv)(C) states that commissions receivable from other brokers or dealers that are outstanding longer than 30 days from the date they arise are non-allowable assets. In 6 of the 19 audits, Inspections staff observed that firms failed to perform sufficient procedures to test the aging of commissions receivable to determine whether the amount reported as an allowable asset met the requirements of Rule 15c3-1(c)(2)(iv)(C).

*Haircuts*

When computing net capital, Rule 15c3-1 generally requires brokers and dealers to apply percentage reductions (referred to as "haircuts") to the values of securities owned by the broker or dealer.<sup>30</sup> As a result, the valuation of the securities and the appropriate haircut percentages can be critical to the net capital computation. Inspections staff observed six audits where firms did not perform sufficient procedures related to haircuts on securities.

In all six audits, Inspections staff found that firms failed to perform procedures to evaluate whether the appropriate haircut percentages were applied by the broker or dealer, including tests of the relevant characteristics of the securities positions. For example, firms failed to test whether haircuts on securities positions were based on the percentages applicable to the categories of securities and maturity dates, if applicable, pursuant to SEC Rule 15c3-1(c)(2)(vi). In one of the audits, Inspections staff found that the firm failed to perform sufficient procedures to test the completeness and accuracy of supporting records obtained from an external party that provided the amount of haircuts used in the computation of net capital.

*Operational charges*

In computing net capital, Rule 15c3-1 requires brokers and dealers to deduct amounts related to operational charges such as aged fail to-deliver balances.<sup>31</sup> In two

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<sup>29</sup> See Interpretation 15c3-1(c)(2)(iv)(E)/021.

<sup>30</sup> See Rule 15c3-1(c)(2)(vi).

<sup>31</sup> See Rule 15c3-1(c)(2)(ix).

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audits, Inspections staff observed that firms failed to perform sufficient procedures to test the completeness or accuracy of operational charges deducted from the broker's or dealer's net capital.

**Deficiencies Related to the Financial Statement Audit**

Consideration of Risks of Material Misstatement Due to Fraud

An auditor conducting an audit in accordance with GAAS is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.<sup>32</sup> AU-C sec. 240 describes the auditor's responsibilities for, among other things, identifying, assessing, and responding to the risks of material misstatement due to fraud.<sup>33</sup> The two types of misstatements that are relevant to the consideration of fraud in a financial statement audit are misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.<sup>34</sup>

Inspections staff identified one or more deficiencies in 36 of the 90 audits selected for inspection. In 13 of the 36 audits with deficiencies related to the consideration of risks of material misstatement due to fraud, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Identification and assessment of the risks of material misstatement due to fraud	11
Responses to the assessed risks of material misstatement due to fraud – management override	32
Responses to fraud risk related to revenue recognition	6

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<sup>32</sup> Paragraph .05 of AU-C sec. 240, *Consideration of Fraud in a Financial Statement Audit*. For audits conducted under pre-clarified AICPA standards, paragraph .01 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, provides that "[t]he auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."

<sup>33</sup> For audits conducted under pre-clarified AICPA standards, see AU sec. 316.

<sup>34</sup> See Paragraph .03 of AU-C sec. 240. For audits conducted under pre-clarified AICPA standards, see Paragraph .06 of AU sec. 316.

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*Identification and Assessment of the Risks of Material Misstatement Due to Fraud*

When identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that risks of fraud exist in revenue recognition, evaluate which types of revenue, revenue transactions, or assertions give rise to such risks.<sup>35</sup> If the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is overcome in the circumstances of the engagement, the auditor should include in the audit documentation the reasons for that conclusion.<sup>36</sup>

The auditor should treat those assessed risks of material misstatement due to fraud as significant risks and, accordingly, to the extent not already done so, the auditor should obtain an understanding of the entity's related controls, including control activities, relevant to such risks, including the evaluation of whether such controls have been suitably designed and implemented to mitigate such fraud risks.<sup>37</sup>

In 10 audits, Inspections staff observed that firms did not identify a fraud risk related to revenue recognition or document their conclusion that no such risk existed. In one audit, a firm identified a fraud risk related to revenue recognition but failed to obtain an understanding of the broker's or dealer's control activities related to revenue in order to evaluate whether such controls were designed and implemented to mitigate the identified fraud risk.

*Responses to the Assessed Risks of Material Misstatement Due to Fraud – Management Override*

The auditor should address the risk of management override of controls apart from any conclusions regarding the existence of more specifically identifiable risks by designing and performing audit procedures to: (a) test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including entries posted directly to financial statement drafts; (b) review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud; and (c) evaluate whether the business rationale (or the lack thereof) of significant

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<sup>35</sup> Paragraph .26 of AU-C sec. 240. For audits conducted under pre-clarified AICPA standards, see Paragraph .41 of AU sec. 316.

<sup>36</sup> Paragraph .46 of AU-C sec. 240. For audits conducted under pre-clarified AICPA standards, see Paragraph .83 of AU sec. 316.

<sup>37</sup> Paragraph .27 of AU-C sec. 240. For audits conducted under pre-clarified AICPA standards, see Paragraphs .44 through .45 of AU sec. 316.

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transactions that are outside the normal course of business suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.<sup>38</sup>

Inspections staff observed in 32 audits that firms failed to perform sufficient procedures to address risks related to management override of controls, including sufficiently testing the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In 24 of these audits, firms failed to: (i) obtain an understanding of the entity's financial reporting process and controls over journal entries and other adjustments, and the suitability of design and implementation of such controls; (ii) make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments; (iii) consider fraud risk indicators, the nature and complexity of accounts, and entries processed outside the normal course of business; (iv) select journal entries and other adjustments made at the end of a reporting period; or (v) consider the need to test journal entries and other adjustments throughout the period.<sup>39</sup> In addition, in 9 of the 32 audits, Inspections staff noted that firms failed to review accounting estimates for bias, or evaluate significant transactions outside the normal course of business, or that otherwise appear unusual, to address the risk of management override of controls.

In 9 of the 32 audits, Inspections staff observed that firms did not test the completeness of the population of journal entries from which they selected a sample for journal entry testing.<sup>40</sup>

*Responses to Fraud Risk Related to Revenue Recognition*

Inspections staff observed six audits where firms failed to design or perform audit procedures whose nature, timing, and extent were responsive to the assessed risks of material misstatement due to fraud related to revenue recognition.<sup>41</sup> For example,

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<sup>38</sup> See Paragraph .32 of AU-C sec. 240. For audits conducted under pre-clarified AICPA standards, see Paragraphs .58 through .67 of AU sec. 316.

<sup>39</sup> See Paragraph .32a of AU-C sec. 240. For audits performed under pre-clarified AICPA standards, see Paragraphs .58 through .62 of AU sec. 316.

<sup>40</sup> See Paragraph .09 of AU-C sec. 500, *Audit Evidence*. For audits performed under pre-clarified AICPA standards, see Paragraph .10 of AU sec. 326, *Audit Evidence*.

<sup>41</sup> Paragraph .06 of AU-C sec. 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. For audits conducted under pre-clarified AICPA standards, see Paragraph .07 of AU sec. 318,

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Inspections staff noted that in instances where the firm's approach to address the identified fraud risk consisted only of substantive procedures, some firms used substantive analytical procedures but did not perform tests of details as required by AU-C sec. 330.<sup>42</sup> In another example, a firm identified cutoff to be a fraud risk but did not perform sufficient procedures to respond to this risk.

### Auditing Related Party Transactions

Related parties often play a significant role in the operations of brokers and dealers, for example, through direct participation in the activities of the brokers and dealers by principals or affiliates under shared service agreements. The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.<sup>43</sup> For example, related parties may be improperly used by brokers and dealers in scenarios such as: 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.

Auditors have a responsibility to perform audit procedures to identify, assess, and respond to the risks of material misstatement arising from a broker's or dealer's failure to appropriately account for or disclose related party relationships, transactions, or balances.<sup>44</sup> The auditor should design and perform audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement

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*Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained.*

<sup>42</sup> See Paragraph .22 of AU-C sec. 330. For audits conducted under pre-clarified AICPA standards, see Paragraph .54 of AU sec. 318.

<sup>43</sup> See Paragraph .03 of AU-C sec. 550, *Related Parties*. For audits conducted under pre-clarified AICPA standards, Paragraph .31 of AU sec. 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, provides that "the business risk of significant transactions with related parties may increase the risk of misstatement of a range of significant account balances and relevant assertions."

<sup>44</sup> See Paragraph .04 of AU-C sec. 550. For audits conducted under pre-clarified AICPA standards, Paragraph .01 of AU sec. 334, *Related Parties*, provides that "when he [the auditor] is performing an audit of financial statements in accordance with generally accepted auditing standards to identify related party relationships and transactions and to satisfy himself concerning the required financial statement accounting and disclosure."

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associated with related party relationships and transactions and should remain alert when inspecting records or documents for arrangements or other information that may indicate the existence of related party relationships or transactions that have not previously been identified or disclosed.<sup>45</sup>

Inspections staff identified one or more deficiencies in 15 of the 90 audits selected for inspection. In 5 of the 15 audits with related party deficiencies, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Existence and identification of related party relationships and or transactions	7
Examining identified related party transactions	13

Inspections staff observed seven audits where firms failed to perform sufficient procedures to determine the existence of related parties and material related party transactions. In five of the seven audits, Inspections staff found that firms limited their procedures to inquiries of management and did not inspect records and documents for the purpose of identifying significant related party relationships or material transactions that had not been previously identified or disclosed.

In 13 audits, Inspections staff observed that firms identified related parties or material related party transactions, including service agreements, fee agreements, or intercompany balances, yet the firms did not perform procedures necessary to obtain sufficient appropriate audit evidence to respond to the assessed risks of material misstatement associated with related party relationships and transactions. For example, firms did not perform sufficient tests for the completeness and accuracy of identified related party transactions. In three of these audits, Inspections staff observed that the firms failed to perform procedures to evaluate the financial capability of related parties to pay their debts to the brokers or dealers in order to test the valuation of the related party receivables.

Auditing Revenue Recognition

Brokers and dealers may generate revenue from a variety of securities-related lines of business. When testing revenue, the auditor should design and perform audit procedures whose nature, timing, and extent are based on, and are responsive to, the

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<sup>45</sup> See Paragraphs .16 and .21 of AU-C sec. 550. For audits conducted under pre-clarified AICPA standards, see Paragraphs .07 through .09 of AU sec. 334.

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assessed risks of material misstatement at the relevant assertion level.<sup>46</sup> The auditor must obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions for his or her opinion on whether the financial statements are presented fairly, in all material respects, in conformity with GAAP.<sup>47</sup>

Inspections staff identified one or more deficiencies in 53 of the 90 audits selected for inspection. In 30 of the 53 audits with deficiencies related to revenue recognition, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Extent of testing	29
Substantive analytical procedures	24
Other procedures to test revenue recognition	36

Inspections staff observed that in 29 audits, the extent of testing was insufficient for material classes of revenue transactions, including trading gains and losses, commission revenue, and advisory fees. For example, Inspections staff observed instances where firms: (a) did not perform any procedures to test material classes of revenue transactions; or, (b) sampling procedures for testing revenue were insufficient because: (i) firms did not have a basis to reduce the extent of substantive tests of material classes of revenue transactions, because some of these firms did not sufficiently test controls yet reduced the extent of their substantive tests; (ii) the sample was not designed to address the relevant risks and other characteristics of the population; or (iii) firms failed to select a sample of revenue transactions for testing that was representative of the underlying population.

When designing and performing analytical procedures, either alone or in combination with tests of details, as substantive procedures, the auditor should: (a) determine the suitability of substantive analytical procedures for given assertions; (b) evaluate the reliability of data from which expectations are developed; (c) develop an expectation and evaluate whether the expectation is sufficiently precise to identify a misstatement; and (d) determine the amount of difference from the expectation that can

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<sup>46</sup> See Paragraph .06 of AU-C sec. 330. For audits conducted under pre-clarified AICPA standards, see Paragraph .07 of AU sec. 318.

<sup>47</sup> See Paragraph .01 of AU-C sec. 500. For audits conducted under pre-clarified AICPA standards, see Paragraph .01 of AU sec. 326.

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be accepted without further investigation.<sup>48</sup> If analytical procedures performed identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor should investigate such differences by (a) inquiring of management and obtaining appropriate audit evidence relevant to management's responses and (b) performing other audit procedures as necessary in the circumstances.<sup>49</sup>

Inspections staff observed 24 audits where firms performed substantive analytical procedures that did not provide the intended level of assurance because the firms failed to (a) develop expectations that were sufficiently precise to identify misstatements; (b) investigate significant unexpected differences; (c) test the completeness and accuracy of the underlying data used in the analytical procedures; or (d) determine that the substantive analytical procedures were based on plausible, predictable relationships.

Inspections staff identified deficiencies in 36 audits selected for inspection that related to the failure of firms to perform sufficient procedures to test the relevant assertions for revenue. For example, firms failed to: (a) evaluate, or evaluate sufficiently, the effect of specific terms or provisions of significant contractual arrangements related to the recognition of revenue; (b) test whether revenue was recorded in the correct period; (c) determine whether assets under management used to calculate fees were complete and accurate; (d) determine whether the commission rates used to calculate commission revenue were consistent with the underlying agreements; or (e) evaluate whether revenue recognition policies were in conformity with GAAP.

### Procedures to Establish a Basis for Reliance on Records and Reports

Inspections staff identified one or more deficiencies in 40 of the 90 audits selected for inspection. In six audits with deficiencies related to establishing a basis for reliance on records and reports, Inspections staff identified more than one deficiency in the categories set forth in the table below:

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<sup>48</sup> See Paragraph .05 of AU-C sec. 520, *Analytical Procedures*. For audits conducted under pre-clarified AICPA standards, see Paragraphs .13 through .20 of AU sec. 329, *Analytical Procedures*.

<sup>49</sup> See Paragraph .07 of AU-C sec. 520. For audits conducted under pre-clarified AICPA standards, see Paragraph .21 of AU sec. 329.

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Deficiencies Related to:	Number of Audits
Auditing information produced by service organizations	31
Testing records and reports produced by brokers and dealers	15

*Auditing Information Produced by Service Organizations*

Many brokers and dealers use the services of other brokers and dealers to perform trade processing and related back-office functions, primarily in the clearing and settling of customer transactions. AU-C sec. 402, *Audit Considerations Relating to an Entity Using a Service Organization*, applies to audits where an entity uses services from a service organization that affect the company's information system, including related business processes, relevant to financial reporting.<sup>50</sup> AU-C sec. 402 also discusses the user auditor's requirement to obtain an understanding of how the company uses the services of a service organization in the company's operations, the user auditor's requirement to obtain an understanding of internal control relevant to the audit, and the user auditor's response to assessed risk of material misstatement, whether through further audit procedures or tests of controls.<sup>51</sup> In responding to the assessed risk of material misstatement, the auditor should (a) determine whether sufficient appropriate audit evidence concerning the relevant assertions is available from records held at the broker or dealer and if not, (b) perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organization on the user auditor's behalf.<sup>52</sup>

Inspections staff observed in 31 audits that firms did not perform sufficient procedures on information produced by service organizations that were used to perform substantive audit procedures or test of controls.

Inspections staff observed in 30 of those 31 audits that firms used information produced by a service organization, such as records or reports from a clearing broker, but failed to obtain sufficient appropriate audit evidence on such information. Some firms used clearing broker statements as audit evidence and did not perform sufficient substantive audit procedures on the statement. In several instances, firms limited their

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<sup>50</sup> See Paragraph .03 of AU-C sec. 402. For audits conducted under pre-clarified AICPA standards, see Paragraph .03 of AU sec. 324, *Service Organizations*.

<sup>51</sup> See Paragraphs .09 through .22 of AU-C sec. 402. For audits conducted under pre-clarified AICPA standards, see Paragraphs .05 through .21 of AU sec. 324.

<sup>52</sup> See Paragraph .15 of AU-C sec. 402.

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procedures to agreeing the clearing broker statement to cash receipts or the general ledger. Other firms obtained and evaluated a service auditor's report to rely on the operating effectiveness of controls at the service organization, but did not perform sufficient substantive audit procedures to address the relevant assertions related to the account balance.

Inspections staff observed that in seven audits, six of which are included in the 30 audits discussed in the previous paragraph, firms obtained a service auditor's report, but failed to sufficiently evaluate the service auditor's report or consider whether the service auditor's report provided evidence about the design and operating effectiveness of the controls being relied upon. For example, Inspections staff observed instances where firms failed to sufficiently evaluate whether the broker or dealer had designed and implemented the necessary user entity controls identified in the service auditor's report or sufficiently tested those controls.

*Testing Records and Reports Produced by Brokers and Dealers*

When information produced by the entity is used by the auditor in designing and performing audit procedures, the auditor should evaluate whether the information is sufficiently reliable for the auditor's purpose, including obtaining audit evidence about the accuracy and completeness of the information and evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.<sup>53</sup>

Inspections staff observed that in 15 audits, firms failed to perform procedures to obtain evidence about the completeness or accuracy of records and reports produced by the brokers and dealers that were used in the performance of tests of controls or substantive tests. Examples of these records and reports included trade blotters, account statements, and schedules or spreadsheets prepared by broker or dealer personnel. Such records and reports were used by firms in performing tests of certain accounts or disclosures without testing the completeness or accuracy of the information in those records and reports.

Auditing Financial Statement Presentation and Disclosures

The auditor should evaluate whether the financial statements, in conformity with GAAP, provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.<sup>54</sup> In addition, the auditor should evaluate (a) the overall presentation,

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<sup>53</sup> See Paragraph .09 of AU-C sec. 500. For audits conducted under pre-clarified AICPA standards, see Paragraph .10 of AU sec. 326.

<sup>54</sup> See Paragraph .16e of AU-C sec. 700, *Forming an Opinion and Reporting on Financial Statements*. For audits conducted under pre-clarified AICPA standards, Paragraph .02 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*,

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structure, and content of the financial statements and (b) whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.<sup>55</sup>

Inspections staff reviewed the audit work performed related to financial statement disclosures for those areas included in the inspections. Inspections staff identified one or more deficiencies in 27 of 90 audits selected for inspection. In 6 of the 27 audits with deficiencies related to financial statement presentation and disclosure, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Omitted disclosures	9
Incomplete or inaccurate disclosures	16
Fair value disclosures (FASB ASC 820)	4
Fair presentation	4

In nine audits, Inspections staff observed instances in which firms failed to identify and evaluate the omission of required disclosures pertaining to areas such as related parties and related party transactions or revenue recognition policies.

Inspections staff also observed in 16 audits that firms failed to identify incomplete disclosures or respond to evidence that was inconsistent with disclosures included in the financial statements. In another four audits, Inspections staff observed that firms failed to evaluate the broker's or dealer's classification of fair value measurements of securities owned within the hierarchy required by FASB ASC 820, *Fair Value Measurement* ("ASC 820").

In addition, Inspections staff observed in four audits that firms failed to evaluate whether the financial statements presented and disclosed the underlying transactions in a manner that complied with GAAP. For example, in some of these audits, firms failed to identify and address that the broker or dealer reported multiple revenue streams as a single line item on the statement of income, which is inconsistent with the financial statement format contained in Form X-17-5 Part II or Part IIA in accordance with Rule 17a-5(d)(2).

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provides that "[t]he presentation of financial statements in conformity with generally accepted accounting principles includes adequate disclosure of material matters."

<sup>55</sup> See Paragraph .17 of AU-C sec. 700. For audits conducted under pre-clarified AICPA standards, see Paragraph .02 of AU sec. 431.

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Auditing Fair Value Accounting Estimates

Brokers and dealers account for and disclose securities at fair value.<sup>56</sup> AU-C sec. 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, describes the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, in an audit of financial statements.<sup>57</sup> The term accounting estimate is used for an amount measured at fair value when there is estimation uncertainty, as well as for other amounts that require estimation.<sup>58</sup>

In responding to the assessed risks of material misstatement, taking into account the nature of the accounting estimate, the auditor should undertake one or more of the following: (a) determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimates; (b) test how management made the accounting estimate and the data on which it is based; (c) test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures; (d) develop a point estimate or range to evaluate management's point estimate.<sup>59</sup>

Inspections staff identified deficiencies in 8 of the 32 audits where the auditor's procedures to test securities valuation were selected for inspection. The following presents a summary of the deficiencies discussed below:

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<sup>56</sup> See FASB ASC 820 and FASB ASC Subtopic 940-320, *Financial Services - Brokers and Dealers, Investments - Debt and Equity Securities*, ("ASC 940-320").

<sup>57</sup> See Paragraph .01 of AU-C sec. 540. For audits conducted under pre-clarified AICPA standards, AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, established standards and provided guidance on auditing fair value measurements and disclosures contained in financial statements; see Paragraph .01.

<sup>58</sup> See Paragraph .07 of AU-C sec. 540. For audits conducted under pre-clarified AICPA standards, Paragraph .01 of AU sec. 342, *Auditing Accounting Estimates* provides that "an accounting estimate is an approximation of a financial statement element, item, or account."

<sup>59</sup> See Paragraph .13 of AU-C sec. 540. For audits conducted under pre-clarified AICPA standards, Paragraph .23 of AU sec. 328 provides that the auditor's approach to performing substantive tests of fair value measurements may involve: (a) testing management's significant assumptions, the valuation model, and the underlying data; (b) developing an independent estimate of fair value for corroborative purposes; or (c) reviewing subsequent events or transactions.

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Deficiencies Related to:	Number of Audits
Auditing fair value accounting estimates	6
Auditing accounting for investments	2

In 6 of the 32 audits, Inspections staff observed that firms did not perform sufficient procedures to test the valuation of securities. For example, in two audits, Inspections staff observed that firms relied on the fair values provided by the brokers or dealers and failed to undertake, or sufficiently undertake, one or more of the procedures described in the second paragraph of this section.

Brokers and dealers are excluded from the scope of FASB ASC Topic 320-10-15-3, *Investments – Debt and Equity Securities* ("ASC 320"). Brokers and dealers should account for investments at fair value,<sup>60</sup> with changes in fair value recorded as income from operations in the statement of income. In two audits, Inspections staff observed that firms failed to identify that the brokers or dealers had applied ASC 320, and therefore, had inappropriately accounted for investments as securities that were held to maturity or available for sale.

Evaluation of Internal Control Deficiencies in the Financial Statement Audit

In a financial statement audit, the auditor should obtain an understanding of control activities relevant to the audit, which are those control activities the auditor judges necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks.<sup>61</sup> During the course of an audit, the auditor may become aware of deficiencies in internal control. If the auditor has identified one or more deficiencies in internal control, the auditor should evaluate each deficiency to determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies or material weaknesses.<sup>62</sup> If the auditor determines that a deficiency, or a combination of deficiencies, in internal control is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and

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<sup>60</sup> See Paragraph .30 of ASC 940-320.

<sup>61</sup> See Paragraph .21 of AU-C sec. 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. For audits conducted under pre-clarified AICPA standards, see Paragraph .40 of AU sec. 314.

<sup>62</sup> Paragraph .09 of AU-C sec. 265, *Communicating Internal Control Related Matters Identified in an Audit*. For audits conducted under pre-clarified AICPA standards, see Paragraph .08 of AU sec. 325, *Communicating Internal Control Related Matters Identified in an Audit*.

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circumstances, would likely reach the same conclusion.<sup>63</sup> In addition, the auditor should consider whether a deficiency, or a combination of deficiencies, identified in internal control is an indicator of a material inadequacy that would be disclosed in the accountant's supplemental report on material inadequacies.

Inspections staff identified one or more deficiencies in 6 of the 90 audits selected for inspection. In one audit with deficiencies related to the evaluation of internal control deficiencies, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Assessment of the severity of a control deficiency	2
Evaluation of errors performed as part of substantive testing	5

In two of the six audits, Inspections staff observed that firms identified one or more internal control deficiencies while performing procedures to obtain an understanding of internal control. Although the firms identified these deficiencies, the evaluations by the firms did not include a sufficient assessment of the severity of the control deficiency to determine whether the deficiency, individually or in combination, represented a significant deficiency or material weakness.

When evaluating the operating effectiveness of relevant controls, the auditor should evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively.<sup>64</sup> In five of the six audits, Inspections staff observed that firms identified errors during the performance of substantive tests. However, the firms failed to evaluate the severity and nature of the errors, both individually and in combination, and the circumstances of their occurrences, including whether the errors were evidence of one or more control deficiencies.

Auditor's Report

Generally, brokers and dealers are required under Rule 17a-5 to file with the SEC audited financial statements and supporting schedules on the computation of net capital, the computation of the customer reserve requirement, and information relating to the possession or control requirements of the Customer Protection Rule. At the time

<sup>63</sup> Paragraph .10 of AU-C sec. 265. For audits conducted under pre-clarified AICPA standards, see Paragraph .16 of AU sec. 325.

<sup>64</sup> Paragraph .16 of AU-C sec. 330. For audits conducted under pre-clarified AICPA standards, see Paragraph .34 of AU sec. 318.

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of the audits discussed here, Rule 17a-5 also required brokers and dealers to file an accountant's supplemental report on material inadequacies. The auditor's report on the supporting schedules should include the elements required by AU-C sec. 725,<sup>65</sup> including an opinion on whether the schedules are fairly stated, in all material respects, in relation to the financial statements taken as a whole.

Inspections staff identified deficiencies in 5 of the 90 audits selected for inspection related to the auditor's report. Inspections staff found that in four of the five audits, the auditor's report on the supporting schedules failed to include one or more of the elements required by AU-C sec. 725, such as a statement that the supplementary information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.

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<sup>65</sup> See Paragraph .09 of AU-C sec. 725. For audits conducted under pre-clarified AICPA standards, see Paragraph .09 of AU sec. 551.

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**Part II: Summary of Inspections of Registered Public Accounting Firms Since Inception of the Interim Inspection Program**

Since inception of the interim inspection program through December 31, 2013, the Board has inspected 101<sup>66</sup> registered public accounting firms that conducted audits of the financial statements and other requirements of brokers and dealers. Nine of these firms were inspected more than once. These inspections covered portions of 173 audits.

The following discussion summarizes the selection of firms and audits made during the interim inspection program through December 31, 2013, and independence findings and audit deficiencies identified by Inspections staff from these inspections.

The Board advises readers to consider the information presented within the remainder of this section in light of the following factors. The selection of firms and audits of brokers and dealers made since inception of the interim inspection program is not necessarily representative of the population of firms or of audits of brokers and dealers. Further, the populations of firms and brokers and dealers are not homogenous. Therefore, the observations presented are not necessarily indicative of the population of firms or of audits of brokers and dealers. In addition, the information presented within this section cannot support a conclusion that audit quality has improved or deteriorated for the reasons just mentioned.

Nevertheless, the continued occurrence and percentage of audits selected for inspection with audit deficiencies and independence findings observed during the interim inspection program provide a useful point of reference for discussions about areas for improvement when performing audits of brokers and dealers.

**Selection of Firms and Audits**

The firms and the audits were selected in order to have a cross section of firms, as well as a cross section of brokers and dealers, based on varying characteristics of both. Selection of registered public accounting firms for inspection took into consideration various characteristics, including the number of audits of brokers and dealers performed by the firms or whether the firms also issued audit reports for issuers. The selection of brokers and dealers considered various characteristics, such as whether or not the brokers or dealers maintained a Special Reserve Bank Account under Rule 15c3-3, the minimum net capital requirement, and reported actual net capital under Rule 15c3-1. The Board did not exclude any audits of brokers or dealers from being eligible for selection.

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<sup>66</sup> This number represents the inspection of 10 firms reported in the First Progress Report, 43 firms reported in the Second Progress Report, and 60 firms covered in Part I of this report. Three firms were included in all three reports and six firms were included in two reports.

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Further, the selections were intended to meet the following objectives: 1) assess compliance with the applicable audit standards and rules of the Commission and the Board, and the Act; 2) help inform the Board's eventual decisions regarding the scope and elements of a permanent inspection program; and 3) assist in the development of the approach to inspections under a permanent inspection program.

Nine firms were inspected more than once since the inception of the interim inspection program. None of the audits selected for inspection were inspected more than once.

The following table presents the number of firms inspected and audits selected for inspection stratified by the number of broker or dealer audits per firm, as determined at the time of the inspections:

Number of Broker or Dealer Audits per Firm	Number of Firms Inspected	Number of Audits Selected
1	19	19
2 to 20	48	60
21 to 50	22	45
51 to 100	8	14
More than 100	5	35
Total	101 <sup>67</sup>	173

The next table presents the number of firms inspected and audits selected for inspection based on whether or not the firms audited the financial statements of an issuer at the time of the inspections:

Firms that Audited Brokers and Dealers	Number of Firms Inspected	Number of Audits Selected
Firms that also audited issuers	35	95
Firms that did not audit issuers	66	78
Total	101	173

The 173 audits of brokers and dealers selected for inspection had financial statement periods ended on December 31, 2010 through June 30, 2013. These audits included 43 brokers or dealers that maintained a Special Reserve Bank Account and 130 brokers or dealers that did not. The following table presents the ranges of minimum net capital requirements and actual net capital reported for these brokers and dealers:

<sup>67</sup> The sum of the number of firms inspected does not add to 101 because one firm that was inspected more than once is reported in multiple stratifications due to a change in the number of broker or dealer audits performed by the firm.

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	Number of Audits Selected	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End
Special Reserve Bank Account	43	\$250,000 - \$600,000,000	\$310,000 - \$6,250,000,000
No Special Reserve Bank Account	130	\$5,000 - \$6,100,000	\$8,000 <sup>68</sup> - \$2,340,000,000

**Independence Findings and Audit Deficiencies from Inspections**

Observations were identified in portions of 151, or approximately 87 percent, of the 173 audits selected for inspection. The 22 audits where Inspections staff did not identify observations in the portions of these audits inspected were performed by 12 firms, of which 11 also audited issuers.

**Independence Findings**

Independence findings relating to a firm's involvement in the preparation of the financial statements were identified in approximately 26 percent of the 173 audits selected for inspection. Inspections staff noted a significantly higher percentage of audits inspected with independence findings for the audits performed by firms that did not audit issuers. The following table presents a summary of independence findings by whether or not the firms also audited issuers:

*Exhibit 1: Independence Findings*

	Number of Audits with Findings	Number of Applicable Audits	Percentage of Audits with Findings
<b>Failure to Satisfy Independence Requirements</b>			
Firms that also audited issuers	5 <sup>69</sup>	95	5%
Firms that did not audit issuers	40	78	51%

<sup>68</sup> Excluded from the range of actual net capital reported at fiscal year end is one instance of reported negative net capital.

<sup>69</sup> The independence findings were identified at firms that issued audit reports for 100 or fewer issuers.

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Audit Deficiencies

Inspections staff identified audit deficiencies in portions of 150 of the 173 audits selected for inspection. The 23 audits where Inspections staff did not identify any audit deficiencies in the portions of audits inspected were performed by 13 firms, 11 of which also audited issuers. The following table presents a summary of certain areas that were reported in the First and Second Progress Reports and in Part I of this report:<sup>70</sup>

*Exhibit 2: Audit Deficiencies*

	Number of Audits with Deficiencies <sup>71</sup>	Number of Applicable Audits	Percentage of Audits with Deficiencies
<b>Related to Customer Protection and Net Capital Rules:</b>			
Report on Material Inadequacies	102	161	63%
Customer Protection Rule	12	43	28%
Net Capital Rule	57	156	37%
<b>Related to the Financial Statement Audit:</b>			
Risk of Material Misstatement Due to Fraud	86	173	50%
Related Party Transactions	50	173	29%
Revenue Recognition	110	173	64%
Reliance on Records and Reports	82	173	47%
Financial Statement Presentation and Disclosures	63	173	36%
Fair Value Estimates	19	60	32%
Evaluation of Internal Control Deficiencies	16	173	9%
Auditor's Report	30	173	17%

The remainder of this section presents observations stratified by certain firm characteristics or broker and dealer characteristics, a comparison of inspections

<sup>70</sup> Audit deficiencies related to understanding the entity (approximately two percent) that were reported in the Second Progress Report are not included in this table.

<sup>71</sup> Seven audits that were reported within the Accountant's Supplemental Report on Material Inadequacies section in the First Progress Report have been re-categorized to Auditor's Report to conform to the presentation in the Second Progress Report and this report.

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performed during 2013 to inspections performed through the end of 2012, and information on firms inspected more than once.

**Observations Stratified By Certain Firm Characteristics**

**Number of Broker or Dealer Audits per Firm**

Inspections staff identified a high percentage of audits and areas inspected with observations. Observations were identified in 100 percent of audits selected for inspection for auditors with only one broker or dealer client, while the percentage was slightly lower for firms that audited 2 to 100 brokers and dealers, and significantly lower for firms that audited more than 100 brokers and dealers. The following table presents the percentage of audits and areas inspected with observations stratified by the number of broker or dealer audits per firm as determined at the time of inspection:

*Exhibit 3: Number of Broker or Dealer Audits per Firm*

	Percentage of Audits with Observations	Percentage of Areas with Observations <sup>72</sup>
1	100%	52%
2 to 20	93%	42%
21 to 50	91%	40%
51 to 100	93%	38%
More than 100	63%	19%

**Firms that Audited Issuers Compared to Firms that Did Not Audit Issuers**

Inspections staff noted that the percentage of audits and areas inspected with observations was significantly higher at firms that did not audit issuers. Of the 95 audits selected for inspection that were conducted by firms that also audited issuers, there were 21 audits where Inspections staff did not identify any independence findings or audit deficiencies in the portions of the audits inspected.

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<sup>72</sup> The term "areas" used within this section represents the portions of audits included in the inspection (revenue recognition, related party transactions, net capital, etc.) by Inspections staff and reported within the First and Second Progress Reports and Part I of this report, as presented in Exhibits 1 and 2. The "Percentage of Areas with Observations" presented within Exhibits 3 through 8 represents the sum of the "Number of Audits with Findings" and "Number of Audits with Deficiencies" disclosed within Exhibits 1 and 2 above divided by the sum of the "Number of Applicable Audits" disclosed within Exhibits 1 and 2 above.

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The following table presents the percentage of audits and areas inspected with observations stratified by firms that also audited issuers and those that did not audit issuers, at the time of the inspection:

*Exhibit 4: Firms that also Audited Issuers and Firms that did not Audit Issuers*

	Percentage of Audits with Observations	Percentage of Areas with Observations
Firms that also audited issuers	78%	29%
Firms that did not audit issuers	99%	48%

**Observations Stratified by Certain Broker and Dealer Characteristics**

**Reported Actual Net Capital, Revenues, and Assets**

Inspections staff noted a high percentage of audits and areas inspected with observations across the spectrum of audits of brokers and dealers in terms of their characteristics, such as reported actual net capital, revenues and assets. There did not appear to be a discernible relationship between the percentage of audits and areas inspected with observations and these broker or dealer characteristics, except for lower percentages noted for the selected audits of brokers and dealers with the largest amounts of reported actual net capital, revenues, or assets.

For illustrative purposes, the following table presents the percentage of audits and areas inspected with observations stratified by the reported actual net capital of the brokers and dealers at the time of the audit:

*Exhibit 5: Reported Actual Net Capital by Brokers and Dealers*

	Percentage of Audits with Observations <sup>73</sup>	Percentage of Areas with Observations
Less than \$100,000	89%	42%
\$100,001 to \$2,000,000	96%	45%
\$2,000,001 to \$15,000,000	90%	37%
\$15,000,001 to \$6,250,000,000	69%	24%

**Special Reserve Bank Account**

Inspections staff noted a high percentage of audits and areas inspected with observations, regardless of whether the broker or dealer maintained a Special Reserve

<sup>73</sup> The number of audits selected for inspection for each of these stratifications is 28, 56, 50, and 39, respectively.

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Bank Account. The percentage of audits and areas inspected with observations was higher for audits of brokers or dealers that did not maintain a Special Reserve Bank Account.

Inspections staff also noted that for firms that also audited issuers, the percentage of audits and areas inspected with observations was higher for audits of brokers and dealers that did not maintain a Special Reserve Bank Account compared to those that did. For firms that did not audit issuers, there was no discernible relationship between the percentage of audits and areas inspected with observations and these types of brokers or dealers.

The following table presents the percentage of audits and areas inspected with observations stratified by whether or not the broker or dealer maintained a Special Reserve Bank Account at the time of the audit:

*Exhibit 6: Special Reserve Bank Account*

	Percentage of Audits with Observations	Percentage of Areas with Observations
No Special Reserve Bank Account	90%	39%
Special Reserve Bank Account	79%	31%

**Comparison of Inspections during 2013 to Inspections through the end of 2012**

The Board began conducting inspections under the interim inspection program during October 2011. Observations from the inspections performed through the end of 2012 were compared to those from the inspections performed during 2013. There were slightly fewer audit deficiencies and independence findings in portions of audits inspected during 2013 than in portions of audits inspected previously, but nevertheless, observations remained high.

The following table shows a comparative summary of the percentages of audits and areas inspected with observations for inspections performed during 2013 with inspections performed through the end of 2012:

*Exhibit 7: Comparison of Inspections during 2013 to Inspections through 2012*

	Percentage of Audits with Observations	Percentage of Areas with Observations
2013	79%	30%
Inspections through 2012	96%	45%

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Inspections staff did not identify any observations in the portions of 19 audits inspected during 2013 and portions of 3 audits inspected through 2012. All but 1 of the 22 audits was performed by firms that also audited issuers.

Independence Findings

Inspections staff noted that, in the 2013 inspections, the percentage of independence findings among audits that were performed by firms that did not audit issuers was slightly lower than for inspections through 2012. The following table presents the percentage of audits selected for inspection during the interim inspection program with independence findings:

*Exhibit 7A: Comparison of Independence Findings*

	Percentage of Audits with Findings	
	2013	Inspections through 2012
<b>Failure to Satisfy Independence Requirements</b>		
Firms that also audited issuers	4%	7%
Firms that did not audit issuers	48%	55%
Total	23%	29%

Audit Deficiencies

Inspections staff noted a lower percentage of audits selected for inspection with audit deficiencies when comparing 2013 to inspections through 2012 for each of the areas inspected. For both periods, the areas with the highest frequency of deficiencies were: report on material inadequacies, revenue recognition, reliance on records and reports, and the risk of material misstatement due to fraud. The following table presents the percentage of applicable audits with deficiencies for the portions of 173 audits inspected during the interim inspection program:

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*Exhibit 7B: Comparison of Audit Deficiencies*

	Percentage of Applicable Audits with Deficiencies	
	2013	Inspections through 2012
<b>Related to Customer Protection and Net Capital Rules:</b>		
Report on Material Inadequacies	49%	77%
Customer Protection Rule	24%	32%
Net Capital Rule	36%	37%
<b>Related to the Financial Statement Audit:</b>		
Risk of Material Misstatement Due to Fraud	40%	60%
Related Party Transactions	17%	42%
Revenue Recognition	59%	69%
Reliance on Records and Reports	44%	51%
Financial Statement Presentation and Disclosures	30%	43%
Fair Value Estimates	25%	39%
Evaluation of Internal Control Deficiencies	7%	12%
Auditor's Report	6%	30%

**Firms Inspected More Than Once**

There were nine firms that were inspected more than once during the interim inspection program through the end of 2013. Inspections staff noted a lower percentage of audits and areas inspected with observations when comparing inspections performed during 2013 to inspections performed through 2012.

The following table shows a comparative summary of the percentage of audits and areas inspected with observations for the nine firms that were inspected more than once:

*Exhibit 8: Firms Inspected More than Once*

	Percentage of Audits with Observations	Percentage of Areas with Observations
2013	57%	16%
Inspections through 2012	90%	35%

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**Part III: Actions Needed by Firms and Next Steps of the Interim Inspection Program**

The Board is concerned by the nature and number of these audit deficiencies and independence findings. Many of the observations in this report and the two previous progress reports are similar in nature and relate to fundamental auditing principles. The Board emphasizes the need for firms to improve the quality of their broker and dealer audits to achieve compliance with applicable standards and rules.

The Board reminds firms that information obtained through the interim inspection program may lead the Board to commence an investigation or disciplinary proceeding concerning the conduct of a firm or associated persons of such firms. The Board has started this process for certain firms. In addition, when it comes to the Board's attention that the financial statements of a broker or dealer appear not to present fairly, in all material respects, the financial position, results of operations, or cash flows of the broker or dealer in conformity with GAAP, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting of the financial statements of brokers and dealers. Similarly, detailed information related to possible violations of laws or rules, including independence rules, by brokers and dealers may be, and has been, reported to the SEC as well as designated examining authorities.

**Actions Needed by Firms**

In light of the observations that continue to be identified by Inspections staff, combined with the need to adapt to amended SEC rules and to follow PCAOB standards, the Board urges registered public accounting firms that audit brokers and dealers to re-examine their audit approaches.

All registered public accounting firms that issue audit reports for brokers or dealers should consider whether the audit deficiencies and independence findings described in this report might be present in audits they currently perform, and should take appropriate action to prevent or correct any such deficiencies and independence findings.

Under GAAS, when audit deficiencies are discovered after the date of the audit report, a firm must take appropriate action to assess the importance of the deficiencies to the firm's present ability to support its previously expressed audit opinions.<sup>74</sup>

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<sup>74</sup> See AU-C sec. 585, *Consideration of Omitted Procedures After the Report Release Date*. For audits conducted under pre-clarified AICPA standards, see AU sec. 390, *Consideration of Omitted Procedures After the Report Date*. The firm might have further responsibilities under AU-C sec. 560, *Subsequent Events and Subsequently Discovered Facts*. For audits conducted under pre-clarified AICPA standards, see AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

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Depending upon the circumstances, the firm may do one or more of the following: (1) perform additional audit procedures; (2) inform a client of the need for changes to its financial statements, supporting schedules, or the firm's supplemental report on material inadequacies; or (3) take steps to prevent reliance on previously expressed audit opinions. The Board expects firms to take appropriate action. Many firms have represented that they have taken, are taking, or will take action. The Board has not conducted a review of any remedial actions taken by the firms to address audit deficiencies or independence findings identified in these inspections but may review those actions through its inspection process in the future.

The Board urges registered public accounting firms to be proactive in considering how to prevent similar or other deficiencies and findings by seeking ways to better anticipate and address risks that might arise in specific broker or dealer audits. The Board encourages registered public accounting firms to continually stress to their personnel the critical need to conduct audits with due professional care, including professional skepticism. The Board also encourages registered public accounting firms to take action to review the following:

### Independence:

- Agreements for services performed for broker and dealer audit clients to ensure that services, including preparation of financial statements, that would violate SEC independence rules will not be provided.
- Guidance and training to ensure all professionals are aware of the SEC independence requirements applicable to audits of brokers and dealers.
- Quality control procedures to ensure compliance with applicable SEC auditor independence requirements, including prohibition of involvement in the preparation of financial statements that the firm audits.

### Audit Deficiencies:

- Firm guidance and training to determine that the topic areas of the observed audit deficiencies identified in the report are given appropriate attention.
- Policies for supervision, including review, to ensure their partners and supervisory personnel are placing appropriate attention on these areas.

The Board also encourages registered public accounting firms to review the Staff Guidance for Auditors of SEC-Registered Brokers and Dealers issued on June 26, 2014, and to attend the Board's periodic Forums on Auditing Smaller Broker-Dealers.

In addition to the actions needed by registered public accounting firms, management and audit committees, or the equivalent, of brokers and dealers may want

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to consider inquiring of their auditor about how these areas are being appropriately addressed in their audits and take steps to ensure that independence violations are avoided.

**Next Steps of the Interim Inspection Program**

**Future Inspections**

The Board will continue to conduct inspections under the interim inspection program of registered public accounting firms that audit brokers and dealers until rules for a permanent inspection program take effect. There were approximately 750 registered public accounting firms that issued audit reports on the financial statements of approximately 4,000 brokers and dealers<sup>75</sup> that were filed with the SEC for fiscal periods ended during 2013.

Number of Broker or Dealer Audits per Firm	Number of Firms <sup>76</sup>	Percentage of Firms
1	355	47%
2 to 20	360	48%
21 to 50	22	3%
51 to 100	7	1%
More than 100	6	1%
Total	750	100%

During 2014, the Board plans to select approximately 60 firms and inspect portions of approximately 100 audits. The firms the Board selects will primarily include firms not previously inspected, but will also include some firms previously inspected under the interim inspection program. In addition, the Board may inspect audits of brokers or dealers whose past audits were previously inspected. In that context, the Board may evaluate whether, or how, the firms addressed audit deficiencies or independence findings from the previous inspection.

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<sup>75</sup> This information is based on the number of brokers and dealers who filed financial statements with the SEC through May 27, 2014, for fiscal years ended during 2013, that included audit reports issued by firms registered with the PCAOB.

<sup>76</sup> Information about the number of firms that audited brokers and dealers and their broker or dealer audits is based on financial statements filed with the SEC through May 27, 2014, for fiscal years ended during 2013. These firms were registered with the PCAOB at the time the audit reports were issued.

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During 2015, the Board will inspect audits of brokers and dealers, which are required to be performed in accordance with PCAOB standards, in order to assess compliance with the applicable standards and rules. In addition, information obtained from these inspections will be used to identify risk factors relevant for selecting firms and audits of brokers and dealers for inspection under a permanent inspection program through the analysis of relationships between inspection observations and characteristics of the firms and the brokers and dealers that were audited.

### **Scope of a Permanent Inspection Program**

The Board is continuing to take a careful and informed approach in establishing a permanent inspection program recognizing the complexity and diversity of the brokers and dealers, as well as working through the challenges in obtaining relevant information for these non-public companies. The Board continues to obtain available information to evaluate the risk of loss to customers and whether this risk can be assessed from attributes that characterize brokers and dealers in an effort to provide for differentiation of the brokers and dealers.

The Board plans to review the contents of the compliance and exemption reports and the respective auditors' reports related to, for example, the brokers' or dealers' compliance with the provisions of the customer protection rule, to evaluate risk of loss to customers. The Board will also continue to gather information regarding customer losses due to fraudulent activities or liquidations of brokers and dealers, and regulatory sanctions imposed on brokers and dealers to evaluate whether correlations exist between these matters and characteristics of the brokers and dealers.

The PCAOB staff is currently working to develop a rule proposal for the Board to issue during 2016 to establish a permanent inspection program and its scope, which will address whether to exempt any category of registered public accounting firm.

### **Other Board Initiatives**

In its efforts and initiatives to protect the interests of investors and further the public interest in informative, accurate, and independent audit reports for brokers and dealers, the Board has, and will continue to, among other things:

- Conduct forums for auditors of brokers and dealers that provide information about the Board, the interim inspection program, observations from the interim inspection program, and audits of brokers and dealers;
- Participate in various outreach initiatives, including conferences and other events to inform registered public accounting firms that issue audit reports for brokers and dealers about observations from the interim inspection program, developments in the Board's standards-setting initiatives, and updates from the SEC and FINRA; and

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- Issue guidance for audits of brokers and dealers to assist with the implementation of PCAOB auditing and attestation standards and will consider utilizing communication tools such as webcasts and stored media presentations to effectively deliver guidance and information to auditors of brokers and dealers.

The Board will issue future progress reports that will describe significant observations from inspections, the publication of which may otherwise be appropriate to protect the interests of investors or to further the public interest. In addition, the Board will use information obtained from the interim inspection program and other research and outreach efforts to inform its future standards-setting activities relevant to the audits of brokers and dealers.

**Appendix**

**References to Certain Releases for Standards and Rules Related to Brokers and Dealers and Their Auditors That Were Adopted During 2013 and 2014**

Audits of brokers and dealers with fiscal years ended on or after June 1, 2014 are required to follow PCAOB standards. The following table provides a list of PCAOB releases and guidance that describe requirements applicable to audits of brokers and dealers.

<b>Title</b>	<b>Release Date</b>	<b>Release and Link</b>
Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards	October 10, 2013	See PCAOB Release No. 2013-007  <a href="http://pcaobus.org/Rules/Rulemaking/Pages/Docket035.aspx">http://pcaobus.org/Rules/Rulemaking/Pages/Docket035.aspx</a>
Auditing Standard No. 17 Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards	October 10, 2013	See PCAOB Release No. 2013-008  <a href="http://pcaobus.org/Rules/Rulemaking/Pages/Docket036.aspx">http://pcaobus.org/Rules/Rulemaking/Pages/Docket036.aspx</a>
Amendments to Conform the Board's Rules and Forms to the Dodd-Frank Act and Make Certain Updates and Clarifications	December 4, 2013	See PCAOB Release No. 2013-010  <a href="http://pcaobus.org/Rules/Rulemaking/Pages/Docket039.aspx">http://pcaobus.org/Rules/Rulemaking/Pages/Docket039.aspx</a>
Staff Guidance for Auditors of SEC-Registered Brokers and Dealers	June 26, 2014	<a href="http://pcaobus.org/News/Releases/Pages/06262014_Staff_Guidance.aspx">http://pcaobus.org/News/Releases/Pages/06262014_Staff_Guidance.aspx</a>

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The following table lists SEC releases and guidance that describe the amendments to the reporting requirements for brokers and dealers under Exchange Act Rule 17a-5 and the SEC's financial responsibility rules, including Exchange Act Rules 15c3-1 and 15c3-3.

Title	Release Date	Release and Link
Broker-Dealer Reports	July 30, 2013	See Exchange Act Release No. 34-70073  <a href="http://www.sec.gov/rules/final/finalarchive/finalarchive2013.shtml">http://www.sec.gov/rules/final/finalarchive/finalarchive2013.shtml</a>
Financial Responsibility Rules for Broker-Dealers	July 30, 2013	See Exchange Act Release No. 34-70072  <a href="http://www.sec.gov/rules/final/finalarchive/finalarchive2013.shtml">http://www.sec.gov/rules/final/finalarchive/finalarchive2013.shtml</a>
Frequently Asked Questions Concerning the Amendments to Certain Broker-Dealer Financial Responsibility Rules	March 6, 2014	<a href="http://www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-financial-responsibility-rule-faq.htm">http://www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-financial-responsibility-rule-faq.htm</a>
Frequently Asked Questions Concerning the July 30, 2013 Amendments to the Broker-Dealer Financial Reporting Rule	April 4, 2014	<a href="http://www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-reporting-rule-faq.htm">http://www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-reporting-rule-faq.htm</a>