Forum on Auditing Smaller Broker-Dealers

October 31, 2013
Jersey City, NJ
Opening Remarks

Jay D. Hanson
Board Member, PCAOB
October 31, 2013
Jersey City, NJ
Caveat

One of the benefits of today's session is that you will hear firsthand from one of the PCAOB Board members and numerous PCAOB staff. You should keep in mind, though, that when we share our views they are those of the speaker alone, and do not necessarily reflect the views of the Board, its members or staff.
PCAOB Overview

Mary M. Sjoquist, Director, Office of Outreach and Small Business Liaison
October 31, 2013
Jersey City, NJ
Mission Statement

- The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.
PCAOB’s Standard-Setting Process

PCAOB Typical Rulemaking Process

1. Proposed Rules Issued by PCAOB for Comment at Open Meeting
2. Comment Period
3. Rules Adopted by PCAOB at Open Meeting
4. Final PCAOB Rule Filed with S.E.C. on Form 19b-4
5. S.E.C. Publishes Notice of Filing and Opens Comment Period
6. Notice of Filing Printed in Federal Register
7. SEC Comment Period
8. S.E.C. Issues Order Approving Rules (or Institutes Proceedings to Disapprove)
9. Rules (if Approved) Become Effective
10. Order Printed in Federal Register
Other Steps in Standard-Setting

- Standing Advisory Group input
- Investor Advisory Group input
- Roundtables
- Outreach to individuals and entities with interest in the subject matter
- Concept releases
- Reproposals
Key Proposed Amendments to Conform PCAOB Rules and Forms to the Dodd-Frank Act

- Definition of audit committee (Rule 3501)
- Overall framework (Rules 3502 and 3520)
- Contingent fees (Rule 3521)
- Tax transactions (Rule 3522)
- Tax services for persons in a financial reporting oversight role (Rule 3523)
- Communications with audit committees concerning independence (Rule 3526)
- PCAOB independence rules applicable to auditors of issuers but not to auditors of brokers and dealers (Rules 3524 and 3525)
- Deferred compliance date for Rules 3521-3526
Dodd-Frank--Funding

- The Act provides that the Board must allocate the accounting support fee equitably among not only issuers but also brokers and dealers (see section 109(d))

- The Board may establish different classes of issuers and of brokers and dealers for funding purposes (sections 109(g) and 109(h)(2))

- The amount due from a broker or dealer must be in proportion to the net capital of the broker or dealer (before or after any adjustments), compared to the total net capital of all brokers and dealers (before or after any adjustments), in accordance with the rules of the Board (see section 109(h)(3))
Funding Rule

- As adopted, fee is based on “tentative net capital,” which under the SEC’s Rules is net capital before deducting certain securities haircuts and charges for certain commodities transactions (see SEC Rule 15c3-1(c)(15)).*

- A class of brokers and dealers, each with average quarterly tentative net capital $5 million or less or that have a basis not to file audited financial statements, will be allocated a portion of the BD ASF of zero.
  - Represents 85.2% of brokers and dealers registered with the SEC or 1.6% of the industry’s total net capital*
  - 687 of the approximately 4,600 BDs registered with the SEC were assessed portions of the 2012 BD ASF fee**

*Adopted by PCAOB on June 14, 2011 and approved by SEC on August 18, 2011
**Fee assessed as of October 19, 2012.
Funding Rule (cont’d)

- Firm may not sign an audit report; consent to the inclusion of a report; or sign a document, report, notice, or other record concerning procedures or controls of any issuer, broker, or dealer required under the securities laws for a BD with an outstanding ASF.

- Limited exception where broker, or dealer needs the audit report or consent in order to submit a report to, or make a filing with, the Commission.

- Under those circumstances, the auditor must provide a notice to the Board the day after the filing is made; only good for 15 days; and is a one time exception.
Fee Summary

- **Registration Application Fees Paid by Firms**
  - 0-49 issuer audit clients--$500
  - 50-100 issuer audit clients--$3000
  - 101-1000 issuer audit clients--$29,000
  - 1001 issuer audit clients and up--$390,000

- **Annual Fees Paid by Firms**
  - More than 500 issuer clients and more than 10,000 personnel--$100,000
  - More than 200 issuer clients and more than 1000 personnel--$25,000
  - All other firms $500

- **Accounting Support Fee (ASF)**
  - Paid by issuers—approximately 92% of 2012 total ASF
  - Paid by broker-dealers—approximately 8% of total ASF
Rules on Periodic Reporting by Registered Public Accounting Firms--Annual Reporting

Form 2 includes –

- General information concerning the firm
- Audit clients and audit reports*
- Offices and affiliations
- Personnel
- Certain relationships
- Acquisitions
- Affirmation of consent

Proposed amendments to Form 2

*Currently only applicable to issuer reports
Rules on Periodic Reporting by Registered Public Accounting Firms--Special Reporting

Form 3 triggering events and disclosures include –

- Name change
- Audit reports (withdrawn report or consent*, or crossed 100 issuer threshold)
- Certain legal proceedings
- Bankruptcy
- Certain relationships
- Licenses and certifications
- Changes in the firm’s Board contact person

Proposed amendments to Form 3

*Currently only applicable to issuer reports
Reporting Rules on Succeeding to a Predecessor Firm’s Registration Status

- The rules provide for:
  - A Form 4 must be filed within 14 days after the event
  - With certain representations

- Allows firms whose structure has changed to retain registration status under two scenarios:
  - A registered firm changes its legal form of organization or jurisdiction in which it operates
  - A registered firm is acquired by an unregistered firm or merges with another firm to create a new legal entity

- If deadline for filing Form 4 not met, registration process using Form 1 may be required along with Board action.
Confidential Treatment Requests

- Confidential Treatment Requests are more limited on these forms than on the registration application form
  - Board has determined that certain information will never qualify
  - In practice, this means no check box is available to request confidential treatment for U.S. firms

- To request confidential treatment:
  - Firm must represent that information is not public AND
    - Firm must provide a detailed explanation of how the information is proprietary OR
    - Firm must provide a detailed explanation of how the information is protected from public disclosure by applicable law, and must provide a publicly available citation to or a copy of the law
Office of Outreach and Small Business Liaison

- Established on December 15, 2010
- Formalized and centralized currently existing small business initiatives
  - Small business forums
  - Outreach to smaller firms and issuers
- New functions
  - Outreach to the broker-dealer community including forums for auditors of broker-dealers
  - Central point of contact for:
    - questions about the Board’s activities
    - identifying areas where information related to the Board’s work is not well understood
    - suggesting actions to address these areas
Office of Outreach Contact Information

- Outreach@PCAOBUS.ORG
- 202-591-4135
Questions?
“(T)he criteria that were considered in making selections for the interim inspection program are not necessarily representative of any decision that the Board will make on whether and how to differentiate among categories of registered accounting firms and classes of brokers and dealers”

PCAOB Release No. 2013-006
August 19, 2013
“The Board has not finalized any determinations on the attributes that provide for differentiation of classes of brokers and dealers or whether the risk of loss can be differentiated.”
1% of Audit Firms Audit 95% of Net Capital in 2012

<table>
<thead>
<tr>
<th>Firm Category</th>
<th># of Firms</th>
<th># of B-Ds</th>
<th>Sum of Net Capital (2012 in $m)</th>
<th>% of Total Net Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firms that audit more than 100 B-Ds</td>
<td>6</td>
<td>899</td>
<td>161,468</td>
<td>95%</td>
</tr>
<tr>
<td>Firms that audit 1 to 100 B-Ds</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>51 to 100 B-Ds</td>
<td>8</td>
<td>542</td>
<td>1,092</td>
<td>1%</td>
</tr>
<tr>
<td>21 to 50 B-Ds</td>
<td>23</td>
<td>665</td>
<td>4,049</td>
<td>2%</td>
</tr>
<tr>
<td>11 to 20 B-Ds</td>
<td>30</td>
<td>433</td>
<td>623</td>
<td>-</td>
</tr>
<tr>
<td>6 to 10 B-Ds</td>
<td>60</td>
<td>464</td>
<td>826</td>
<td>-</td>
</tr>
<tr>
<td>5 B-Ds</td>
<td>30</td>
<td>150</td>
<td>165</td>
<td>-</td>
</tr>
<tr>
<td>4 B-Ds</td>
<td>57</td>
<td>228</td>
<td>222</td>
<td>-</td>
</tr>
<tr>
<td>3 B-Ds</td>
<td>71</td>
<td>213</td>
<td>273</td>
<td>-</td>
</tr>
<tr>
<td>2 B-Ds</td>
<td>135</td>
<td>270</td>
<td>189</td>
<td>-</td>
</tr>
<tr>
<td>1 B-D</td>
<td>363</td>
<td>363</td>
<td>212</td>
<td>-</td>
</tr>
<tr>
<td>Subtotal – Firms that audit 1 to 100 B-Ds</td>
<td>777</td>
<td>3,328</td>
<td>7,651</td>
<td>5%</td>
</tr>
<tr>
<td>Grand Total</td>
<td>783</td>
<td>4,227</td>
<td>169,120</td>
<td>100%</td>
</tr>
</tbody>
</table>
## Demographics of Firms that Audited B-D’s in 2012

<table>
<thead>
<tr>
<th>Firm Category</th>
<th># of Firms</th>
<th>% Audit Carrying B-Ds</th>
<th>% Audit Issuers</th>
<th>% of B-Ds Outside NY, NJ, IL and CA</th>
<th>Average Number of CPAs</th>
<th>Median Number of CPAs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Firms that audit more than 100 B-Ds</strong></td>
<td>6</td>
<td>100%</td>
<td>100%</td>
<td>40%</td>
<td>6,929</td>
<td>8,065</td>
</tr>
<tr>
<td><strong>Firms that audit 1 to 100 B-Ds</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>51 to 100 B-Ds</td>
<td>8</td>
<td>63%</td>
<td>50%</td>
<td>43%</td>
<td>73</td>
<td>8</td>
</tr>
<tr>
<td>21 to 50 B-Ds</td>
<td>23</td>
<td>43%</td>
<td>43%</td>
<td>42%</td>
<td>314</td>
<td>5</td>
</tr>
<tr>
<td>11 to 20 B-Ds</td>
<td>30</td>
<td>37%</td>
<td>70%</td>
<td>56%</td>
<td>200</td>
<td>67</td>
</tr>
<tr>
<td>6 to 10 B-Ds</td>
<td>60</td>
<td>23%</td>
<td>55%</td>
<td>52%</td>
<td>159</td>
<td>19</td>
</tr>
<tr>
<td>5 B-Ds</td>
<td>30</td>
<td>13%</td>
<td>47%</td>
<td>57%</td>
<td>102</td>
<td>17</td>
</tr>
<tr>
<td>4 B-Ds</td>
<td>57</td>
<td>7%</td>
<td>39%</td>
<td>63%</td>
<td>43</td>
<td>12</td>
</tr>
<tr>
<td>3 B-Ds</td>
<td>71</td>
<td>10%</td>
<td>34%</td>
<td>54%</td>
<td>23</td>
<td>9</td>
</tr>
<tr>
<td>2 B-Ds</td>
<td>135</td>
<td>7%</td>
<td>30%</td>
<td>63%</td>
<td>31</td>
<td>10</td>
</tr>
<tr>
<td>1 B-D</td>
<td>363</td>
<td>3%</td>
<td>36%</td>
<td>60%</td>
<td>23</td>
<td>6</td>
</tr>
<tr>
<td><strong>Subtotal – Firms that audit 1 to 100 B-Ds</strong></td>
<td>777</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td>783</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## Demographics of Firms Inspected in 2012

<table>
<thead>
<tr>
<th>Firm Category</th>
<th># of Firms</th>
<th>% Audit Issuers</th>
<th>Average Number of CPAs</th>
<th>Median Number of CPAs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Firms that audit more than 100 B-Ds</strong></td>
<td>5</td>
<td>100%</td>
<td>8,022</td>
<td>8,654</td>
</tr>
<tr>
<td><strong>Firms that audit 1 to 100 B-Ds</strong></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>51 to 100 B-Ds</td>
<td>3</td>
<td>33%</td>
<td>129</td>
<td>3</td>
</tr>
<tr>
<td>21 to 50 B-Ds</td>
<td>12</td>
<td>25%</td>
<td>343</td>
<td>2</td>
</tr>
<tr>
<td>11 to 20 B-Ds</td>
<td>5</td>
<td>100%</td>
<td>595</td>
<td>650</td>
</tr>
<tr>
<td>6 to 10 B-Ds</td>
<td>4</td>
<td>50%</td>
<td>53</td>
<td>29</td>
</tr>
<tr>
<td>5 B-Ds</td>
<td>1</td>
<td>0%</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>4 B-Ds</td>
<td>2</td>
<td>0%</td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td>3 B-Ds</td>
<td>1</td>
<td>0%</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>2 B-Ds</td>
<td>2</td>
<td>0%</td>
<td>23</td>
<td>23</td>
</tr>
<tr>
<td>1 B-D</td>
<td>8</td>
<td>25%</td>
<td>11</td>
<td>2</td>
</tr>
<tr>
<td><strong>Subtotal – Firms that audit 1 to 100 B-Ds</strong></td>
<td><strong>38</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td><strong>43</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Customer Protection Rules

### All B-Ds

- No Exemption: 7%
- (k)(1): 11%
- (k)(2)(i): 35%
- (k)(2)(ii): 44%
- Multiple: 2%
- Not Available: 1%

### 2012 Inspections

- No Exemption: 25%
- (k)(1): 5%
- (k)(2)(i): 20%
- (k)(2)(ii): 44%
- Multiple: 3%
- Not Available: 0%
### Lines of Business

#### All B-Ds

<table>
<thead>
<tr>
<th>Lines of Business</th>
<th>1</th>
<th>2-5</th>
<th>6-10</th>
<th>11-15</th>
<th>over 15</th>
<th>Not Available</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012 Inspections</td>
<td>289</td>
<td>2,088</td>
<td>1,039</td>
<td>626</td>
<td>181</td>
<td>4</td>
</tr>
</tbody>
</table>

#### 2012 Inspections

<table>
<thead>
<tr>
<th>Lines of Business</th>
<th>1</th>
<th>2-5</th>
<th>6-10</th>
<th>11-15</th>
<th>over 15</th>
<th>Not Available</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012 Inspections</td>
<td>5</td>
<td>19</td>
<td>11</td>
<td>17</td>
<td>7</td>
<td>7</td>
</tr>
</tbody>
</table>
Minimum Fixed-Dollar Net Capital Requirement Reported

All B-Ds

- 5K: 105
- 25K: 30
- 45K: 322
- 100K: 749
- 250K: 603
- 1000K: 87
- 1500K: 31
- Other or NA: 88

2012 Inspections

- 5K: 15
- 25K: 2
- 45K: 2
- 50K: 3
- 100K: 6
- 250K: 26
- 1000K: 4
- 1500K: 1
- Other or NA: 1
Revenue

All B-Ds

- < $250K: 996
- $250K - $1M: 754
- $1M - $10M: 1,544
- $10M - $100M: 654
- > $100M: 270
- NA: 9

2012 Inspections

- < $250K: 5
- $250K - $1M: 5
- $1M - $10M: 14
- $10M - $100M: 27
- > $100M: 9
- NA: -
Assets

All B-Ds

<table>
<thead>
<tr>
<th>Category</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;$250K</td>
<td>1,451</td>
</tr>
<tr>
<td>$250K - $1M</td>
<td>948</td>
</tr>
<tr>
<td>&gt;$1M - $10M</td>
<td>1,069</td>
</tr>
<tr>
<td>&gt;$10M - $100M</td>
<td>468</td>
</tr>
<tr>
<td>&gt;$100M</td>
<td>291</td>
</tr>
<tr>
<td>NA</td>
<td>-</td>
</tr>
</tbody>
</table>

2012 Inspections

<table>
<thead>
<tr>
<th>Category</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;$250K</td>
<td>9</td>
</tr>
<tr>
<td>$250K - $1M</td>
<td>8</td>
</tr>
<tr>
<td>&gt;$1M - $10M</td>
<td>16</td>
</tr>
<tr>
<td>&gt;$10M - $100M</td>
<td>16</td>
</tr>
<tr>
<td>&gt;$100M</td>
<td>11</td>
</tr>
<tr>
<td>NA</td>
<td>-</td>
</tr>
</tbody>
</table>
Number of SIPC Proceeding Down / Impact Up

SIPC Proceedings

SIPC Advances
Population of Broker Dealers in Steady Decline Since Late 80’s
Revenue Trends

- **Total Securities Commissions**
- **P/L from Underwriting and Selling Groups**
- **Margin Interest**
- **Revenue From Sale of Invest Company Shares**

Here are the revenue trends from 2001 to 2013-Q2:

- **2001**: 6%, 7%, 8%, 8%, 6%, 5%, 7%, 21%, 21%, 20%, 14%, 11%, 12%, 6%, 7%, 6%, 8%, 3%, 7%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%, 8%
Revenue vs. Pre-Tax Net Income Trends
Questions?
Break

(15 minutes)
PCAOB inspected portions of 60 audits by 43 firms, 24 of which audit broker-dealers only. Deficiencies were identified in 57 of the 60 audits.

**PCAOB Observations:**

- **Auditor Independence.**
  - In 22 of 60, it appeared that auditors performed bookkeeping or other services related to the accounting records, financial statements or supporting schedules required to be included in the audit per SEA Rule 17a-5.
  - Independence required by Rule 2-01 of Regulation S-X, *Qualification of Accountants*

- **Procedures Regarding Broker-Dealer Compliance with the Net Capital Rule**
  - In 23 of the 60 audits, issues were noted in the following areas:
    - Minimum Net Capital Requirements: 10 of 23
    - Allowable Assets: 17 of 23
    - Haircuts: 9 of 23
    - Operational changes: 3 of 23

- **Auditing Financial Statement Disclosures**
  - In 19 of the 60, auditors failed to identify incomplete disclosures or respond to evidence that was inconsistent with the disclosures included in the financial statements.

Audit Quality Issues

PCAOB Observations, for the second time, align with FINRA experience.

Audit Quality Issues may be the result of multiple factors.

One possible reason - auditor may lack a breadth of knowledge about the industry and regulatory requirements.

Statistics:
- Approximately 4,200 broker/dealer audits were submitted with a FYE date in 2012.
- 363 FINRA members utilized the services of an auditor who had no other broker-dealer clients.
- 483 FINRA members utilized the services of an auditor who had only one or two other broker-dealer audit clients
  - In the case of more than one broker-dealer audit client, the broker-dealers may have been affiliated with each other.
Audit Quality/FOCUS Report Issues

Neither the auditor nor the broker/dealer may fully understand:

1. **The Net Capital Rule**
   - Rule is self-operative
   - Net Capital Requirement is, conceptually, ever-changing
   - Not established by Firm’s Membership Agreement with FINRA

2. **The Customer Protection Rule**
   - The meaning of the exemption claimed by the broker-dealer
   - Claim must be supported by the scope of the firm’s activity with respect to its customers
Approximately 300 Firms Are Required to Comply with the Customer Protection Rule.
  • Amended Rule 17a-5 will require such firms to submit a Compliance Report as part of their Annual Audit.
  • Auditors will have to perform an examination of the Compliance Report.

Approximately 3,900 Firms Claimed an Exemption from the Customer Protection Rule.
  • Amended Rule 17a-5 will require such firms to submit an Exemption Report as part of their Annual Audit.
  • Auditors will have to perform a review of the Exemption Report.
The Exemption Report must contain the following statements made to the best knowledge and belief of the broker-dealer:

1. A statement that identifies the provisions in paragraph (k) of Rule 15c3-3 under which the broker-dealer claimed an exemption;

2. A statement the broker-dealer met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year without exception or that it met the identified exemption provisions in paragraph (k) throughout the most recent fiscal year except as described in the exemption report; (emphasis added) and

3. If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified provisions in paragraph (k) and that briefly describes the nature of each exception and the appropriate date(s) on which the exception existed.
Re: The Exemption Report…

“There may be circumstances in which a broker-dealer has not held customer securities or funds during the fiscal year, but does not fit into one of the exemptive provisions… these broker-dealers should file an exemption report and related accountant’s report.”

See Federal Register 78 FR 51910 dated 2013-08-21 re: Broker-Dealer Reports or SEC Final Rule Release 34-70073, Footnote 74
Integrity of Firms’ Books and Records

- Inappropriate offsetting of assets and liabilities, or offsetting without adequate documentation
  - Offsetting or netting related transactions, but with differing counter-parties; or with the same party but lacking documentation regarding right of offset

- Failing to record liabilities
  - Constructive obligations – cost relates to the activities of, and is paid by, the broker-dealer

- Inappropriate revenue recognition
  - Recognizing service-based revenue before it has been earned

- Not accurately comprehending the financial implications of related party transactions
  - Expense Sharing Agreements
  - Management Services Agreements
Importance of Firms’ Books and Records

Recent changes to SEA Rule 15c3-1 (Net Capital Rule)

A broker/dealer is insolvent if it is unable to make such computations as may be necessary to establish compliance with this section [i.e. the entirety of the net capital rule] or with the Customer Protection Rule.

SEA Rule 15c3-1(c)(16)(iv)
Rule Change Effective October 21, 2013
Expense Sharing Agreements (ESAs)

- Where warranted the 2003 letter imposes “charges” in the Broker-Dealer’s (B/D) Net Capital Computation.

- A written ESA is required anytime a parent or an affiliate assumes responsibility for:
  1) costs incurred by the B/D (i.e., B/D is obligor to 3rd party service provider) OR
  2) parent or affiliate incurs costs which will benefit the B/D (i.e., parent or affiliate contracts for services that will be used by the B/D (in whole or in part)).

- The agreement between the B/D and parent/affiliate must:
  1) be with a parent/affiliate which has independent financial resources from B/D,
  2) make clear the nature of the responsibility of each party,
  3) identify the costs covered by the agreement and how they arise, and
  4) allocate costs on a reasonable basis and in a consistent manner.
Recent changes to SEA Rule 15c3-1 (Net Capital Rule)

In calculating net capital, deduct from net worth

“… any liability or expense relating to the business of the broker or dealer for which a third party has assumed the responsibility, unless the broker or dealer can demonstrate that the third party has adequate resources independent of the broker or dealer to pay the liability or expense.” (emphasis added)

SEA Rule 15c3-1(c)(2)(i)(F)
Rule Change Effective October 21, 2013
Expense Sharing Agreements (ESAs) - continued

When agreements are required:

**Scenario 1**
Parent is liable to 3rd party.
B/D expected to pay parent something.
ESA establishes BD liability to parent, and allocates cost to BD.

**Scenario 2**
Parent is liable to 3rd party.
B/D is expected to pay nothing to parent.
ESA establishes BD has no liability to parent, but parent informs the broker-dealer of the cost so the broker-dealer can satisfy its recordkeeping obligation. Points 2 and 6 of the SEC’s letter. See NTM 03-63.

**Scenario 3**
B/D is liable to 3rd party.
Parent will pay 3rd party.
ESA establishes that parent will make payment to 3rd party, and allocates some/all of the costs back to BD.
Note: B/D has obligation under GAAP to record payable to vendor until parent has made payment. B/D’s ultimate cost may be adjusted downward due to allocation.
Management Services Agreements (MSAs)

What is an MSA?

- An MSA describes services whereby a party (usually the B/D’s parent or affiliate) provides administrative or management services to the B/D.
  - Different from an ESA. In an MSA, the parent or affiliate is providing the services. In an ESA, there is a contract with a 3rd party that provides a good or service.

- In an MSA, we look for the following:
  -- The parent or affiliate has the capacity to offer the service.
  -- The BD needs the service to support its operations.
  -- There is evidence that the services were provided to the B/D.
  -- The costs of the services are reasonable. What would an independent 3rd party charge?

- An MSA should not include the following:
  -- Costs based upon the B/D’s revenue/profits.
  -- A clause providing for the automatic forgiveness of payments by the B/D if net capital issues arise.

Possible undeclared withdrawal of capital.
Possible Undeclared Withdrawals of Capital

- Evidenced by:
  - Increase in MSA agreements that appear to have no economic substance
  - Decline in Withdrawals of Equity Capital Notifications
    - Notifications declined by over 40% between 2008 and 2012
  - Questionable Profit Margins
Recent changes to SEA Rule 15c3-1 (Net Capital Rule)

“The Commission may by order restrict, for a period up to twenty business days, any withdrawal by the broker or dealer of equity capital or unsecured loan or advance to a stockholder, partner, sole proprietor, member, employee or affiliate under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors.”

SEA Rule 15c3-1(e)(3)(i)
Rule Change Effective October 21, 2013
Examination Findings

- Misuse of accounts
  - Inappropriate use of firm error accounts, or other accounts
    - For the Benefit of the Firm
    - For the Benefit of a Customer(s)
- Failing to recognize charges to net worth
  - Unsecured Debits
  - Open Contractual Commitment Changes
- Inappropriate role of affiliates,
  - Activity may require the affiliate to register as a broker-dealer
  - Activity which if conducted in the broker-dealer would result in a higher net capital requirement
- "Borrowing" Capital
Borrowing Capital

Potential Obligations when Guarantees Exist

- Capital Contributions from Parent, Using Borrowed Funds
  - Interpretation to SEA Rule 15c3-1(c)(2)/08
  - The parent of a broker-dealer *may* borrow funds and infuse those funds as additional paid-in capital into the firm without adverse net capital consequences provided the broker-dealer:
    - 1) Is not, in any way, *a party to* the lending arrangement:
    - 2) Has no *assets*, directly or indirectly, *pledged to secure* the loan; and
    - 3) Is not subject to any *recourse* of any kind to the lender *for collection* of the loan against the parent. (*emphasis added*)
Capital Contributions – Sources of Capital

• Source of Capital Contributions
  – Acceptable contributions for regulatory purposes may be made by existing owners or parties which receive newly issued ownership interests in exchange for their contributions
  – Capital contributions from any other party will be considered a “loan” and excluded from regulatory capital

• Basis for the Limitation on Contributors
  – Ownership and capital structures are deliberately designed
  – Capital contributions should be made in a manner consistent with the capitalization structure of the firm
  – By-passing ownership structure creates potential risk to the broker/dealer
    ▪ Contributions from non-owners could be claimed in a lawsuit
    ▪ Potential claims due to the insolvency of the contributing party
Capital Contributions – Permanency of

Recent changes to SEA Rule 15c3-1 (Net Capital Rule)

In calculating net capital, deduct from net worth

“... any contribution of capital to the broker or dealer: (1) Under an agreement that provides the investor with the option to withdraw the capital; or (2) That is intended to be withdrawn within a period of one year of contribution. Any withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer.”

SEA Rule 15c3-1(c)(2)(i)(G)
Rule Change Effective October 21, 2013
Financial and Operational Interpretations

- Interpretations to SEC’s Financial and Operational Rules can be found on finra.org

Financial and Operational Considerations

Questions?
Results of Inspections of Audits of Brokers and Dealers and Related Standards

Bob Maday and Kate Ostasiewski
Division of Registration and Inspections

October 31, 2013
Jersey City, NJ
Agenda

- Introduction and Background
- Overview of the Second Annual Progress Report
- Inspection Observations
- Summary
Interim Inspection Program – Objective

- Assess compliance with applicable Board and Commission rules and professional standards
- Help 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 category of registered public accounting firm
  - Establishment of minimum inspection frequency schedules
Interim Inspection Program - Status

- Inspections - First Progress Report
  - Inspected 10 Firms and portions of 23 audits

- Inspections during 2012 – Second Progress Report
  - Inspected 43 Firms and portions of 60 audits

- Inspections during 2013
  - In process of inspecting approximately 60 firms and portions of 90 audits

- Looking forward: Plans for 2014
Inspection Process

- Communication and scheduling with the registered public accounting firm
- Inspection of audit work
- Information gathering
- Communication of findings/observations
- Firm response to findings and responsibilities under AU-C 585
- Reporting
Consideration of Omitted Procedures

**AU-C 585 Consideration of Omitted Procedures After the Report Release Date**

.06 “If subsequent to the report release date, the auditor becomes aware of an omitted procedure, the auditor should assess the effect of the omitted procedure on the auditor’s present ability to support the previously expressed opinion on the financial statements.”
Consideration of Omitted Procedures

AU-C 585 Consideration of Omitted Procedures After the Report Release Date

.07 “If the auditor concludes that an omitted procedure of which the auditor has become aware impairs the auditor’s present ability to support a previously expressed opinion on the financial statements and the auditor believes that there are users currently relying, or likely to rely, on the previously released report, the auditor should promptly perform the omitted procedures, or alternative procedures, to determine whether there is a satisfactory basis for the auditor’s previously expressed opinion.”
Recent Developments

- Amendments to Rule 17a-5
- PCAOB standards
  - Transition
  - New or Amended
- Conforming changes to PCAOB Rules
- AICPA clarified standards
2013 Annual Progress Report

- Issued on August 19, 2013
  - Part I – Inspections of Registered Public Accounting Firms
  - Part II – Determining the Scope and Elements of a Permanent Inspection Program
  - Part III – Recent Developments and Next Steps of the Interim Inspection Program
Inspections Observations by Audit Area

# of Audits with Deficiencies – All Areas

- # Audits with Deficiencies - Customer Protection and Net Capital Rules
- # of Audits with Deficiencies - Financial Statement Audit
- # of Audits with Deficiencies - Independence
Inspections Observations: Customer Protection and Net Capital Rules

- Report on Material Inadequacies: 40
- Customer Protection Rule: 5
- Net Capital Rule: 20

# Audits with Deficiencies - Customer Protection and Net Capital Rules
### Inspections Observations: Customer Protection and Net Capital Rules

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<th>Number of Applicable Audits</th>
<th>Percentage of Audits with Deficiencies</th>
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<tr>
<td>Customer Protection Rule</td>
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<td>13</td>
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<td>Net Capital Rule</td>
<td>23</td>
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Inspections Observations: Financial Statement Audit and Independence

- Fraud
- Related Party
- Revenue
- Establishing a Basis for Reliance
- Fair Value
- Evaluation of Control Deficiencies
- Financial Statement Disclosures
- Understanding the Entity
- Auditor's Report
- Independence

# of Audits with Deficiencies - Financial Statement Audit
# of Audits with Deficiencies - Independence
## Inspections Observations: Financial Statement Audit

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<thead>
<tr>
<th>Audit Deficiencies</th>
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<th>Number of Applicable Audits</th>
<th>Percentage of Audits with Deficiencies</th>
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<td>Risk of Material Misstatement Due to Fraud</td>
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<td>60</td>
<td>62%</td>
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<td>Related Party Transactions</td>
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<td>60</td>
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<td>Revenue Recognition</td>
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<td>Reliance on Records and Reports</td>
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<td>50%</td>
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<td>Fair Value Measurements</td>
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<td>26%</td>
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<tr>
<td>Evaluation of Internal Control Deficiencies</td>
<td>6</td>
<td>60</td>
<td>10%</td>
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<td>Financial Statement Disclosures</td>
<td>29</td>
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<td>Understanding the Entity</td>
<td>4</td>
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<tr>
<td>Auditor's Report</td>
<td>18</td>
<td>60</td>
<td>30%</td>
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</table>
## Inspections Observations: Independence

<table>
<thead>
<tr>
<th>Independence Findings</th>
<th>Number of Audits with Findings</th>
<th>Number of Applicable Audits</th>
<th>Percentage of Audits with Findings</th>
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</thead>
<tbody>
<tr>
<td>Failure to Satisfy Independence Requirements</td>
<td>22</td>
<td>60</td>
<td>37%</td>
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</table>
2013 Inspections Observations

- Observations continuing
- Many similar to prior inspections
- Independence
- Other observations
Deficiencies Related to the Net Capital Rule and the Customer Protection Rule
Rule 17a-5 Annual Reporting Requirements

Generally, brokers and dealers are required to file with the SEC, audited financial statements along with:

- Audited supporting schedules relating to:
  - The computation of net capital,
  - The computation of the customer reserve requirements, and
  - Information relating to the possession or control requirements under Rule 15c3-3
Compliance with Net Capital Requirements

PCAOB Observation

Deficiencies noted related to:

- Minimum net capital requirements
- Allowable assets
- Haircuts
- Operational charges
Compliance with Customer Protection Rule

PCAOB Observation

Deficiencies noted related to:

- Customer credits or debits
- Special Reserve Bank Account
AU-C 725 Supplementary Information in Relation to the Financial Statements as a Whole

.07 “In addition to the procedures performed during the audit of the financial statements, 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 the following procedures using the same materiality level used in the audit of the financial statements...”
Example #1

Broker A has material amounts of receivables from clearing organization, payables to clearing organization, and other assets as part of its net capital computation. Auditor obtained a copy of the clearing agreement for the files and reviewed the interim and year-end FOCUS reports to verify that net capital met or exceeded the minimum requirement.

*Given the required scope of the auditor’s work, what additional procedures, if any, would the auditor perform and why?*
Example #2

Broker B relies on its clearing firm to calculate haircuts. The clearing firm uses a risk-based haircut methodology. The auditor obtained an understanding of the methodology used by the clearing firm and agreed the haircuts to the clearing broker report.

Given the required scope of the auditor’s work, what additional procedures, if any, would the auditor perform and why?
Audit Deficiencies Related to the Accountant’s Supplemental Report on Material Inadequacies
Accountant’s Supplemental Report on Material Inadequacies

Generally, brokers and dealers are required to file with the SEC, audited financial statements along with (cont.):

- An accountant’s report on material inadequacies describing any material inadequacies found to exist or found to have existed since the date of the previous audit
Accountant’s Supplemental Report on Material Inadequacies

PCAOB Observation

Deficiencies noted related to:

- Reasonable assurance to support whether material inadequacies were disclosed
- Exemption claimed under Rule 15c3-3
- Evaluation of reported net capital deficiencies as indicators of a material inadequacy
- Timely notification of material inadequacy to SEC/FINRA
Rule 17a-5 states that:
The scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide **reasonable assurance** that any material inadequacies existing at the date of the examination in (a) the **accounting system**; (b) the **internal accounting controls**; (c) **procedures for safeguarding securities**; and (d) the **practices and procedures** whose review is specified in (i), (ii), (iii) and (iv) of this paragraph would be disclosed.
Example #1

Auditor completed questionnaires documenting an understanding of internal controls for significant transaction cycles and obtained narratives prepared by management describing regulatory processes. Auditor performs independent tests of the net capital and reserve calculations and finds no errors.

*Did the auditor perform sufficient procedures to obtain reasonable assurance? If not, what other procedures could be considered to enable the auditor to obtain reasonable assurance?*
Example #2

Auditor tested accounting controls and the accounting systems and concludes there are 2 deficiencies: 1) a lack of segregation of duties over journal entries and 2) no ability to prevent or detect changes made to the general ledger system. The auditor also tested that focus reports are reviewed for accuracy and approved by the CEO by obtaining draft reports from the CEO and noting that they had hand-written notes.

What additional procedures, if any, did the auditor need to perform to issue the MI report?
Internal Control Considerations

- Understand business process and identify “what could go wrongs”
- Identify controls to address “what could go wrongs”
- Testing design of control
  - Controls address relevant assertions
  - Controls address risk of material misstatements if operating properly
- Testing operating effectiveness of controls
  - Relevant, consistent, by whom and by what means
  - Inquiry, observation, examination of evidence, reperformance
- Evaluating control deficiencies
  - Assess severity of control deficiencies individually and in combination
  - Identify and assess mitigating controls
Deficiencies Related to the Financial Statement Audit
Consideration of Material Misstatement Due to Fraud

PCAOB Observation

Deficiencies noted related to:

- Audit response to identified fraud risk
- Presumption that revenue recognition is a fraud risk
- Journal entry testing
Consideration of Material Misstatement Due to Fraud

**AU-C 240 Consideration of Fraud in a Financial Statement Audit**

.32 “…Accordingly, 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…”
Consideration of Material Misstatement Due to Fraud

Example #1

Auditor identified a fraud risk related to cash, commissions and compensation. Auditor tested cash disbursement journal entries greater than $20,000 including verifying that associated wire transfers and checks were authorized.

Has the auditor performed sufficient procedures to examine journal entries to address the risk of management override? To address the presumptive fraud risk associated with revenue recognition?
Example #2

Auditor identified trading and fee revenue as having a greater risk of management override. Auditor obtained a listing of journal entries and tested for completeness. Auditor identified a population of 100 journal entries related to these accounts and selected a sample of 20 and verified that each entry had a valid business purpose.

Has the auditor performed sufficient procedures to examine journal entries to address the risk of management override?
Related Party Transactions

PCAOB Observation

Deficiencies noted related to:

- No procedures performed
- Existence and identification of related parties and related party transactions
- Examining identified related party transactions
- Other
AU-C 550 Related Parties

.12 “As part of the risk assessment procedures and related activities that section 240 and section 315 require the auditor to perform during the audit, the auditor should perform the audit procedures and related activities set out in paragraph .13-.18 to obtain information relevant to identifying the risks of material misstatements associated with related party relationships and transactions.”
Related Party Transactions

Example

Broker A disclosed in the footnotes that two shareholders generate substantially all of its commission revenues. The auditor obtained management’s representation that there were no other related parties or related party transactions.

What additional procedures, if any, should the auditor perform to determine the existence of related parties and identify related party transactions?
Lunch

(70 minutes)
Revenue Recognition

PCAOB Observation

Deficiencies noted related to:

- Extent of testing
- Substantive analytical procedures
- Other procedures to test revenue recognition
Revenue Recognition

**AU-C 330 Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained**

.18 “Irrespective of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.”

.22 “If the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedure, those procedures should include tests of details.”
Example #1

Auditor tests commissions and fee revenue by obtaining clearing statements from the BD for all 12 months and tracing revenue reported to the general ledger. Auditor obtained a confirmation of commissions revenue for December 2012 from the clearing firm. Auditor observed that the amount confirmed agreed to the December clearing statement and the general ledger.

What else, if anything, does the auditor need to do to test the revenue balance?
Example #2

Auditor tests commission income by selecting a sample of 30 transactions that occurred during June, September or December as recorded in the BD’s general ledger and agreed the amount and date recorded to reports received by the BD from insurance carriers and to bank deposits.

What else, if anything, does the auditor need to do to test the revenue balance?
Example #3

Auditor performed analytical procedures to test underwriting revenue and trading gains. Auditor established prior year recorded balance as the expectation for each revenue component and performed a comparison of prior year revenues by component to current year recorded balances. Auditor investigated differences that exceeded the lesser of 80% of planning materiality or 30% of the expectation.

What else, if anything, does the auditor need to do to test the revenue balance?
Establishing a Basis for Reliance on Records and Reports

**PCAOB Observation**

Deficiencies noted related to:

- Completeness and accuracy of records and reports from service organizations
- Completeness and accuracy of records and reports produced by brokers and dealers
Establishing a Basis for Reliance on Records and Reports
Establishing a Basis for Reliance on Records and Reports

AU-C 402 Audit Considerations Relating to an Entity Using a Service Organization

.09 “When obtaining an understanding of the user entity in accordance with section 315, the user auditor should obtain an understanding of how the user entity uses the service organization in the user entity’s operations…”

.15 “In responding to assessed risks in accordance with section 330, the user auditor should

   a. determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertion is available from records held at the user entity 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.”
Establishing a Basis for Reliance on Records and Reports

**AU-C 500 Audit Evidence**

.09 “When using information produced by the entity, the auditor should evaluate whether the information is sufficiently reliable for the auditor’s purposes, including, as necessary, in the following circumstances:

a. Obtaining audit evidence about the accuracy and completeness of the information…”
Example #1

Auditor performed analytical procedures to test advisory fees. Auditor expected advisory fees to be approximately 65 basis points (based on a historical average) of assets under management (AUM). Auditor obtained system based reports of AUM to calculate the historical average. Auditor calculated expected revenue and compared it to actual advisory fees recorded.

What else does the auditor need to do to establish a reasonable basis for reliance on AUM used in these procedures?
Example #2
Auditor selected a sample of accounts receivables from private placements from an accounts receivable schedule provided by the BD. Auditor selected a sample of receivable balances from this schedule and traced the balances to cash receipts subsequent to year-end.

What else does the auditor need to do to establish a reasonable basis for reliance on the accounts receivable schedule obtained from the BD?
Evaluation of Internal Control Deficiencies

**PCAOB Observation**

Deficiencies noted related to:

- Assessment of the severity of a control deficiency
- Evaluation of errors performed as part of substantive testing
AU-C 265 *Communicating Internal Control Related Matters Identified in an Audit*

.09 “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.”
Evaluation of Internal Control Deficiencies

Example

Auditor documents in its understanding of the BD’s control environment that given the size of the BD and its operations the checks and balances included in a system of internal accounting control and division of duties are difficult to achieve. Auditor indicates that reliance therefore is placed on owner oversight.

What factors does the auditor need to consider to determine whether an internal control deficiency exists?
Financial Statement Disclosures

PCAOB Observation

Deficiencies noted related to:

- Omitted disclosures
- Inaccurate or incomplete disclosures
- Fair value disclosures
Financial Statement Disclosures

AU-C 705

.07a “The auditor should modify the opinion in the auditor’s report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are materially misstated....”

.A7a “With regard to the appropriateness of the financial statement presentation or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when the financial statements do not include all of the disclosures required by the applicable financial reporting framework...”
Financial Statement Disclosures

Example

Auditor determined that BD earned 53% of its commission income from Company 1 and 39% of its commission income from Company 2. The BD has disclosed the following in the financial statements: “BD earned a substantial portion of its income from commission earned on the sale of variable universal life insurance policies. Income earned on commissions from these products represented 96% of income for the year ended.”

What should the auditor consider when evaluating the adequacy of this disclosure?
Auditor’s Report

PCAOB Observation

Deficiencies noted related to:

- Auditor’s report on supporting schedules
- Accountant’s supplemental report on material inadequacies
Understanding the Entity

PCAOB Observation

Deficiencies noted related to:

- Understanding of the entity and its environment
Determining the Scope of a Permanent Program

- Part II of the 2013 Progress Report
- Promote investor protection
- Auditor’s role in the protection of the assets of customers
- Differentiation of the risk of loss to customers
- Consideration of attributes that characterize brokers and dealers
Summary

- Interim inspection program continues through 2013 and 2014
- Third progress report to be issued in 2014
- Transition to PCAOB Standards
- Determination of the scope and elements of a permanent inspection program under consideration
- Rule proposal for a permanent inspection program
Next Steps for Firms that Audit Brokers and Dealers

- Review and enhance as necessary:
  - arrangements with brokers and dealers and quality control procedures to help ensure that SEC independence rules are not violated
  - guidance and training to determine whether topics observed as audit deficiencies are given appropriate attention
  - policies for supervision and review to help ensure partners and supervisory personnel place appropriate attention to these areas

- Prepare now for transition to PCAOB Standards and amended Rule 17a-5 requirements
Questions?
The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author’s colleagues upon the staff of the Commission.
Agenda

- Broker-Dealer Rulemaking
  - Background/Rulemaking Timeline
  - Existing SEC Annual Reporting Requirements
  - Final Amendments to SEC Annual Reporting Requirements
    - Compliance Report (Examination)
    - Exemption Report (Review)
    - Other Requirements

- Applicability of Auditor Independence Rules to Broker-Dealer Audits
Broker-Dealer Rulemaking
Background/Rulemaking Timeline

- July 21, 2010 – Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act granted the PCAOB oversight over audits of brokers and dealers registered with the Commission.
- Sept. 24, 2010 – Commission published interpretive guidance to clarify the application of certain rules, regulations, releases, and staff bulletins in light of the PCAOB’s oversight.
- Nov. 18, 2010 – Letter issued by SEC Director of Trading and Markets and SEC Chief Accountant concerning requirements for broker-dealer annual audits pursuant to Rule 17a-5.
Background/Rulemaking Timeline

- June 14, 2011 – PCAOB adopted final rules for allocation of the Board’s accounting support fee among issuers, brokers, and dealers, and other amendments to the Board’s funding Rules
- June 14, 2011 – PCAOB adopted temporary rule for an interim program of inspection related to audits of brokers and dealers
- August 18, 2011 - Commission order approving the rules noted above
- October 10, 2013 - PCAOB adopted new attestation standards and a new auditing standard, subject to Commission approval
Rulemaking Timeline

- June 15, 2011 – Commission proposed amendments to broker-dealer financial reporting rules to:
  - Update existing requirements of Rule 17a-5
  - Facilitate the ability of the PCAOB to implement oversight of independent public accountants of broker-dealers
  - Eliminate potentially redundant requirements for certain broker-dealers affiliated with, or dually registered as, investment advisors
  - Other amendments included:
    - Access to audit documentation
    - New Form Custody
Rulemaking Timeline

- Comment period closed on August 26, 2011
  - 27 comment letters received
- Areas of public comment included:
  - Material non-compliance and material weakness
  - Reporting of remediation of material weaknesses
  - Relationship between internal control over compliance with Financial Responsibility Rules and internal control over financial reporting
  - Internal control considerations related to broker-dealer’s books and records
Areas of public comment included (cont’d):

- Period or “as of date” exemption from Rule 15c3-3
- Notification requirements to the Commission
- Effective date and transition period
- Access to audit documentation
- Interaction with other regulatory rules and requirements
Rulemaking Timeline

- On July 30, 2013, the SEC finalized amendments to broker-dealer financial responsibility rules and financial reporting rules

- The amendments to the reporting rules are expected to improve compliance with the SEC’s financial responsibility rules
Final Amendments to SEC Financial Responsibility Rules

- Amendments made to:
  - Customer Protection Rule (15c3-3)
  - Net Capital Rule (15c3-1)
  - Books and Records Rules (17a-3 and 17a-4)
  - Notification Rule (17a-11)

- The amendments to the financial responsibility rules are expected to better protect customers and enhance the SEC’s ability to monitor and prevent unsound practices.
Existing SEC Annual Reporting Requirements

- Broker-dealers are required to file an annual report with the SEC and the broker-dealer’s designated examining authority pursuant to Rule 17a-5
  - Annual report must contain audited financial statements and certain supporting schedules and supplemental reports, as applicable
  - The audit is conducted in accordance with GAAS (i.e., not PCAOB standards)
- The new annual reporting requirements become effective for all broker-dealers with fiscal years ending on or after June 1, 2014.
Existing SEC Annual Reporting Requirements

- **Report on internal controls**
  - The auditor is required to obtain reasonable assurance that any *material inadequacies* existing at the audit report date in the following areas are disclosed:
    - Accounting system
    - Internal control
    - Procedures for safeguarding securities, and
    - Practices and procedures specified by Rule 17a-5
  - Study of practices and procedures followed, including consideration of control activities for safeguarding securities
  - Broker-dealers that are exempt from Rule 15c3-3
Final Amendments to SEC Annual Reporting Requirements

- In addition to existing requirements to file audited financial statements and certain supporting schedules ("Financial Report"), the revised Rule 17a-5 also requires the following new reports:
  - **Carrying** broker-dealer that has custody of customer assets to file a new Compliance Report, that will be examined by its independent public accountant
  - **Non-carrying** broker-dealer that does not have custody of customer assets to file a new Exemption Report, that will be reviewed by its independent public accountant
Final Amendments to SEC Annual Reporting Requirements

- Audits of the Financial Report, the examination of the Compliance Report and the review of the Exemption Report are to be conducted in accordance with PCAOB standards, instead of GAAS.

- The PCAOB has developed new attestation standards (AT Nos. 1 & 2) specifically tailored to the examination of the Compliance Report and the review of the Exemption Report, as well as a new auditing standard for supplemental information included with the financial statements.
**Final Amendments to SEC Annual Reporting Requirements**

- *Carrying* broker-dealers are required to file a Compliance Report which would include statements as to whether:
  - The broker-dealer has established and maintained Internal Control over Compliance;
  - Internal Control over Compliance was effective during the most recent fiscal year;
  - Internal Control over Compliance was effective as of the end of the most recent fiscal year;
  - The broker-dealer was in compliance with Rule 15c3-1 and Rule 15c3-3(e) as of its fiscal year-end;
  - The information used to state whether it was in compliance was derived from the books and records of the broker-dealer.
Final Amendments to SEC Annual Reporting Requirements

- If applicable, a carrying broker-dealer would be required to include:
  - A description of each material weakness in Internal Control Over Compliance during the most recent fiscal year
  - A description of each instance of non-compliance with Rules 15c3-1 or 15c3-3(e) as of the end of the most recent fiscal year
Final Amendments to SEC Annual Reporting Requirements

- **Internal Control Over Compliance**
  - Internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with Rules 15c3-1, 15c3-3, 17a-13, or any rule of the designated examining authority of the broker or dealer that requires account statements (an “Account Statement Rule”) to be sent to the customers of the broker or dealer will be prevented or detected on a timely basis.
Final Amendments to SEC Annual Reporting Requirements

- The rules covered by the term Internal Control Over Compliance ("ICOC") are broader than those covered by the compliance statement.

- Additionally, the statements in the Compliance Report on ICOC cover the entire year and year end, where the statement on compliance is as of year end only.

Internal Control Over Compliance:
- 15c3-1, 15c3-3, 17a-13
- Account Statement Rule
- 15c3-3(e)
- 15c3-1
Internal Control Over Compliance (ICOC) is intended to focus on a broker-dealer’s net capital requirements, oversight of custody arrangements and protection of customer assets.

ICOC differs from Internal Control over Financial Reporting, which focuses on the reliability of financial reporting and the preparation of financial statements.

The Final Rule does not require that the effectiveness of internal control over financial reporting be included as one of the statements made by the broker-dealer in the compliance report, or opined on by the auditor.
Final Amendments to SEC Annual Reporting Requirements

- **Material Weakness**
  - A deficiency, or a combination of deficiencies, in Internal Control Over Compliance such that there is a reasonable possibility that non-compliance with Rule 15c3-1 or Rule 15c3-3(e) will not be prevented or detected on a timely basis or that non-compliance to a material extent with Rule 15c3-3, except for paragraph (e), Rule 17a-13, or any Account Statement Rule will not be prevented or detected on a timely basis.

- Existing term “material inadequacy” no longer relevant
Final Amendments to SEC Annual Reporting Requirements

- Carrying broker-dealer is not permitted to conclude that its Internal Control Over Compliance was effective
  - during the fiscal year if there were one or more material weaknesses in ICOC during the fiscal year
  - as of the end of the fiscal year if there were one or more material weaknesses in ICOC as of the end of the fiscal year

- Carrying broker-dealer required to engage an independent public accountant to:
  - Prepare a report based on an examination of certain of the broker-dealer’s statements contained in the Compliance Report
Non-carrying broker-dealer required to state the following in its Exemption Report:

- The provisions in Rule 15c3-3(k) under which the broker-dealer claimed an exemption from Rule 15c3-3

- Either:
  - The broker-dealer met the identified exemption provisions in Rule 15c3-3(k) throughout the most recent fiscal year without exception, or
  - The broker-dealer met the identified exemption provisions except as described in the Exemption Report

- If applicable, an identification of each exception, a description of the nature of each exception, and the approximate date(s) on which the exception existed
Final Amendments to SEC Annual Reporting Requirements

- **Non-carrying** broker-dealer required to engage an independent public accountant to:
  - Prepare a report based on a review of the broker-dealer’s statements contained in the Exemption Report

- Note that a broker-dealer must file an exemption report if it claimed that it was exempt from Rule 15c3-3 throughout the most recent fiscal year, even in situations in which the broker-dealer had exceptions to meeting the exemption provisions in 15c3-3(k).
Final Amendments to SEC Annual Reporting Requirements

- **Notification requirements**
  - An auditor must immediately notify the CFO of the broker-dealer if
    - the auditor determines, in the course of preparing its reports, that the broker-dealer was not in compliance with any of the financial responsibility rules, or
    - In the performance of an examination of the Compliance Report, the accountant determines that any material weakness existed in the broker-dealer’s ICOC
Final Amendments to SEC Annual Reporting Requirements

- **Notification requirements (cont’d)**
  - The broker-dealer must file a notification with the Commission and its DEA if the auditor’s notice relates to an instance of non-compliance that would trigger notification, and provide a copy of the notification to the auditor.
  
  - If the auditor does not receive a copy of the notification within 1 business day, or if the auditor does not agree with the statements in the notification, the auditor must notify the SEC and DEA within one business day.
Final Amendments to SEC Annual Reporting Requirements

- **Form Custody**
  - New form to be filed by broker-dealers quarterly
  - Filed with DEA concurrent with FOCUS Reports
  - Comprised of 9 items designed to elicit information about a broker-dealer’s custodial activities.
  - The Commission believes that the information required by Form Custody will provide the Commission with an enhanced understanding of the scope of broker-dealer introducing/carrying relationships and activities, and the custodial practices of broker-dealers involved in such relationships.
Final Amendments to SEC Annual Reporting Requirements

- **Access to audit documentation**
  - Clearing and Carrying broker-dealers to consent to permitting their independent public accountants to:
    - Make available to the Commission and Designated Examining Authority (“DEA”) examiners the audit documentation associated with its annual reports required under Rule 17a-5
    - Discuss findings relating to the audit reports with the Commission and DEA examiners
Final Amendments to SEC Annual Reporting Requirements

- **Effective dates:**
  - New Form Custody requirement effective on December 31, 2013.
  - Broker-dealer annual reports must be filed with SIPC for fiscal years ending on or after December 31, 2013.
  - The filing of compliance reports and exemption reports and the related auditor reports effective for fiscal years ending on or after June 1, 2014.
  - Amendments to the notification requirements effective for fiscal years ending on or after June 1, 2014.
Final Amendments to SEC Annual Reporting Requirements

- Interaction with the Investment Advisors Custody Rule:
  - Broker-dealers that must also comply with the Custody Rule are required to obtain annually an auditor’s written internal control report
  - The Commission has determined that the independent public accountant’s report based on an examination of the compliance report will satisfy this requirement
Applicability of Auditor Independence Rules to Broker-Dealer Audits
Applicability of Auditor Independence Rules to Broker-Dealer Audits

- Auditors of both issuer and non-issuer broker-dealers are required to be qualified and independent in accordance with the Commission’s auditor independence requirements in Rule 2-01 of Regulation S-X, Qualifications of Accountants
  - No currently proposed changes to current requirements
Examples of applicable independence requirements:

- Non-Audit Services – An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides, among others, the following non-audit services to an audit client:
  - Bookkeeping or Other Services Related to the Accounting Records or Financial Statements of the Audit Client.
  - Management Functions
- Other Financial Interests in Audit Client

- Auditors of non-issuer brokers-dealers are not subject to SEC rules related to:
  - Partner rotation requirements
  - Certain partner compensation arrangements

- Auditors of non-issuer broker-dealers are also not subject to rules related to:
  - Audit committee administration requirements
  - "Cooling off" period requirements
Contact Information

- **Office of the Chief Accountant Involvement in Auditor Independence Matters**
  - Professional Practice Group – Independence
    - Phone: (202) 551-5300
    - E-mail: OCA@sec.gov

- **Subscribe to receive SEC updates by e-mail:**
Questions?
Break

(15 minutes)
Agenda

- Existing PCAOB Standards
- Recently Adopted Standards, Subject to SEC Approval
  - Attestation Standard Nos. 1 and 2
  - Auditing Standard No. 17
Standards of the PCAOB

- Auditing
- Attestation
- Quality control
- Ethics and independence standards
- Standards-related rules
  - Example: Rule 3101
Recently Adopted Standards Related to Audits of Brokers and Dealers
Recently Adopted Standards, Subject to SEC Approval

- Attestation Standard No. 1 – Examination Engagements Regarding Compliance Reports of Brokers and Dealers
- Attestation Standard No. 2 – Review Engagements Regarding Exemption Reports of Brokers and Dealers
- Auditing Standard No. 17 – Auditing Supplemental Information Accompanying Audited Financial Statements
Attestation Standard No. 1 – Examination Engagements Regarding Compliance Reports of Brokers and Dealers
Examination Engagements Regarding Compliance Reports of Brokers and Dealers

- Applies when auditor examines certain statements in the broker’s or dealer’s compliance report

- Covers four assertions:
  - Internal control over compliance during the year
  - Internal control over compliance as of year end
  - Compliance with net capital rule and reserve requirements rule
  - Whether the information for asserting compliance with the net capital rule and reserve requirements rule was derived from the broker’s or dealer’s books and records
Examination Engagements Regarding Compliance Reports of Brokers and Dealers

- Sets forth an approach consisting of:
  - General and planning procedures, including consideration of risk
  - Selecting and testing controls over compliance
  - Testing compliance with the net capital rule and reserve requirements rule, including obtaining evidence about the existence of customer assets
  - Performing procedures, in connection with compliance tests, to determine whether the information used to assert compliance is derived from the books and records
Examination Engagements Regarding Compliance Reports of Brokers and Dealers

- Requires coordination with the financial statement audit and audit procedures on supporting schedules
- Includes communication requirements to the audit committee and/or management
- Provides requirements for the auditor’s report which address both unqualified and adverse opinions
Attestation Standard No. 2 – 
Review Engagements Regarding Exemption Reports of Brokers and Dealers
Review Engagements Regarding Exemption Reports of Brokers and Dealers

- Applies when auditors review the statements in a broker’s or dealer’s exemption reports
- Focuses on conditions that might cause the assertions not to be fairly stated, in all material respects, e.g.:
  - Incorrect exemption provision
  - Incorrectly asserting that exemption provisions met without exception
  - Incorrect or incomplete list of exceptions
Review Engagements Regarding Exemption Reports of Brokers and Dealers

- Sets forth an approach that covers:
  - General and planning procedures, including consideration of risk factors
  - Review procedures to obtain moderate assurance
  - Additional procedures, in certain instances
  - Communication to the audit committee and/or management

- Requires coordination with the financial statement audit and audit procedures on the supporting schedules

- Establishes reporting requirements
Auditing Standard No. 17 – Auditing Supplemental Information Accompanying Audited Financial Statements
Auditing Supplemental Information Accompanying Audited Financial Statements

- Applies when the auditor of the financial statements is engaged to perform audit procedures and report on supplemental information that accompanies financial statements audited under PCAOB standards
  - Example: Supporting schedules required by SEC Rule 17a-5 for broker-dealers
- Retains “in relation to approach” – generally use the same materiality considerations as for the financial statement audit
- Requires procedures to test supplemental information, including evaluating compliance with regulatory requirements
- Changes the standard language in the auditor’s report on supplemental information
Keeping Current with Standards

  - PCAOB standards and related rules, including interim standards
  - PCAOB proposed standards
  - Staff questions and answers
  - Staff audit practice alerts
  - Standing Advisory Group

- Contact us at info@pcaobus.org

- Sign up for the PCAOB Updates service to receive a notification via e-mail that briefly describes significant new postings to our Web site:
  http://pcaobus.org/About/Pages/Subscribe.aspx
Questions?
The views expressed are the views of the speaker and do not necessarily reflect the views of the Board, individual Board members, or other members of the Board’s staff.
Division of Enforcement and Investigations Overview

- Staff consists of 29 attorneys, 17 accountants, and support staff, totaling over fifty staff based in DC and NY offices.

- Enforcement’s role:
  - Identify appropriate matters for investigation
  - Conduct investigations and make recommendations to the Board
  - Litigate disciplinary proceedings before Board’s Hearing Officer and, on appeal, to the Board
Enforcement’s Jurisdiction

- Registered Public Accounting Firms
  - Audits of “Issuers” (i.e., public companies) and Broker/Dealers
- “Associated Persons”
Investigative Authority

- The PCAOB may investigate possible violations by registered public accounting firms or their associated persons of:
  - Any relevant provision of the Sarbanes-Oxley Act
  - The rules of the Board
  - The provisions of the securities laws relating to the preparation and issuance of audit reports
  - Professional standards
Sources of Investigations

- Other PCAOB divisions and offices
  - Division of Registration and Inspections
  - Office of Research and Analysis

- Enforcement public source analysis
  - Issuer disclosures of restatements and auditor changes
  - Media reports, blogs, and analyst reports
  - Tips

- Referrals from other regulators, *e.g.*, SEC and FINRA
Common Types of Investigations

- Violations of professional standards
  - Audit failures: e.g., failure to obtain sufficient audit evidence, exercise due care and professional skepticism (ignored red flags)
  - Failure of firm quality control procedure to operate effectively
- Independence violations
- Failure to cooperate with an inspection or investigation
Investigations Process Overview

- The Act requires confidentiality of investigative information
- Most matters start as informal inquiries—reliance on voluntary productions based on Division requests
- If matter warrants significant use of resources, or parties are not complying with requests, Staff requests an Order of Formal Investigation from the Board
  - “Accounting Board Demands” compel firms/associated persons to
    - Produce documents
    - Testify
    - Provide other information
  - Refusal to comply may amount to sanctionable non-cooperation
- DEI frequently coordinates its investigations with the enforcement efforts of other regulators, such as the SEC
Investigations Process Overview

- If evidence of serious violations exists
  - Staff communicates to the firm or associated persons and gives them an opportunity to respond to staff’s position in writing
  - Staff reviews the responses and determines whether to recommend charges against firm(s) and/or associated person(s), or closure of the formal investigation
  - Staff communicates recommendations to the Board
Investigations Process Overview

- Enforcement recommendations to the Board for disciplinary proceedings
  - Enforcement submits a memorandum to the Board outlining facts and law and parties to be charged with violations
    - If Board approves litigated proceeding, order is nonpublic
  - If parties wish to settle, the recommendation will include whether acceptance of the settlement is recommended by the Division
    - If Board approves settlement, order becomes public
Disciplinary Proceedings and Hearings

- Hearings (trials) are conducted by the Board Hearing Officer to determine whether firms or associated persons committed violations and should be disciplined

- Hearings are nonpublic, as required by Act

- Initial decision by Board’s Hearing Officer

- Any sanctions imposed can be appealed to the Board, then to the SEC, and then to the United States Circuit Court
In a disciplinary proceeding, the Board may

- Impose a censure
- Suspend or permanently bar an individual from association with a registered public accounting firm
- Temporarily or permanently revoke a firm’s registration
- Temporarily or permanently limit the activities, functions, or operations of a firm or person
- Impose a civil money penalty
- Appoint an independent monitor
- Require additional professional education or training, and/or impose any other sanction allowed by the Board rules
Effect of Suspension or Bar

- A person suspended or barred from associating with a registered public accounting firm by the Board is prohibited from associating with a registered public accounting firm.

- Dodd-Frank also makes it unlawful for the person to associate with any issuer, broker, or dealer in an accountancy or a financial management capacity.
Settled and Adjudicated Disciplinary Proceedings

- To date the Board has settled or completed adjudication on over 40 disciplinary orders.
- These orders have resulted in the following sanctions:
  - Bars (Firms and auditors)
  - Suspensions
  - Censures
  - Civil money penalties
Settled Disciplinary Proceeding

- Ernst & Young, Jeffrey Anderson, CPA, Ronald Butler, CPA, Thomas Christie, CPA, and Robert Thibault, CPA (Feb. 8, 2012)
  - Ernst & Young and four partners
  - Found to have violated PCAOB auditing standards in connection with three audits and a National Office consultation stemming from an internal audit quality review related to the company’s non-GAAP methodology for its sales returns reserve estimate
  - $2 million civil money penalty and censure imposed on firm penalty (largest PCAOB penalty to-date)
  - 2 year bar and $50,000 penalty imposed on partner responsible for two audits
  - 1 year bar and $25,000 penalty imposed against national office partner who also served as concurring partner on two audits; $25,000 penalty and censure imposed against partner who served as second partner on one audit and signing partner on another audit; and a censure imposed against the second partner on one audit
Settled Disciplinary Proceeding

  - Two PwC International firms found to have violated PCAOB rules and auditing standards in connection with the audit of India IT service provider, Satyam Computer Services
  - $1.5 million fine imposed on these two firms (in addition to $6 million penalty imposed by SEC)
  - Five PwC International firms based in India (including the above two) were censured based on violations of the PCAOB’s quality control standards, prohibited from accepting new U.S. issuer work for six months, independent monitor appointed, and remedial steps required
  - Matter was part of coordinated investigation with the SEC
Settled Disciplinary Proceeding

In the Matters of Peter C. O'Toole, CPA; Darrin G. Estella, CPA; and Jacqueline A. Higgins, CPA (Aug. 1, 2011)

- Partner, Sr. Manager and Manager at Ernst & Young
- Failed to comply with AS3 (Audit Documentation) and failed to cooperate with Inspections
- Improperly removed, added and backdated working papers in advance of an inspection
- Partner received bar (can petition for Board consent to associate with a registered public accounting firm after 3 years) and $50,000 civil money penalty
- Sr. Manager barred (can petition for Board consent to associate with a registered public accounting firm after 2 years)
- Manager censured
In the Matter of Davis Accounting Group, P.C. and Edwin R. Davis, Jr., CPA

- Audit firm and its sole owner failed to cooperate with a PCAOB investigation
- While the firm and its sole owner continued to issue more than 30 audit opinions, they claimed they were unable to respond to an Accounting Board Demand
- Firm’s registration was permanently revoked and its sole owner was permanently barred from association, with monetary sanctions of $75,000
PCAOB Center for Enforcement Tips, Complaints and Other Information

Website: http://pcaobus.org/Enforcement/Tips
Letter: PCAOB Tip Center
1666 K Street, NW
Washington, DC 20006
FAX: 202-862-0757
Telephone: 800-741-3158
Closing Remarks and Wrap-Up

Jay Hanson
Board Member, PCAOB
October 31, 2013
Jersey City, NJ