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**STAFF GUIDANCE FOR AUDITORS  
OF SEC-REGISTERED BROKERS AND DEALERS**

**JUNE 26, 2014**

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Note: The example auditor's report on pages 29-30 of this document has been superseded by the [Annotated Example Auditor's Report for the Audit of a Broker or Dealer \(Dec. 18, 2018\)](#).

This publication was prepared by the staff of the Public Company Accounting Oversight Board (the "Board" or "PCAOB") to help auditors plan and perform audits of brokers and dealers in accordance with PCAOB standards. It is not a standard or rule of the Board, nor has it been approved by the Board. While this publication summarizes and explains applicable rules and standards, it is not a substitute for any rule or standard itself. Only the rule or standard itself can provide complete and definitive information regarding its requirements.

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## **INTRODUCTION**

On July 30, 2013, the U.S. Securities and Exchange Commission ("SEC" or "Commission") adopted amendments to Rule 17a-5 under the Securities Exchange Act of 1934 ("Exchange Act") ("SEC Rule 17a-5"),<sup>1</sup> that, among other things, require audits of brokers<sup>2</sup> and dealers<sup>3</sup> to be performed in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board") for fiscal years ending on or after June 1, 2014. Prior to the effective date of the amendments, those audits were performed under generally accepted auditing standards.

On October 10, 2013, the PCAOB adopted two new attestation standards, Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* ("Attestation Standard No.1" or the "examination standard"), and Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* ("Attestation Standard No. 2" or the "review standard"), along with related amendments to certain PCAOB standards.<sup>4</sup> The attestation standards and related amendments apply to registered firms conducting attestation engagements related to broker and dealer compliance or exemption reports required by the SEC. The Board also adopted a new auditing standard, Auditing Standard No. 17, *Auditing Supplemental*

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<sup>1</sup> See Exchange Act Rule 17 C.F.R. § 240.17a-5 and SEC Exchange Act Release No. 70073, *Broker-Dealer Reports*, (July 30, 2013), 78 Federal Register 51910 (August 21, 2013) ("SEC Release"), available at <http://www.sec.gov/rules/final/2013/34-70073.pdf>.

<sup>2</sup> According to PCAOB Rule 1001(b)(iii), the term "broker" means a broker (as defined in Section 3(a)(4) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

<sup>3</sup> According to PCAOB Rule 1001(d)(iii), the term "dealer" means a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

<sup>4</sup> See PCAOB Release No. 2013-007, *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), available at [http://pcaobus.org/Rules/Rulemaking/Docket035/PCAOB\\_Release\\_2013\\_007.pdf](http://pcaobus.org/Rules/Rulemaking/Docket035/PCAOB_Release_2013_007.pdf).

*Information Accompanying Audited Financial Statements*, and related amendments, which are applicable when the auditor reports on the supporting schedules of a broker or dealer.<sup>5</sup> These standards and related amendments were approved by the SEC on February 12, 2014, and are effective for fiscal years ending on or after June 1, 2014, which coincides with the effective date for the amendments to SEC Rule 17a-5.<sup>6</sup>

This publication was developed primarily for auditors of smaller brokers and dealers that have less complex operations. Because some auditors of smaller, less complex brokers and dealers will be applying PCAOB standards for the first time, this publication includes "Getting Started," a chapter, which introduces these auditors to certain PCAOB standards and rules. This publication highlights relevant requirements for SEC-required broker and dealer audits and attestation engagements and provides staff guidance on the application of PCAOB standards<sup>7</sup> to these engagements.

This publication was prepared by staff of the PCAOB to help auditors plan and perform audits of brokers and dealers in accordance with PCAOB standards. It is not a standard or rule of the Board, nor has it been approved by the Board. While this publication summarizes and explains applicable rules and standards, it is not a substitute for any rule or standard itself. Only the rule or standard itself can provide complete and definitive information regarding its requirements. Additionally, this publication highlights some of the significant provisions of SEC Rule 17a-5 and PCAOB standards and rules applicable to audits of brokers and dealers. It is not comprehensive, and auditors must comply with all applicable SEC rules and PCAOB standards and rules. Auditors should

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<sup>5</sup> See PCAOB Release No. 2013-008, Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards (October 10, 2013), available at [http://pcaobus.org/Rules/Rulemaking/Docket036/PCAOB\\_Release\\_2013\\_008.pdf](http://pcaobus.org/Rules/Rulemaking/Docket036/PCAOB_Release_2013_008.pdf).

<sup>6</sup> See SEC Exchange Act Release No. 71524, Order Granting Approval of Proposed Rules, 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, (February 12, 2014), available at <http://www.sec.gov/rules/pcaob/2014/34-71524.pdf> and SEC Exchange Act Release No. 71525, Order Granting Approval of Proposed Rules, Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements, and Related Amendments to PCAOB Standards, (February 12, 2014), available at <http://www.sec.gov/rules/pcaob/2014/34-71525.pdf>.

<sup>7</sup> The standards of the Board can be found on the PCAOB's website at <http://pcaobus.org/Standards/Pages/default.aspx>.

consult the SEC and PCAOB releases listed in Appendix A of this publication for more information.

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## **Chapter 1: Getting Started**

This chapter provides a general overview of certain requirements relevant to audits and compliance attestation engagements of brokers and dealers. Specifically, the chapter presents an overview of the annual report and audit-related requirements under SEC Rule 17a-5, a high-level summary of certain PCAOB auditing and professional practice standards, and certain terms used in PCAOB standards to describe auditors' responsibilities, and it highlights certain requirements under Auditing Standard No. 3, *Audit Documentation*, and Auditing Standard No. 7, *Engagement Quality Review*, which have been amended to specifically address their applicability to broker and dealer audit and attestation engagements.

### **SEC Rule 17a-5 Annual Report Requirements**

SEC Rule 17a-5 requires a broker or dealer to, among other things, file an annual report<sup>1</sup> with the SEC and the broker's or dealer's designated examining authority ("DEA").<sup>2</sup> SEC Rule 17a-5 requires the annual report to contain, among other things:

- a. A financial report consisting of financial statements and supporting schedules<sup>3</sup> ("financial report"), and
- b. A compliance report or an exemption report.<sup>4</sup>

SEC Rule 17a-5 generally requires an examination by an auditor of the financial report 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>5</sup> The examination of the financial

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<sup>1</sup> Paragraph (d) of SEC Rule 17a-5 contains general requirements for annual reports to be filed by SEC-registered brokers and dealers. Paragraphs (d)(1)(iii) and (iv) of SEC Rule 17a-5 provide certain limited exceptions to the requirement to file an annual report.

<sup>2</sup> See paragraph (d)(6) of SEC Rule 17a-5. Examples of DEAs include the Financial Industry Regulatory Authority ("FINRA") or a registered national securities exchange of which the broker or dealer is a member. See Section II.A. of the SEC Release.

<sup>3</sup> See paragraph (d)(2) of SEC Rule 17a-5.

<sup>4</sup> See paragraphs (d)(3) and (4) of SEC Rule 17a-5.

<sup>5</sup> See paragraph (d)(1)(i)(C) of SEC Rule 17a-5.

report, the examination of the compliance report ("examination engagement"), and the review of the exemption report ("review engagement") are required to be performed in accordance with PCAOB standards by "an independent public accountant" that is "qualified and independent in accordance with § 210.2-01 . . . and registered with the Public Company Accounting Oversight Board if required by the Sarbanes-Oxley Act of 2002."<sup>6</sup>

### *SEC Independence Rules*

As noted above, SEC Rule 17a-5 requires auditors of brokers and dealers to comply with SEC independence rules.<sup>7</sup> These independence requirements predate the recent July 2013 amendments to Rule 17a-5.<sup>8</sup> Among other things, SEC independence rules prohibit auditors from performing bookkeeping or other services related to the accounting records or financial statements of the audit client.<sup>9</sup> These prohibited services include: (1) maintaining or preparing the audit client's accounting records; (2) preparing financial statements that are filed with the Commission or the information that forms the basis of financial statements filed with the Commission; or (3) preparing or originating source data underlying the audit client's financial statements.<sup>10</sup> In addition to these SEC

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<sup>6</sup> See paragraph (f)(1) of SEC Rule 17a-5, which requires the independent public accountant to be, among other things, independent in accordance with § 210.2-01 of Regulation S-X.

<sup>7</sup> Id. Auditors of brokers and dealers should note, however, that they "are not subject to the partner rotation requirements or the compensation requirements of the Commission's independence rules because the statute mandating those requirements is limited to issuers," and they "are not subject to the audit committee pre-approval requirements or the cooling-off period requirements for employment because those requirements only reference issuers." See Section II.E. of the SEC Release.

<sup>8</sup> See Id.

<sup>9</sup> See Rule 2-01(c)(4) of Regulation S-X, 17 C.F.R. §210.2-01(c)(4).

<sup>10</sup> See Section II.E. of the SEC Release and 17 C.F.R. §210.2-01(c)(4)(i). Non-compliance with the prohibitions on these particular services has been an area of significant inspection observations under the Board's interim inspection program. These inspection observations are discussed in PCAOB Release No. 2012-005, *Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers* (August 20, 2012), and PCAOB Release No. 2013-006, *Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers* (August 19, 2013).

independence requirements, auditors of brokers and dealers must also comply with PCAOB independence requirements, as discussed later in this chapter.

## **PCAOB Standards and Rules**

PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*, requires registered public accounting firms and their associated persons<sup>11</sup> to comply with all applicable auditing and related professional practice standards.

PCAOB auditing and related professional practice standards include the following:<sup>12</sup>

- Auditing standards;
- Attestation standards;
- Ethics and independence standards and rules; and
- Quality control standards.

Additionally, PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, defines specific terms that are used to describe the auditor's responsibilities when complying with PCAOB auditing and related professional practice standards (among others, "must," "should," and "may").

### *Auditing Standards*

PCAOB auditing standards consist of: (1) standards issued by the Board and (2) standards adopted by the Board on an initial transitional basis, as amended by the Board.<sup>13</sup> PCAOB auditing standards apply to the examination of the broker's or dealer's

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<sup>11</sup> See PCAOB Rule 1001(p)(i) for the definition of a person associated with a public accounting firm.

<sup>12</sup> Also, periodically, the staff issues guidance to highlight audit issues or to clarify application of the standards of the Board. Staff publications are not rules of the Board, but they may be helpful to auditors in applying the standards of the PCAOB. They are available on the PCAOB website.

<sup>13</sup> On April 16, 2003, the PCAOB adopted on an interim, transitional basis, the generally accepted auditing standards, described in the American Institute of Certified Public Accountants' ("AICPA's") Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, then in existence. Since that

financial report, that is, the audit of the financial statements and the audit procedures and reporting on the supporting schedules.<sup>14</sup> This includes Auditing Standard No. 17, which applies when the auditor reports on the supporting schedules of the broker or dealer.<sup>15</sup>

### *Audit Documentation Requirements*

Auditing Standard No. 3 applies to all engagements performed under PCAOB standards, including audit engagements and attestation engagements, such as the examination and review engagements performed pursuant to SEC Rule 17a-5.

Among other things, Auditing Standard No. 3 establishes requirements regarding the following:

- Extent and level of detail of documentation regarding procedures performed, evidence obtained, and conclusions reached on the engagement;<sup>16</sup>
- Documenting significant findings or issues in an engagement completion document;<sup>17</sup> and

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time, the Board has superseded several of those interim auditing standards and has amended substantially all of the remaining interim standards.

<sup>14</sup> The requirements for integrated audits of financial statements and internal control over financial reporting do not apply to audits of brokers and dealers performed pursuant to SEC Rule 17a-5. However, if a broker or dealer is a subsidiary of an issuer that is subject to Section 404 of the Sarbanes-Oxley Act of 2002, the issuer's internal control over financial reporting would encompass controls over the relevant assertions of the significant accounts and disclosures of the subsidiary.

<sup>15</sup> Examples of such supporting schedules include a Computation of Net Capital Under Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1 ("SEC Rule 15c3-1" or the "net capital rule"), a Computation for Determination of the Reserve Requirements under Exhibit A of Exchange Act Rule 15c3-3, 17 C.F.R. § 240.15c3-3 ("SEC Rule 15c3-3"), and Information Relating to Possession or Control Requirements Under SEC Rule 15c3-3.

<sup>16</sup> See generally paragraphs 4-11 of Auditing Standard No. 3.

<sup>17</sup> See generally paragraphs 12-13 of Auditing Standard No. 3.

- Requirements for completing, assembling, and retaining audit documentation, including subsequent changes to the documentation.<sup>18</sup>

Chapters 3 and 4 of this publication discuss the amendments to Auditing Standard No. 3 related to the examination and review engagements, respectively.

### *Engagement Quality Review Requirements*

Auditing Standard No. 7 applies to all engagements performed under PCAOB standards, including audit engagements and attestation engagements, such as the examination and review engagements performed pursuant to SEC Rule 17a-5.<sup>19</sup> Auditors are not permitted to issue their reports under those engagements until they have obtained concurring approval of issuance from the engagement quality reviewer.<sup>20</sup>

Auditing Standard No. 7 establishes requirements for engagement quality reviews, including the following:

- The qualifications to be an engagement quality reviewer;<sup>21</sup>
- The procedures to be performed in an engagement quality review;<sup>22</sup> and
- Granting concurring approval of issuance.<sup>23</sup>

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<sup>18</sup> See generally paragraphs 14-20 of Auditing Standard No. 3.

<sup>19</sup> The amendments to Auditing Standard No. 7 set forth certain procedures to be applied in an engagement quality review of the examination and review.

<sup>20</sup> See paragraph 18C of Auditing Standard No. 7.

<sup>21</sup> See paragraphs 3-8 of Auditing Standard No. 7.

<sup>22</sup> See paragraphs 9-11 and 18A of Auditing Standard No. 7. The procedures to be performed in an engagement quality review for an attestation engagement include evaluating significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the attestation engagement and in preparing the engagement report.

<sup>23</sup> See paragraphs 12 and 18B of Auditing Standard No. 7.

### *Attestation Standards*

Similar to the auditing standards, PCAOB attestation standards consist of: (1) standards issued by the Board and (2) standards adopted by the Board on an initial transitional basis, as amended by the Board.

Attestation Standards Issued by the Board. Attestation Standard No. 1 applies to examinations of brokers' or dealers' compliance reports, and Attestation Standard No. 2 applies to reviews of brokers' or dealers' exemption reports. Although these standards incorporate many of the principles and concepts from other PCAOB attestation standards, these standards are designed to be used on a standalone basis.

Interim Attestation Standards. Other PCAOB attestation standards may be applicable to other attestation engagements that auditors of brokers or dealers might be engaged to perform, such as the agreed-upon procedures report regarding the broker's or dealer's supplemental report on Securities Investor Protection Corporation membership pursuant to SEC Rule 17a-5.<sup>24</sup> Auditors should continue to look to AT sec. 101, *Attest Engagements*, AT sec. 201, *Agreed-Upon Procedures Engagements*, and AT sec. 601, *Compliance Attestation*,<sup>25</sup> for the requirements applicable to those engagements.

### *Ethics and Independence Standards and Rules*

PCAOB ethics and independence rules consist of ethics and independence rules issued by the Board and certain ethics and independence standards adopted by the Board on an interim, transitional basis.

Board Issued Ethics and Independence Rules. In addition to the SEC independence rules described above, certain Board issued independence and ethics rules apply to audits of brokers and dealers. Specifically, the following PCAOB rules apply to audits of brokers and dealers: PCAOB Rule 3501, *Definitions of Terms Employed in Section 3, Part 5 of the Rules*; PCAOB Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations*; PCAOB Rule 3520, *Auditor Independence*; PCAOB Rule 3521, *Contingent Fees*; PCAOB Rule 3522, *Tax Transactions*; and PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*. Other rules, by their terms, apply only to audits of issuers.<sup>26</sup>

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<sup>24</sup> See paragraph (e)(4) of SEC Rule 17a-5.

<sup>25</sup> See AT sec. 601.16-.29.

<sup>26</sup> See, e.g., PCAOB Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*; PCAOB Rule 3524, *Audit Committee Pre-approval of Certain*

Other Independence and Ethics Rules. In addition to the Board issued independence and ethics rules, the following standards and rules are also in effect:

- AICPA's Code of Professional Conduct Rules 101 and 102, and interpretations and rulings thereunder,<sup>27</sup> as in existence on April 16, 2003, to the extent not superseded or amended by the Board ("Interim Independence Standards")

The Board's Interim Independence Standards do not supersede the Commission's auditor independence rules. For example, a note to PCAOB Rule 3500T indicates that to the extent that a provision of the Commission's rule is more restrictive—or less restrictive—than the Board's Interim Independence Standards, a registered public accounting firm must comply with the more restrictive rule.

### *Quality Control Standards*

PCAOB quality control standards consist principally of standards adopted by the Board on an interim transitional basis, as amended by the Board.<sup>28</sup> Those standards include quality control standards of the AICPA as in existence on April 16, 2003, and certain requirements of the AICPA SEC Practice Section ("SECPS") as in existence on April 16, 2003.<sup>29</sup>

### *Certain Terms Used in PCAOB Standards*

PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards*, describes certain terms used in PCAOB standards and the degree

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Tax Services; and PCAOB Rule 3525, Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting, which apply only to audits of issuers.

<sup>27</sup> See, e.g., ET sec. 101, Independence; ET sec. 102, Integrity and Objectivity; and ET sec. 191, Ethics Rulings on Independence, Integrity, and Objectivity.

<sup>28</sup> PCAOB Quality Control Standards can be found at: <http://pcaobus.org/Standards/QC/Pages/default.aspx>. See also PCAOB Rule 3400T, which defines sections of the quality control standards which are only applicable to registered firms who had been members of the AICPA's SECPS prior to April 16, 2003.

<sup>29</sup> The SECPS requirements apply to firms that were SECPS member firms as of April 16, 2003. Certain SECPS requirements only apply to audits of SEC registrants, as defined in SECPS Section 1000.38, *Appendix D*.

of responsibility imposed on auditors by those terms. PCAOB Rule 3101 describes three categories of responsibilities:<sup>30</sup>

- **Unconditional Responsibility:** The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies. Failure to discharge an unconditional responsibility is a violation of the relevant standard and PCAOB Rule 3100.
- **Presumptively Mandatory Responsibility:** The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. Failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and PCAOB Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard.

Note: In the rare circumstances in which the auditor believes the objectives of the standard can be met by alternative means, the auditor, as part of documenting the planning and performance of the work, must document the information that demonstrates that the objectives were achieved.

- **Responsibility to Consider:** The words "may," "might," "could," and other terms and phrases describe actions and procedures that auditors have a responsibility to consider. Matters described in this fashion require the auditor's attention and understanding. How and whether the auditor implements these matters in the audit will depend on the exercise of professional judgment in the circumstances consistent with the objectives of the standard.

Note: If a Board standard provides that the auditor "should consider" an action or procedure, consideration of the action or procedure is presumptively mandatory, while the action or procedure is not.<sup>31</sup>

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<sup>30</sup> See PCAOB Rule 3101.

<sup>31</sup> The documentation requirement relating to an action or procedure that an auditor "should consider" is not the same as the documentation requirement for a

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presumptively mandatory responsibility because in a "should consider" situation, only the consideration of the action or procedure is presumptively mandatory, while the action or procedure itself is not. In these situations, the auditor should use his or her professional judgment in determining how to document his or her consideration of the specific action or procedure.

## ***Chapter 2: Audits of Financial Statements and Audit Procedures Performed on Supporting Schedules***

This chapter discusses certain auditing considerations that are often relevant to auditing the financial statements and supporting schedules of brokers and dealers under PCAOB standards, and certain notification requirements the auditor has under SEC Rule 17a-5, and it presents an example of an auditor's report with unqualified audit opinions on the financial statements and supporting schedules of a broker or dealer.

### **Overview of Audit Approach Under PCAOB Standards**

In general terms, PCAOB standards set forth a risk-based audit approach to the audit of the financial statements. Among other things, this includes:

1. Performing risk assessment procedures to provide a reasonable basis for identifying and assessing risks of material misstatement, which includes obtaining an understanding of the company and its environment;<sup>1</sup>
2. Designing further audit procedures, that is, tests of controls and substantive procedures;
3. Developing and applying overall responses and audit procedures that address the assessed risks of material misstatement, including, among other things,<sup>2</sup>
  - a. Performing substantive procedures for each relevant assertion of each significant account and disclosure in the financial statements;
  - b. Obtaining more persuasive evidence the higher the risk of material misstatement;<sup>3</sup>

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<sup>1</sup> See generally Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement.

<sup>2</sup> See generally Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

<sup>3</sup> See paragraph 9.a. of Auditing Standard No. 13. In addition, paragraph 10 of Auditing Standard No. 15, *Audit Evidence*, requires auditors to evaluate whether company-provided information is sufficient and appropriate for purposes of the audit by performing procedures to: test the accuracy and completeness of the information, or test

- c. For risks of material misstatement due to fraud ("fraud risks") and other significant risks,<sup>4</sup> performing substantive procedures, including tests of details that are specifically responsive to the identified risks;
  - d. When relying on controls, performing tests of controls over the entire period of reliance;<sup>5</sup> and
4. Evaluating all relevant audit evidence obtained during the audit to form an opinion on the financial statements and to conclude whether sufficient appropriate audit evidence has been obtained to support an opinion.<sup>6</sup>

### **Auditing Considerations for Brokers and Dealers**

The risk-based auditing approach set forth in PCAOB standards is designed to be scalable based on the facts and circumstances of the audit, including a company's size and complexity. The complexity of a broker or dealer is an important factor in the auditor's risk assessment and the determination of the necessary audit procedures to address the risks of material misstatement. In general, a smaller, less complex broker or dealer may have fewer lines of business, simpler processes, fewer employees, and fewer locations. A larger and more complex broker or dealer might have multiple lines of business, many branch locations, and decentralized accounting and compliance functions, which would necessarily require more time and attention by the auditor to understand its operations, environment, and the relevant controls. Also, a larger and more complex broker or dealer might enter into more complex transactions than a smaller, less complex broker or dealer. Regardless of the size of the broker or dealer, more complex transactions—for example, complex expense sharing and shared services agreements with related parties, less liquid harder-to-value securities, and international custody arrangements—generally warrant audit attention to address the associated risks of material misstatement.

The following paragraphs discuss certain topics related to applying PCAOB standards to audits of the financial statements of brokers and dealers. Specifically, the following topics are discussed below:

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the controls over the accuracy and completeness of that information and to evaluate whether the information is sufficiently precise and detailed for purposes of the audit.

<sup>4</sup> See generally paragraphs 70 and 71 of Auditing Standard No. 12 for factors to consider when assessing risks as significant risks.

<sup>5</sup> See generally paragraphs 28–31 of Auditing Standard No. 13 regarding the timing of tests of controls.

<sup>6</sup> See generally Auditing Standard No. 14, *Evaluating Audit Results*.

- Understanding the broker or dealer and its environment;
- Consideration of fraud;
- Consideration of materiality;
- Consideration of the broker's or dealer's use of third parties and service organizations;
- Audit procedures regarding related party transactions;
- Coordinating the audit of the financial statements with the audit procedures on the supporting schedules and with the attestation engagements;
- Performing audit procedures on the supporting schedules;
- Communication requirements; and
- Reporting on an audit of a broker or dealer.

In addition, Appendix B discusses auditing considerations for certain accounts and records that are particular to brokers and dealers.

### **Understanding the Broker or Dealer and Its Environment**

PCAOB standards require the auditor to obtain an understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement.<sup>7</sup>

The auditor's understanding of these matters informs the auditor's identification and assessment of risk. For example, brokers and dealers are regulated entities that operate in an environment with various oversight authorities and compliance requirements. The auditor's understanding of the regulatory environment and the relevant compliance requirements could help the auditor identify risks of material misstatements for the financial statements, including those that could arise due to lack of compliance with the SEC's financial responsibility rules.<sup>8</sup> Reading regulatory filings, related

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<sup>7</sup> See paragraph 7 of Auditing Standard No. 12.

<sup>8</sup> The SEC Release adopting amendments to SEC Rule 17a-5 used the term "financial responsibility rules" to refer to SEC Rule 15c3-1, SEC Rule 15c3-3, and 17 C.F.R. § 240.17a-13, *Quarterly securities counts to be made by certain exchange members, brokers, and dealers* ("SEC Rule 17a-13"), and any rule of the DEA of the

correspondence, and a broker's or dealer's DEA examination reports can help inform the auditor's understanding of the regulatory environment and the auditor's risk assessment.<sup>9</sup>

In obtaining an understanding of the broker or dealer and its environment, understanding the various relationships the broker or dealer has with affiliates and the nature of the transactions executed by the broker or dealer also helps the auditor identify risks of material misstatement of the financial statements, including risks associated with related party transactions and risks of misappropriation of customer assets. For example, an introducing broker<sup>10</sup> may have an agreement with an affiliate to execute and carry their customers' transactions. Understanding the introducing broker's relationship with the carrying broker<sup>11</sup> and whether transactions are introduced on a fully-disclosed or omnibus basis is important to the auditor's identification and assessment of the risk of material misstatement and how the auditor plans substantive and control testing procedures. It may also inform the auditor's assessment of fraud risk.

Other engagements performed for the broker or dealer and its affiliates or other related parties can also provide information that informs the auditor's understanding of the broker's or dealer's business. For example, information related to compliance with the financial responsibility rules or whether the broker or dealer claims exemption under paragraph (k) of SEC Rule 15c3-3 can provide information that informs the auditor's understanding of the broker's or dealer's business.

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broker or dealer that requires account statements to be sent to the customers of the broker or dealer.

<sup>9</sup> See also "Planning the Examination Engagement" in Chapter 3.

<sup>10</sup> An introducing broker is a broker that agrees to act as the customer's account representative (for example, by providing the customer with account opening documents, ascertaining the customer's investment objectives, and making investment recommendations). See Section IV.C.1. of the SEC Release.

<sup>11</sup> A carrying broker is a broker that maintains custody of customer funds and securities. The carrying broker typically agrees to receive and hold the customer's cash and securities, clear transactions, make and retain records relating to the transactions and the receipt and holding of assets, and extend credit to the customer in connection with the customer's securities transactions. See Section IV.C.1. of the SEC Release. The carrying broker generally receives and executes the orders of the introducing broker's customers. See Section VII.B.1. of the SEC Release.

## Consideration of Fraud<sup>12</sup>

Assessing and responding to fraud risks are integral parts of the audit process set forth in PCAOB auditing standards. PCAOB standards include specific requirements for identifying and responding to fraud risks and considering fraud risks in evaluating audit results. PCAOB standards generally focus on two types of fraud that are relevant to all companies, including brokers and dealers: fraudulent financial reporting and misappropriation of company assets.

The risk of fraudulent financial reporting involves the risk of intentional misstatement of the financial statements, which may involve misstatement of the supporting schedules and misrepresentation in the compliance report or exemption report to conceal non-compliance with SEC Rule 15c3-1 or SEC Rule 15c3-3. For example, such situations could involve intentional manipulation of the financial statements or related records to inflate the reported amount of net capital or reserves or to conceal the fact that the broker or dealer is holding customer assets in contradiction of its statements in regulatory filings.

Brokers and dealers, however, also have other fraud risks that warrant audit attention, specifically, the risk of misappropriation of customer assets. Misappropriation of customer assets, which can occur in all types of brokers or dealers, can affect the financial statements, the supporting schedules, and the auditor's attestation engagement, and they can trigger required reporting under PCAOB standards or SEC Rule 17a-5. Misappropriation of customer assets can occur in a number of ways, such as falsifying customer account statements, withdrawing or transferring funds out of customer accounts without authorization, and transmitting customer funds to an alternate address not designated by the customer. Brokers or dealers that clear transactions or carry customer accounts could present fraud risks related to misappropriation of customer assets since these brokers and dealers can hold customer funds and securities. Brokers or dealers that do not carry or clear transactions also may present fraud risks related to misappropriation of customer assets since they could receive securities or cash, even if they are required to promptly remit them to another entity.

It is important for auditors to assess fraud risks that are applicable to the financial statement audit of the broker or dealer, particularly as they relate to the facts and circumstances of the broker's or dealer's business, and respond to those risks as appropriate.

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<sup>12</sup> See, e.g., Auditing Standard No. 12, Auditing Standard No. 13, Auditing Standard No. 14, and AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

### **Consideration of Materiality<sup>13</sup>**

PCAOB standards require the auditor to establish a materiality level for the financial statements as a whole that is appropriate in light of the particular circumstances.<sup>14</sup> Also, the auditor should evaluate whether separate materiality levels should be established for those accounts or disclosures for which there is a substantial likelihood that misstatement of lesser amounts than the materiality level established would influence the judgment of the primary users of the financial statements to plan the nature, timing, and extent of audit procedures.<sup>15</sup> A lower materiality level may be necessary for accounts in situations where misstatements in amounts less than materiality for the financial statements as a whole would cause the broker or dealer not to be in compliance with the net capital rule or SEC Rule 15c3-3.<sup>16</sup>

### **Consideration of the Broker's or Dealer's Use of Third Parties and Service Organizations**

Brokers and dealers, like other companies, may use a service organization to process certain transactions, such as payroll transactions, as part of their financial reporting system. Brokers and dealers also may use the services of third parties to perform trade processing and related back-office functions, for example, in the clearing and settling of customer transactions, or they may use information from third parties, such as haircut computations,<sup>17</sup> in preparing the schedule of the computation of net capital.

AU sec. 324, *Service Organizations*, is applicable in the case where a company obtains services from another organization that are considered part of the company's information system. This includes services that affect the financial reporting process used to prepare the company's financial statements, significant accounting estimates, and

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<sup>13</sup> Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, discusses the auditor's responsibilities for applying the concept of materiality in planning the audit and determining the scope of the audit procedures.

<sup>14</sup> See paragraph 6 of Auditing Standard No. 11.

<sup>15</sup> See paragraph 7 of Auditing Standard No. 11.

<sup>16</sup> See paragraph 3.b. of Auditing Standard No. 17.

<sup>17</sup> 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. See Rule 15c3-1(c)(2)(vi).

disclosures.<sup>18</sup> If a broker or dealer uses a service organization and incorporates information from the records of the service organization into its own information system, for example, information on commission revenues and receivables, the auditor is required to obtain an understanding of controls at the service organization when performing risk assessment procedures.<sup>19</sup> Service auditor reports, if available, can help in obtaining an understanding of the controls at the service organization.

Further, when using information produced by a service organization that is part of the information system, the auditor is required to, among other things, perform procedures to test the accuracy and completeness of the information or test the controls over the accuracy and completeness of that information.<sup>20</sup> If the auditor plans to use the report of a service auditor, rather than perform his or her own procedures regarding the information or controls of the service organization, the auditor should comply with the applicable requirements in PCAOB standards for using service auditor reports.<sup>21</sup> In the absence of a service auditor report, the auditor should perform his or her own procedures to obtain the necessary evidence.<sup>22</sup>

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<sup>18</sup> See AU sec. 324.03.

<sup>19</sup> See paragraphs .03 and .06-.10 of AU sec. 324.

<sup>20</sup> See paragraph 10 of Auditing Standard No. 15.

<sup>21</sup> See generally AU secs. 324.11-.20.

<sup>22</sup> See generally AU secs. 324.14-.15.

## Audit Procedures Regarding Related Party Transactions<sup>23</sup>

Related parties<sup>24</sup> often play a significant role in the operations of brokers and dealers, for example, through direct participation in the activities of the broker or dealer by principals or affiliates under shared-service agreements or expense-sharing agreements.<sup>25</sup> Related party transactions can be used to manipulate the reported financial position or results of operations. For example, transactions with related parties, including owners or affiliates, may be improperly used by brokers and dealers in 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.

PCAOB standards require the auditor to perform procedures to identify and evaluate a company's relationships and transactions with its related parties as part of performing an audit of financial statements.<sup>26</sup> PCAOB standards also require auditors to

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<sup>23</sup> On June 10, 2014, the PCAOB adopted Auditing Standard No. 18, *Related Parties*, amendments to certain PCAOB auditing standards regarding significant unusual transactions, and other related amendments to PCAOB auditing standards. This standard and amendments will be effective, subject to approval by the SEC, for audits of fiscal years beginning on or after December 15, 2014. See PCAOB Release 2014-002, *Auditing Standard No. 18—Related Parties Amendments to Certain PCAOB Auditing Standards Regarding Significant Unusual Transactions and Other Amendments to PCAOB Auditing Standards* (June 10, 2014), [http://pcaobus.org/Rules/Rulemaking/Docket038/Release\\_2014\\_002\\_Related\\_Parties.pdf](http://pcaobus.org/Rules/Rulemaking/Docket038/Release_2014_002_Related_Parties.pdf).

<sup>24</sup> The auditor should look to the definition in the applicable financial reporting framework with respect to the term "related parties."

<sup>25</sup> See also FINRA Notice to Members 03-63, *Expenses-Sharing Agreements* (October 2003), available at <http://www.finra.org/Industry/Regulation/Notices/2003/p003100>, for the SEC's guidance on expense-sharing arrangements.

<sup>26</sup> See paragraphs .04-.08 of AU sec. 334, *Related Parties*. See also paragraphs 10, 52, 57, 60, and 71 of Auditing Standard No. 12, which discuss consideration of related parties in performing risk assessment procedures and identifying and assessing the risks of material misstatement.

perform procedures regarding identified related party transactions.<sup>27</sup> This includes evaluating whether the related party transactions are appropriately accounted for and disclosed.<sup>28</sup> The auditor should design and perform audit procedures that address the assessed risks of material misstatement associated with related party relationships and transactions.<sup>29</sup> Understanding related party arrangements also is important in planning the attestation engagements, as discussed in Chapters 3 and 4.

### **Coordinating the Audit of the Financial Statements with the Audit Procedures on the Supporting Schedules and the Attestation Engagements**

PCAOB standards require coordination among the audit of the financial statements, the audit procedures on the supporting schedules, and the examination engagement or review engagement.<sup>30</sup> Specifically, those standards provide that:

- *Financial statement audit.* The auditor should take into account evidence obtained from the results of the auditing procedures on the supporting schedules and the examination engagement or review engagement when evaluating the results of the audit and forming an opinion on the financial statements.<sup>31</sup>
- *Supporting schedules.* The auditor should take into account relevant evidence from the audit of the financial statements and the examination engagement or the review engagement in planning and performing audit procedures related to the supporting schedules and in evaluating the results of the audit procedures to form the opinion on the supporting schedules.<sup>32</sup>
- *Attestation engagements.* In planning and performing procedures for, and evaluating the results of the procedures performed in, the examination engagement or the review engagement, the auditor should take into

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<sup>27</sup> See AU secs. 334.09-.10.

<sup>28</sup> See, e.g., AU secs. 334.11-.12.

<sup>29</sup> See paragraph 8 of Auditing Standard No. 13.

<sup>30</sup> See paragraph 8 of Attestation Standard No. 1 and paragraph 7 of Attestation Standard No. 2.

<sup>31</sup> See generally paragraph 3 of Auditing Standard No. 14.

<sup>32</sup> See note to paragraph 3.c. of Auditing Standard No. 17.

account relevant evidence from the audit of the financial statements and the audit procedures performed on the supporting schedules.<sup>33</sup>

Coordinating procedures performed on the audit and attestation engagements helps the auditor to focus attention on those matters that are important to the audit and attestation engagements. Coordination also is important in evaluating the results of the audit and the examination or review.

Chapters 3 and 4 also discuss coordination of the audit of the financial statements and audit procedures on the supporting schedules with the examination or the review, respectively.

### **Performing Audit Procedures on the Supporting Schedules**

As discussed in Chapter 1, SEC Rule 17a-5 requires a broker or dealer to file a financial report, which consists of the financial statements and supporting schedules of the broker or dealer, examined by the independent auditor.

Auditing Standard No. 17 applies to the supporting schedules that brokers and dealers are required to file with the SEC. Auditing Standard No. 17 provides, among other things, that the nature, timing, and extent of audit procedures necessary to obtain sufficient appropriate audit evidence and to report on the supporting schedules depend on:<sup>34</sup>

- The risk of material misstatement of the supporting schedules;
- The materiality considerations relevant to the information presented; and
- The evidence obtained from the audit of the financial statements and, if applicable, other engagements by the auditor or affiliates of the accounting firm for the period presented.

The auditor's knowledge obtained from the audit of the financial statements and the examination or review engagement generally should contribute to the auditor's knowledge in assessing the risk of material misstatement regarding the supporting schedules.

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<sup>33</sup> See paragraph 8 of Attestation Standard No. 1 and paragraph 7 of Attestation Standard No. 2.

<sup>34</sup> See paragraph 3 of Auditing Standard No. 17.

When planning and performing the audit procedures to report on the supporting schedules, the auditor generally should use the same materiality considerations as those used in planning and performing the audit of the financial statements.<sup>35</sup> However, similar to the discussion in the financial statement audit, this includes using a lower materiality level when the broker or dealer is at or near the minimum required threshold for net capital or required reserves. In those situations, the auditor's responsibility is to design and perform procedures to detect misstatements that, if uncorrected, would result in the schedule inaccurately presenting compliance with the required level of net capital under the net capital rule or required reserves under SEC Rule 15c3-3(e) (the "reserve requirements rule") when it should have presented non-compliance, as those misstatements generally would result in the schedule being materially misstated.<sup>36</sup>

Auditing Standard No. 17 requires the auditor to perform procedures to obtain sufficient appropriate audit evidence to support the opinion on the supporting schedules in relation to the financial statements as a whole.<sup>37</sup> The procedures should be planned and performed in conjunction with the audit of the financial statements and coordinated with the examination or review engagement.<sup>38</sup> In addition, the auditor should take into account relevant evidence from these engagements in planning and performing audit procedures related to the supporting schedules and in evaluating the results of the procedures performed to form the opinion on the supporting schedules.<sup>39</sup>

Auditing Standard No. 17 requires the auditor to, among other things: (1) perform procedures to test the completeness and accuracy of information presented in the supporting schedules to the extent that it was not tested as part of the audit of the financial statements; (2) determine that the supporting schedules reconcile to the underlying accounting and other records or to the financial statements, as applicable; and (3) evaluate whether the supporting schedules, including their form and content, comply with relevant regulatory requirements.<sup>40</sup> These requirements apply both to financial statement

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<sup>35</sup> See note to paragraph 3.b. of Auditing Standard No. 17.

<sup>36</sup> See paragraph 4 of Auditing Standard No. 17 and paragraph B2 of Auditing Standard No. 14.

<sup>37</sup> See paragraph 3 of Auditing Standard No. 17.

<sup>38</sup> See note to paragraph 3.c. of Auditing Standard No. 17.

<sup>39</sup> Id.

<sup>40</sup> See paragraph 4 of Auditing Standard No. 17, which also lists other required procedures to be applied to the supporting schedules.

information and to information presented only in the supporting schedules, such as the haircuts and operational charges<sup>41</sup> in the schedule of the computation of net capital.

For the financial statement information presented in the supporting schedules, the auditor can, with proper planning and design, perform procedures to satisfy the requirements for the financial statement audit and the supporting schedules. Certain procedures, such as testing the existence and valuation of investments can be designed to address the requirements for both the financial statement audit and the audit procedures on the schedules.<sup>42</sup> Other procedures, such as testing the classification of assets as allowable or non-allowable,<sup>43</sup> are necessary to comply with the requirements for testing the supporting schedules.<sup>44</sup>

Information presented only in the supporting schedules typically is not covered by the procedures in the financial statement audit, so separate testing of that information is needed to comply with the requirements of Auditing Standard No. 17.<sup>45</sup> When performing an examination engagement, however, examination procedures performed to test the schedules used for determining compliance with the net capital rule and reserve requirements rule<sup>46</sup> and determining whether the information in the schedules was derived from the books and records of the broker or dealer<sup>47</sup> might be performed in conjunction with testing the completeness and accuracy of the supporting schedules in the financial report.<sup>48</sup>

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<sup>41</sup> In computing net capital, Rule 15c3-1 requires brokers and dealers to deduct amounts related to operational charges, such as aged failed to deliver balances. See Rule 15c3-1(c)(2)(ix).

<sup>42</sup> See "Appendix B: Auditing Considerations for Particular Accounts and Records of Brokers and Dealers" for additional examples.

<sup>43</sup> Rule 15c3-1 requires that assets not readily convertible into cash ("non-allowable assets") be deducted from equity when computing net capital. See Rule 15c3-1(c)(2)(iv).

<sup>44</sup> See paragraph 4 of Auditing Standard No. 17.

<sup>45</sup> See paragraph 4.e. of Auditing Standard No. 17.

<sup>46</sup> See paragraph 21 of Attestation Standard No. 1.

<sup>47</sup> See paragraph 21.e. of Attestation Standard No. 1.

<sup>48</sup> See paragraphs 4.d. and 4.e. of Auditing Standard No. 17.

Also, the supporting schedules relate to compliance with the two SEC rules, the net capital rule and the reserve requirements rule, for which the auditor tests compliance in the examination engagement. Attestation procedures performed in the examination engagement may provide evidence regarding the supporting schedules. For example, as part of testing the design of the controls over compliance during an examination engagement,<sup>49</sup> the auditor may obtain information relating to how the net capital calculation is performed and whether management relies on interpretations issued by the SEC or the DEA of the broker or dealer. This information may be relevant to the requirements in Auditing Standard No. 17 regarding:

- Obtaining an understanding of the methods of preparing the supporting schedules, evaluating the appropriateness of those methods, and determining whether those methods have changed from the methods used in the prior period and, if the methods have changed, determining the reasons for and evaluate the appropriateness of such changes<sup>50</sup> and
- Inquiring of management about any significant assumptions or interpretations underlying the measurement or presentation of the supporting schedules.<sup>51</sup>

The objectives of the audit and the examination or review engagement are not the same, however, so the auditor must plan and perform the work to meet the objectives of both the audit and the attestation engagement.<sup>52</sup>

### **Communication Requirements**

A number of communication requirements apply to auditors' broker or dealer engagements. In the financial statement audit, PCAOB auditing standards and rules<sup>53</sup>

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<sup>49</sup> See paragraphs 14 and 15 of Attestation Standard No. 1.

<sup>50</sup> See paragraph 4.b. of Auditing Standard No. 17.

<sup>51</sup> See paragraph 4.c. of Auditing Standard No. 17.

<sup>52</sup> See paragraph 8 of Attestation Standard No. 1 and paragraph 7 of Attestation Standard No. 2.

<sup>53</sup> See generally Auditing Standard No. 16, *Communications with Audit Committees*, which establishes certain communication requirements and includes an appendix listing other applicable communication requirements in PCAOB auditing standards and rules. In addition, Appendix C to Auditing Standard No. 16 includes matters that should be included in the audit engagement letter.

require communication of certain matters to the audit committee.<sup>54</sup> SEC rules also include certain communication requirements for auditors of brokers or dealers.<sup>55</sup> Additional communication requirements for examination engagements and review engagements are described below.

In an examination of a compliance report, the auditor should communicate to management all identified Deficiencies in Internal Control Over Compliance.<sup>56</sup> Further, the auditor should communicate to management and the audit committee instances of identified non-compliance with the financial responsibility rules, identified Material Weaknesses,<sup>57</sup> and identified instances in which information used to determine

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<sup>54</sup> The term "audit committee" is defined in Auditing Standard No. 16 as "a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, the entire board of directors of the company. For audits of non-issuers, if no such committee or board of directors (or equivalent body) exists with respect to the company, the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company."

<sup>55</sup> For example, SEC Rule 17a-5 requires an auditor, when replaced by the broker or dealer, to furnish the broker or dealer with a letter addressed to the Commission stating whether the former auditor agrees with the statements of the broker or dealer contained in the notice submitted to the SEC and, if not, stating the respects in which the former auditor does not agree. See paragraph (f)(3)(v)(B) of SEC Rule 17a-5.

<sup>56</sup> See paragraph 34 of Attestation Standard No. 1. As defined in Appendix A to Attestation Standard No. 1, a "Deficiency in Internal Control over Compliance exists when the design or operation of a control does not allow the management or employees of the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect on a timely basis non-compliance with 17 C.F.R. § 240.15c3-1, § 240.15c3-3, § 240.17a-13 or any rule of the designated examining authority of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer."

<sup>57</sup> As defined in Appendix A to Attestation Standard No. 1, a Material Weakness is "a deficiency, or a combination of deficiencies, in Internal Control Over Compliance such that there is a reasonable possibility that non-compliance with 17 C.F.R. §240.15c3-1 or 17 C.F.R. § 240.15c3-3(e) will not be prevented or detected on a timely basis or that non-compliance to a material extent with 17 C.F.R. §240.15c3-3, except for paragraph (e), 17 C.F.R. § 240.17a-13, or any rule of the designated examining authority

compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records.<sup>58</sup>

In a review engagement, the auditor should communicate to management and to the audit committee any exceptions to the exemption provisions identified by the auditor and information that causes the broker's or dealer's assertions about the exemption provisions not to be fairly stated, in all material respects.<sup>59</sup>

Also, the auditor may identify instances of non-compliance with the SEC rules subjected to testing in an examination of a compliance report or in the review of an exemption report or identify Material Weaknesses in Internal Control Over Compliance in an examination of a compliance report.<sup>60</sup> When instances of non-compliance with the financial responsibility rules or Material Weaknesses are identified by the auditor, paragraph (h) of SEC Rule 17a-5 requires the auditor to immediately notify the chief financial officer of the broker or dealer. The nature of the non-compliance or Material Weakness may then require the broker or dealer to provide notification pursuant to SEC rules to the SEC within 24 hours and a written report within 48 hours.<sup>61</sup> To the extent the broker or dealer does not make this notification or the auditor does not agree with the statements made in the notification, paragraph (h) further requires the auditor to notify the SEC and the DEA within one business day.<sup>62</sup> Accordingly, it is important for auditors to

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of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer will not be prevented or detected on a timely basis."

<sup>58</sup> See paragraph 35 of Attestation Standard No. 1.

<sup>59</sup> See paragraph 15 of Attestation Standard No. 2.

<sup>60</sup> As defined in Appendix A to Attestation Standard No. 1, Internal Control Over Compliance refers to "those internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with 17 C.F.R. § 240.15c3-1, § 240.15c3-3, § 240.17a-13, or any rule of the designated examining authority of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer, will be prevented or detected on a timely basis."

<sup>61</sup> See, e.g., 17 C.F.R. 240.15c3-1(a)(6)(iv)(B), (a)(6)(v), (a)(7)(ii), (a)(7)(iii), (c)(2)(x)(C)(1), (c)(2)(x)(D) (notification requirements with respect to SEC Rule 15c3-1); 17 C.F.R. 240.17a-11(b)-(c) (notification requirements with respect to SEC Rule 15c3-1); and 17 C.F.R. 240.15c3-3(i) (notification requirement in the event of a failure to make a required deposit to the reserve account).

<sup>62</sup> See the note to paragraph 35 of Attestation Standard No. 1 and the note to paragraph 15 of Attestation Standard No. 2, which say that the auditor must comply with

have a monitoring process to determine whether the broker or dealer makes the required notifications in the first instance. Therefore, when planning the audit and the examination engagement or review engagement, it is important for auditors to implement measures to determine whether, and if so when, the auditor received a copy of the notification required to be provided by the broker or dealer to the SEC and, if applicable, to the broker's or dealer's DEA. An auditor could decide not to rely solely on the receipt of a copy of the notice from the broker or dealer and take other steps to check whether the broker or dealer provided notice to the SEC and the DEA, such as obtaining evidence of the transmission of the notification from the broker or dealer to the SEC and DEA.<sup>63</sup>

### **Reporting on an Audit of a Broker or Dealer**

Prior to the report release date, the auditor must have completed all necessary auditing procedures and obtained sufficient evidence to support the representations in the auditor's report.<sup>64</sup> AU sec. 508, *Reports on Audited Financial Statements*, sets forth the required elements of the audit report, the types of reports, and the circumstances in which each is appropriate. Auditing Standard No. 17 establishes the requirements that apply to reports on the supporting schedules filed by the broker or dealer pursuant to SEC Rule 17a-5.<sup>65</sup> Besides the basic report elements in PCAOB standards,<sup>66</sup> SEC Rule 17a-5 requires that auditors' reports, among other things, be manually signed.<sup>67</sup>

The auditor should not issue the auditor's report until the auditor has obtained concurring approval of issuance from the engagement quality reviewer.<sup>68</sup> Further, PCAOB Rule 7104(b), *Determination of Payment of Accounting Support Fees by Registered Public Accounting Firm*, provides that the auditor shall not sign an unqualified audit opinion with respect to a broker's or dealer's financial statements unless the auditor

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the notification requirements of paragraph (h) of SEC Rule 17a-5 that apply to auditors of brokers and dealers.

<sup>63</sup> See Section II.F.1.iii. of the SEC Release.

<sup>64</sup> See paragraph 15 of Auditing Standard No. 3.

<sup>65</sup> See paragraphs 10-15 of Auditing Standard No. 17.

<sup>66</sup> See AU sec. 508.08 for the basic elements of the auditor's standard report.

<sup>67</sup> See generally paragraph (i) of SEC Rule 17a-5.

<sup>68</sup> See paragraph 13 of Auditing Standard No. 7.

has ascertained that the broker or dealer has no outstanding past-due accounting support fees.<sup>69</sup>

The example report in the exhibit to this chapter illustrates a combined report on financial statements and supporting schedules.

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<sup>69</sup> See PCAOB Rule 7104(b)(1). Note 1 to PCAOB Rule 7104(b) states that the auditor may ascertain that the broker or dealer has no past-due accounting support fees by obtaining a representation from the broker or dealer.

**EXHIBIT**

***Example of an Auditor's Report with Unqualified Opinions on the Financial Statements and Supporting Schedules (**Superseded**)***

Note: The example auditor's report on pages 29-30 of this document has been superseded by the [Annotated Example Auditor's Report for the Audit of a Broker or Dealer \(Dec. 18, 2018\)](#).

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## **Chapter 3: Examinations of Compliance Reports**

This chapter highlights certain requirements in Attestation Standard No. 1 regarding examinations of compliance reports of brokers or dealers, reproduces an example of examination report with an unqualified opinion, and presents an example of a modified examination report. In addition, this chapter provides examples of ways in which the examination can be coordinated with the audit of the financial statements and audit procedures performed on the supporting schedules.

### **Content of Compliance Reports**

The compliance report, generally, is filed by a broker or dealer that maintains custody of customer securities and cash and that did not claim an exemption from the reserve requirements rule throughout the fiscal year. SEC Rule 17a-5 requires the broker or dealer to engage an independent accountant to perform an examination of certain statements regarding compliance with the financial responsibility rules made by a broker or dealer in a compliance report prepared pursuant to SEC Rule 17a-5.<sup>1</sup>

Specifically, SEC Rule 17a-5 requires a broker's or dealer's compliance report to include the following statements ("assertions") by the broker or dealer as to whether:<sup>2</sup>

- a. The Internal Control Over Compliance of the broker or dealer was effective during the most recent fiscal year;<sup>3</sup>

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<sup>1</sup> See paragraphs (d)(1)(i)(C) and (g)(2)(i) of SEC Rule 17a-5 and the SEC Release.

<sup>2</sup> See paragraph (d)(3)(i)(A) of SEC Rule 17a-5. SEC Rule 17a-5 also requires the compliance report to contain a statement as to whether the broker or dealer has established and maintained Internal Control Over Compliance. However, the auditor is not required by SEC Rule 17a-5 to examine and report on that statement. The compliance report also includes, if applicable, a description of each Material Weakness in the Internal Control Over Compliance of the broker or dealer during or as of the end of the most recent fiscal year and a description of any instance of non-compliance with the net capital rule or the reserve requirements rule as of the end of the most recent fiscal year. See paragraphs (d)(3)(i)(B) and (C) of SEC Rule 17a-5.

<sup>3</sup> Staff guidance issued by the SEC's Division of Trading and Markets, *Frequently Asked Questions Concerning the July 30, 2013 Amendments to the Broker-Dealer Financial Reporting Rule* (April 4, 2014), available at <http://www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-reporting-rule-faq.htm>, identifies certain situations in which the Division staff will not object if a broker or

- b. The Internal Control Over Compliance of the broker or dealer was effective as of the end of the most recent fiscal year;
- c. The broker or dealer was in compliance with the net capital rule and the reserve requirements rule as of the end of the most recent fiscal year; and
- d. The information the broker or dealer used to state whether it was in compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer.<sup>4</sup>

In an examination engagement, the auditor's responsibility is to express an opinion on the broker's or dealer's assertions. Attestation Standard No. 1 establishes requirements for auditors engaged to perform an examination engagement. Under the examination standard, the auditor's objective is to express an opinion regarding whether the assertions made by the broker or dealer in its compliance report are fairly stated, in all material respects.<sup>5</sup>

To express an opinion on the assertions made by a broker or dealer in a compliance report, the auditor must plan and perform the examination engagement to obtain appropriate evidence that is sufficient to obtain reasonable assurance about whether: (1) one or more Material Weaknesses existed in the broker's or dealer's Internal Control Over Compliance during the most recent fiscal year specified in the broker's or dealer's assertion; (2) one or more Material Weaknesses existed as of the end of the most recent fiscal year specified in the broker's or dealer's assertion; and (3) one or more instances of non-compliance with the net capital rule or the reserve requirements rule existed as of the end of the most recent fiscal year specified in the broker's or dealer's assertion.<sup>6</sup>

The auditor also must plan and perform the examination engagement to obtain appropriate evidence that is sufficient to obtain reasonable assurance to support the

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dealer submits statements that cover a period longer or shorter than one year. See specifically questions and answers 1 and 2. In those situations, if a broker or dealer submits statements covering a period longer or shorter than one year, the auditor's examination procedures and examination report should be tailored to address the period covered in the broker's or dealer's statements.

<sup>4</sup> See paragraph (d)(3) of SEC Rule 17a-5. These statements also are presented in paragraph 2 of Attestation Standard No. 1.

<sup>5</sup> See paragraph 3 of Attestation Standard No. 1.

<sup>6</sup> See paragraph 4 of Attestation Standard No. 1.

auditor's opinion regarding whether the assertion by the broker or dealer that the information used to assert compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer, is fairly stated, in all material respects.<sup>7</sup>

### **Relationship Between the Examination Engagement and the Audit of the Financial Statements and Audit Procedures Performed on the Supporting Schedules**

When planning and performing the examination of the broker's or dealer's compliance report, the auditor should coordinate the work with the audit of the financial statements and the audit procedures performed on the supporting schedules.<sup>8</sup> This includes taking into account the results of the procedures from the audit of the financial statements and auditing procedures on the supporting schedules in performing the examination. This chapter, Chapter 2, and Appendix B discuss the coordination of the examination of the compliance report with the audit of the financial statements and the audit procedures performed on the supporting schedules. However, the objectives of the financial statement audit and the examination engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.<sup>9</sup>

### **Performing the Examination Engagement**

#### *General Requirements*

The examination standard sets forth general requirements that include, among other things, a requirement that an auditor performing an examination engagement obtain an understanding of the financial responsibility rules<sup>10</sup> and other rules and regulations that are relevant to the broker's or dealer's assertions.<sup>11</sup> Understanding the financial responsibility rules is important to designing and performing appropriate procedures for testing the broker's or dealer's compliance and Internal Control Over Compliance. This understanding can be informed by procedures performed in planning the audit and

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<sup>7</sup> See paragraph 5 of Attestation Standard No. 1.

<sup>8</sup> See paragraph 8 of Attestation Standard No. 1.

<sup>9</sup> Id.

<sup>10</sup> See footnote 8 of Chapter 2 for a description of the financial responsibility rules.

<sup>11</sup> See paragraph 6.b. of Attestation Standard No. 1.

performing risk assessment procedures.<sup>12</sup> Understanding the requirements in other rules and regulations is important to enable the auditor to form conclusions on the broker's or dealer's assertions, as well as aiding the auditor's own compliance with the requirements in the examination standard and SEC Rule 17a-5. An example of other rules and regulations is paragraph (h) of SEC Rule 17a-5, which requires a broker or dealer to provide notification to the Commission and other securities regulators when the auditor notifies the broker or dealer pursuant to SEC rules<sup>13</sup> that the auditor has determined that the broker or dealer is not in compliance with SEC Rule 15c3-1. In addition to the financial responsibility rules, it is of course important that the auditor understands the requirements of SEC Rule 17a-5, including the notification requirements when an instance of non-compliance is identified.

### *Planning the Examination Engagement*

The examination standard requires the auditor to plan the examination engagement and perform procedures that are sufficient to provide a reasonable basis for determining whether the broker's or dealer's assertions are fairly stated in all material respects. This is similar to requirements for planning an audit pursuant to PCAOB standards.<sup>14</sup> Like an audit, the nature and extent of planning activities depend on the size and complexity of the broker or dealer. In general, the auditor might coordinate performing the required planning procedures for the examination engagement with the planning procedures for the audit. For example, in planning the examination engagement, the auditor should, among other things, obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the financial responsibility rules.<sup>15</sup> Performing this procedure might be coordinated with the risk assessment procedures for the financial statement audit or procedures performed on the supporting schedules.

Under the Exchange Act, brokers and dealers generally are required to be registered with the SEC. Additionally, registered brokers and dealers are required to be members of one or more self-regulatory organizations ("SROs"), such as FINRA or securities exchanges, one of which is designated as the broker's or dealer's DEA for surveillance and monitoring purposes. Correspondence and notifications the broker or

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<sup>12</sup> See, e.g., paragraph 7 of Auditing Standard No. 9, *Audit Planning*, and paragraph 7 of Auditing Standard No. 12.

<sup>13</sup> See SEC Rule 17a-11, Notification provisions for brokers and dealers.

<sup>14</sup> See generally Auditing Standard No. 9.

<sup>15</sup> See paragraph 9.b. of Attestation Standard No. 1.

dealer has sent to or received from the SEC or the broker's or dealer's DEA can identify matters relevant to a broker's or dealer's compliance with the net capital rule and the reserve requirements rule. As such, when planning the examination engagement, the auditor should perform specific procedures related to regulatory examinations and correspondence. In particular, the examination standard includes, among other things, requirements for the auditor to:<sup>16</sup>

- Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to the broker's or dealer's assertions.
- Read correspondence and notifications regarding non-compliance that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA that are relevant to the broker's or dealer's assertions, and, when necessary in the circumstances, make inquiries of the regulatory agencies.
- Obtain an understanding of the nature and frequency of customer complaints that are relevant to compliance with the financial responsibility rules.

Those examination procedures also might provide relevant information about the risk of material misstatement of the supporting schedules.<sup>17</sup>

### *Consideration of Fraud*

The auditor's consideration of fraud is an important part of the examination engagement. Fraud risks particularly relevant to a broker's or dealer's non-compliance with the financial responsibility rules include the risk of misappropriation of customer funds or securities held for customers and intentional manipulation of the books and records to conceal material misappropriations or other non-compliance. The SEC Release notes that the amendments to SEC Rule 17a-5, which include requiring the examination or review engagement, are designed to provide additional safeguards with respect to broker and dealer custody of customer securities and funds.<sup>18</sup>

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<sup>16</sup> See paragraph 9 of Attestation Standard No. 1.

<sup>17</sup> See paragraph 3.a. of Auditing Standard No. 17. See also "Understanding the Broker or Dealer and Its Environment" in Chapter 2.

<sup>18</sup> See SEC Release at 206.

The examination standard includes a requirement for the auditor to assess the risk of fraud, and specifically refers to the risk of misappropriation of customer assets, which is relevant to compliance with the net capital rule and the reserve requirements rule, as well as the broker's or dealer's Internal Control Over Compliance.<sup>19</sup>

Coordinating the examination engagement with the audit of the financial statements and audit procedures performed on the supporting schedules is also important for the proper assessment of fraud risk in the examination engagement. The auditor's assessment of fraud risk in the examination engagement might be informed in part by the procedures performed and the fraud risk assessments in the audit of the financial statements and audit procedures performed on the supporting schedules. Many of the fraud risk factors identified in the financial statement audit regarding (1) incentives or pressures to misappropriate assets or commit fraudulent financial reporting and (2) attitudes and rationalizations that justify such fraudulent actions<sup>20</sup> are relevant when identifying and assessing risks of misappropriation of customer assets or intentional manipulation of the books and records to conceal misappropriation of customer assets or non-compliance with the financial responsibility rules. Also, weaknesses in controls regarding safeguarding of assets or stock records can result in opportunities for misappropriation of customer assets or non-compliance. In addition, the evaluation of misstatements for indications of fraud or matters identified during the audit that might affect the assessment of fraud risks in the audit of the financial statements also might affect the assessment of fraud risks in the examination engagement.<sup>21</sup>

The examination standard includes a requirement for the auditor to assess the risks associated with related parties, including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship, that are relevant to compliance and controls over compliance.<sup>22</sup> Given the nature of the transactions with related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship, they are particularly relevant to the auditor's consideration of the risks associated with related parties in the examination engagement and in considering both the broker's or dealer's assertions related to Internal

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<sup>19</sup> See paragraph 10 of Attestation Standard No. 1.

<sup>20</sup> See paragraphs 65-66 of Auditing Standard No. 12 and paragraph .85 of AU sec. 316.

<sup>21</sup> See paragraphs 19-22, 28-29, and Appendix C of Auditing Standard No. 14.

<sup>22</sup> See paragraph 9.d. of Attestation Standard No. 1.

Control Over Compliance, as well as to the broker's or dealer's assertion related to compliance with the net capital rule and the reserve requirements rule.<sup>23</sup>

Likewise, the examination standard includes a requirement for the auditor to obtain an understanding of the nature and frequency of customer complaints that are relevant to compliance with the financial responsibility rules, which can provide evidence relevant to the assessment of fraud risks, especially if there is a high incidence of customer complaints, thematic issues in the complaints that indicate the potential for misappropriation of customer assets, or specific allegations of fraud or misfeasance by the broker's or dealer's customers.<sup>24</sup>

Other paragraphs in the examination standard address the auditor's responsibilities for responding to fraud risks. For example, the examination standard requires the auditor to perform compliance tests that are responsive to risks, including fraud risks.<sup>25</sup> Notably, the examination standard requires the auditor to perform procedures to obtain evidence about the existence of customer funds or securities held for customers.<sup>26</sup> This is an important responsibility in an audit of a broker or dealer that has access to customer assets. It affects compliance with the net capital rule and the reserve requirements rule, and it has the potential to result in a contingent liability to the broker or dealer that requires recognition or disclosure in the financial statements.<sup>27</sup>

Because the examination standard requires the auditor to perform tests that are responsive to fraud risks, the nature, timing, and extent of procedures to obtain evidence about the existence of assets held for customers should be commensurate with the risk of misappropriation of customer assets. Determining the necessary procedures involves considering relevant risk factors, including, but not limited to, the amount of cash and securities held for customers and the results of testing and evaluation of the relevant controls. Examples of procedures that provide evidence about the existence of customer assets include: (1) counting customer securities or observing and testing the broker's or dealer's procedures for physical inspection and (2) confirming customer security positions

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<sup>23</sup> Chapter 2 presents examples of risks associated with related party transactions, some of which might also present risks of non-compliance or risks associated with controls that are relevant to the examination engagement.

<sup>24</sup> See paragraph 9.j. of Attestation Standard No. 1.

<sup>25</sup> See paragraph 22 of Attestation Standard No. 1.

<sup>26</sup> See paragraph 23 of Attestation Standard No. 1.

<sup>27</sup> See discussion of "Customers' Accounts" and "Securities" in Appendix B.

directly with depositories and clearing organizations. Procedures performed in the audit of the financial statements and the audit procedures performed on the supporting schedules to test the existence of assets held for customers also provide relevant evidence in the examination engagement.<sup>28</sup>

### *Testing Controls over Compliance*

SEC Rule 17a-5 requires the broker's or dealer's compliance report to include an assertion regarding the effectiveness of Internal Control Over Compliance during the most recent fiscal year and as of the end of the fiscal year.<sup>29</sup> Accordingly, the auditor is required to obtain evidence about the design and operating effectiveness of relevant controls over compliance throughout the fiscal year and as of the end of the fiscal year. Testing design effectiveness includes determining whether the broker's or dealer's controls, if they are operating as prescribed by persons possessing the necessary authority and competence to perform the control effectively, can effectively prevent or detect instances of non-compliance with the financial responsibility rules on a timely basis.<sup>30</sup> These requirements for testing the design and operating effectiveness of controls over compliance are analogous to the requirements for testing controls in Auditing Standard No. 13.

In an examination, the auditor should test those controls that are important to the auditor's conclusion about whether the broker or dealer maintained effective Internal Control Over Compliance for each financial responsibility rule during the fiscal year and as of the end of the fiscal year.<sup>31</sup> This includes obtaining evidence that the controls over compliance selected for testing are designed effectively and operated effectively during the fiscal year and as of the fiscal year end.<sup>32</sup> As the financial responsibility rules outline the requirements necessary to be in compliance, the auditor can identify the controls for testing by understanding the controls the broker or dealer has implemented to provide the broker or dealer with reasonable assurance that non-compliance with the financial

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<sup>28</sup> See the discussions of the "Stock Record," "Customers' Accounts," and "Securities" in Appendix B.

<sup>29</sup> See paragraphs (d)(3)(i)(A)(2) and (3) of SEC Rule 17a-5, which requires the broker or dealer to assert on the effectiveness of its Internal Control Over Compliance with the financial responsibility rules throughout the fiscal year and as of the end of the most recent fiscal year.

<sup>30</sup> See paragraph 14 of Attestation Standard No. 1.

<sup>31</sup> See paragraph 11 of Attestation Standard No. 1.

<sup>32</sup> Id.

responsibility rules will be prevented or detected on a timely basis. In selecting controls to test, the auditor also might consider the following factors:

- Are the controls likely to be effective?
- What evidence exists regarding operation of the controls?

As the broker's or dealer's assertions regarding Internal Control Over Compliance relate to each financial responsibility rule individually, the auditor should obtain evidence about the effectiveness of the selected controls for each financial responsibility rule. However, when testing controls over compliance, the auditor's objective is not to support an opinion about the effectiveness of each individual control; rather, the objective is to form an opinion about whether the broker's or dealer's assertions regarding Internal Control Over Compliance are fairly stated, in all material respects.<sup>33</sup> This allows the auditor to focus his or her effort on the controls that are important to each of the financial responsibility rules and to vary the level of evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

The examination standard provides that the risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a Material Weakness in Internal Control Over Compliance would result. As the risk associated with a control being tested increases, the persuasiveness of the evidence that the auditor should obtain also increases.<sup>34</sup>

The examination standard identifies certain factors that affect the risk associated with a control.<sup>35</sup> One of these factors is the broker's or dealer's history of instances of non-compliance with the financial responsibility rule that the control is intended to prevent or detect. A recent history of non-compliance generally indicates higher risk associated with the control.

Another factor discussed in the examination standard is the extent of use of part-time personnel (e.g., a part-time financial and operations principal) to perform controls over compliance.<sup>36</sup> Part-time personnel may perform a variety of functions in the

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<sup>33</sup> See note to paragraph 12 of Attestation Standard No. 1.

<sup>34</sup> See paragraph 12 of Attestation Standard No. 1.

<sup>35</sup> See paragraph 13 of Attestation Standard No. 1.

<sup>36</sup> Id. See also SEC Compliance Alert, June 2007, available at <http://www.sec.gov/about/offices/ocie/complialert.htm>. The SEC's June 2007 compliance

compliance area from simple record-keeping to being responsible for the computation of net capital or the reserve requirements. While the existence of part-time personnel, whether employed or contracted by a broker or dealer, does not by itself indicate a risk in Internal Control Over Compliance, it is important for auditors to understand the roles and responsibilities of part-time employees who perform tasks important to compliance with the financial responsibility rules, as well as the frequency with which the part-time employee performs the tasks. Situations in which part-time personnel perform important tasks less frequently can pose higher risk because those personnel may lack the knowledge of the broker's or dealer's operations and controls to perform their tasks effectively, which can affect the risks associated with controls.

Under the examination standard, the auditor should obtain evidence about the effectiveness of controls each year.<sup>37</sup> Similar to testing controls in a financial statement audit, the examination standard provides factors for the auditor to take into account if the auditor plans to use evidence obtained in prior years in determining the extent of testing in the current year.<sup>38</sup>

The examination standard also addresses testing of controls that are modified during the year. A broker or dealer might implement changes to controls over compliance to make them more effective or efficient or to address control deficiencies. As stated in the examination standard, to evaluate controls over compliance throughout the period, the auditor should obtain an understanding of the reason for the change and obtain evidence regarding the design and operating effectiveness of the new and superseded controls.<sup>39</sup> The nature, timing, and extent of the testing of the new and superseded controls depend on the evidence needed to support the auditor's conclusions about the effectiveness of Internal Control Over Compliance during and as of the end of the fiscal year.<sup>40</sup>

Because the auditor expresses an opinion on Internal Control Over Compliance both during and as of the end of the fiscal year, it is possible that the auditor may have different opinions on Internal Control Over Compliance within one report. For example, if a Material Weakness in Internal Control Over Compliance exists in the first part of the

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alert noted that SEC examinations found that many part-time financial and operations principals did not actually supervise or create and maintain various books and records.

<sup>37</sup> See paragraph 19 of Attestation Standard No. 1.

<sup>38</sup> See paragraphs 13 and 19 of Attestation Standard No. 1.

<sup>39</sup> See paragraph 20 of Attestation Standard No. 1.

<sup>40</sup> Id.

year and is fully remediated before year end (and sufficient evidence exists to test that remediated control), the audit report would express an adverse opinion on Internal Control over Compliance during the year and an unqualified opinion as of the end of the fiscal year (see Exhibit 2 to this chapter).

### *Performing Compliance Tests*

With respect to compliance tests, the auditor's objective is to form a conclusion about whether the broker's or dealer's assertion regarding compliance with the net capital rule and the reserve requirements rule is fairly stated, in all material respects. To satisfy this objective, the auditor performs procedures that are sufficient to support the auditor's conclusions regarding whether the broker or dealer was in compliance with the net capital rule and reserve requirements rule as of the end of its most recent fiscal year.<sup>41</sup> To test compliance, the auditor will need to design his or her procedures to test the provisions of the net capital rule and reserve requirements rule that have a bearing on the broker's or dealer's compliance with these rules.<sup>42</sup> For example, the current requirements in the net capital rule generally include:

- a. The requirement to maintain minimum net capital and tentative net capital, as applicable, at all times.<sup>43</sup>
- b. The requirement for certain brokers or dealers not to let a specified amount of certain accounts it carries exceed a specified threshold for more than five business days.<sup>44</sup>
- c. The requirement for brokers or dealers carrying accounts of listed options specialists not to let the amount of certain deductions required under Appendix A of the net capital rule to exceed a specified threshold for more than three business days.<sup>45</sup>

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<sup>41</sup> See paragraph 21 of Attestation Standard No. 1.

<sup>42</sup> Id.

<sup>43</sup> See paragraph (a) of 17 C.F.R. § 240.15c3-1.

<sup>44</sup> See paragraph (a)(6)(v) of 17 C.F.R. § 240.15c3-1.

<sup>45</sup> See paragraph (c)(2)(x)(C) of 17 C.F.R. § 240.15c3-1.

- d. The notification requirement relating to paragraph (c)(2)(x)(C) of the net capital rule.<sup>46</sup>
- e. The requirement for brokers or dealers carrying accounts of listed options specialists to liquidate accounts when a liquidating deficit exists which includes a notice requirement.<sup>47</sup>
- f. The requirement that total of outstanding principal amounts of satisfactory subordination agreements cannot exceed 70% of firm's total debt-equity for a period in excess of 90 days.<sup>48</sup>
- g. The notification requirements relating to withdrawals of equity capital.<sup>49</sup>
- h. The limitations on withdrawal of equity capital.<sup>50</sup>
- i. The requirements regarding temporary restrictions on net capital withdrawals.<sup>51</sup>

Other provisions of the rule also may apply depending on the particular activities or elections of the broker or dealer. Auditors should look to the requirements of the individual rules in testing for compliance.<sup>52</sup>

The auditor should perform specific procedures on the schedules the broker or dealer used to determine compliance with the net capital rule and the reserve requirements rule as of the end of its fiscal year, including:<sup>53</sup>

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<sup>46</sup> See paragraph (c)(2)(x)(C)(1) of 17 C.F.R. § 240.15c3-1.

<sup>47</sup> See paragraph (c)(2)(x)(D) of 17 C.F.R. § 240.15c3-1.

<sup>48</sup> See paragraph (d) of 17 C.F.R. § 240.15c3-1.

<sup>49</sup> See paragraph (e)(1) of 17 C.F.R. § 240.15c3-1.

<sup>50</sup> See paragraph (e)(2) of 17 C.F.R. § 240.15c3-1.

<sup>51</sup> See paragraph (e)(3) of 17 C.F.R. § 240.15c3-1.

<sup>52</sup> See paragraph 6.b. of Attestation Standard No. 1, which requires the auditor to obtain an understanding of the financial responsibility rules and other rules and regulations that are relevant to the broker's or dealer's assertions.

<sup>53</sup> See paragraph 21 of Attestation Standard No. 1.

- a. Evaluating whether the amounts in the schedule were determined in accordance with the net capital rule or reserve requirements rule, as applicable;
- b. Testing the accuracy and completeness of the information in the schedule;
- c. Determining whether the broker or dealer maintained the required level of net capital in accordance with the net capital rule;
- d. Determining whether the broker or dealer maintained a special reserve bank account for the exclusive benefit of customers and deposited funds in at least the required amount in accordance with the reserve requirements rule;
- e. Determining whether the information in the schedule was derived from the books and records of the broker or dealer; and
- f. Determining whether the broker or dealer made the notifications, if any, required by the net capital rule and reserve requirements rule as of the end of the most recent fiscal year.

Also, as discussed previously, the examination standard requires the auditor to: (1) perform compliance tests that are responsive to risks, including fraud risks, associated with non-compliance with the net capital rule and the reserve requirements rule<sup>54</sup> and (2) obtain evidence about the existence of customer funds or securities held for customers.<sup>55</sup>

When testing compliance with the net capital rule and the reserve requirements rule, it is important to take into account the results of the procedures in the financial statement audit. For example, if the audit uncovers misstatements in the valuation or classification of the broker's or dealer's investments, those misstatements could affect the broker's or dealer's compliance with requirements in the net capital rule. Similarly, audit procedures performed to test cash and cash equivalents might identify misstatements in the special reserve account, withdrawals from the account, or failures to maintain the required designations with the bank, any of which might affect the broker's or dealer's compliance with the reserve requirements rule.

The procedures to determine whether the information used to assert compliance with the net capital rule and the reserve requirements rule was derived from the broker's or dealer's books and records provide evidence relating to the auditor's work on the

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<sup>54</sup> See paragraph 22 of Attestation Standard No. 1.

<sup>55</sup> See paragraph 23 of Attestation Standard No. 1.

supporting schedules.<sup>56</sup> For example, Auditing Standard No. 17 includes a requirement for the auditor to determine that the supplemental information reconciles to the underlying accounting and other records or to the financial statements themselves, as applicable.<sup>57</sup>

### **Evaluating the Results of the Examination Procedures**

The examination standard states that in forming an opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects, the auditor should evaluate all evidence obtained, regardless of whether the evidence corroborates or contradicts the broker's or dealer's assertions.<sup>58</sup> This includes evaluating evidence obtained from performing compliance tests and tests of controls, performing the audit of the broker's or dealer's financial statements, and performing audit procedures on the supporting schedules.

The opinion in the auditor's examination report applies to each assertion made by the broker or dealer in the compliance report.<sup>59</sup> Thus, in the auditor's evaluation, the auditor should form a conclusion about each assertion individually. Specifically, the auditor should evaluate: (1) identified instances of non-compliance<sup>60</sup> with the net capital rule and reserve requirements rule, to determine whether any instances of non-compliance existed as of the end of the most recent fiscal year; (2) identified instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived from the broker's or dealer's books and records to determine whether they are material, individually or in combination; and (3) identified Deficiencies in Internal Control Over Compliance to determine whether the deficiencies,

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<sup>56</sup> See paragraph 21.e. of Attestation Standard No. 1.

<sup>57</sup> See paragraph 4.d. of Auditing Standard No. 17.

<sup>58</sup> See paragraph 25 of Attestation Standard No. 1.

<sup>59</sup> See paragraph 3 of Attestation Standard No. 1.

<sup>60</sup> In evaluating the results of compliance testing, an error in a broker's or dealer's computation used to determine compliance with a provision of the net capital rule or reserve requirements rule is not an instance of non-compliance if, after giving consideration to the effect of the error, the broker or dealer still met the requirements of that provision, e.g., maintained at least the required minimum level of net capital or at least the minimum level on deposit in the special reserve account. However, such an instance might be an indication of a Deficiency in Internal Control Over Compliance that requires evaluation pursuant to Attestation Standard No. 1.

individually or in combination, are Material Weaknesses. Identified instances of non-compliance might be an indication of a Deficiency in Internal Control Over Compliance.<sup>61</sup>

SEC Rule 17a-5 requires the broker or dealer to make an assertion about the effectiveness of Internal Control Over Compliance with the financial responsibility rules during the entire fiscal year.<sup>62</sup> To form an opinion on whether the assertions made by the broker or dealer are fairly stated, in all material respects, during the entire fiscal year, the auditor should evaluate identified Deficiencies in Internal Control Over Compliance to determine whether the deficiencies, individually or in combination, are, or were at some point during the specified period, Material Weaknesses.<sup>63</sup>

Although the existence of a Material Weakness in Internal Control Over Compliance does not necessarily mean that an instance of non-compliance exists at the specified date, the auditor nonetheless should take into account the existence of the Material Weakness in determining the necessary nature, timing, and extent of compliance tests and in evaluating the evidence obtained.<sup>64</sup> Furthermore, the auditor cannot assume that an identified control deficiency is an isolated occurrence.<sup>65</sup>

The auditor's evaluation of the materiality of instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived from the broker's or dealer's books and records is based on relevant quantitative and qualitative factors, including, in particular, the importance of the information not derived from the books and records to the broker's or dealer's compliance with the corresponding requirement in the net capital rule or the reserve requirements rule. For example, when a broker or dealer asserts that the information used to state whether it was in compliance with the net capital rule was derived from its books and records, and the auditor identifies an amount not derived from a broker's or dealer's books and records, the broker or dealer may still be able to support its assertion that it maintained the required net capital using information that was derived from the books and records of the broker or dealer. However, such an instance might be an indication of a Deficiency in Internal Control Over Compliance.

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<sup>61</sup> See paragraph 26 of Attestation Standard No. 1.

<sup>62</sup> See paragraph (d)(3)(i)(A)(2) of SEC Rule 17a-5.

<sup>63</sup> See paragraphs 4 and 26.c. of Attestation Standard No. 1.

<sup>64</sup> See paragraphs 24 and 27 of Attestation Standard No. 1.

<sup>65</sup> See the second note to paragraph 26.c. of Attestation Standard No. 1.

Under the examination standard, the auditor should evaluate whether he or she has obtained sufficient appropriate evidence to support the conclusions to be presented in the examination report taking into account the risks associated with controls and non-compliance, the results of the examination procedures performed, and the appropriateness of the evidence obtained.<sup>66</sup> Factors relevant to the auditor's evaluation include:

- The results of procedures performed in the examination engagement and evidence obtained from procedures performed as part of the audit of the financial statements and audit procedures performed on the supporting schedules, including whether the evidence obtained supports or contradicts the broker's or dealer's assertions;
- The nature and frequency of any non-compliance identified, including the facts and circumstances surrounding such non-compliance, the period covered, the total number of occurrences, and the likelihood of the non-compliance having a material effect, individually or in combination, considering the possibility of further undetected non-compliance;
- The significance of any identified instances in which the information used to assert compliance with the net capital rule or reserve requirements rule was not derived from the broker's or dealer's books and records and the likelihood of the instances having a material effect, individually or in combination, considering the possibility of further undetected instances;
- The nature and frequency of any identified deficiencies in controls over compliance with the net capital rule or reserve requirements rule, including the facts and circumstances surrounding such deficiencies, the period covered, the total number of occurrences, and the likelihood of the control deficiencies resulting in a Material Weakness, individually or in combination, considering the possibility of further undetected deficiencies;
- The risks of non-compliance associated with the net capital rule or reserve requirements rule; and

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<sup>66</sup> See paragraph 27 of Attestation Standard No. 1.

- The appropriateness (that is, the relevance and reliability) of the evidence obtained.<sup>67</sup>

When the auditor has not obtained sufficient appropriate evidence about an assertion or has substantial doubt about an assertion, the auditor is required to perform additional procedures to address the matter.<sup>68</sup> Performing the examination with due professional care requires an auditor conducting an examination to take appropriate actions when becoming aware of non-compliance or Material Weaknesses not included in the broker's or dealer's assertions or when substantial doubt remains. For example, if, during the audit of the broker's or dealer's financial statements, the auditor identified control deficiencies over classification of securities during the year that may cause the broker or dealer to use incorrect securities haircut percentages when computing its net capital under SEC Rule 15c3-1,<sup>69</sup> the auditor should (1) assess the implications on Internal Control Over Compliance with the net capital rule and determine whether such deficiencies individually or in combination are Material Weaknesses and (2) revise the planned compliance tests as necessary to obtain more evidence about whether the broker's or dealer's year-end net capital computation complies with the requirements of the net capital rule.

If the auditor is unable to obtain sufficient appropriate evidence about an assertion to provide a reasonable basis for forming a conclusion, the auditor should withdraw from the examination engagement or express a disclaimer of opinion.<sup>70</sup>

In an examination, the auditor should evaluate the effect on the audit of the financial statements and the audit procedures performed on the supporting schedules of any non-compliance, Material Weaknesses, or instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records.<sup>71</sup> This includes determining whether sufficient appropriate audit evidence has been obtained to support the relevant financial statement assertions, including assertions related to the

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<sup>67</sup> Paragraphs 5-9 of Auditing Standard No. 15 discuss matters that affect the sufficiency and appropriateness of evidence.

<sup>68</sup> See paragraph 28 of Attestation Standard No. 1.

<sup>69</sup> See paragraph (c)(2)(vi) of SEC Rule 15c3-1.

<sup>70</sup> See paragraph 29 of Attestation Standard No.1. See also "Examination Report Modifications" in this chapter.

<sup>71</sup> See the third note to paragraph 26.c. of Attestation Standard No. 1.

completeness and accuracy of disclosures. For example, if, in performing procedures related to net capital requirements, the auditor determines that the broker's or dealer's net capital position is misstated because the information used in the calculation was not derived from the broker's or dealer's books and records, the auditor should evaluate whether the broker's or dealer's financial statement disclosures and the supporting schedules also are materially misstated.

### **Communication Requirements**

The examination standard requires the auditor to communicate certain matters to management and the audit committee, as well as to comply with the requirements of paragraph (h) of SEC Rule 17a-5.<sup>72</sup> Additional information on these requirements is discussed in Chapter 2 of this publication.<sup>73</sup>

### **Documenting the Work Performed**

Auditing Standard No. 3 establishes documentation requirements that apply to the examination engagement.<sup>74</sup> Among other things, the auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to the broker's or dealer's assertions.<sup>75</sup> The auditor's documentation should demonstrate that the engagement complied with the standards of the PCAOB.<sup>76</sup>

Also, Auditing Standard No. 3 requires all significant findings or issues identified in the engagement to be included in an engagement completion document.<sup>77</sup> In an examination engagement, significant findings include, when applicable: (a) the assessment of, and the responses to, risks requiring special consideration by the auditor; (b) significant matters involving systems, processes, and controls to ensure the

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<sup>72</sup> See paragraphs 34 and 35 of Attestation Standard No. 1.

<sup>73</sup> See also the discussion of the notification requirements in the SEC Release at 101-107.

<sup>74</sup> Paragraph 1 of Auditing Standard No. 3 states that the "standard establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the Public Company Accounting Oversight Board."

<sup>75</sup> See footnote to paragraph 6 of Auditing Standard No. 3.

<sup>76</sup> See paragraph 4 of Auditing Standard No. 3.

<sup>77</sup> See paragraph 13 of Auditing Standard No. 3.

appropriateness of the subject matter and management's related assertions; and (c) the evaluation of identified instances of nonconformity with the evaluation criteria (e.g., errors, instances of non-compliance or control deficiencies).<sup>78</sup> Auditing Standard No. 3 allows the auditor to prepare a combined engagement completion document for the audit and the examination.<sup>79</sup>

## Reporting on the Examination Engagement

The examination standard includes requirements for the auditor's examination report<sup>80</sup> which are aligned with the requirements in SEC Rule 17a-5. The auditor's examination report also includes certain elements that are important for a reader of the auditor's examination report to understand regarding the auditor's responsibilities.

The auditor should date the examination report no earlier than the date on which the auditor obtains sufficient appropriate evidence to support his or her opinion.<sup>81</sup> Because of the coordination between the examination engagement, the audit of the financial statements and the audit procedures performed on the supporting schedules, the date of the examination report should not be earlier than the date of the auditor's report on the financial statements and the supporting schedules.<sup>82</sup>

### Interpretations of Rules and Regulations

When management has made an interpretation of the financial responsibility rules and the auditor has determined that it is necessary to emphasize this interpretation in the auditor's report, the examination standard allows the auditor to include a paragraph in the examination report stating the description and the source of interpretations made by the broker's or dealer's management immediately after the scope paragraph of the auditor's report.<sup>83</sup> The following is an example of such a paragraph:

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<sup>78</sup> See the note to paragraph 12 of Auditing Standard No. 3.

<sup>79</sup> See the second note to paragraph 13 of Auditing Standard No. 3.

<sup>80</sup> See paragraph 36 of Attestation Standard No. 1.

<sup>81</sup> See paragraph 38 of Attestation Standard No. 1.

<sup>82</sup> See note to paragraph 38 of Attestation Standard No. 1.

<sup>83</sup> See footnote to paragraph 36.h. of Attestation Standard No. 1.

We have been informed that, under X Broker's interpretation of [*identify the compliance requirement, e.g., SEC Rule 15c3-1*], [*explain the source and nature of the relevant interpretation*].

### *Examination Report Modifications*

The examination standard includes requirements regarding modifications of the auditor's report, including situations involving adverse opinions, scope limitations, or instances in which other information is included in the broker's or dealer's compliance report.<sup>84</sup>

#### Adverse Opinion

Under the examination standard, if one or more instances of non-compliance with the net capital rule or the reserve requirements rule exist as of the end of the most recent fiscal year, one or more Material Weaknesses in Internal Control Over Compliance exist during or as of the end of the most recent fiscal year, or the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer, the auditor must express an adverse opinion directly on the subject matter of the respective assertions, rather than on the assertions themselves, unless there is a restriction on the scope of the examination engagement.<sup>85</sup> For example, if the broker or dealer is not in compliance with the net capital rule, the auditor's report would include an adverse opinion on compliance and would identify the instance of non-compliance regardless of whether it was described in the broker's or dealer's compliance report.

Certain matters are included in the examination report when expressing an adverse opinion.<sup>86</sup> For example, when expressing an adverse opinion because one or more Material Weaknesses exist, the auditor's examination report must include a statement that one or more Material Weaknesses have been identified and an identification of the description of the Material Weaknesses in the compliance report.

The requirement to express an adverse opinion applies only to the respective assertion. For example, if a Material Weakness was identified during the year but not at

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<sup>84</sup> See Appendix C of Attestation Standard No. 1.

<sup>85</sup> See paragraph C2 of Attestation Standard No. 1. The requirement to express an adverse opinion applies regardless of whether the instance of non-compliance, Material Weakness, or other matters preventing an unqualified opinion were identified by management or the auditor.

<sup>86</sup> See paragraph C3 of Attestation Standard No. 1.

year end, and there were no instances of non-compliance or instances in which the information used to assert compliance with the net capital rule and the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records, the examination report should include an adverse opinion on Internal Control Over Compliance during the year and an unqualified opinion on the other three assertions.<sup>87</sup>

### Scope Limitations

The examination standard states that if the auditor is unable to obtain sufficient appropriate evidence about an assertion, the auditor should express a disclaimer of opinion.<sup>88</sup> The auditor can express an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects, only if the auditor has been able to apply the procedures necessary in the circumstances.<sup>89</sup>

When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that: (1) one or more instances of non-compliance with the net capital rule or the reserve requirements rule existed as of the end of the fiscal year; (2) one or more Material Weaknesses in Internal Control Over Compliance existed during or as of the end of the most recent fiscal year; or (3) the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer, the examination report should identify the non-compliance, Material Weakness, or instances in which the information was not derived in all material respects from the books and records of the broker or dealer.<sup>90</sup>

The auditor may issue a report disclaiming an opinion on the assertions made by a broker or dealer in a compliance report as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion.<sup>91</sup> The auditor is not required to perform any additional work before

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<sup>87</sup> See Exhibit 2, "Example of a Modified Examination Report—Material Weakness Existed During the Most Recent Fiscal Year," in this chapter.

<sup>88</sup> See paragraph 29 of Attestation Standard No. 1.

<sup>89</sup> See paragraph C4 of Attestation Standard No. 1.

<sup>90</sup> See paragraph C6 of Attestation Standard No. 1.

<sup>91</sup> See paragraph C4 of Attestation Standard No. 1. Furthermore, when the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion, the auditor may decide to

issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion. In addition, if the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the examination engagement, under the examination standard, the auditor should communicate on a timely basis, in writing, to management and the audit committee that the examination engagement cannot be satisfactorily completed.<sup>92</sup>

#### Other Information in the Compliance Report

If the broker's or dealer's compliance report contains other information in addition to the statements and descriptions, if applicable, required by SEC Rule 17a-5,<sup>93</sup> the auditor should disclaim an opinion on the other information.<sup>94</sup> For example, if the broker's or dealer's compliance report states that an identified Material Weakness no longer exists because controls have been implemented after the end of the fiscal year that address the Material Weakness, the auditor should disclaim an opinion on this information.

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withdraw from the examination engagement. Paragraph (f)(3) of SEC Rule 17a-5 sets forth certain notification requirements for brokers and dealers when the auditor notifies the broker or dealer that the auditor will not continue the engagement.

<sup>92</sup> See paragraph C8 of Attestation Standard No. 1.

<sup>93</sup> See paragraphs (d)(3) and (g)(2) of SEC Rule 17a-5.

<sup>94</sup> See paragraph C9 of Attestation Standard No. 1.

## EXHIBIT 1

### ***Example of an Examination Report with an Unqualified Opinion***

The following example, reproduced from paragraph 37 of Attestation Standard No. 1, illustrates the report elements in paragraph 36 of Attestation Standard No. 1 for an examination report expressing an unqualified opinion on the assertions made by a broker or dealer in a compliance report:

#### Report of Independent Registered Public Accounting Firm

##### *[ Introductory paragraph ]*

We have examined W Broker's statements, included in the accompanying [*title of the compliance report*], that (1) W Broker's internal control over compliance was effective during the most recent fiscal year ended [*date*]; (2) W Broker's internal control over compliance was effective as of [*date*]; (3) W Broker was in compliance with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e) as of [*date*]; and (4) the information used to state that W Broker was in compliance with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e) was derived from W Broker's books and records. W Broker's management is responsible for establishing and maintaining a system of internal control over compliance that has the objective of providing W Broker with reasonable assurance that non-compliance with 17 C.F.R. § 240.15c3-1, 17 C.F.R. § 240.15c3-3, 17 C.F.R. § 240.17a-13, or Rule [*fill in name/number*] of [*fill in DEA*] that requires account statements to be sent to the customers of W Broker will be prevented or detected on a timely basis. Our responsibility is to express an opinion on W Broker's statements based on our examination.

##### *[ Scope paragraph ]*

We conducted our examination in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the examination to obtain reasonable assurance about whether W Broker's internal control over compliance was effective as of and during the most recent fiscal year ended [*date*]; W Broker complied with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e) as of [*date*]; and the information used to assert compliance with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e) as of [*date*] was derived from W Broker's books and records. Our examination includes testing and evaluating the design and operating effectiveness of internal control over compliance, testing and evaluating W Broker's compliance with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e), determining whether the information used to assert compliance with 240.15c3-1 and 240.15c3-3(e) was derived from W Broker's books and records, and performing such other procedures as we considered

necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[ *Opinion paragraph* ]

In our opinion, W Broker's statements referred to above are fairly stated, in all material respects.

[ *Signature* ]

[ *City and State or Country* ]

[ *Date* ]

## EXHIBIT 2

### ***Example of a Modified Examination Report—Material Weakness Existed During the Most Recent Fiscal Year***

The following example illustrates the report elements in paragraph 36 of Attestation Standard No. 1 and modifications contained in paragraphs C2 and C3 of Attestation Standard No. 1 for an examination report expressing an adverse opinion on Internal Control Over Compliance during the year, when a Material Weakness existed during the year but did not exist as of year-end:

#### Report of Independent Registered Public Accounting Firm

We have examined W Broker's statements, included in the accompanying compliance report, that (1) W Broker's internal control over compliance was not effective during the most recent fiscal year ended [date]; (2) W Broker's internal control over compliance was effective as of [date]; (3) W Broker was in compliance with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e) as of [date]; and (4) the information used to state that W Broker was in compliance with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e) was derived from W Broker's books and records.

W Broker's management is responsible for establishing and maintaining a system of internal control over compliance that has the objective of providing W Broker with reasonable assurance that non-compliance with 17 C.F.R. § 240.15c3-1, 17 C.F.R. § 240.15c3-3, 17 C.F.R. § 240.17a-13, or Rule [fill in name/number] of [fill in DEA] that requires account statements to be sent to the customers of W Broker will be prevented or detected on a timely basis. Our responsibility is to express an opinion on W Broker's statements based on our examination.

We conducted our examination in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the examination to obtain reasonable assurance about whether W Broker's internal control over compliance was effective as of and during the most recent fiscal year ended [date]; W Broker complied with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e) as of [date]; and the information used to assert compliance with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e) as of [date] was derived from W Broker's books and records. Our examination includes testing and evaluating the design and operating effectiveness of internal control over compliance, testing and evaluating W Broker's compliance with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e), determining whether the information used to assert compliance with 240.15c3-1 and 240.15c3-3(e) was derived from W Broker's books and records, and performing such other procedures as we considered

necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

As described in the accompanying compliance report, a material weakness has been identified in W Broker's internal control over compliance during the fiscal year ended [date]. [*Describe material weakness*].

In our opinion, because of the material weakness referred to above, W Broker's internal control over compliance was not effective during the most recent fiscal year ended [date]. In our opinion, W Broker's statements that W Broker's internal control over compliance was effective as of [date]; W Broker complied with §§ 240.15c3-1 and 240.15c3-3(e) as of [date]; and the information used to state that W Broker was in compliance with §§ 240.15c3-1 and 240.15c3-3(e) was derived from W Broker's books and records are fairly stated, in all material respects.<sup>95</sup>

[ *Signature* ]

[ *City and State or Country* ]

[ *Date* ]

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See generally paragraph C2 of Attestation Standard No. 1.

## **Chapter 4: Reviews of Exemption Reports**

This chapter highlights certain requirements in Attestation Standard No. 2 regarding reviews of exemption reports of brokers or dealers, reproduces an example of a standard review report, and presents an example of a modified review report. In addition, this chapter provides examples of procedures performed during the audit that can provide evidence that is relevant to the review.

### **Content of Exemption Reports**

SEC Rule 17a-5 requires a broker or dealer that claimed it was exempt from SEC Rule 15c3-3 throughout the most recent fiscal year (generally, a "non-carrying broker or dealer")<sup>1</sup> to file an exemption report containing the following statements ("assertions"):

- a. A statement that identifies the provisions in paragraph (k) of SEC Rule 15c3-3 (the "exemption provisions")<sup>2</sup> under which the broker or dealer claimed an exemption from SEC Rule 15c3-3 (the "identified exemption provisions");<sup>3</sup>

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<sup>1</sup> The SEC Release adopting amendments to SEC Rule 17a-5 used the term "non-carrying broker or dealer" to refer to a broker or dealer that claimed it was exempt from SEC Rule 15c3-3 throughout the most recent fiscal year. See Section II.A. of the SEC Release.

<sup>2</sup> Appendix C contains the text from paragraph (k) of SEC Rule 15c3-3 that describes the exemption provisions.

<sup>3</sup> Footnote 74 of the SEC Release states that "[t]here 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 [exemption] provisions listed under Item 24 of Part IIa [of the FOCUS Report]. Even though there is not a box to check on the FOCUS Report, these broker-dealers should file an exemption report and related accountant's report." See also Question and Answer 6 of the SEC's Division of Trading and Markets *Frequently Asked Questions Concerning the July 30, 2013 Amendments to the Broker-Dealer Financial Reporting Rule* at <http://www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-reporting-rule-faq.htm>. If the broker or dealer files an exemption report under those circumstances, the auditor's review procedures and review report should be tailored to address the broker's or dealer's assertions in the exemption report.

- b. A statement that the broker or dealer (1) met the identified exemption provisions throughout the most recent fiscal year<sup>4</sup> without exception or (2) met the identified exemption provisions throughout the most recent fiscal year except as described in the exemption report; and
- c. If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions (an "exception") and that briefly describes the nature of each exception and the approximate date(s) on which the exceptions existed.<sup>5</sup>

SEC Rule 17a-5 requires the broker or dealer to engage an independent accountant to perform a review of the statements regarding the exemption provisions made by a broker or dealer in an exemption report prepared pursuant to SEC Rule 17a-5.<sup>6</sup> Because brokers and dealers claiming exemption from SEC Rule 15c3-3 requirements might have access to customer funds, a review focusing on the identification of exceptions to the identified exemption provisions claimed by brokers and dealers is important to the protection of customers.<sup>7</sup>

Attestation Standard No. 2 establishes requirements for auditors engaged to perform a review of the statements made by a broker or dealer in the exemption report. Under the review standard, the auditor's objective is to state whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertions for the assertions to be fairly stated,

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<sup>4</sup> Staff guidance issued by the SEC's Division of Trading and Markets, *Frequently Asked Questions Concerning the July 30, 2013 Amendments to the Broker-Dealer Financial Reporting Rule* (April 4, 2014), provides that the Division staff will not object if a broker or dealer whose fiscal year begins prior to June 1, 2014 submits statements that cover only the period beginning after June 1 through the end of the fiscal year. In those cases, the auditor's review procedures and review report should be tailored to address the period covered in the broker's or dealer's assertions. See Question and Answer No. 1 at <http://www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-reporting-rule-faq.htm>.

<sup>5</sup> See paragraph (d)(4) of SEC Rule 17a-5.

<sup>6</sup> See paragraphs (d)(1)(i)(C) and (g)(2)(ii) of SEC Rule 17a-5 and the SEC Release.

<sup>7</sup> See SEC Release at 90.

in all material respects.<sup>8</sup> To state such a conclusion, the auditor should plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance about whether one or more conditions exist that would cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects.<sup>9</sup> Such conditions include:

- a. The broker's or dealer's assertion that identifies the provisions in paragraph (k) of SEC Rule 15c3-3 under which the broker or dealer claimed an exemption for SEC Rule 15c3-3 is inaccurate;
- b. The broker or dealer asserts that it met the identified exemption provisions in paragraph (k) of SEC Rule 15c3-3 without exception when the auditor is aware of exceptions in meeting the exemption provisions; or
- c. The broker's or dealer's assertion that identifies and describes each exception during the most recent fiscal year in meeting the identified provisions in paragraph (k) of SEC Rule 15c3-3 is inaccurate or incomplete.<sup>10</sup>

Obtaining moderate assurance regarding the broker's or dealer's assertions in a review engagement differs from the examination engagement discussed in Chapter 3 where the auditor obtains reasonable assurance to support his or her opinion on the broker's or dealer's assertions. Moderate assurance is a lower level of assurance than reasonable assurance and is obtained by performing with due professional care the inquiries and other procedures required by the review standard in order to reach a conclusion about whether there is a need to modify the broker's or dealer's assertions regarding the exemption provisions for the assertions to be fairly stated in all material respects.<sup>11</sup>

### **Relationship Between the Review Engagement and the Audit of the Financial Statements and Audit Procedures Performed on the Supporting Schedules**

When planning and performing the review of the broker's or dealer's exemption report, the auditor should coordinate the work with the audit of the financial statements

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<sup>8</sup> See paragraph 3 of Attestation Standard No. 2.

<sup>9</sup> See paragraph 4 of Attestation Standard No. 2.

<sup>10</sup> Id.

<sup>11</sup> See footnote 7 of Attestation Standard No. 2.

and the audit procedures performed on the supporting schedules.<sup>12</sup> This includes taking into account the results of the procedures from the audit of the financial statements and auditing procedures on the supporting schedules in performing the review. However, the objectives of the financial statement audit and the review engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.<sup>13</sup> This publication provides examples of ways in which the review can be coordinated with the audit of the financial statements and audit procedures performed on the supporting schedules; however, the auditor is responsible for performing the procedures required by Attestation Standard No. 2 to support his or her review report. Coordinating the review with the audit is also discussed in Chapter 2.

## **Performing the Review Engagement**

### *General Requirements*

The review standard includes general requirements that include, among other things, a requirement that an auditor performing a review engagement obtain an understanding of the exemption conditions and other rules and regulations that are relevant to the broker's or dealer's assertions.<sup>14</sup> This understanding can be informed by procedures performed in planning the audit and performing risk assessment procedures.<sup>15</sup>

### *Nature, Timing, and Extent of Procedures*

The nature, timing, and extent of the necessary inquiries and other review procedures (collectively, the "review procedures") are dependent on certain risk factors described in Paragraph 9 of the review standard. The auditor also considers evidence about the broker's or dealer's compliance with the identified exemption provisions or about the effectiveness of controls over the identified exemption provisions obtained from the audit of the financial statements and the audit procedures performed on the supporting schedules in determining the nature, timing, and extent of the review procedures. For example, in planning and performing the audit, the auditor might learn about changes in the broker's or dealer's procedures, controls, the environment in which

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<sup>12</sup> See paragraph 7 of Attestation Standard No. 2.

<sup>13</sup> Id.

<sup>14</sup> See paragraph 5.b. of Attestation Standard No. 2.

<sup>15</sup> See, e.g., paragraph 7 of Auditing Standard No. 9 and paragraph 7 of Auditing Standard No. 12.

the controls operate since the prior year, and changes in the broker's or dealer's operations that are relevant to compliance with the exemption provisions.

The risk of fraud, including the risk of misappropriation of customer assets, is an important consideration in determining the nature, timing, and extent of the review procedures.<sup>16</sup> In considering the risk of fraud relevant to the exemption provisions, it is important to assess whether the broker or dealer has misrepresented its activities, e.g., the broker or dealer claims to be operating as a non-carrying broker or dealer when the broker or dealer is holding customer funds or securities. The auditor's consideration of fraud in the financial statement audit and results of substantive procedures in the audit can inform the auditor's assessment of fraud risk for the review engagement. For example, the auditor's fraud risk assessment in the financial statement audit might identify risk factors regarding incentives, pressures, or opportunities to commit fraud that also warrant consideration during the review engagement. Also, the procedures performed in the audit might provide evidence that the broker or dealer is holding customer funds or securities, which would impact the review engagement.

The auditor's consideration of fraud in the audit can equally inform other considerations relevant to the review engagement. For example, audit procedures related to related party transactions or revenue and intercompany balances can provide information relevant to potential non-compliance associated with related parties,<sup>17</sup> including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship.

Another example where information obtained during the audit of the financial statements or audit procedures performed on the supporting schedules might provide information relevant to the risk factors in paragraph 9 of the review standard relates to understanding the degree to which the processes regarding the exemption provisions are performed, monitored, or controlled in a centralized or decentralized environment.<sup>18</sup> For example, in smaller brokers and dealers, one or a few individuals may be responsible for ensuring that the broker or dealer maintains compliance with the identified exemption provisions.

Procedures performed during the audit of the financial statements and the audit procedures performed on the supporting schedules may provide evidence about the

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<sup>16</sup> See item (5) of paragraph 9.a. of Attestation Standard No. 2.

<sup>17</sup> See item (6) of paragraph 9.a. of Attestation Standard No. 2. Chapter 2 discusses audit procedures regarding related parties.

<sup>18</sup> See item (7) of paragraph 9 of Attestation Standard No. 2.

broker's or dealer's compliance with the exemption provisions. Specifically, evidence about the broker's or dealer's compliance with the exemption provisions or about the effectiveness of controls over the exemption provisions obtained from the audit of the financial statements and the audit procedures performed on the supporting schedules all affect the nature, timing, and extent of the necessary review procedures.<sup>19</sup> For example, if the broker or dealer claims an exemption under SEC Rule 15c3-3(k)(1), the broker's or dealer's transactions are limited to those in redeemable securities of investment companies or of interests or participations in an insurance company separate account. Further, this exemption limits transaction activities outside of the allowable security types.<sup>20</sup> Audit procedures regarding the broker's or dealer's investment inventory or investment transactions related to the broker's or dealer's trading for its own account, including confirmation of investment inventory with the custodian and testing investment transactions, can provide evidence relevant to the accuracy of the broker's or dealer's assertion relating to the (k)(1) exemption provision.<sup>21</sup>

Likewise, if the broker or dealer claims an exemption under sections (k)(1) or (k)(2) of SEC Rule 15c3-3, the exemption provisions require the broker or dealer to promptly transmit all funds and deliver all securities received in connection with its activities as a broker or dealer, and not otherwise hold funds or securities for, or owe money or securities to, customers.<sup>22</sup> Audit procedures performed on customer trade and transaction activities can provide evidence relevant to the broker's or dealer's compliance with the exemption provisions.<sup>23</sup>

Other procedures performed during the audit that may provide evidence relevant to the exemption provisions include testing of cash accounts (including specially

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<sup>19</sup> See paragraph 9.b. of Attestation Standard No. 2.

<sup>20</sup> Appendix C presents the exemption provisions in paragraph (k) of SEC Rule 15c3-3.

<sup>21</sup> Appendix B discusses some of the possible risks related to particular accounts and records that are specific to brokers and dealers and provides examples of audit and attest procedures that can provide evidence in response to those risks.

<sup>22</sup> Appendix C presents the exemption provisions in paragraph (k) of SEC Rule 15c3-3.

<sup>23</sup> See paragraph 10.g. of Attestation Standard No. 2. See also the note to paragraph 10.g. of Attestation Standard No. 2 for additional examples of procedures performed during an audit of the financial statements that might provide evidence relevant to the broker's or dealer's compliance with the exemption provisions.

designated accounts) and reading clearing agreements between the broker or dealer and carrying brokers in connection with testing trade fee or commission revenues and expenses.<sup>24</sup>

### *Review Procedures*

The review standard includes procedures that the auditor should perform when conducting the review, such as reading the exemption report and making certain inquiries of management and other knowledgeable individuals. Those inquiries cover topics such as controls and monitoring activities that are in place regarding compliance with the exemption provisions, known exceptions to the exemption provisions or deficiencies in controls over compliance with the exemption provisions, and the nature and frequency of customer complaints that are relevant to the broker's or dealer's compliance with the exemption provisions.<sup>25</sup>

Certain review procedures might be informed by the financial statement audit, or be performed at the same time as related audit procedures, while others might need additional effort, if not addressed in the audit. For example, review procedures at a broker or dealer that claims an exemption from SEC Rule 15c3-3 that can be performed while performing audit procedures include making inquiries about: (1) the controls in place to maintain compliance with the exemption provisions, including the nature of the controls and their frequency of operation; (2) subsequent events through the date of the auditor's review report that might have a material effect on the broker's or dealer's assertions; and (3) whether the individual is aware of any exceptions to the exemption provisions and, if so, the nature, frequency, timing, and cause (if known) of the exceptions to the exemption provisions during the year under review or any deficiencies in controls over compliance with the exemption provisions and, if so, the nature, frequency, and cause (if known) of the control deficiencies during the year under review.<sup>26</sup>

The review standard also requires the auditor to evaluate whether the evidence obtained and the results of the procedures performed in the audit of the financial statements and the audit procedures performed on the supporting schedules corroborate or contradict information in the broker's or dealer's assertion.<sup>27</sup> Other procedures

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<sup>24</sup> Appendix B discusses some possible risks and audit and attest procedures regarding customers' accounts.

<sup>25</sup> See generally paragraph 10 of Attestation Standard No. 2.

<sup>26</sup> See paragraphs 10.b. and 10.c. of Attestation Standard No. 2.

<sup>27</sup> See paragraph 10.g. of Attestation Standard No. 2.

performed during the audit can provide evidence about the broker's or dealer's assertion, depending upon the provisions in paragraph (k) of SEC Rule 15c3-3 under which the broker or dealer claimed an exemption. These procedures may include testing of transactions related to customer trades, testing investment inventory or transactions related to the broker's or dealer's trading for its own account, and testing cash and bank account reconciliations.<sup>28</sup>

To illustrate, assume that a broker claims exemption under section (k)(1) of SEC Rule 15c3-3 which requires, among other things, that the broker or dealer promptly transmits all funds and delivers all securities received in connection with its activities. The broker asserts that it met the identified exemption provisions throughout the most recent fiscal year without exception.<sup>29</sup> Also assume that while performing audit procedures on customers' accounts,<sup>30</sup> the auditor identifies evidence that there were instances where the broker did not promptly transmit customer funds. In that situation, the audit procedures have uncovered evidence suggesting an exception to the broker's or dealer's claimed exemption that warrants follow-up by the auditor during the review.

As another example, if the broker or dealer has claimed exemption under section (k)(2)(i) of SEC Rule 15c3-3,<sup>31</sup> evidence obtained in testing the bank account designated as "Special Account for the Exclusive Benefit of Customers" would provide evidence regarding whether any exceptions to the identified exemption provisions existed or whether the exceptions identified in the broker's or dealer's exemption report are complete. This evidence would include evidence obtained from procedures performed to determine that all customer transactions were effectuated through such accounts, as required by the rule, and confirmation of the account balance and restrictions on the account with the carrying broker.

As a further example, if the broker's or dealer's assertion stated that it met the identified exemption provisions in paragraph (k)(2)(ii) of SEC Rule 15c3-3,<sup>32</sup> evidence

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<sup>28</sup> See note to paragraph 10.g. of Attestation Standard No. 2.

<sup>29</sup> Appendix C presents the exemption provisions in paragraph (k) of SEC Rule 15c3-3.

<sup>30</sup> Appendix B discusses some possible risks and audit and attest procedures regarding customers' accounts.

<sup>31</sup> Appendix C presents the exemption provisions in paragraph (k) of SEC Rule 15c3-3.

<sup>32</sup> Id.

obtained in testing that the broker operated as an introducing broker and forwarded all orders for customers to the carrying brokers on a fully-disclosed basis would provide evidence relevant to the broker's compliance with the specified exemption provision. For instance, confirming the clearing arrangements with the carrying broker to ensure the auditor received all clearing agreements and reading the agreements to determine the basis—omnibus or fully-disclosed—orders are forwarded to the carrying broker would provide evidence relevant to the broker's compliance with the specified exemption provision and whether the broker's assertion was complete.

### **Evaluating the Results of the Review Procedures**

After completing the required procedures, the auditor should evaluate the results of the procedures performed. This evaluation includes determining whether information has come to the auditor's attention that causes one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects.<sup>33</sup> If the broker's or dealer's assertion is not fairly stated, in all material respects, the auditor then should modify the review report<sup>34</sup> and evaluate the effect of the matter on the audit of the financial statements and the audit procedures performed on the supporting schedules. If, however, the auditor communicates the exceptions to the broker or dealer and the broker or dealer modifies the assertions in the exemption report, modification of the review report is unnecessary. Paragraph 4 of Attestation Standard No. 2 lists examples of conditions that cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects, and the examples are reproduced earlier in this chapter. Those examples include a broker's or dealer's failure to disclose in the exemption report an existing exception to the identified exemption provisions.

Paragraph 12 of the review standard applies when information comes to the auditor's attention during the engagement indicating that one or more undisclosed exceptions might exist that might cause the broker's or dealer's assertions not to be fairly stated or when the auditor has substantial doubt about the assertion. Pursuant to paragraph 12, the auditor in those situations is required to perform additional procedures to address the matter. In the context of a review engagement, these additional procedures could include, but are not limited to, making additional inquiries, reading documents, or performing search and verification procedures, as necessary.<sup>35</sup>

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<sup>33</sup> See paragraph 11 of Attestation Standard No. 2.

<sup>34</sup> See "Reporting on the Review Engagement" in this chapter.

<sup>35</sup> See, e.g., AT sec. 101.56.

To illustrate these points, assume that a broker or dealer claims exemption under (k)(1) of SEC Rule 15c3-3 and asserts in the exemption report that there were no exceptions. Yet, the auditor identifies during the review several exceptions in which the broker or dealer failed to promptly transmit all funds received from customers.<sup>36</sup> In those circumstances, the auditor has a responsibility to:

- *Assess the potential for further undisclosed exceptions.* The auditor's identification of one or more previously undisclosed exceptions typically indicates a heightened risk that further undisclosed exceptions might exist, which require auditor attention, as discussed earlier in this section.
- *Evaluate the effect on the review report.* If the auditor communicates the exceptions to the broker or dealer, and the broker or dealer modifies the assertions in the exemption report, modification of the review report is unnecessary. If the broker or dealer does not modify the assertions, however, the auditor should modify the review report (see discussion of "Reporting on the Review Engagement" for modifications to the review report later in this chapter).
- *Assess the effect on the audit of the financial statements and audit procedures on the supporting schedules.* The nature and cause of the exceptions might indicate a previously unidentified risk of material misstatement of the financial statements, for which additional audit procedures are needed. In this example, the nature and cause of the exceptions might indicate a risk that received funds are not recorded in the proper period.

### **Communication Requirements**

The review standard requires the auditor to communicate certain matters to management and the audit committee, as well as to comply with the requirements of paragraph (h) of SEC Rule 17a-5.<sup>37</sup> Additional information on the requirements are discussed in Chapter 2 of this publication.<sup>38</sup>

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<sup>36</sup> Appendix C presents the exemption provisions in paragraph (k) of SEC Rule 15c3-3.

<sup>37</sup> See paragraph 15 of Attestation Standard No. 2.

<sup>38</sup> See also the discussion of the notification requirements in the SEC Release at 101-107.

## Documenting the Work Performed

Auditing Standard No. 3 establishes documentation requirements that apply to the review engagement.<sup>39</sup> Among other things, the auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to the broker's or dealer's assertions.<sup>40</sup> The auditor's documentation should demonstrate that the engagement complied with the standards of the PCAOB.<sup>41</sup>

Also, Auditing Standard No. 3 requires all significant findings or issues identified in the engagement to be included in an engagement completion document.<sup>42</sup> In a review engagement, significant findings include, when applicable: (a) the assessment of, and the responses to, risks requiring special consideration by the auditor; (b) significant matters involving systems, processes, and controls to ensure the appropriateness of the subject matter and management's related assertions; and (c) the evaluation of identified instances of nonconformity with the evaluation criteria (e.g., errors, instances of non-compliances or control deficiencies).<sup>43</sup> Auditing Standard No. 3 allows the auditor to prepare a combined engagement completion document for the audit and the review.<sup>44</sup>

## Reporting on the Review Engagement

The review standard includes requirements for the auditor's review report,<sup>45</sup> which are aligned with the requirements in SEC Rule 17a-5. The auditor should date the review report no earlier than the date on which the auditor has completed his or her review procedures.<sup>46</sup> Because of the coordination between the review engagement and the audit

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<sup>39</sup> Paragraph 1 of Auditing Standard No. 3 states that "the standard establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to the standards of the Public Company Accounting Oversight Board."

<sup>40</sup> See footnote to paragraph 6 of Auditing Standard No. 3.

<sup>41</sup> See paragraph 4 of Auditing Standard No. 3.

<sup>42</sup> See paragraph 13 of Auditing Standard No. 3.

<sup>43</sup> See note to paragraph 12 of Auditing Standard No. 3.

<sup>44</sup> See the second note to paragraph 13 of Auditing Standard No. 3.

<sup>45</sup> See paragraph 16 of Attestation Standard No. 2.

<sup>46</sup> See paragraph 18 of Attestation Standard No. 2.

of the financial statements and the audit procedures performed on the supporting schedules, the date of the review report should not be earlier than the date of the auditor's report on the financial statements and the audit procedures performed on the supporting schedules.<sup>47</sup>

### *Modifications of the Report*

If one or more of the broker's or dealer's assertions are not fairly stated, in all material respects, the auditor must modify the review report to describe the reasons why the assertions are not fairly stated, in all material respects. If the broker's or dealer's assertion is not fairly stated because of one or more omitted exceptions, the auditor's review report should disclose each omitted exception.<sup>48</sup> Exhibit 2 to this chapter includes an example of a review report modified to describe the reasons why the assertions are not fairly stated, in all material respects.

The review standard also sets forth circumstances involving scope limitations.<sup>49</sup> Scope limitations exist when the auditor cannot perform the procedures required by the standard or other procedures that the auditor deems necessary in the circumstances.

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<sup>47</sup> See note to paragraph 18 of Attestation Standard No. 2.

<sup>48</sup> See paragraph 19 of Attestation Standard No. 2. In addition, if the broker or dealer modified its assertions such that they were fairly stated, in all material respects, the auditor would not need to modify the auditor's review report.

<sup>49</sup> See paragraph 20 of Attestation Standard No. 2.

## EXHIBIT 1

### ***Example of a Standard Review Report***

The following example review report, reproduced from paragraph 17 of Attestation Standard No. 2, illustrates the report elements described in paragraph 16 of Attestation Standard No. 2 for an unmodified review report on the assertions made by a broker or dealer in an exemption report, depending on whether the broker's or dealer's exemption report includes exceptions to the exemption provisions:

#### Report of Independent Registered Public Accounting Firm

[ *Introductory paragraph—no exceptions to the exemption provisions included in the broker's or dealer's assertion* ]

We have reviewed management's statements, included in the accompanying [*title of the exemption report*], in which (1) Z Broker identified the following provisions of 17 C.F.R. § 15c3-3(k) under which Z Broker claimed an exemption from 17 C.F.R. § 240.15c3-3: ([*fill in which exemption provision—(1), (2)(i), (2)(ii), or (3)*]) (the "exemption provisions") and (2) Z Broker stated that Z Broker met the identified exemption provisions throughout the most recent fiscal year without exception. Z Broker's management is responsible for compliance with the exemption provisions and its statements.

[ *Introductory paragraph—exceptions to the exemption provisions included in the broker's or dealer's assertion* ]

We have reviewed management's statements, included in the accompanying [*title of the exemption report*], in which (1) Z Broker identified the following provisions of 17 C.F.R. § 15c3-3(k) under which Z Broker claimed an exemption from 17 C.F.R. § 240.15c3-3: ([*fill in which exemption provision—(1), (2)(i), (2)(ii), or (3)*]) (the "exemption provisions") and (2) Z Broker stated that Z Broker met the identified exemption provisions throughout the most recent fiscal year except as described in its exemption report. Z Broker's management is responsible for compliance with the exemption provisions and its statements.

[ *Scope paragraph* ]

Our review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included inquiries and other required procedures to obtain evidence about Z Broker's compliance with the exemption provisions. A review is substantially less in scope

than an examination, the objective of which is the expression of an opinion on management's statements. Accordingly, we do not express such an opinion.

[ *Review results paragraph* ]

Based on our review, we are not aware of any material modifications that should be made to management's statements referred to above for them to be fairly stated, in all material respects, based on the conditions set forth in paragraph (k)(*fill-in which exemption provision—(1), (2)(i), (2)(ii), or (3)*) of Rule 15c3-3 under the Securities Exchange Act of 1934.

[ *Signature* ]

[ *City and State or Country* ]

[ *Date* ]

## EXHIBIT 2

### ***Example of a Modified Review Report—Unreported Exception***

The following example illustrates the report elements described in paragraph 16 of Attestation Standard No. 2 and modifications to the report contained in paragraph 19 of Attestation Standard No. 2 for a report requiring modification due to an unreported exception with the exemption provisions:

#### Report of Independent Registered Public Accounting Firm

[ *Introductory paragraph—no exceptions to the exemption provisions included in the broker's or dealer's assertion* ]

We have reviewed management's statements, included in the accompanying [*title of the exemption report*], in which (1) Z Broker identified the following provisions of 17 C.F.R. § 15c3-3(k) under which Z Broker claimed an exemption from 17 C.F.R. § 240.15c3-3: Paragraph (k)(2)(i) (the "exemption provisions") and (2) Z Broker stated that Z Broker met the identified exemption provisions throughout the most recent fiscal year without exception. Z Broker's management is responsible for compliance with the exemption provisions and its statements.

[ *Scope paragraph* ]

Our review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included inquiries and other required procedures to obtain evidence about Z Broker's compliance with the exemption provisions. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's statements. Accordingly, we do not express such an opinion.

[ *Review results paragraphs* ]

The accompanying [*title of the exemption report*] includes a statement that Z Broker met the exemption provisions without exception. During our review, we have identified that in one instance occurring on [*date*], Z Broker did not promptly remit all funds and securities received from customers in accordance with the identified exemption provisions during the last week of the most recent fiscal year.<sup>50</sup> Because of this exception, we believe the statement in the [*title of the*

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<sup>50</sup> See paragraph (d)(4)(iii) of SEC Rule 17a-5, which describes the exemption report requirement when a broker or dealer identifies an exemption. Paragraph (d)(4)(iii) states that "[i]f applicable, a statement that identifies each exception during the most

*exemption report*] was required to be modified and the exception was required to be disclosed in the [*title of the exemption report*].

Based on our review, with the exception of the matters described in the preceding paragraph, we are not aware of any material modifications that should be made to management's statements referred to above for them to be fairly stated, in all material respects, based on the provisions set forth in paragraph (k)(2)(i) of Rule 15c3-3 under the Securities Exchange Act of 1934.

[ *Signature* ]

[ *City and State or Country* ]

[ *Date* ]

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recent fiscal year in meeting the identified exemption provisions in § 240.15c3-3(k) and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed."

## **Appendix A: Recent PCAOB and SEC Releases Relevant to Audits of Brokers and Dealers**

This appendix lists certain releases from the PCAOB and SEC that are relevant to audits of brokers and dealers. This list is not all-inclusive.

### **PCAOB Releases for Standards and Rules**

- PCAOB Release No. 2013-010, *Amendments to Conform The Board's Rules and Forms to the Dodd-Frank Act and Make Certain Updates and Clarifications* (December 4, 2013)
- PCAOB Release No. 2013-007, *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)
- PCAOB Release No. 2013-008, *Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards* (October 10, 2013)
- PCAOB Release No. 2011-001, *Temporary Rule for an Interim Inspection Program for the Audits of Brokers and Dealers* (June 14, 2011)
- PCAOB Release No. 2011-002, *Board Funding 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 General Inspection Reports**

- PCAOB Release No. 2013-006, *Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers* (August 19, 2013)
- PCAOB Release No. 2012-005, *Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers* (August 20, 2012)

### **Recent SEC Releases**

- SEC Exchange Act Release No. 70072, *Financial Responsibility Rules for Broker-Dealers* (July 30, 2013)
- SEC Exchange Act Release No. 70073, *Broker-Dealer Reports* (July 30, 2013)

**Recent SEC Staff Frequently Asked Questions**

- Division of Trading and Markets, *Frequently Asked Questions Concerning the July 30, 2013 Amendments to the Broker-Dealer Financial Reporting Rule*, SEC (April 4, 2014)

## ***Appendix B: Auditing Considerations for Particular Accounts and Records of Brokers and Dealers***

This appendix discusses some of the possible risks associated with particular accounts and records that are specific to brokers and dealers, including smaller and less complex brokers and dealers, and audit and attest procedures that can provide evidence in responding to those risks. The accounts and records described in this appendix include the stock record, suspense accounts, customers' accounts, omnibus and fully-disclosed accounts, securities, subordinated borrowings, and accounts related to fees and other revenue sources.

This appendix does not describe all possible risks, all accounts, or all procedures that may be relevant for an audit or attestation engagement of a broker or dealer.<sup>1</sup> Auditors should look to the requirements in PCAOB auditing standards and attestation standards and also consider the specific facts and circumstances related to the broker or dealer, including, for example, the nature of its operations, when determining the nature, timing, and extent of procedures necessary for an individual audit or attestation engagement of a broker or dealer.

In general, the procedures discussed in this appendix provide evidence for one or more of the following purposes:

- a. *To address certain risks of material misstatement of the financial statements.*<sup>2</sup> This appendix presents examples of possible risks of material misstatement of the financial statements for each account or record described below.

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<sup>1</sup> For example, this appendix does not address certain accounts, such as good faith deposits and private placements, that are more likely to be encountered in audits of larger or more complex brokers and dealers or of brokers and dealers in specialized lines of business. Also, this appendix does not address accounts, such as property and equipment, that are common across all industries.

<sup>2</sup> See Auditing Standard No. 13 for the auditor's requirements regarding designing and implementing appropriate responses to the risks of material misstatement.

- b. *To test information in performing audit procedures on supplemental information.*<sup>3</sup> Each account described in this appendix is a component of one or more of the supporting schedules required by SEC Rule 17a-5, on which the auditor performs procedures and reports. The auditor is responsible for testing, among other things, the completeness and accuracy of the information presented in the supporting schedules prepared by the broker or dealer.<sup>4</sup>
- c. *To test compliance with certain rules in examination engagements.*<sup>5</sup> In examination engagements, auditors perform procedures to test the broker's or dealer's compliance with the net capital rule and the reserve requirements rule as of the end of its most recent fiscal year.<sup>6</sup>

## Stock Record

The stock record is a ledger identifying the ownership and location of all securities for which the broker or dealer has custodial responsibility or proprietary ownership. As such, the stock record contains transaction information for all customers' accounts and proprietary accounts. The stock record includes both long positions<sup>7</sup> and short positions<sup>8</sup> and should always be in balance (that is, the total long positions should equal the total short positions). Although the majority of information, specifically customers' assets and liabilities, contained within the stock record is not on the broker's or dealer's balance sheet

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<sup>3</sup> See Auditing Standard No. 17 for the requirements when the auditor is engaged to perform audit procedures and report on supplemental information that accompanies financial statements audited under PCAOB standards.

<sup>4</sup> See paragraph 4.e. of Auditing Standard No. 17.

<sup>5</sup> See Attestation Standard No. 1 for the requirements when an auditor performs an examination engagement.

<sup>6</sup> See paragraph 21 of Attestation Standard No. 1.

<sup>7</sup> Long positions in the stock record refer to those securities that are owned by a customer or the broker or dealer. Long positions represent assets of the customer, broker, or dealer.

<sup>8</sup> Short positions in the stock record refer to the location of securities or the responsibility of other parties to deliver these to the broker or dealer. Short positions, among others, include those securities that were sold by the customer, broker, or dealer before the securities were purchased and represent liabilities of the customer, broker, or dealer.

nor disclosed in the notes to the financial statements, the stock record warrants audit attention. For example, errors in the stock record could lead to, among other things, inaccurate regulatory computations or be indicative of loss of customer assets. Inaccurate recording of positions in the stock record also could result in inappropriate allocation of revenues to customers (e.g., interest, dividends, gains, or losses) and corporate actions (e.g., stock splits) not recorded in customers' accounts. Incomplete or unrecorded transactions in securities accounts not reflected in the stock record could result in inaccurate regulatory computations and operational charges. Also, misstatements identified in the stock record can be indicative of, or result in, misstatements in other accounts, such as securities accounts, customers' accounts, and suspense accounts.

### *Audit and Attest Procedures*

The procedures discussed in this section generally serve one or more of the following purposes:

- To determine whether the stock record is complete and accurate as to proprietary and customer assets and liabilities, including classification of long and short positions and customer versus proprietary balances;
- To determine whether the security positions in a broker's or dealer's stock record are in balance;
- To obtain evidence of the existence of securities positions within the stock record; and
- To obtain evidence of the completeness and accuracy of the stock record, which is a primary source of information used in the SEC Rule 15c3-3 computation of the reserve requirement.

Procedures to test existence of securities in the stock record can be performed in conjunction with the testing of other accounts and disclosures, including securities accounts, customers' accounts, and suspense accounts. (See also "Securities," "Customers' Accounts," and "Suspense Accounts" in this appendix for further discussion.)

Procedures that can provide evidence of completeness and existence of securities consist of (1) confirmation of positions and (2) inspection of account reconciliations.

Confirmation. Confirmation of securities positions with custodians, depositories, or customers, as applicable, can provide evidence regarding the existence and completeness of securities positions in the stock record. (See also "Securities" in this appendix for further discussion.)

Inspection and Reperformance. Inspection of account reconciliations prepared by the broker or dealer of the long and short positions within the stock record to the various subsidiary ledgers by investment type maintained by the broker or dealer can provide evidence regarding the completeness of the stock record. Reperformance of the account reconciliation, by comparing the broker's or dealer's records to any statements received directly through confirmation procedures, also can provide evidence regarding the completeness and accuracy of the stock record.

Other procedures. In an examination engagement, procedures performed over the stock record can be designed such that the auditor also tests the broker's or dealer's controls over the computation of reserve requirements.<sup>9</sup> In the audit of the financial statements and audit procedures over the supporting schedules, audit procedures over the stock record can provide evidence as to the completeness and accuracy of the information used to prepare the supporting schedules. Relevant procedures include determining whether securities have been appropriately classified: (1) as customer versus proprietary; (2) in the appropriate security type; and (3) as to where the securities are held.

### **Suspense Accounts**

Brokers or dealers maintain purchases, sales, and operations suspense accounts in order to record transactions with customers or other parties that are yet to be cleared. Suspense accounts are usually monitored and reconciled by brokers or dealers periodically so the amounts can be properly recorded as income or expenses or reclassified to other accounts, such as securities, customer receivable, or customer payable. Because suspense accounts can affect several accounts and disclosures and their relevant assertions, unusually large balances or aged items in these accounts could indicate risks of material misstatement due to inaccurate recording of the underlying transactions.

Suspense accounts that are not properly monitored and contain many aged items can affect the net capital and reserve computations and the risk of non-compliance with the net capital rule and reserve requirements rule. For example, items aged over a certain period of time may result in operational charges, which could affect compliance with the net capital requirements. Also, items not properly reclassified against customer debit or credit balances may result in misstatement of the minimum requirement for the reserve bank account.

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<sup>9</sup> See paragraph 21.a. of Attestation Standard No. 1. Additional information on the required procedures performed during an examination engagement is available in Chapter 3 of this publication.

### *Audit and Attest Procedures*

The procedures discussed in this section generally serve one or more of the following purposes:

- To obtain an understanding of how the broker or dealer monitors and reconciles suspense account activities;
- To test the broker's or dealer's analysis of the suspense account activities for accuracy of aging and classification; and
- To determine whether the broker or dealer has properly recorded suspense accounts in the computation of net capital and/or in the computation of the reserve requirements.

Inquiry and Inspection. Inquiries of individuals responsible for preparing the suspense account reconciliation can provide information about how the broker or dealer monitors and reconciles these accounts. Inspection of account reconciliations and testing of reconciliation data, including resolution of outstanding items subsequent to year end, can provide evidence regarding the accuracy of aging and classification of suspense items.

Confirmation. For suspense account entries that arise when only one side of pending buy or sell transactions are processed, confirmation of transactions with the third parties whose order was processed can provide evidence of the existence of those orders at a specific date.

Other procedures. Comparison of reconciling items with underlying records, or other procedures, such as reviewing evidence of the subsequent clearing of a reconciling item after year-end also can provide evidence of the existence, completeness, and accuracy of outstanding items as of a specific date.

### **Customers' Accounts**

Customers' accounts are neither recorded in the broker's or dealer's statement of financial condition nor disclosed in the notes to the financial statements. However, customers' accounts warrant audit attention because they pose risks of material misstatement of the financial statements, for example, customers' accounts may create contingent liabilities for the broker or dealer. Also, a portion of the transactions in customers' accounts represent transactions in the broker's or dealer's accounts, particularly in customer receivables and payables. Further, customers' accounts are a significant component of the computation of reserve requirements. Thus, misstatements in customers' accounts can result in misstatements of the broker's or dealer's financial

statements or the supporting schedules. Misstatements in customers' accounts also could result in inaccurate computation of reserve requirements and insufficient cash segregated for the benefit of customers. In addition, misappropriation or loss of customers' assets exposes the broker or dealer to potential liability.

### *Audit and Attest Procedures*

The procedures discussed in this section generally serve one or more of the following purposes:

- To test the existence of customers' accounts and to determine whether they are recorded at the proper amounts, including whether securities in customers' accounts are properly valued;
- To determine whether securities in customers' accounts are properly classified (for example, margined versus not margined accounts; fully secured, partially secured, or unsecured accounts); and
- To determine whether customers' accounts are properly considered in determining compliance with the net capital rule or the reserve requirements rule.

Confirmation. Confirmation with customers can provide evidence regarding the completeness of customers' accounts and security positions. To address risks of non-compliance and material misstatement associated with both understatement and overstatement of customers' accounts, it is important to include zero balance accounts in the population from which accounts are selected for confirmation.

Other procedures. The auditor must perform procedures to obtain evidence about the existence of customer funds or securities held for customers under paragraph 23 of Attestation Standard No. 1. In the examination engagement and when testing the supporting schedules, these procedures include testing customers' accounts for evidence of under-margined, partly secured, or unsecured positions that may affect the net capital computation under SEC Rule 15c3-1 and the reserve and possession-or-control requirements of SEC Rule 15c3-3, as well as the collectability of accounts.<sup>10</sup>

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<sup>10</sup> In performing such tests, it may be helpful to obtain a report that indicates, for each customer's account, the ledger balance and the market values of all securities positions in the account (an "equity run").

Testing customers' accounts also includes obtaining evidence of commitments to purchase or sell securities that may affect the reserve and possession-or-control requirements of SEC Rule 15c3-3, as well as the collectability of accounts.<sup>11</sup>

The fair values of customer security positions are used to compute reserve requirements in accordance with SEC Rule 15c3-3 or to compute net capital under SEC Rule 15c3-1. AU sec. 328, *Auditing Fair Value Measures and Disclosure*, sets forth procedures for testing fair value measurements and disclosures.

### **Omnibus and Fully-Disclosed Accounts**

The components of an omnibus account and a fully-disclosed account are recorded in the financial statements of the broker or dealer to the extent that such components relate to pending (or unsettled) trade activity of customers or reflect proprietary accounts of the broker or dealer. The remaining components are off-balance sheet as the positions are not owned by the broker or dealer.

Omnibus and fully-disclosed accounts warrant audit attention because they pose certain risks of material misstatement of the financial statements. Omnibus and fully-disclosed accounts are part of the books and records of both carrying brokers and introducing brokers. For a carrying broker, problematic execution of trades and recording of trade information and the associated clearing fees could affect the existence and accuracy of the clearing fee revenue reported and could lead to contractual penalties due to violations of the clearing agreement or regulatory fines for violations of rules and regulations of applicable regulatory agencies. For the introducing broker, inaccurate or incomplete recording of customer trade activity in the introducing broker's books and records may lead to errors in the stock record, which could lead to errors in the financial statements and might result in contingent liabilities for the broker or dealer (see "Stock Record" in this appendix for further discussion).

#### *Audit and Attest Procedures*

The procedures discussed in this section generally serve one or more of the following purposes:

- To test the completeness and accuracy of trading activity for customers' accounts and proprietary accounts held on a fully-disclosed and/or omnibus basis;

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<sup>11</sup> See paragraphs 4.d. and 4.e. of Auditing Standard No. 17.

- To determine whether fee revenues and expenses related to customers' accounts held on a fully-disclosed and/or omnibus basis were properly recorded in the financial statements; and
- To determine whether security positions held on a fully-disclosed and/or omnibus basis are accurately reflected in determining compliance with the net capital rule and the reserve requirements rule.

When performing procedures at an introducing broker over customers' accounts held on an omnibus or a fully-disclosed basis, it is important to understand the relationship with the carrying broker and to understand the extent to which the introducing broker's processes and controls rely on the processes and controls of the carrying broker. For example, AU sec. 324 applies when an introducing broker obtains services from a carrying broker that are part of the introducing broker's information system.

#### *Procedures for Omnibus Accounts*

Confirmation. For carrying brokers holding customers' accounts on an omnibus basis, confirmation of balances in omnibus accounts with the introducing broker can provide evidence of the existence of the account and accuracy of the balance. This includes investigating differences between the carrying broker's books and confirmation responses, as well as any reconciling items.

For introducing brokers forwarding orders on an omnibus basis, confirmation of the balance in the omnibus account with the carrying broker can provide evidence of existence and accuracy of the account balance. This includes examining supporting documentation for reconciling items or other differences between the confirmation response and the broker's records. Confirmation of transactions in customers' accounts directly with customers also can provide evidence of the existence of those transactions. (See "Customers' Accounts" in this appendix for further discussion.)

Other procedures. For carrying brokers holding customer accounts on an omnibus basis, tests of transactions in these accounts can provide evidence regarding whether trades are executed and completed properly, timely, and in compliance with contractual agreements and regulatory requirements. These tests also can provide evidence that the related fees have been recorded properly.

#### *Procedures for Fully-Disclosed Accounts*

Customer account audit procedures. For carrying brokers holding customers' accounts on a fully-disclosed basis, the auditing procedures for those accounts are similar to those performed on their customers' accounts, because the accounts of the introducing

broker's customers are maintained on the books of the carrying broker, as if they were customers of the carrying broker. (See "Customers' Accounts" for further discussion.)

Confirmation. For introducing brokers forwarding orders on a fully-disclosed basis, confirming the account balance by individual customer with the carrying broker can provide evidence of the existence of these accounts. Account reconciliations can be tested by comparing daily trading activity summaries received from the carrying broker through the confirmation process with documentation maintained by the introducing broker.

Recalculation. For carrying brokers, recalculating carrying and clearing fees (revenues) earned for carrying the other broker's accounts or clearing another broker's transactions based on the terms of the related agreements can provide evidence of the accuracy of the recorded fees and identify any potential deferred revenue. (See also "Trading Gains and Losses, Transaction Fees, Commissions, Mutual Fund Fees, and Other Income Accounts" in this appendix for other risks and example audit procedures responding to those risks regarding revenues of brokers and dealers).

For introducing brokers, recalculating clearing fees based on the terms of the related agreements can provide evidence of the accuracy of the recorded fees and can identify potential contingencies that arise out of the clearing agreement for guarantees of the deficits of introduced customers.

Other procedures. For introducing brokers forwarding orders on a fully-disclosed basis, testing whether the introducing broker is credited with the agreed-on fee for trades generated by its customers, whether the trades were executed in accordance with its instructions, and whether the fees comply with the applicable agreement can provide evidence regarding the accuracy and proper recording of customer transactions.

## **Securities**

The securities handled by brokers and dealers include:

- Securities in physical possession or in custody with branch offices;
- Securities held in the street name;
- Securities in or out for transfer, exchange, or redemption;
- Securities in custody with depositories;
- Securities failed to receive and failed to deliver; and

- Securities used in collateralized transactions<sup>12</sup> (securities borrowed and loaned, securities held under repurchase and reverse repurchase agreements, and securities held as collateral for bank loans).

Each category of security should be reflected in the stock record, but only securities owned or securities sold, not yet purchased by the broker or dealer are included in the statement of financial condition. The securities of the broker or dealer engaging in proprietary trading activities (that is, the broker or dealer is trading for its own account) may be presented in the statement of financial condition as trading or investment accounts, securities owned, or securities sold, not yet purchased. Securities transactions of either the broker or dealer or its customers that resulted in a receivable or payable for the broker or dealer are also reflected in the financial statements, as are those securities used in collateralized transactions.

Substantial portions of the securities in physical possession represent transactions of customers and other brokers and dealers that are not recorded in the financial statements of the carrying broker. Securities owned by other brokers or dealers and customers are recorded on the carrying broker's statement of financial condition only if: (1) there is an outstanding receivable or payable between the broker, dealer, or customer and the carrying broker for securities transactions; (2) the customer has a margin account (a receivable to the carrying broker); or (3) the customer's assets include cash positions (a payable by the carrying broker).

Errors in the recorded amounts of securities in physical possession in the stock record—including securities held in custody with branch locations—can result in misstatements of the broker's or dealer's financial statements and supporting schedules.

Securities in or out for transfer, exchange, or redemption, securities failed to receive, and securities failed to deliver that are not properly recorded could increase the risk of improper cut-off or inaccurate recording of security positions in the stock record, which also could result in misstatements of the broker's or dealer's financial statements and supporting schedules.

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<sup>12</sup> Securities held as collateral that are not owned by the broker or dealer are included in the stock record, but do not represent securities owned by the broker or dealer and as such, are not included in the securities owned balance in the statement of financial condition. On the contrary, securities that the broker or dealer has transferred to a third party to hold as collateral for the broker's or dealer's own borrowing would be accounted for as securities owned on the statement of financial condition and included in the stock record.

Securities held in custody with depositories represent securities owned by the broker or dealer and the customers of the broker or dealer. A failure to account for all securities held in custody with depositories could result in an incomplete stock record and accordingly, the broker's or dealer's proprietary positions may be misstated in the statement of financial condition or the customer security positions may be misstated in the computation of reserve requirements.

Market conditions can affect the risk of improper classification of securities between readily and not readily marketable, and some securities that are thinly traded may have less observable market data on which to determine fair value. Securities that have been improperly classified or valued can result in errors in regulatory computations. For example, the classification of securities affects the determination of the haircut percentages, which in turn, affects the net capital computation. Further, investments that are not readily marketable may have increased risk of material misstatement when there are fewer observable market inputs and there is a wide range of measurement uncertainty.

#### *Audit and Attest Procedures*

The procedures discussed in this section generally serve one or more of the following purposes:

- To test the existence of the securities;
- To determine whether the securities have been recorded at the proper amount (including consideration of quantity and cost), properly accounted for, and recorded in the proper period;
- To determine whether the fair value of securities is reasonable and in conformity with generally accepted accounting principles as of the reporting date; and
- To determine whether the securities' balances have been properly reported in the computations of the net capital and the reserve requirements, as applicable.

Physical Inspection and Observation. Performance of a physical inspection in the form of a security count provides evidence of the existence of securities in physical possession and held in custody with branch offices of the broker or dealer.<sup>13</sup> For securities

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<sup>13</sup> See paragraphs .09 and .12 of AU sec. 331, *Inventories*, for a description of how an auditor may obtain evidence from performing physical counts.

in or out for transfer, exchange, or redemption, physical inspection of the securities when they are returned to the broker or dealer after year-end, combined with additional procedures to cover the intervening period between year-end and the inspection date, can provide evidence of existence of these securities. Inspection procedures include testing the adjustments made to the stock record or account balances resulting from the security counts to determine whether these securities are properly reflected in the broker's or dealer's financial statements and supporting schedules.

Observing the security count performed by management of the broker or dealer can provide evidence of existence of those securities and, in an examination engagement, controls over compliance with the quarterly security count requirements of SEC Rule 17a-13.<sup>14</sup>

Confirmation. For securities out for transfer, exchange, or redemption, confirmation with transfer agents or corporate issuers can provide evidence of the existence of those securities. For security positions held in custody on behalf of the broker or dealer, confirmation directly with depositories and clearing organizations as of the date of the statement of financial condition can provide evidence of the existence of the types of securities and quantity of such positions.

For securities failed to receive and failed to deliver, securities borrowed and loaned, securities held under repurchase and reverse repurchase agreements, and securities held as collateral for bank loans, confirmation sent to the appropriate counterparties (for example, custodians, depositories, and lenders) can provide evidence of the existence and completeness of these securities accounts.

Confirmation of securities transaction activity also can provide evidence that transactions have been recorded in the appropriate period and help the auditor to determine if the proper receivables or payables have been recorded in the balance sheet.

Confirming the existence of securities can be performed in conjunction with other confirmation procedures related to the stock record or customers' accounts. For example, confirmation of securities being held by other parties or securities out on loan to the broker or dealer can be performed in conjunction with confirmation of the related receivable or

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<sup>14</sup> Paragraph (b) of SEC Rule 17a-13 requires the broker or dealer to perform quarterly physical inspections of securities and to account for and verify the security account balances for all securities in transit, pledged, loaned, borrowed, deposited, failed to receive, failed to deliver, subject to repurchase or reverse repurchase agreements or otherwise subject to his control or direction but not in his physical possession, where such securities have been in said status for longer than thirty days.

payable. (See also "Stock Record" and "Customers' Accounts" in this appendix for additional discussion.)

Inspection and Reperformance. For securities in physical possession and those in custody with branch offices, inspecting and testing account reconciliations performed by the broker or dealer or reperforming portions of the security counts performed by the broker or dealer at the test date can provide evidence of completeness and accuracy of the security positions.

For securities used or received in collateralized transactions and those in custody with depositories and clearing organizations, inspecting and testing the account reconciliations prepared by the broker or dealer of the related positions can provide evidence regarding the completeness of the stock record with respect to those security types (e.g., securities used or received in collateralized transactions and those in custody with depositories and clearing organizations). Also, for these security types, reperforming account reconciliations—including comparing the broker's or dealer's records to statements received through the confirmation process directly from custodians, depositories, lenders, or clearing organizations through the confirmation process—can provide evidence of the accuracy of the transaction recording.

Reperformance. Reperformance of the reconciliation of the trading department position records to the stock record can provide evidence as to the completeness of the broker's or dealer's proprietary accounts. Also, such reperformance can provide evidence that unsettled trading activities and related profits or losses have been properly recorded in the balance sheet and income statement.

Other procedures. In the examination engagement, testing compliance with the net capital rule and reserve requirements rule involves performing procedures to obtain evidence of the existence and valuation of securities that affect the net capital and reserve computations.<sup>15</sup> It also involves evaluating whether securities have been appropriately classified as allowable or non-allowable in the net capital computation.<sup>16</sup> Testing the existence of securities also may be performed in conjunction with testing the stock record, if that is the primary source of information for the required reserve computation. These

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<sup>15</sup> See generally paragraphs 21 and 23 of Attestation Standard No. 1.

<sup>16</sup> Id.

procedures can be performed in conjunction with testing the supporting schedule of net capital pursuant to Auditing Standard No. 17.<sup>17</sup>

The auditor's tests of the broker's or dealer's proprietary accounts include obtaining evidence of commitments to purchase or sell securities that may affect the supporting schedule of net capital computation under SEC Rule 15c3-1.<sup>18</sup>

Many securities serviced by brokers or dealers are located at depositories, custodians, or clearing organizations. AU sec. 324 applies when a broker or dealer obtains services from another organization that are considered part of the broker's or dealer's information system. This includes services that affect the financial reporting process used to prepare the company's financial statements, significant accounting estimates, and disclosures. AU sec. 324 also describes considerations for the user auditor when planning and performing the audit, including the user auditor's consideration of the service organization's effect on the user organization's internal control, the user auditor's assessment of control risk, and the user auditor's response to risks identified, whether through tests of controls or substantive tests.<sup>19</sup>

As previously mentioned, the valuation of customers' accounts is a significant component of the broker's or dealer's computation of reserve requirements under SEC Rule 15c3-3. The valuation of proprietary accounts is a significant component of the computation of net capital under SEC Rule 15c3-1. AU sec. 328 establishes requirements for testing fair value measurements of securities in the broker's or dealer's financial statements.

Also, audit procedures performed to test the valuation and classification of the broker's or dealer's investments as of the end of the fiscal year can provide evidence relevant to testing the broker's or dealer's compliance with the net capital rule. Testing the applied haircut percentages also is an important part of testing the broker's or dealer's compliance with the net capital rule.

### **Subordinated Borrowings**

Subordinated borrowings are components of the net capital computation and are reported as mezzanine debt on the statement of financial condition of the broker or dealer. In order for a subordinated borrowing to qualify as equity for net capital purposes, the broker or dealer needs to obtain approval from the broker's or dealer's DEA. Lack of DEA

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<sup>17</sup> See paragraph 3.c. of Auditing Standard No. 17.

<sup>18</sup> See generally paragraph 4 of Auditing Standard No. 17.

<sup>19</sup> See AU secs. 324.05-.21.

approval of subordinated borrowings could significantly affect the computation of net capital pursuant to SEC Rule 15c3-1 and can result in non-compliance with the minimum net capital requirements.

#### *Audit and Attest Procedures*

The procedures discussed in this section generally serve one or more of the following purposes:

- To test the existence of cash subordination or secured demand note agreements;
- To determine that subordinated borrowings are properly recorded and disclosed; and
- To determine whether subordinated borrowings are properly classified in determining compliance with the net capital rule.

Confirmation. Confirmation with the appropriate counterparties can provide evidence of important information affecting the accounting and disclosure of subordinated borrowings and net capital. Confirmation responses also can provide information about cash subordination or secured demand note agreements, including expiration dates of the agreements, the amounts subordinated, collateral, other significant contractual provisions, and the nature of the liability to the counterparty.<sup>20</sup>

Inspection. Inspection of the relevant documentation can provide evidence about whether the subordinated borrowing transactions have been approved by the DEA.

Other procedures. Inspecting the subordination agreement and evaluating compliance with covenants in the agreement is important for evaluating presentation and disclosure of the agreement in the financial statements and determining whether they are accurately reflected in the computation of net capital.<sup>21</sup>

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<sup>20</sup> See AU secs. 330.24-.25 for the nature of information that can be confirmed, for example, terms of the borrowing.

<sup>21</sup> See also paragraph .07 of AU sec. 337, Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments.

## **Trading Gains and Losses, Transaction Fees, Commissions, Mutual Fund Fees, and Other Income Accounts**

Brokers and dealers record revenue from a variety of activities, including trading gains and losses, fees and commissions for executing transactions, providing credit to customers, underwriting transactions, or by sponsoring, distributing, and advising mutual funds. Brokers and dealers that have proprietary securities accounts record trading gains and losses. Carrying brokers also earn revenue from clearing transactions of other brokers and dealers and customers. Brokers or dealers that actively manage mutual funds may have deferred sales charges in addition to mutual fund fees (for example, SEC Rule 12b-1 fees). Errors in accounting for purchases and redemptions of mutual fund shares in the name of the customer or in the name of the broker or dealer could result in misstatement of the broker's or dealer's liabilities or inaccurate recording of fees and amortization.

Understanding how revenue is generated, how the related transactions are initiated and recorded, how fair value measurements are determined, and the controls over these processes, can help the auditor to assess the risk of material misstatement associated with revenue recognition and determine the necessary responses to address such risk.<sup>22</sup>

### *Audit Procedures*

The procedures discussed in this section generally serve one or more of the following purposes:

- To test the accuracy and completeness of trading gains and losses, transaction fees, commissions, mutual fund fees, and other income accounts;
- To determine whether trading gains and losses, transaction fees, commissions, mutual fund fees, and other income accounts have been accounted for in conformity with the applicable financial reporting framework; and
- To determine whether trading gains and losses, transaction fees, commissions, mutual fund fees, and other income accounts are recorded in

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<sup>22</sup> PCAOB standards require the auditor to presume that revenue recognition represents a fraud risk. See paragraph 68 of Auditing Standard No. 12.

the appropriate period and properly presented in the statement of income and notes to the financial statements.

Auditing revenue involves, among other things, performing tests to determine whether revenue has been recognized in conformity with U.S. generally accepted accounting principles. Auditing revenue can also involve determining whether assets under management used to calculate fees were complete and whether the fair values of securities owned used to determine trading gains and losses were reasonable. The nature, timing, and extent of the procedures performed should be determined based on the auditor's understanding of the broker or dealer, composition of revenues, specific attributes of the revenue transactions, and unique industry considerations.<sup>23</sup>

Depending on the type of revenue transactions, testing revenue might involve evaluating whether revenue should be recognized on a gross or net basis, evaluating the effect of contractual provisions on revenue recognition, and determining whether commission rates used to compute commission revenue are consistent with the underlying agreements, as such agreements may be unique to each individual transaction. For example, often, the salaries of traders are based on transaction volume and revenue earned from each transaction, and at times, commission rates are negotiated on a transaction by transaction basis. This may create an incentive for traders to manipulate commission revenue to increase the salaries paid to them.

To address the risk of material misstatement regarding 12b-1 fees, it is important for auditors to test the year-end accrual as well as fee income for the year.

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<sup>23</sup> See paragraph .54 of AU sec. 316 for additional examples of auditing procedures to address revenue recognition as a fraud risk factor.

### **Appendix C: Exemption Provisions in SEC Rule 15c3-3(k)**

This appendix presents the provisions ("exemption provisions") set forth in paragraph (k) of SEC Rule 15c3-3 for exemption from the requirements of the reserve requirements rule, that is, SEC Rule 15c3-3(e):

(k) *Exemptions.* (1) The provisions of this section shall not be applicable to a broker or dealer meeting all of the following conditions:

- (i) The broker's or dealer's transactions as dealer (as principal for its own account) are limited to the purchase, sale, and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company; except that a broker or dealer transacting business as a sole proprietor may also effect occasional transactions in other securities for its own account with or through another registered broker or dealer;
- (ii) The broker's or dealer's transactions as broker (agent) are limited to:
  - (a) The sale and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company;
  - (b) the solicitation of share accounts for savings and loan associations insured by an instrumentality of the United States; and
  - (c) the sale of securities for the account of a customer to obtain funds for immediate reinvestment in redeemable securities of registered investment companies; and
- (iii) The broker or dealer promptly transmits all funds and delivers all securities received in connection with its activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.
- (iv) Notwithstanding the foregoing, this section shall not apply to any insurance company which is a registered broker-dealer,

and which otherwise meets all of the conditions in paragraphs (k)(1) (i), (ii), and (iii) of this section, solely by reason of its participation in transactions that are a part of the business of insurance, including the purchasing, selling, or holding of securities for or on behalf of such company's general and separate accounts.

- (2) The provisions of this section shall not be applicable to a broker or dealer:
  - (i) Who carries no margin accounts, promptly transmits all customer funds and delivers all securities received in connection with its activities as a broker or dealer, does not otherwise hold funds or securities for, or owe money or securities to, customers and effectuates all financial transactions between the broker or dealer and its customers through one or more bank accounts, each to be designated as "Special Account for the Exclusive Benefit of Customers of (name of the broker or dealer)"; or
  - (ii) Who, as an introducing broker or dealer, clears all transactions with and for customers on a fully disclosed basis with a clearing broker or dealer, and who promptly transmits all customer funds and securities to the clearing broker or dealer which carries all of the accounts of such customers and maintains and preserves such books and records pertaining thereto pursuant to the requirements of §§240.17a-3 and 240.17a-4 of this chapter, as are customarily made and kept by a clearing broker or dealer.
- (3) Upon written application by a broker or dealer, the Commission may exempt such broker or dealer from the provisions of this section, either unconditionally or on specified terms and conditions, if the Commission finds that the broker or dealer has established safeguards for the protection of funds and securities of customers comparable with those provided for by this section and that it is not necessary in the public interest or for the protection of investors to subject the particular broker or dealer to the provisions of this section.