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

**PCAOB Release No. 2013-006
August 19, 2013**

Executive Summary

The Public Company Accounting Oversight Board (the "PCAOB" or the "Board") is issuing this second report on the progress of its interim inspection program for auditors of brokers and dealers registered with the Securities and Exchange Commission ("SEC" or the "Commission"). This report describes observations noted during inspections performed during the period covering March 1, 2012 to December 31, 2012; lists a number of considerations pertaining to the scope of a permanent inspection program that the Board is currently evaluating; and describes recent developments and next steps of the Board's interim inspection program. The Board issued its first progress report on August 20, 2012 (the "2012 Report").

Inspections of Registered Public Accounting Firms

This report describes observations noted in the Board's inspections of portions of 60 audits conducted by 43 firms. At the time of the inspections, 19 of the 43 firms were subject to regular inspection as they also audited issuers, generally referred to as public companies. The remaining 24 firms did not audit issuers and were not subject to regular inspection other than under the interim inspection program.

Failure to Satisfy Independence Requirements

In 22 of the 60 audits selected for inspection, it appeared to Inspections staff that, contrary to the requirements of SEC independence rules, auditors were involved in the preparation of the financial statements that they audited. These independence findings were identified in approximately eight percent of the audits selected for inspection that were performed by firms that audited brokers and dealers and also audited issuers. In contrast, independence findings were identified in approximately 80 percent of the audits selected for inspection that were performed by firms that audited brokers and dealers but did not audit issuers.

Audit Deficiencies

Inspections staff identified audit deficiencies in 57 of the 60 audits selected for inspection. Deficiencies were identified across the spectrum of brokers and dealers selected, regardless of their characteristics. These brokers and dealers varied based on minimum net capital requirements, exemptions claimed, lines of business, reported revenues, and reported assets. In addition, these deficiencies were also identified across the firms that were inspected, regardless of whether they also audited issuers.

Inspections staff did not identify deficiencies in every selected portion of the audits. For example, no deficiencies were identified in audit procedures performed on

the supporting schedule for information related to possession or control of securities, for the 13 audits selected of brokers and dealers that did not claim an exemption under Securities Exchange Act of 1934 ("Exchange Act") Rule 15c3-3 ("Rule 15c3-3" or the "Customer Protection Rule").

Deficiencies in compliance with audit requirements for brokers and dealers under the Exchange Act were most frequently noted with respect to:

- Audit procedures related to net capital and customer reserve supporting schedules, compliance with the conditions of the exemption claimed by the broker or dealer, and the accountant's supplemental report on material inadequacies. Deficiencies in at least one of these areas were noted in more than one-third of the audits selected for inspection.
- Audit procedures regarding tests of revenue, related parties, and the consideration of fraud in the audit of the financial statements. Deficiencies in at least one of these areas were noted in more than one-third of the audits selected for inspection.

The Board is particularly troubled by the nature and frequency of these deficiencies in the performance of audits and the continued identification of independence findings.

Actions Needed

The Board urges registered public accounting firms that audit brokers and dealers, and other interested parties, to read this report in its entirety for a more detailed description of the inspection findings. All registered public accounting firms that issue audit reports for SEC-registered brokers and dealers should consider whether the audit deficiencies and independence findings described in this report might be present in audits they currently perform, and should take appropriate action to prevent or correct any such deficiencies.

The Board encourages registered public accounting firms that audit brokers and dealers to continually stress to their personnel the critical need to conduct audits with due professional care, including professional skepticism. The Board also encourages registered public accounting firms to take action to help prevent the types of deficiencies and findings identified in this report from occurring in the future by reviewing the following:

- Arrangements with brokers and dealers and quality control procedures to help ensure that SEC independence rules are not violated;
- Guidance and training to determine whether the topics noted as observed audit deficiencies identified in the report are given appropriate attention; and
- Policies for supervision and review to help ensure their partners and supervisory personnel are placing appropriate attention on these areas.

In addition, management and audit committees, or the equivalent, of brokers and dealers may want to consider inquiring of their auditor about how these areas are being appropriately addressed in the audit.

Determining the Scope of a Permanent Inspection Program

The Board is gathering information for use in determining the scope of a permanent inspection program for auditors of brokers and dealers with the objective of protecting the interests of investors and furthering the public interest. The Board is working to identify ways that the risk of loss to customers can be differentiated through various attributes that characterize a broker or dealer. These include whether or not a broker or dealer:

- Receives, handles or holds securities or cash from the purchase or sale of securities by customers;
- Carries customer accounts;
- Engages in lines of business that transact with customers;
- Reports financial measurements of net capital, revenues or assets that, on a combined basis, represent a differentiation of risk of loss to customers;
- Has characteristics that may indicate heightened fraud risk or has received regulatory sanctions; and
- Is a member of the Securities Investor Protection Corporation ("SIPC").

Recent Developments and Next Steps of the Interim Inspection Program

Recent Developments

On July 30, 2013, the SEC approved amendments to Exchange Act Rule 17a-5 that affect certain annual reporting, audit, and notification requirements for brokers and dealers. These amendments include the requirement that the audits of brokers and dealers be conducted in accordance with standards of the PCAOB. The principal amendments affecting audits of brokers and dealers are effective for fiscal years ending on or after June 1, 2014.

Next Steps of the Interim Inspection Program

The Board will continue to conduct inspections under the interim inspection program of registered public accounting firms that audit brokers and dealers until rules for a permanent inspection program take effect. During 2013, the Board plans to inspect approximately 60 firms and portions of approximately 90 audits. The Board currently expects that by the end of 2013, the interim inspection program will include inspections of portions of more than 170 audits of brokers and dealers conducted by approximately 100 registered public accounting firms.

The Board will continue to gather and assess information to inform an eventual rule proposal concerning the scope of a permanent inspection program. The Board currently anticipates presenting a rule proposal for a permanent inspection program in 2014 or later.

The Board will issue future progress reports and expects to hold forums and participate in other public outreach activities. These activities are intended to inform auditors of SEC-registered brokers and dealers of the observations from the interim inspection program, developments in standards-setting, and updates from the SEC and designated examining authorities ("DEA"), such as the Financial Industry Regulatory Authority ("FINRA").

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recent developments related to amendments to Rule 17a-5 and summarizes next steps related to the interim inspection program of the PCAOB. The Appendix contains excerpts from the 2012 Report about the interim inspection program, including an overview of net capital, customer protection, and annual reporting requirements for brokers and dealers.

On July 30, 2013, the SEC approved amendments to Rule 17a-5 that affect certain annual reporting, audit, and notification requirements for brokers and dealers.^{2/} References to Exchange Act Rule 17a-5 ("Rule 17a-5")^{3/} in Parts I, II and in the Appendix to this report relate to the rules that were in effect prior to the amendments to Rule 17a-5.^{4/}

Part I: Inspections of Registered Public Accounting Firms

Pursuant to Rule 17a-5, brokers and dealers are generally required to file with the SEC and other regulators, among other things, (1) annual financial statements, (2) supporting schedules relating to the computation of net capital and the customer reserve, if applicable, and (3) an accountant's supplemental report on material inadequacies. The audits of brokers and dealers that are discussed in this report were required, by Rule 17a-5, to be conducted in accordance with generally accepted auditing standards ("GAAS").^{5/} Refer to the Appendix for further discussion on annual reporting requirements and the responsibilities of registered public accounting firms.

^{2/} See Exchange Act Release No. 70073 (July 30, 2013), which includes the final rules, available at <http://www.sec.gov/rules/final.shtml>.

^{3/} See Exchange Act Rule 17 C.F.R. §240.17a-5.

^{4/} On July 30, 2013, the SEC also approved amendments to the net capital, customer protection, books and records, and notification rules for brokers and dealers under the Exchange Act. References to these Exchange Act rules within this report relate to the rules that were in effect prior to these amendments. See Exchange Act Release No. 70072 (July 30, 2013), which includes the final rules, available at <http://www.sec.gov/rules/final.shtml>.

^{5/} Following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank amendments"), the SEC provided transitional guidance in Exchange Act Release No. 62991 (September 24, 2010), stating that "references in Commission rules and staff guidance and in the federal securities laws to GAAS or to specific standards under GAAS, as they relate to non-issuer brokers or dealers, should continue to be understood to mean auditing standards generally accepted in the United States of America, plus any applicable rules of the Commission." References to auditing standards contained within this report are those of

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Firms that Audit Brokers and Dealers

There were 783 registered public accounting firms that issued audit reports on the financial statements of brokers and dealers for fiscal periods ended during 2012 that were filed with the SEC.^{6/} Many of these firms audited as few as one broker or dealer, while several firms audited more than 100 brokers and dealers.

Number of Audits per Firm	Number of Firms	Percentage of Firms
1	363	46%
2 to 5	293	37%
6 to 50	113	15%
51 to 100	8	1%
More than 100	6	1%
Total	783	100%

There were 287^{7/} firms, or 37 percent, that also reported issuing audit reports for issuers.^{8/} There were 4,227 brokers and dealers that filed audited annual financial statements with the SEC for fiscal years ended during 2012.^{9/}

the American Institute of Certified Public Accountants ("AICPA"). The audits selected for inspection that are discussed in this report covered periods before the effective date of the AICPA's revised and redrafted auditing standards under its Clarity Project. The AICPA's clarified auditing standards are generally effective for audits of periods ending on or after December 15, 2012.

^{6/} This represents the number of firms that issued audit reports for brokers and dealers filed with the SEC through May 1, 2013, for fiscal years ended during 2012. These firms were registered with the PCAOB at the time the audit reports were issued.

^{7/} This information is derived from data obtained from the most recently submitted annual reports on Form 2 filed through July 1, 2013. PCAOB Rule 2201 requires each registered public accounting firm to file an annual report on Form 2 by June 30 of each year. The report covers the twelve-month period ending March 31.

^{8/} The term "issuer" encompasses, in general, public companies, investment companies, and certain employee benefit plans. See definition of "issuer" in Section 2(a)(7) of the Act.

^{9/} This information is based on the number of brokers and dealers who filed financial statements with the SEC through May 1, 2013, for fiscal years ended during 2012, that included audit reports issued by firms registered with the PCAOB.

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Registered Public Accounting Firms	Number of Firms	Number of Brokers and Dealers Audited
Audit issuers	287	2,419
Do not audit issuers	496	1,808
Total	783	4,227

Selection of Audits

This report addresses the inspections of 43 firms that were selected under the interim inspection program. Selection of firms for inspection took into consideration whether they also issued audit reports for issuers and, thus, were subject to regular inspection by the PCAOB, as well as other characteristics, to obtain a cross section of firms that audit brokers and dealers. At the time of the inspections, 19 of the 43 firms were subject to regular inspection as they also audited issuers. The remaining 24 firms did not audit issuers and were not subject to inspection other than under the interim inspection program.

Firms that Audit Brokers and Dealers	Number of Firms Inspected	Number of Audits Selected
Firms that also audit issuers - inspected annually	9	22
Firms that also audit issuers - inspected triennially	10	14
Firms that do not audit issuers	24	24
Total	43	60

The selection of audits of brokers and dealers considered various factors, such as the broker's or dealer's lines of business, the minimum net capital requirement under Exchange Act Rule 15c3-1^{10/} ("Rule 15c3-1" or the "Net Capital Rule"), and whether or not the broker or dealer maintained a Special Reserve Bank Account^{11/} under Rule 15c3-3.^{12/} The Board did not exclude any firms or any audits of SEC-registered brokers or dealers from being eligible for selection.

^{10/} See Exchange Act Rule 17 C.F.R. § 240.15c3-1.

^{11/} Brokers and dealers who do not claim an exemption under Rule 15c3-3 are generally required to maintain a "Special Reserve Bank Account for the Exclusive Benefit of Customers" ("Special Reserve Bank Account"). See *Customer Protection* in the Appendix.

^{12/} See Exchange Act Rule 17 C.F.R. § 240.15c3-3.

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For the 43 firms inspected, portions of 60 audits of brokers and dealers were selected for inspection with financial statement periods ended September 30, 2011 through June 30, 2012. The audits selected for inspection included 13 brokers and dealers that maintained a Special Reserve Bank Account and 47 brokers and dealers that did not. The following table presents the minimum net capital requirements and actual net capital reported for these brokers and dealers:

	Number of Audits Selected	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End
Special Reserve Bank Account	13	\$250,000 - \$30,000,000	\$400,000 - \$475,000,000
No Special Reserve Bank Account	47	\$5,000 - \$5,000,000	\$8,000 ^{13/} - \$65,000,000
Total	60		

As indicated in the Board's release related to the adoption of Rule 4020T (the "Temporary Rule"),^{14/} the decision to include certain auditors in the scope of the interim inspection program should not be construed as a decision on the likely scope of a permanent inspection program or suggest that every auditor of a broker or dealer will be inspected as part of the interim inspection program. In addition, the criteria that were considered in making selections for the interim inspection program are not necessarily representative of any decision that the Board will make on whether and how to differentiate among categories of registered public accounting firms and classes of brokers and dealers.

Independence Findings and Audit Deficiencies from Inspections

The inspections focused on portions of 60 audits performed pursuant to Rule 17a-5 that related to audit procedures on certain aspects of the financial statements and compliance with the Net Capital Rule and the Customer Protection Rule. The audits selected for inspection were performed under GAAS, as established by the AICPA.^{15/}

^{13/} Excluded from the range of actual net capital reported at fiscal year end is one instance of reported negative net capital.

^{14/} See PCAOB Release No. 2011-001 (June 14, 2011).

^{15/} One audit was performed under both PCAOB and AICPA standards.

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

Independence Findings	Number of Audits with Findings	Number of Applicable Audits	Percentage of Audits with Findings
Failure to Satisfy Independence Requirements	22	60	37%

Audit Deficiencies	Number of Audits with Deficiencies	Number of Applicable Audits	Percentage of Audits with Deficiencies
Related to Customer Protection and Net Capital Rules:			
Report on Material Inadequacies	43	60	72%
Customer Protection Rule	5	13	38%
Net Capital Rule	23	60	38%
Related to the Financial Statement Audit:			
Risk of Material Misstatement Due to Fraud	37	60	62%
Related Party Transactions	25	60	42%
Revenue Recognition	42	60	70%
Reliance on Records and Reports	30	60	50%
Fair Value Measurements	5	19	26%
Evaluation of Internal Control Deficiencies	6	60	10%
Financial Statement Disclosures	29	60	48%
Understanding the Entity	4	60	7%
Auditor's Report	18	60	30%

Independence findings were noted by Inspections staff in 22 of the 60 audits selected for inspection and were communicated to the firms in writing.

Audit deficiencies were noted by Inspections staff in each of the 43 firms inspected and in 57 of the 60 audits selected for inspection. Audit deficiencies identified included failures by firms to perform, or perform sufficiently, certain required audit procedures. Audit deficiencies that exceeded a certain level of significance were communicated to the firms in writing. This report summarizes those audit deficiencies that Inspections staff determined were important to convey within this report based on their nature, severity, or frequency.

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Audit deficiencies were identified across the spectrum of brokers and dealers selected, regardless of their characteristics. These brokers and dealers varied based on minimum net capital requirements, exemptions claimed under the Customer Protection Rule, lines of business, reported revenues, and reported assets. In addition, audit deficiencies were also identified across the firms inspected, regardless of whether they also audited issuers.

Inspections staff did not identify audit deficiencies in every selected portion of the audits. For example, no deficiencies were identified in audit procedures performed on the supporting schedule for information related to possession or control of securities,^{16/} for the 13 audits selected of brokers and dealers that did not claim an exemption from Rule 15c3-3 and maintained a Special Reserve Bank Account.

The Board is particularly troubled by the nature and frequency of these deficiencies in the performance of audits and the continued identification of independence findings.

Failure to Satisfy Independence Requirements

The independence of the registered public accounting firm is required under SEC rules and plays an important role in fostering high quality audits. Rule 17a-5(f)(3) requires auditors of brokers and dealers to comply with SEC independence requirements,^{17/} which differ from AICPA independence requirements. SEC rules provide, among other things, that an accountant is not independent if the accountant provides bookkeeping or other services related to the accounting records or financial statements of the audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures performed by the accountant during an audit of the client's financial statements.^{18/}

Inspections staff identified independence findings in 22 of the 60 audits selected for inspection. The following presents the independence findings observed at firms that also audit issuers and those that do not:

^{16/} Rule 17a-5(d) generally requires certain brokers and dealers registered with the SEC to file audited financial statements that include a supporting schedule for Information Relating to the Possession or Control Requirements under Rule 15c3-3. See Appendix for reporting requirements related to brokers and dealers.

^{17/} Rule 17a-5(f)(3) states "[a]n accountant shall be independent in accordance with the provisions of Rule 2-01(b) and (c) of Regulation S-X."

^{18/} See Rule 2-01(c)(4)(i) of Regulation S-X.

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Independence Findings Observed:	Number of Audits
Firms that also audit issuers - inspected annually	-
Firms that also audit issuers - inspected triennially	3
Firms that do not audit issuers	19

Inspections staff observed 22 audits, by 22 firms, where the firms performed bookkeeping or other services related to the accounting records or financial statements of the brokers or dealers. All of these firms prepared, or assisted in the preparation of, the financial statements or supporting schedules required by Rule 17a-5. In addition, some of these firms also prepared trial balances or source data underlying the financial statements of the broker or dealer.

These independence findings were identified in approximately eight percent of the audits selected for inspection performed by firms that audited brokers and dealers and also audited issuers. In contrast, independence findings were identified in approximately 80 percent of the audits selected for inspection performed by firms that audited brokers and dealers but did not audit issuers.

Audit Deficiencies Related to Customer Protection and Net Capital Rules

Accountant's Supplemental Report on Material Inadequacies

Rule 17a-5(g)(1) requires the scope of the audit and review of the accounting system, the internal accounting controls, procedures for safeguarding securities, and the practices and procedures in making the periodic computations of aggregate indebtedness, net capital, and the customer reserve to be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination are disclosed in the accountant's supplemental report.^{19/}

Inspections staff identified deficiencies in 43 of the 60 audits selected for inspection. In 32 of the 43 audits, Inspections staff identified deficiencies in two or more categories noted below. The following presents a summary of the deficiencies discussed below:

^{19/} In order to obtain reasonable assurance to support the reporting of material inadequacies to the Commission, the auditor should follow the requirements contained in existing professional standards, including the AICPA's Statements on Standards for Attestation Engagements.

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Deficiencies Related to:	Number of Audits
Reasonable assurance that any existing material inadequacies would be disclosed	41
Exemption claimed under Rule 15c3-3 ^{20/}	33
Evaluation of reported net capital deficiencies as indicators of a material inadequacy	2
Evaluation of error in net capital computation as an indicator of a material inadequacy	1
Timely notification of material inadequacy to SEC/FINRA	1

Inspections staff observed that in 41 audits, firms failed to perform sufficient audit procedures to obtain reasonable assurance that any material inadequacies existing at the date of the examination would be disclosed in the accountant's supplemental report. Inspections staff noted that firms performed a risk assessment and made inquiries of management regarding internal controls as part of the financial statement audit. However, these firms did not sufficiently test controls related to the accounting system, internal accounting controls, or procedures for safeguarding securities of the broker or dealer. For example, several firms limited their procedures to inquiries of management. In addition, several firms did not sufficiently test controls related to the broker's or dealer's practices and procedures in making the periodic computations of aggregate indebtedness, net capital, or the customer reserve. Inspections staff found that several firms tested only those computations without testing design and operating effectiveness of controls over the computations.

When a broker or dealer claims an exemption under the Customer Protection Rule, auditors are required under Rule 17a-5(g)(2) to ascertain whether the conditions of the exemption were being complied with as of the examination date, and whether facts came to the auditor's attention to indicate that the broker or dealer was not in compliance with the exemption during the period since the last examination. For 33 of the 47 audits of brokers and dealers that claimed an exemption from the requirement to maintain a Special Reserve Bank Account, Inspections staff found that the firms limited their procedures to inquiry alone and did not perform sufficient other inquiries or other procedures related to the exemption claimed by the broker or dealer under the Customer Protection Rule.

In two audits, Inspections staff found that the firms failed to evaluate if a material inadequacy existed when the broker or dealer reported a net capital deficiency in its

^{20/} This area was inspected for the 47 audits of brokers and dealers that claimed an exemption from the requirement to maintain a Special Reserve Bank Account.

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financial statements. Inspections staff found in another audit, the firm was aware of an error in the computation required under the Net Capital Rule, but failed to assess whether this error indicated the existence of a material inadequacy.

Rule 17a-5(h)(2) requires that if, during the course of the audit or interim work, the independent public accountant determines that any material inadequacies exist, then the independent public accountant is required to inform the chief financial officer of the broker or dealer, who, in turn, is required to give notice to the Commission and the broker's or dealer's DEA within 24 hours. The broker or dealer must furnish the independent public accountant with the notice, and if the independent public accountant failed to receive the notice within the 24 hour period, or if the independent public accountant disagreed with any statements contained in the notice, the independent public accountant is required to inform the SEC and the broker's or dealer's DEA, within 24 hours. In one audit, Inspections staff found that a firm did not notify the SEC or FINRA of a material inadequacy, related to the customer reserve computation, within the required time frame after the broker or dealer failed to provide notification.

Procedures Regarding Compliance with the Customer Protection Rule

Brokers and dealers that maintain a Special Reserve Bank Account must include supporting schedules with the financial statements that present the customer reserve computation and information relating to requirements for possession or control of securities. Rule 17a-5(g) states that the audit shall include all procedures necessary under the circumstances to enable the independent public accountant to express an opinion on, among other things, the customer reserve computation. In order to opine on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should perform certain procedures using the same materiality level used in the audit of the financial statements.^{21/}

Inspections staff identified deficiencies in 5 of 13 audits where brokers or dealers did not claim an exemption from the requirement to maintain a Special Reserve Bank Account. The following presents a summary of the deficiencies discussed below:

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

^{21/} See Paragraph .07 of AU sec. 551, *Supplementary Information in Relation to the Financial Statements as a Whole*.

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In two of the five audits, the firms failed to sufficiently test completeness and accuracy of customer credits or customer debits included in the customer reserve computation.

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

Inspections staff observed in the other three of five audits, the firms failed to verify the existence of a Special Reserve Bank Account or failed to evaluate that the account agreements contained the required restrictive provisions of Rule 15c3-3(f).

Procedures Regarding Compliance with the Net Capital Rule

Brokers and dealers must include a supporting schedule to the financial statements that presents the computation of net capital. Net capital is also generally disclosed in the notes to the financial statements. Similar to the procedures regarding compliance with the Customer Protection Rule noted above, Rule 17a-5(g) and AU sec. 551 are applicable.

Inspections staff identified deficiencies in 23 of the 60 audits selected for inspection. In 13 of the 23 audits, Inspections staff identified deficiencies in two or more categories noted below. The following presents a summary of the deficiencies discussed below:

Deficiencies Related to:	Number of Audits
Minimum net capital requirements	10
Allowable assets	17
Haircuts	9
Operational charges	3

Minimum net capital requirements

Generally, a broker's or dealer's required minimum net capital is the greater of (1) one of a number of fixed-dollar amounts prescribed in Rule 15c3-1 applicable to the broker or dealer relative to its lines of business, or (2) an amount computed using one of

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two financial ratios.^{22/} In ten audits, Inspections staff found that firms failed to assess the nature of the broker's or dealer's operations in relation to the required minimum net capital amounts in accordance with Rule 15c3-1.

Allowable assets

Rule 15c3-1 requires that assets not readily convertible into cash ("non-allowable assets") be deducted from equity when computing net capital.^{23/} Inspections staff observed 17 audits where firms did not perform sufficient procedures to test the broker's or dealer's classification of allowable and non-allowable assets when computing net capital.

Rule 15c3-1 allows the offset of certain receivables and payables when specific conditions are met. In 3 of those 17 audits, Inspections staff observed that the firms failed to perform sufficient procedures to verify that the conditions necessary for the right of offset of certain receivables by related payables were met in accordance with the applicable sections of Rule 15c3-1. For example, in one of those three audits, a firm failed to perform tests to determine whether valid agreements existed with all of the registered representatives whose commissions were included in commissions payable and whether the agreements included the conditions prescribed in accordance with Rule 15c3-1(c)(2)(iv)(C) such that the commissions payable could offset the commissions receivable in the determination of the non-allowable asset amount.

When a broker or dealer has its proprietary assets and clearing deposit in a proprietary account held by a clearing broker, these assets are permitted to be classified as allowable assets in its net capital computation provided certain conditions are met.^{24/} In 3 of the 17 audits, Inspections staff observed that firms failed to test if the assets held by a clearing broker, under this arrangement, met the requirements of an allowable asset under Rule 15c3-1.

Haircuts

When computing net capital, Rule 15c3-1 generally requires brokers and dealers to apply percentage reductions (referred to as "haircuts") to the values of securities

^{22/} See Rule 15c3-1(a)(1).

^{23/} See Rule 15c3-1(c)(2)(iv).

^{24/} See Rule 15c3-1(c)(2)(iv)(E)/021.

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owned by the broker or dealer.^{25/} As a result, the valuation of the securities and the appropriate haircut percentages can be critical to the net capital computation. Inspections staff observed nine audits where the firms did not perform sufficient procedures for haircuts on securities.

In five of those nine audits, Inspections staff found that firms failed to perform sufficient audit procedures on supporting records obtained from the broker or dealer, or external parties, related to haircuts on securities. In these instances, firms did not test the completeness and accuracy of supporting records received from the broker or dealer, or external parties. Further, in three other audits, Inspections staff found that firms failed to perform procedures to evaluate whether the appropriate haircut percentages were applied by the broker or dealer, including tests of the relevant characteristics of the securities positions.

Operational charges

In computing net capital, Rule 15c3-1 requires brokers and dealers to deduct amounts related to operational charges such as aged fail to-deliver balances.^{26/} In three audits, Inspections staff observed that firms failed to perform sufficient procedures to test the completeness and accuracy of operational charges deducted from the broker's or dealer's net capital.

Deficiencies Related to the Financial Statement Audit

Procedures to Respond to the Risk of Material Misstatement Due to Fraud

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud.^{27/} AU sec. 316 describes the auditor's responsibilities for, among other things, identifying, assessing, and responding to the risks of material misstatement due to fraud. The two types of misstatements that are relevant to the consideration of fraud in a financial statement audit are misstatements arising from fraudulent financial reporting and misappropriation of assets.^{28/}

^{25/} See Rule 15c3-1(c)(2)(vi).

^{26/} See Rule 15c3-1(c)(2)(ix).

^{27/} Paragraph .01 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

^{28/} Paragraph .06 of AU sec. 316.

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The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity.^{29/} Furthermore, professional skepticism requires ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.^{30/}

Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period).^{31/} Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.^{32/}

Inspections staff identified deficiencies in 37 of the 60 audits selected for inspection. In 13 of the 37 audits, Inspections staff identified deficiencies in two or more categories noted below. The following presents a summary of the deficiencies discussed below:

Deficiencies Related to:	Number of Audits
Audit response to identified fraud risks	11
Presumption that revenue recognition is a fraud risk	4
Journal entry testing	35

Inspections staff observed 11 audits where the firms failed to perform audit procedures to respond to the identified risk of fraud for revenue recognition. Further, in four other audits, firms did not identify a fraud risk related to revenue recognition or overcome the presumption that such risk existed.

The auditor should perform procedures to examine journal entries and other adjustments for evidence of possible material misstatement due to fraud.^{33/} Inspections

^{29/} See Paragraph .13 of AU sec. 316.

^{30/} See Id.

^{31/} Paragraph .41 of AU sec. 316.

^{32/} Id.

^{33/} See Paragraph .58 of AU sec. 316.

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staff observed in 35 audits that the firms failed to perform sufficient journal entry testing in response to the risk of management override. For example, Inspections staff observed in 28 of these 35 audits, the firms failed to consider the characteristics of potentially fraudulent journal entries or other adjustments, such as those that were, to the extent present, (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically did not make journal entries, (c) recorded at the end of the period or as post-closing entries that had little or no explanation or description, (d) made either before or during the preparation of the financial statements that did not have account numbers, or (e) comprised of round numbers or a consistent ending number.^{34/} In addition, in 10 of these 35 audits, Inspections staff observed that the firms did not test the completeness of the population of journal entries from which they selected a sample for journal entry testing.

Auditing Related Party Transactions

Related parties often play a significant role in the operations of brokers and dealers, for example, through direct participation in the activities of the brokers and dealers by principals or affiliates under shared service agreements. The substance of a particular transaction could be significantly different from its form^{35/} in certain situations. For example, related parties may be improperly used by brokers and dealers in scenarios such as: overpaying for goods or services and disguising capital withdrawals; avoiding the imposition of higher capital requirements and various capital charges; structuring a broker's or dealer's business to avoid certain rules; and transferring customer assets to parties that are not approved custodians.

Auditors should be aware of the possible existence of material related party transactions that could affect the financial statements and of common ownership or management control relationships for which Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 850-10-50, *Related Party Disclosures*, requires disclosure.^{36/} Procedures to address possible related party transactions are normally performed even if the auditor has no reason to suspect that related party transactions or control relationships exist.^{37/}

^{34/} See Paragraph .61 of AU sec. 316.

^{35/} See Paragraph .02 of AU sec. 334, *Related Parties*.

^{36/} Paragraph .04 of AU sec. 334.

^{37/} See Id.

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Inspections staff identified deficiencies in 25 of the 60 audits selected for inspection. In 7 of the 25 audits, Inspections staff identified deficiencies in two or more categories noted below. The following presents a summary of the deficiencies discussed below:

Deficiencies Related to:	Number of Audits
No procedures performed	3
Existence and identification of related parties and related party transactions	10
Examining identified related party transactions	18
Other	1

In three audits, Inspections staff observed that firms did not perform any procedures to test for related parties or related party transactions.

Inspections staff observed ten audits where the firms failed to perform sufficient procedures to determine the existence of related parties and material related party transactions. Inspections staff found that firms identified certain related parties or material related party transactions, yet failed to test for the existence of undisclosed related parties and related party transactions.

In 18 of the audits selected for inspection, Inspections staff observed that firms identified material related parties or related party transactions pertaining to service agreements, fee agreements, and intercompany balances, yet the firms did not perform procedures necessary to obtain sufficient appropriate audit evidence or did not sufficiently evaluate audit evidence concerning the purpose, nature, or extent of such transactions and their effect on the financial statements. In nine of these audits, Inspections staff observed that the firms failed to perform procedures to evaluate whether the allocation of revenue and expense amounts for related party transactions was reasonable.

In addition, Inspections staff identified one audit where the firm failed to identify that the broker or dealer did not appear to account for a related party transaction appropriately. Inspections staff noted documentation at the firm indicating that the transaction appeared to have been recorded in a manner to avoid an adverse effect on net capital.

Auditing Revenue Recognition

Brokers and dealers may generate revenue from a variety of securities-related lines of business. The auditor should design and perform audit procedures whose

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nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level.^{38/} The auditor must obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion on whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles ("GAAP").^{39/}

Inspections staff identified deficiencies in 42 of the 60 audits selected for inspection. In 11 of the 42 audits, Inspections staff identified deficiencies in two or more categories noted below. The following presents a summary of the deficiencies discussed below:

Deficiencies Related to:	Number of Audits
Extent of testing	18
Substantive analytical procedures	9
Other procedures to test revenue recognition	27

Inspections staff observed that in 18 audits, the extent of testing was insufficient for material classes of revenue transactions, including trading gains and losses, commission revenue, and principal transaction revenue. For example, Inspections staff observed instances in which firms did not perform any procedures to test material classes of revenue transactions. Inspections staff also noted instances where the firms did not support a reduced extent of substantive tests of material classes of revenue transactions. Finally, a number of firms failed to select a sample of revenue transactions for testing that was representative of the underlying population or adequate to support a conclusion about the reported revenues, given the basis of the sampling approach applied.

When analytical procedures are used as a substantive test of a relevant financial statement assertion, the auditor should take actions necessary to obtain the necessary level of assurance of detecting differences that may be material misstatements. Those actions include, among other things: (a) developing an expectation at a sufficient level of precision to provide the desired level of assurance;^{40/} (b) considering the amount of

^{38/} Paragraph .07 of AU sec. 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

^{39/} See Paragraph .01 of AU sec. 326, *Audit Evidence*.

^{40/} See Paragraph .17 of AU sec. 329, *Analytical Procedures*.

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difference from the expectation that can be accepted without further investigation;^{41/} and (c) evaluating significant unexpected differences.^{42/} Auditors should ordinarily perform procedures to obtain corroboration for management's explanations of significant unexpected differences with other audit evidence.^{43/}

Inspections staff observed nine audits where firms performed substantive analytical procedures that did not provide the intended level of assurance. The deficiencies included firms' failures to: (a) develop appropriately precise expectations; (b) investigate significant unexpected differences; or (c) test the underlying data used in the analytical procedures.

Inspections staff identified deficiencies in 27 audits selected for inspection that related to the failure of firms to perform sufficient procedures to test the occurrence, accuracy, completeness, or cutoff of revenue. For example, firms failed to: (a) evaluate, or evaluate sufficiently, the effect of specific terms and provisions in significant contractual arrangements on the recognition of revenue; (b) test whether revenue was recorded in the correct period; (c) evaluate whether certain amounts should be recorded on a gross or net basis; or (d) determine whether the commission rates used to calculate commission revenue were consistent with the underlying agreements.

Procedures to Establish a Basis for Reliance on Records and Reports

Inspections staff identified deficiencies in 30 of the 60 audits selected for inspection. Inspections staff identified deficiencies in both categories noted below in one audit. The following presents a summary of the deficiencies discussed below:

Deficiencies Related to:	Number of Audits
Completeness and accuracy of records and reports from service organizations	23
Completeness and accuracy of records and reports produced by brokers and dealers	8

^{41/} See Paragraph .20 of AU sec. 329.

^{42/} See Paragraph .21 of AU sec. 329.

^{43/} See Id.

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Records and Reports from Service Organizations

Many brokers and dealers use the services of other brokers and dealers to perform trade processing and related back-office functions, primarily in the clearing and settling of customer transactions. AU sec. 324, *Service Organizations*, applies to audits where a company obtains services from another organization that are part of the company's information system, such as services that affect the financial reporting process used to prepare the company's financial statements.^{44/} AU sec. 324 also discusses 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.^{45/}

Inspections staff observed in 23 audits that firms did not perform sufficient procedures on reports prepared by service organizations and used in audit procedures.

Inspections staff observed in 11 of those 23 audits that firms used reports from a service organization, such as a clearing broker, for purposes of testing commission revenue and the related commission receivable, but either did not obtain and evaluate a service auditor's report or failed to perform procedures regarding the accuracy and completeness of information obtained from the service organization.

Inspections staff observed that in 13 audits^{46/} where the firm obtained a service auditor's report, the firm did not sufficiently evaluate the service auditor's report or failed to consider whether the service auditor's report provided evidence about the design and operating effectiveness of the controls being relied upon. Inspections staff also observed in five audits that the firms failed to perform additional procedures when the service auditor did not test controls over relevant financial statement assertions.

Records and Reports Produced by Brokers and Dealers

When information produced by the entity being audited is used by the auditor to perform tests of controls or substantive tests, the auditor should obtain sufficient evidence about the accuracy and completeness of the information.^{47/}

^{44/} See Paragraph .03 of AU sec. 324.

^{45/} See Paragraphs .06-.21 of AU sec. 324.

^{46/} Includes one audit referenced in the previous paragraph.

^{47/} See Paragraph .10 of AU sec. 326.

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

Auditing Fair Value Measurements

Brokers and dealers account for and disclose securities at fair value.^{48/} The auditor's approach to performing substantive tests of fair value measurements might include one or a combination of the following: (a) testing management's significant assumptions, the valuation model, and the underlying data; (b) developing an independent estimate of fair value for corroborative purposes; or (c) reviewing subsequent events or transactions.^{49/} When testing the entity's fair value measurements and disclosures, the auditor evaluates whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information.^{50/} In addition, the auditor should test the data used to develop the fair value measurements and disclosures.^{51/}

In 5 of 19 audits, where the auditor's procedures to test securities valuation were a subject of the inspection, Inspections staff observed that the firms did not perform sufficient procedures to test the valuation of securities. For example, in two of these audits, Inspections staff found that the firms failed to perform sufficient procedures to test the reasonableness of the fair value estimates. These firms compared fair value estimates of the broker's or dealer's securities values to fair value estimates provided to the broker or dealer by external parties. These firms failed to perform additional

^{48/} See FASB ASC Topic 820, *Fair Value Measurement*, and FASB ASC Subtopic 940-320, *Financial Services - Broker and Dealers, Investments - Debt and Equity Securities*.

^{49/} See Paragraph .23 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures*.

^{50/} See Paragraph .26 of AU sec. 328.

^{51/} Paragraph .39 of AU sec. 328.

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procedures as described in the previous paragraph to test the fair value estimates from the external parties.

Evaluation of Internal Control Deficiencies in the Financial Statement Audit

In an audit of the financial statements, the auditor should obtain an understanding of the entity's internal controls sufficient to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.^{52/} During the course of an audit, the auditor may become aware of control deficiencies. The auditor should evaluate the severity of each control deficiency identified during the audit to determine whether the deficiencies, individually or in combination, represent a significant deficiency or material weakness.^{53/} The severity of a control deficiency does not depend on whether a misstatement has actually occurred.^{54/}

Inspections staff identified deficiencies in 6 of the 60 audits selected for inspection. The following presents a summary of the deficiencies discussed below:

Deficiencies Related to:	Number of Audits
Assessment of the severity of a control deficiency	3
Evaluation of errors performed as part of substantive testing	3

In three of the six audits, Inspections staff observed that the firms identified one or more internal control deficiencies while performing procedures to obtain an understanding of internal control. Although the firms identified these deficiencies, the evaluations by the firms did not include a sufficient assessment of the severity of the control deficiency to determine whether the deficiency, individually or in combination, represented a significant deficiency or material weakness. In addition, the firms failed to consider whether there would be any effect on the financial statement audit.

^{52/} See Paragraph .40 of AU sec. 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

^{53/} Paragraph .08 of AU sec. 325, *Communicating Internal Control Related Matters Identified in an Audit*.

^{54/} Id.

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Misstatements that the auditor detects by performing substantive procedures should be considered by the auditor when assessing the operating effectiveness of related controls.^{55/} In three of the six audits, Inspections staff observed that firms identified errors during the performance of substantive tests. However, the firms failed to evaluate the severity and nature of the errors, both individually and in the aggregate, and the circumstances of their occurrences, including whether the errors were evidence of one or more control deficiencies. In addition, the firms failed to consider whether there would be any effect on the financial statement audit.

Auditing Financial Statement Disclosures

The presentation of financial statements in conformity with GAAP includes adequate disclosure of material matters.^{56/} An auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which the auditor is aware at the time.^{57/}

Inspections staff reviewed the audit work performed related to financial statement disclosures for those audit areas included in the inspections. Inspections staff identified deficiencies in 29 of 60 audits selected for inspection. In 2 of the 29 audits, Inspections staff identified deficiencies in two or more categories noted below. The following presents a summary of the deficiencies discussed below:

Deficiencies Related to:	Number of Audits
Omitted disclosures	8
Inaccurate or incomplete disclosures	19
Fair value disclosures (FASB ASC 820)	4

In eight audits, Inspections staff observed instances in which the firms failed to identify and address the omission of disclosures pertaining to areas such as related parties and related party transactions, fair value of securities, or revenue recognition policies, despite the fact that these matters were applicable and exceeded materiality thresholds set by the firms. For example, some audited financial statements did not include revenue recognition policy disclosures for all material revenue streams.

^{55/} Paragraph .34 of AU sec. 318.

^{56/} Paragraph .02 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

^{57/} Id.

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Inspections staff also observed in 19 audits that the firms failed to identify incomplete disclosures or respond to evidence that was inconsistent with disclosures included in the financial statements. In addition, Inspections staff observed that in four audits, firms failed to sufficiently test the disclosure of securities within the hierarchy required by FASB ASC 820.

Understanding the Entity and Its Environment When Performing the Audit

An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.^{58/}

Inspections staff observed that in four audits, the firms did not obtain an understanding of the entity and its environment, including its internal control, in order to design the nature, timing, and extent of audit procedures. For example, in one instance, a firm failed to obtain an understanding of control activities related to significant accounts, such as revenue.

Auditor's Report

Generally, brokers and dealers are required under Rule 17a-5 to file with the SEC (1) audited financial statements and supporting schedules on the computation of net capital, the computation of the customer reserve requirement, and information relating to the possession or control requirements of the Customer Protection Rule; and (2) an accountant's supplemental report on material inadequacies. The auditor's report on the supporting schedules should include the elements required by AU sec. 551,^{59/} including an opinion on whether the schedules are fairly stated, in relation to the financial statements taken as a whole.

Inspections staff identified deficiencies in 18 of the 60 audits selected for inspection. In 3 of the 18 audits, Inspections staff identified deficiencies in both categories noted below. The following presents a summary of the deficiencies discussed below:

^{58/} Paragraph .01 of AU sec. 314.

^{59/} See Paragraph .09 of AU sec. 551.

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Deficiencies Related to:	Number of Audits
Auditor's report on supporting schedules	14
Accountant's supplemental report on material inadequacies	7

Inspections staff found that in 14 audits, the auditor's reports on the supporting schedules failed to include one or more of the elements required by AU sec. 551,^{60/} such as a statement that the supplementary information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.

While Rule 17a-5 does not provide a prescribed format for the accountant's supplemental report on material inadequacies, auditors generally follow the illustrative guidance in Exhibit A of AU sec. 325 that includes definitions for the terms "control deficiency," "significant deficiency," and "material weakness."^{61/}

Inspections staff identified errors in the accountant's supplemental report on material inadequacies issued by the firms for seven of the audits selected for inspection. For example, Inspections staff observed that the auditor's reports contained definitions for the terms "significant deficiency" and "material weakness" that were inconsistent with those prescribed by AU sec. 325, suggesting that the firms may have applied these incorrect definitions in their evaluation of any identified control deficiencies.

Actions Needed

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

Under GAAS, when audit deficiencies are discovered after the date of the audit report, a firm must take appropriate action to assess the importance of the deficiencies to the firm's present ability to support its previously expressed audit opinions.^{62/}

^{60/} See Id.

^{61/} See Paragraphs .05-.07 of AU sec. 325.

^{62/} See AU sec. 390, *Consideration of Omitted Procedures After the Report Date*. The firm might have further responsibilities under AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

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

When it comes to the Board's attention that the financial statements of a broker or dealer appear not to present fairly, in all material respects, the financial position, results of operations, or cash flows of the broker or dealer in conformity with GAAP, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting in the financial statements of brokers and dealers. Similarly, information suggesting violations of laws or rules, including independence rules, by brokers and dealers may be reported to the SEC as well as other DEAs.

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

Independence:

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

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Audit Deficiencies:

- Guidance and training to determine whether the topics noted as observed audit deficiencies identified in the report are given appropriate attention, in particular, procedures related to:
 - Accountant's supplemental report on material inadequacies, exemptions claimed from Rule 15c3-3, and net capital; and
 - Revenue recognition, related parties and related party transactions, responses due to risk of material misstatement due to fraud, and establishing a basis for reliance on records and reports.
- Policies for supervision and review to ensure their partners and supervisory personnel are placing appropriate attention on these areas.

In addition, management and audit committees, or the equivalent, of brokers and dealers may want to consider inquiring of their auditor about how these areas are being appropriately addressed in the audit.

Part II: Determining the Scope of a Permanent Inspection Program

The Board is taking a careful and informed approach with the objective to promote investor protection in establishing a permanent inspection program for registered public accounting firms that audit brokers and dealers. The Board is informed by the interim inspection program, through the inspections performed and the information gathered. In carrying out its mission to oversee the audits of brokers and dealers, the Board is paying particular attention to how the auditor's role contributes to the protection of the assets of the customers^{63/} of brokers and dealers.

The Board recognizes that the Exchange Act rules related to the work required of auditors of brokers and dealers is an important component of the SEC's oversight of brokers and dealers, and in order for this oversight to be effective, the auditors are expected to perform their work in accordance with existing rules and the professional auditing standards. In its role of furthering the public interest and protecting customers of brokers and dealers, the SEC and the broker's or dealer's DEA monitors compliance by brokers and dealers with rules specific to, among others, books and records, net capital, the customer reserve requirements, quarterly securities counts, and customer

^{63/} See definition of "customer" in Rule 15c3-3(a)(1).

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account statement rules. As described in Part I and in the Appendix, the auditor is required to perform procedures for the accountant's supplemental report on material inadequacies and the supporting schedules for the customer reserve and net capital computations that relate to these rules.

The risk of loss to customers can occur through misappropriation of customer assets, such as unauthorized trading or embezzlement, among others. The Board is considering this risk of loss to customers in relation to the auditor's responsibilities under the Exchange Act rules.

In this regard, the Board is working to identify ways to differentiate the risk of loss to customers and to determine whether any particular differentiation provides a basis to inform the Board's determination of the scope of a permanent inspection program. The Board is evaluating whether the risk of loss to customers of brokers and dealers can be assessed from various attributes that characterize brokers and dealers and, thus, provide for differentiation of classes of brokers and dealers. The Board has not finalized any determinations on the attributes that provide for differentiation of classes of brokers and dealers or whether the risk of loss can be differentiated. For informational purposes, six of these attributes are described below.

Receive, Handle, or Hold Customer Securities or Cash

Brokers and dealers that carry^{64/} customer accounts and receive, handle, or hold customer securities or cash, among other requirements, maintain a deposit in a Special Reserve Bank Account in accordance with Rule 15c3-3. When the operations of a broker or dealer include receiving, handling, or holding customer securities or cash, there is risk of loss to customers if, for example, the broker or dealer ceases to operate or there is misappropriation of customer securities or cash at the broker or dealer.

Other types of brokers and dealers do not carry customer accounts, yet may receive or handle customer securities or cash, and claim an exemption from maintaining a Special Reserve Bank Account. These brokers and dealers must either promptly^{65/} remit the securities or cash received from customers to brokers or dealers that carry customer accounts or temporarily deposit the cash into a special account for the exclusive benefit of customers, pursuant to Rule 15c3-3. Further, Rule 15c3-3 does not allow brokers or dealers that receive or handle cash from customers to deposit customer cash into their own bank accounts.

^{64/} This includes brokers and dealers that clear customer transactions.

^{65/} See Rule 15c3-1(c)(9).

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The Board is considering the extent to which these other types of brokers and dealers present a risk of loss to customers and whether this should be a factor in determining the scope of a permanent inspection program.

Customer Protection Rule

Rule 15c3-3 was established to protect customer securities and cash that a broker or dealer holds for its customers. Under this rule, the broker or dealer is required to periodically compute the amount of funds ("customer credits") it has that is either customer cash or cash obtained from the use of customer securities. From that figure, the broker or dealer subtracts the amount of funds ("customer debits") that it is owed by customers, or by other brokers and dealers, relating to customer transactions. If the customer credits exceed the customer debits, the broker or dealer must deposit the excess in a Special Reserve Bank Account. If the customer debits exceed customer credits, no deposit is necessary. A broker or dealer may claim an exemption from maintaining a Special Reserve Bank Account under this rule if the broker or dealer meets certain conditions specified in the rule, such as the broker or dealer does not carry customer accounts and promptly remits any customer securities or cash received to the brokers or dealers that carry customer accounts or to the entities sponsoring particular securities. On a periodic basis, brokers and dealers self-report the exemption claimed under the provisions of Rule 15c3-3.

The following tables represent a summary of brokers and dealers based on their reporting related to the provisions of Rule 15c3-3 as of December 31, 2012:^{66/}

^{66/} This information is based on unaudited Financial and Operational Combined Uniform Single ("FOCUS") reports filed with FINRA or the Chicago Stock Exchange ("CHX") through May 1, 2013, for the quarter ended December 31, 2012, or annual audited financial statements filed with the SEC through May 1, 2013. Information that was not obtained from the SEC, FINRA, or CHX is noted as "Not Available."

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Provisions of Rule 15c3-3	Broker and Dealer Attributes	Number of Brokers and Dealers	Percentage
Special Reserve Bank Account Maintained (and all others that do not claim exemption)	Most carry customer accounts	311	7%
Exemption(s) Claimed	Do not carry customer accounts; may receive or handle securities or cash	3,909	93%
Not Available		7	0%
	Total	4,227	100%

Exemption(s) Claimed Under Rule 15c3-3	Broker and Dealer Attributes	Number of Brokers and Dealers	Percentage
(k)(1)	Usually non-introducing, required to promptly remit customer securities transactions in mutual funds or insurance products	464	11%
(k)(2)(i)	Usually non-introducing, required to promptly remit	1,464	35%
(k)(2)(ii)	Introducing broker	1,848	44%
(k)(3)	Claims special order by the SEC	4	0%
Multiple	N/A	99	2%
Not available		30	1%
Exemption(s) Claimed Subtotal		3,909	93%

The Board is analyzing the various exemptions claimed by brokers and dealers and their relationship to activities with customers in order to consider whether there is a basis to differentiate the risk of loss to customers.

Lines of Business

Brokers and dealers registered with the SEC engage in a variety of securities-related business lines. The SEC requires that brokers and dealers report the lines of business that the broker or dealer is engaged in, or expects to be engaged in, on the Uniform Application for Broker-Dealer Registration ("Form BD"). There are currently 29

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business activities (inclusive of a category titled "other") listed in Form BD, many of which involve providing investment services directly to customers.

The Board is reviewing the lines of business of brokers and dealers to identify those that involve customers and those that do not, as this may be a factor to differentiate the risk of loss to customers. For example, proprietary trading by a broker through another broker or dealer does not involve any customer participation. Similarly, selling proprietary securities to other brokers and dealers does not involve responsibility to, or contact with, customers. In addition, brokers who operate solely on the floor of a securities exchange, such as market makers, specialists, and floor brokers, and who only transact with other brokers and dealers, do not deal with customers.

The Board is analyzing the extent to which brokers and dealers limit their activities to exclusively non-customer operations.

Financial Characteristics

The Board is reviewing various financial characteristics of brokers and dealers, such as the minimum net capital requirement, reported revenues, and reported assets.

Net Capital

The primary purpose of the Net Capital Rule is to ensure that brokers and dealers maintain, at all times, sufficient liquid assets to promptly satisfy their liabilities to customers, creditors, and other brokers and dealers, and to provide a cushion of liquid assets in excess of liabilities to cover potential market, credit, and other risks, if the broker or dealer were to be liquidated.^{67/}

Minimum net capital requirements are generally based on the type of security activity undertaken, the type of security being traded, and whether a broker or dealer receives, handles, or holds customer securities or cash in conducting its business.^{68/} For example, a broker or dealer conducting business as a clearing broker has a higher minimum net capital requirement, as defined in Rule 15c3-1, than a broker or dealer that engages only in the selling of mutual funds or variable annuities.

The Board is assessing the potential risk of loss to customers in relation to the various minimum net capital requirements.

^{67/} See Exchange Act Release No. 68071 (October 18, 2012).

^{68/} See Rule 15c3-1(a) and (b).

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The following table presents the number of brokers and dealers that reported the following required minimum fixed-dollar amounts of net capital as of December 31, 2012.^{69/}

Minimum Fixed-Dollar Net Capital Requirements Reported	Number of Brokers and Dealers
\$5,000	2,212
\$25,000	105
\$45,000	30
\$50,000	322
\$100,000	749
\$250,000	603
\$1,000,000	87
\$1,500,000	31
Other or Not Available	88
Total	4,227

Revenues and Assets

Revenues and assets reported by a broker or dealer can be indicators of the extent of its operations. The following table provides a stratification of brokers and dealers based on the amounts they reported for revenue during 2012 and total assets as of December 31, 2012.^{70/}

^{69/} This information is based on unaudited FOCUS reports filed with FINRA or CHX through May 1, 2013, for the quarter ended December 31, 2012, or annual audited financial statements filed with the SEC through May 1, 2013. Information that was not obtained from the SEC, FINRA, or CHX is noted as "Not Available."

^{70/} Revenue information is based on the aggregate of revenues reported in the unaudited FOCUS reports filed with FINRA or CHX through May 1, 2013, for calendar quarters ended during 2012 or revenues reported in annual audited financial statements filed with the SEC through May 1, 2013, for fiscal periods ended during 2012. Asset information is based on unaudited FOCUS reports filed with FINRA or CHX through May 1, 2013, for the quarter ended December 31, 2012, or audited financial statements filed with the SEC through May 1, 2013, for fiscal periods ended during 2012. Information that was not obtained from the SEC, FINRA, or CHX is noted as "Not Available."

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Reported Amount	Revenues - Number of Brokers and Dealers	Assets – Number of Brokers and Dealers
Less than \$10,001	315	67
\$10,001 to \$50,000	203	463
\$50,001 to \$100,000	156	324
\$100,001 to \$250,000	322	597
\$250,001 to \$500,000	346	504
\$500,001 to \$1 million	408	444
\$1,000,001 to \$10 million	1,544	1,069
\$10,000,001 to \$100 million	654	468
More than \$100 million	270	291
Not Available	9	-
Total	4,227	4,227

In considering financial characteristics, the Board will assess whether these characteristics, on a combined basis, are a factor in differentiating risk of loss to customers.

Fraud and Regulatory Sanctions

Customers of brokers and dealers are exposed to the risk of loss due to fraudulent activity when conducting business with brokers and dealers that have access to their assets. Examples of fraudulent activities include misappropriation of customer assets and intentional misstatements of net capital, the customer reserve, or the financial statements.

The financial responsibility rules are designed to protect customers of brokers and dealers and their assets. In this regard, the auditor performs procedures related to certain financial responsibility rules, such as procedures related to net capital and customer reserve computations. In addition, the auditor is required to perform procedures to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.

The Board is considering information about fraudulent activities that have occurred over the past several years to evaluate whether correlations exist between the types of fraudulent activities that occurred and characteristics of the brokers and dealers. For example, fraudulent activities could have occurred at brokers or dealers that do not carry customer accounts, yet may have received or handled customer securities or cash, and claimed an exemption from maintaining a Special Reserve Bank Account.

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Another consideration in assessing the risk of loss due to fraudulent activity involves the point of contact with customers through its broker representatives, including those brokers or dealers that are dually-registered as investment advisors. Customers have contact with registered broker representatives who are licensed to sell securities or provide investment advice. There are approximately 630,000^{71/} FINRA registered representatives subject to regulatory oversight who employ or contract with brokers and dealers that either carry customer accounts or claim an exemption.

The Board is also considering sanctions imposed on brokers and dealers by regulators, such as the SEC or FINRA, and whether these are an indicator of risk of loss to customers that can be used to differentiate such risk at brokers and dealers.

The Board is assessing whether there are brokers and dealers that are less susceptible to fraud resulting in losses to customers, and if so, how best to identify these brokers and dealers.

SIPC Coverage

Customers of brokers or dealers that are members of SIPC have a degree of protection from financial harm if a broker or dealer ceases operations and undergoes liquidation. Currently, the protection covers up to \$500,000 per customer, including claims for cash that are limited to \$250,000 per customer. SIPC protects only the custody or safekeeping function performed by brokers or dealers. SIPC does not protect investors against the loss of value of any security, even if that loss was caused by fraud. SIPC protection does not extend to all types of investments.

The Board is assessing data on the closures of brokers and dealers that have resulted in SIPC liquidations to evaluate whether correlations exist between the reason for the liquidation and the characteristics of the brokers and dealers.

Part III: Recent Developments and Next Steps of the Interim Inspection Program

Recent Developments

On July 30, 2013, the SEC approved amendments to Rule 17a-5 that affect certain annual reporting, audit, and notification requirements for brokers and dealers. These amendments include the requirement that the audits of brokers and dealers be conducted in accordance with standards of the PCAOB. The principal amendments

^{71/} Obtained from FINRA website <http://www.finra.org/Newsroom/Statistics>.

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affecting audits of brokers and dealers are effective for fiscal years ending on or after June 1, 2014.

Next Steps of the Interim Inspection Program

The Board will continue to conduct inspections under the interim inspection program until rules for a permanent inspection program take effect. During 2013, the Board plans to inspect approximately 60 firms and portions of approximately 90 audits. The scope and approach of these inspections will continue to follow what was described earlier in Part I with substantially the same objectives. The Board will adjust its inspection approach, as deemed necessary, in consideration of the results of inspections, changes in the industry, and any future changes in rules or standards. The Board currently expects that by the end of 2013, the interim inspection program will include inspections of portions of more than 170 audits of brokers and dealers conducted by approximately 100 registered public accounting firms.

The Board will continue to gather and assess information to inform an eventual rule proposal concerning the scope of a permanent inspection program, including the criteria for inclusion within the scope of a permanent program. The Board will assess the benefits of the proposed program, consider the scalability of inspections through their frequency and approach, and evaluate the regulatory burden imposed on brokers and dealers and their auditors. The Board anticipates presenting a rule proposal for a permanent inspection program in 2014 or later. At such time, the Board will seek comments on any proposed rules regarding a permanent inspection program for audits of brokers and dealers.

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

The Board will continue to hold forums and participate in other public outreach activities to inform registered public accounting firms that issue audit reports for brokers and dealers of observations from our interim inspection program, developments in Board standards-setting initiatives, and updates from the SEC and FINRA.

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Appendix

Background Information on the Establishment of the Interim Inspection Program and Net Capital, Customer Protection, and Annual Reporting Requirements for SEC-Registered Brokers and Dealers

Background

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act amended various provisions of the Sarbanes-Oxley Act of 2002. Among other things, the Dodd-Frank amendments gave the Board oversight authority with respect to audits of brokers and dealers that are registered with the Commission. Specifically, the Dodd-Frank amendments provided the Board with authority to carry out the same oversight responsibilities for auditors of brokers and dealers as it has carried out with respect to auditors of issuers – inspections, standards-setting, investigations, and disciplinary proceedings.

Since December 31, 2008, as previously required by the Act, all auditors of brokers or dealers have been required to register with the PCAOB. On June 14, 2011, in light of the Dodd-Frank amendments, the Board adopted Rule 4020T to establish an interim inspection program related to the audits of brokers and dealers. The SEC approved this rule on August 18, 2011.^{72/}

The interim inspection program has two purposes. First, it enables the Board to begin the process of assessing the compliance of registered public accounting firms and their associated persons with the Act, the Board's rules, the Commission's rules, and professional standards in connection with the performance of audits, issuance of audit reports, and related matters involving brokers and dealers.^{73/} Second, it will help inform the Board's eventual determinations about the scope and elements of a permanent inspection program, including whether and how to differentiate among classes of brokers and dealers, whether to exempt any category of registered public accounting firm, and the establishment of minimum inspection frequency schedules.

The Temporary Rule provides that, no less frequently than every twelve months, the Board will publish a report that describes the progress of the interim inspection program and any significant observations.

^{72/} See Exchange Act Release No. 65163 (August 18, 2011).

^{73/} See Section 104(a) of the Act.

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Net Capital, Customer Protection, and Annual Reporting Requirements for SEC-Registered Brokers and Dealers

This section provides an overview of the regulation of brokers and dealers with a focus on:

- Net capital requirements under Rule 15c3-1;
- The protection of customer assets as prescribed by Rule 15c3-3; and
- Annual reporting requirements and the responsibilities of registered public accounting firms.

Minimum Net Capital Requirements of SEC-Registered Brokers and Dealers

Brokers and dealers registered with the SEC can engage in a variety of securities-related lines of business, including services for buying and selling securities, and capital raising activities. Other examples of brokers' and dealers' lines of business include acting as prime brokers, market makers, specialists, municipal securities brokers, and distributors of shares of registered investment companies. The lines of business conducted by the broker or dealer are factors in the determination of a broker's or dealer's minimum net capital requirement as prescribed in the Net Capital Rule.^{74/}

In general, Rule 15c3-1 prescribes minimum liquidity standards for brokers and dealers, requiring brokers and dealers to maintain certain specified levels of net capital (i.e., liquid assets). Whether a broker or dealer receives, handles, or holds customer securities or cash in conducting its business will have an effect on the amount of minimum net capital that the broker or dealer must maintain under Rule 15c3-1. For example, brokers and dealers that carry customer, broker, or dealer accounts and receive or hold securities or cash for those persons are generally required by Rule 15c3-1 to maintain greater amounts of net capital than brokers and dealers that do not handle securities or cash for others.

^{74/} Generally, a broker's or dealer's required minimum net capital is the greater of (1) one of a number of fixed-dollar amounts prescribed in Rule 15c3-1 applicable to the broker or dealer relative to its lines of business, or (2) an amount computed using one of two financial ratios. The first financial ratio generally provides that a broker or dealer shall not permit its aggregate indebtedness to exceed 1500% of its net capital. See Rule 15c3-1(a)(1)(i). The second financial ratio provides that a broker or dealer shall not permit its net capital to be less than \$250,000 or 2% of aggregate customer debit items. See Rule 15c3-1(a)(1)(ii).

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Customer Protection

As noted above, in operating their lines of business, brokers and dealers may receive, handle, or hold customer securities or cash. The provisions of the Customer Protection Rule relate to protecting customer securities and cash that a broker or dealer holds for customers.^{75/} In general, Rule 15c3-3 is designed to prevent brokers and dealers from using customer funds to finance their businesses, except as related to customer transactions. As a result, brokers and dealers must provide the capital to finance their trades and activities and may not use customer funds left with them for such purposes.

One aspect of the Customer Protection Rule requires a broker or dealer to have possession or control of fully paid and excess margin securities of their customers.^{76/} A broker or dealer must make a daily determination to help ensure that it is complying with this aspect of the rule.^{77/}

Another aspect of the Customer Protection Rule covers customer securities and cash and requires each broker or dealer not exempt from the provisions of this rule to make a periodic computation to determine the amount of funds it is holding that is either customer cash or cash obtained from the use of customer securities ("customer credits").^{78/} From that figure, the broker or dealer subtracts the amount of funds that it is owed by customers or by other brokers and dealers relating to customer transactions ("customer debits"). If the customer credits exceed customer debits, the broker or dealer must deposit the excess in a Special Reserve Bank Account. If the customer debits exceed customer credits, no deposit is necessary. Funds deposited in a Special Reserve Bank Account cannot be withdrawn until the broker or dealer completes another computation that shows that the broker or dealer has on deposit more funds than are required in the Special Reserve Bank Account.

^{75/} See Rule 15c3-3.

^{76/} See Rule 15c3-3(b)(1). Subparagraph (a)(3) of Rule 15c3-3 defines "fully paid securities" as securities carried in any type of account for which the customer has made full payment. Subparagraph (a)(5) of Rule 15c3-3 defines "excess margin securities" as securities having a market value in excess of 140% of the amount the customer owes the broker or dealer and which the broker or dealer has designated as not constituting margin securities.

^{77/} See Rule 15c3-3(d).

^{78/} See Rule 15c3-3(e).

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Annual Reporting Requirements and the Responsibilities of Registered Public Accounting Firms

Brokers and dealers are required to make and maintain accurate books and records.^{79/} Pursuant to Rule 17a-5, brokers and dealers are also generally required to file with the SEC and other regulators, among other things (1) annual financial statements, (2) supporting schedules relating to the computation of net capital and determination of the reserve requirement for the Special Reserve Bank Account, if applicable, and (3) an accountant's supplemental report on material inadequacies.^{80/}

Under Rule 17a-5, the financial statements and supporting schedules are generally required to be audited by a registered public accounting firm.^{81/} In addition, the scope of the accountant's supplemental report on material inadequacies includes a review of the broker's or dealer's accounting system, internal accounting controls, and

^{79/} See Exchange Act Rules 17a-3 and 17a-4.

^{80/} Rule 17a-5(g)(3) states that a material inadequacy in the accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures of a broker or dealer includes any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to (i) inhibit a broker or dealer from promptly completing securities transactions or promptly discharging his responsibilities to customers, other brokers, dealers, or creditors; (ii) result in material financial loss; (iii) result in material misstatements of the broker's or dealer's financial statements; or (iv) result in violations of the SEC's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described above.

^{81/} Rule 17a-5(d) generally requires that brokers or dealers registered pursuant to Section 15 of the Exchange Act shall file annually, on a calendar or fiscal year basis, a report which shall be audited by an independent public accountant. The annual audited report shall contain a Statement of Financial Condition (in a format and on a basis which is consistent with the totals reported on the Statement of Financial Condition contained in Form X-17A-5, Part II or Part IIA), a Statement of Income, a Statement of Cash Flows, a Statement of Changes in Stockholders' or Partners' or Sole Proprietor's Equity, and Statement of Changes in Liabilities Subordinated to Claims of General Creditors. Supporting schedules shall include, from Part II or Part IIA of Form X-17A-5, a Computation of Net Capital Under Rule 15c3-1, a Computation for Determination of the Reserve Requirements under Exhibit A of Rule 15c3-3 and Information Relating to the Possession or Control Requirements Under Rule 15c3-3. Rule 17a-5(j) requires the broker or dealer to file concurrently with the annual audit report a supplemental report by the accountant describing any material inadequacies found to exist or found to have existed since the date of the previous audit.

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procedures for safeguarding securities. Rule 17a-5 provides that the scope of the audit and review shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination would be disclosed. These procedures are to include a review of the practices and procedures of the broker or dealer in making the periodic computations of aggregate indebtedness and net capital under Rule 15c3-1.

In addition to the above, Rule 17a-5 provides that the audit is to include a review of the practices and procedures followed by the broker or dealer related to, as applicable:

- Making the periodic computations of the reserve required by Rule 15c3-3(e);
- Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Exchange Act Rule 17a-13;^{82/}
- Complying with the requirements for prompt payment for securities under Regulation T of the Board of Governors of the Federal Reserve System; and
- Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.

In addition, Rule 17a-5(g)(2) provides that if the broker or dealer is exempt from the Customer Protection Rule, the accountant shall ascertain whether the broker or dealer complied with the applicable conditions for exemption.

^{82/} 17 C.F.R. §240.17a-13 requires brokers and dealers to perform securities counts not less than once each calendar quarter.