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

**PCAOB Release No. 2015-006
August 18, 2015**

Executive Summary

The Public Company Accounting Oversight Board (the "PCAOB" or the "Board") is issuing this annual 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 from 106 audits covered by inspections performed during 2014;
- Summarizes the observations from 279 audits covered by inspections performed under the interim inspection program since its inception in October 2011 through December 31, 2014;
- Describes observations from seven inspections covering portions of seven audits at seven firms where a prior audit was found to have deficiencies during a previous inspection; and
- Describes actions needed by registered public accounting firms and next steps of the interim inspection program.

Observations continue to occur at unacceptably high levels despite the emphasis on these findings in the previous progress reports, in PCAOB staff guidance for brokers and dealers, at the Board's Forums for Auditors of Broker-Dealers, and through other outreach by the Board and Board staff. Particularly concerning is an apparent lack of due professional care in the conduct of these audits by some firms, as evidenced by a lack of attention to the requirements of SEC rules and professional standards in planning and performing procedures on some engagements.

The inspections described in this annual report were of audits required to be performed under generally accepted auditing standards ("GAAS"), applicable before SEC rules were amended to require audits of brokers and dealers to be performed in accordance with PCAOB standards. During 2014, however, the Board also inspected five firms covering portions of five audit and attestation engagements of brokers and dealers that were required to be performed under PCAOB standards. The Board issued [a report](#) on January 28, 2015, that discussed its observations related to those audit and attestation engagements, which are not repeated in this report.

The Board's inspections of auditors under the interim inspection program assess the auditor's compliance with the requirements that govern the conduct of the audit. The selection of firms for inspection took into consideration the number of broker or dealer audits performed by the firms, whether they also issued audit reports for issuers and,

thus, were subject to regular inspection by the PCAOB, as well as other characteristics, to obtain a cross section of firms that audit brokers and dealers. However, the populations of firms and brokers and dealers are not homogenous. Therefore, observations discussed in this report are not necessarily indicative of the full population of firms or of audits of brokers and dealers because the selection of firms and of audits of brokers and dealers for inspection is not necessarily representative of these populations.

Inspections of Registered Public Accounting Firms During 2014

This report describes audit deficiencies and independence findings, collectively referred to as "observations," noted in the Board's inspections during 2014 of 66 firms, covering portions of 106 audits, which were required to be performed under GAAS. At the time of the inspections, 27 of the 66 firms were subject to regular inspection as they also audited issuers, generally referred to as public companies. Inspections staff identified observations at all 66 firms and in portions of 92 of the 106 audits selected for inspection. In addition to the 106 audits described above, seven audits at seven firms were selected to assess whether during the current audit the firms had addressed certain observations identified during a previous inspection of the firm that covered a prior audit of that broker or dealer. Inspections staff identified at least one audit deficiency in the same area as previously identified in each of the seven audits.

Failure to Satisfy Independence Requirements

For 26 of the 106 audits selected for inspection, it appeared to Inspections staff, that contrary to the requirements of SEC independence rules, auditors were involved in the preparation of the financial statements they audited or the terms of the engagement included that the broker or dealer would indemnify the auditor in the event of losses incurred, as described below:

- Involvement in the preparation of the financial statements was observed in 18 of the 42 audits (or approximately 43 percent) selected for inspection performed by 39 firms that did not also audit issuers;
- Involvement in the preparation of the financial statements was observed in four of the 64 audits (or approximately six percent) selected for inspection that were performed by 27 firms that also audited issuers; and
- Four audits at three firms included clauses in the engagement letters with brokers or dealers that the brokers or dealers would indemnify the auditor in the event the auditor incurred certain losses or liability in connection with the engagement.

The Board continues to report apparent independence violations to the SEC as such violations may have implications to the broker's or dealer's compliance with the requirements of the Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5 ("Rule 17a-5").

Audit Deficiencies

Inspections staff identified audit deficiencies at each of the 66 firms inspected and in portions of 92 of the 106 audits selected for inspection, which represents approximately 87 percent of these audits. The 14 audits where Inspections staff did not identify any audit deficiencies in the portions of audits inspected were performed by seven firms, of which five also audited issuers.

Audit deficiencies are failures by firms to perform, or perform sufficiently, certain required audit procedures and do not necessarily indicate that the broker's or dealer's financial statements or supporting schedules are misstated, that there are undisclosed material inadequacies or material weaknesses, or that the broker or dealer has violated Exchange Act Rules 15c3-3 ("Rule 15c3-3" or the "Customer Protection Rule") or 15c3-1 ("Rule 15c3-1" or the "Net Capital Rule").

The most frequent audit deficiencies were in the following areas:

- Revenue Recognition;
- Reliance on Records and Reports;
- Fair Value Accounting Estimates;
- Financial Statement Presentation and Disclosures; and
- The Customer Protection Rule.

Summary of Inspections Since Inception of the Interim Inspection Program

Since the inception of the interim inspection program through the end of 2014, the Board has inspected 155 firms, covering portions of 279 audits that were required to be performed under GAAS. Thirteen of these firms have been inspected more than once. At the time of the inspections, 53 of the 155 firms were subject to regular inspection as they also audited issuers. These firms performed 159 of the 279 audits selected for inspection.

Observations were identified in portions of 243, or approximately 87 percent, of the 279 audits selected for inspection. The 36 audits where Inspections staff did not identify observations were performed by 15 firms, of which 12 also audited issuers.

Inspections staff identified observations in a high percentage of the audits and areas inspected across various stratifications of firm characteristics, such as whether or

not the firm audited issuers and the number of broker or dealer audits performed by the firm. Although observations were identified across the various stratifications, firms that did not also audit issuers were noted to have a higher percentage of observations than firms that also audited issuers. Further, firms that audited 100 or fewer brokers and dealers had a higher percentage of observations than firms that audited more than 100 brokers and dealers.

Observations were identified in portions of selected audits and areas across the spectrum of brokers and dealers in terms of their characteristics, such as reported actual net capital, revenues, and assets. There did not appear to be a discernible relationship between the percentage of observations and broker or dealer characteristics, with two exceptions. Lower percentages of observations were noted for the selected audits of brokers and dealers with the highest amounts of reported actual net capital, revenues, or assets, and the percentage of observations for audits of brokers or dealers that did not claim an exemption under Rule 15c3-3 was lower than for audits of brokers or dealers that claimed an exemption under Rule 15c3-3.

Observations from the inspections performed during 2014 were compared to those from the inspections performed during prior years of the interim inspection program. The percentage of observations in the audits and areas inspected in 2014 continued to remain high and was higher in comparison to the inspections performed during 2013.

Of the 13 firms that have been inspected more than once during the interim inspection program, 10 firms also audited issuers. Inspections staff noted that, for these 10 firms, the percentage of audits and areas inspected with observations was higher during 2014 than during 2013. Inspections staff also noted that, for the three firms that did not audit issuers, the percentage of audits with observations remained at 100 percent and the percentage of areas inspected with observations was higher in 2014 than 2013.

Observations Related to Audits With Previous Inspection Observations

In addition to the inspections covering 106 audits during 2014 as discussed above, Inspections staff selected seven audits by seven firms where deficiencies had been observed in a previous inspection. These inspections covered only those areas with audit deficiencies from the previous inspection and included an evaluation of whether or how the firms addressed those previously identified audit deficiencies in the current audit. Inspections staff identified at least one audit deficiency in the same area as previously identified in each of the seven audits selected. These deficiencies were in the areas of revenue recognition, risks of material misstatements due to fraud, related party transactions, and the Net Capital Rule.

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

The Board continues to be concerned with the high number of independence findings and audit deficiencies as well as the high percentages of observations across the firms inspected and audits of brokers and dealers selected. The high number of independence findings is especially troubling because most of the violations relate to long-standing SEC independence rules regarding involvement in the preparation of the financial statements.

The Board also continues to be concerned by the nature and number of audit deficiencies. The already high percentages of audits and areas inspected with deficiencies identified in 2013 were even higher in 2014. Many of the observations in this report continue to be similar in nature to the observations described in the three previous progress reports and relate to the fundamentals of auditing. Further, some firms do not appear to have taken sufficient action to prevent similar deficiencies from occurring in audits inspected during 2014 that were previously inspected. Many of the inspected firms need to significantly improve their audit work to meet the requirements of the professional standards and SEC rules.

The Board reminds firms that information obtained through the interim inspection program may lead the Board to commence an investigation or disciplinary proceeding concerning the conduct of a firm or associated persons of such firms, and the Board has done so in certain instances. As of the date of this report, the Board has announced settled disciplinary orders against 14 audit firms for violating rules requiring that auditors of brokers and dealers be independent of their audit clients.

In addition, when it comes to the Board's attention that the financial statements appear not to be fairly stated, in all material respects, in conformity with GAAP, or there are possible violations by brokers or dealers of laws, rules, or regulations, the Board's practice is to report that information to the SEC and designated examining authorities. The SEC announced on December 8, 2014 settled actions for violations of independence rules against eight audit firms, which were not the same firms as those that reached settlements with the Board.

Actions Needed by Firms

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

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

The Board encourages registered public accounting firms that audit brokers and dealers to review the [Staff Guidance for Auditors of SEC-Registered Brokers and Dealers](#) issued on June 26, 2014, as well as the practice alerts issued by the Board related to areas such as auditing revenue recognition and exercising professional skepticism. The Board also encourages registered public accounting firms to attend the Board's periodic Forums for Auditors of Broker-Dealers and review the [webcasts](#) archived on the Board's website.

Next Steps of the Interim Inspection Program

The Board will continue to conduct inspections of registered public accounting firms that audit brokers and dealers under the interim inspection program until rules for a permanent inspection program take effect. During 2015, the Board plans to perform inspections of 75 firms covering portions of approximately 115 audit and attestation engagements of brokers and dealers to assess compliance with PCAOB standards, rules of the SEC and the Board, and the Sarbanes-Oxley Act of 2002 (the "Act").

The Board is continuing to take a careful and informed approach in establishing a permanent inspection program. The Board continues to consider the risk of loss to customers and the high percentage of audit deficiencies and independence findings that have been observed during the inspections under the interim inspection program. The PCAOB staff is currently working to develop a rule proposal for the Board to consider during 2016 to establish a permanent inspection program, which will address whether to exempt any category of registered public accounting firm.

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

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Background

The PCAOB is issuing this annual report on the progress of its interim inspection program¹ for auditors of brokers and dealers registered with the SEC.² This report describes observations identified by Inspections staff during inspections that covered audits of brokers and dealers required to be performed under GAAS. All of the audits discussed in this report relate to fiscal years that ended on or before May 31, 2014. Those audits were conducted before certain changes to applicable SEC rules took effect, including changes that now require audits of brokers and dealers to be performed in accordance with PCAOB standards.³ See Appendix A for references to certain

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

² The Board issued its First Progress Report on August 20, 2012 (the "First Progress Report"), its Second Progress Report on August 19, 2013 (the "Second Progress Report"), and its Third Progress Report on August 18, 2014 (the "Third Progress Report"), all of which are available on the PCAOB website at: <http://pcaobus.org/Inspections/Pages/PublicReports.aspx>.

³ On July 30, 2013, the SEC adopted amendments to its net capital, customer protection, books and records, and notification rules for brokers and dealers under the Exchange Act, see Exchange Act Release No. 70072 (July 30, 2013), and adopted amendments to Exchange Act Rule 17a-5, *Reports to be Made by Certain Brokers and Dealers* (see Exchange Act Rule 17 C.F.R. § 240.17a-5) and Exchange Act Rule 17a-11, *Notification Provisions for Brokers and Dealers* (17 C.F.R. § 240.17a-11), see Exchange Act Release No. 70073 (July 30, 2013). Among other things, the amendments to Rule 17a-5 require that audits of brokers and dealers be performed in accordance with PCAOB standards, effective beginning with audits for fiscal years ended on or after June 1, 2014. With respect to audits for earlier fiscal years, such as

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releases issued by the SEC or PCAOB related to standards and rules for brokers and dealers and their auditors.

During 2014, the Board also inspected five firms covering portions of five audit and attestation engagements of brokers and dealers that were required to be performed under PCAOB standards and the amended SEC rules. The Board issued a report on January 28, 2015,⁴ that discussed its observations related to those audit and attestation engagements and other matters. Those observations included independence findings and deficiencies in audit and attestation procedures performed by these firms that were similar to many of the observations discussed in Part I of this report.⁵ The description of those inspections and related observations included in the January 28, 2015 report are not repeated in this progress report.

Under the interim inspection program, the Board conducts inspections of registered public accounting firms in connection with their performance of audits, issuance of audit reports, and related matters involving brokers and dealers registered with the Commission⁶ to assess compliance with the professional standards, rules of the Commission and the Board, and the Act.

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

The audits selected for inspection were evaluated against the standards and rules applicable at the time of the audit, and this report's discussion of those audits refers to those standards and rules. For all audits selected for inspection discussed in this report, Rule 17a-5 generally required brokers and dealers to file with the SEC and

those discussed in this report, Rule 17a-5 required that the audits be performed in accordance with GAAS, which are promulgated by the American Institute of Certified Public Accountants ("AICPA").

⁴ Refer to <http://pcaobus.org/Inspections/Pages/PublicReports.aspx>.

⁵ The Appendix to the January 28, 2015 report provides references to PCAOB standards that correspond to certain generally accepted auditing standards.

⁶ Under Section 15 of the Exchange Act, most brokers and dealers must register with the SEC and join a self-regulatory organization, such as the Financial Industry Regulatory Authority ("FINRA"). Hereinafter, the use of the terms "broker(s) and dealer(s)" or "broker(s) or dealer(s)" refers to brokers and dealers registered with the SEC.

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other regulators, among other things, (1) annual financial statements, (2) supporting schedules related to the computation of net capital and the customer reserve requirement, and (3) an accountant's supplemental report on material inadequacies. Refer to the Appendix of the Second Progress Report for an overview of net capital, customer protection, and annual reporting requirements for SEC-registered brokers and dealers.

This report contains four parts:

- Part I describes the inspections performed during 2014 of 66 registered public accounting firms covering 106 audits;
- Part II provides a summary of inspections performed under the interim inspection program since its inception through December 31, 2014;
- Part III describes observations identified by Inspections staff for seven audits performed by seven firms where a prior audit was found to have deficiencies during a previous inspection; and
- Part IV describes actions needed by registered public accounting firms and next steps of the interim inspection program.

Observations continue to occur at unacceptably high levels despite the emphasis on these findings in the previous progress reports, in PCAOB staff guidance for auditors of brokers and dealers, at the Board's Forums for Auditors of Broker-Dealers, and through other outreach by the Board and Board staff. Particularly concerning is an apparent lack of due professional care in the conduct of these audits by some firms, as evidenced by a lack of attention to the requirements of SEC rules and professional standards in planning and performing procedures on some engagements.

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Part I: Inspections of Registered Public Accounting Firms During 2014

The following section describes registered public accounting firms that audit brokers and dealers, the selection of audits inspected during 2014, and independence findings and audit deficiencies identified by Inspections staff.

Firms that Audit Brokers and Dealers

For fiscal periods ended during the period from June 1, 2013 through May 31, 2014, there were 758 registered public accounting firms that issued audit reports on the financial statements of brokers and dealers that were filed with the SEC. Many of the registered public accounting firms audited as few as one broker or dealer, while several firms audited more than 100 brokers and dealers.

Number of Broker or Dealer Audits per Firm	Number of Firms ⁷	Percentage of Firms
1	348	46%
2 to 20 ⁸	374	49%
21 to 50	22	3%
51 to 100	8	1%
More than 100	6	1%
Total	758	100%

There were 4,164 brokers and dealers that filed audited annual financial statements with the SEC for fiscal years ended during the period from June 1, 2013 through May 31, 2014. The following table expands on the information above to provide further information on which firms also audited issuers and the number of their broker and dealer audits:⁹

⁷ Information about the number of firms that audited brokers and dealers and their broker or dealer audits is based on financial statements filed through May 15, 2015, for fiscal years ended during the period from June 1, 2013 through May 31, 2014. These firms were registered with the PCAOB at the time the audit reports were issued.

⁸ There were 283 firms that audited 2 to 5 brokers and dealers that represented approximately 37 percent of the total firms that audited brokers and dealers.

⁹ Information about the firms that audited issuers is derived from data obtained from the most recently submitted annual reports on Form 2 filed through June 30, 2015. 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-

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Number of Broker or Dealer Audits per Firm	Also Audited Issuers		Did Not Audit Issuers	
	Number of Firms	Number of Brokers and Dealers	Number of Firms	Number of Brokers and Dealers
1	99	99	249	249
2 to 20	147	810	227	924
21 to 50	11	333	11	344
51 to 100	3	197	5	346
More than 100	6	862	-	-
Total	266	2,301	492	1,863

Selection of Firms and Audits

During 2014, the Board inspected 66 firms and portions of 106 audits of brokers and dealers. The 106 audits selected for inspection had financial statement periods ended on September 30, 2013 through May 31, 2014 and were required to be performed under GAAS.¹⁰ The selection of firms for inspection took into consideration the number of broker or dealer audits performed by the firms, whether they also issued audit reports for issuers (and, thus, were subject to regular inspection by the PCAOB), as well as other characteristics, to obtain a cross section of firms that audit brokers and dealers. This approach for the selection of firms has been consistent since the inception of the interim inspection program. The selection of firms and audits of brokers and dealers is not necessarily representative of the population of firms or of audits of brokers and dealers. Further, the populations of firms and brokers and dealers are not homogenous. Therefore, the observations discussed in this report are not necessarily indicative of the full population of firms or of audits of brokers and dealers.

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

month period ending March 31. Information about the number of firms that audited brokers and dealers and the number of their broker or dealer audits is based on financial statements filed through May 15, 2015, for fiscal years ended during the period from June 1, 2013 through May 31, 2014. These firms were registered with the PCAOB at the time the audit reports were issued.

¹⁰ In addition to the 106 audits, seven audits at seven firms were selected to assess whether during the current audit the firms had addressed certain audit deficiencies identified during a previous inspection of the firm that covered a prior audit of that broker or dealer. The selection of firms and audits, as well as the audit deficiencies related to these audits, are not included in this section, given the portions of the audits covered in the inspections were only those with audit deficiencies identified during the previous inspection and are separately described in Part III of this report.

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Number of Broker or Dealer Audits per Firm	Number of Firms Inspected	Number of Audits Selected
1	7	7
2 to 20	42	46
21 to 50	8	15
51 to 100	3	3
More than 100	6	35
Total	66	106

At the time of the inspections, 27 of the 66 firms were subject to regular inspection as they also audited issuers. Of these 27, eight firms selected for inspection audited more than 100 issuers and 19 firms selected for inspection audited 100 or fewer issuers. The remaining 39 firms did not audit issuers and were not subject to inspection other than under the interim inspection program.

Registered Public Accounting Firms	Number of Firms Inspected	Number of Audits Selected
Also audited issuers	27	64
Did not audit issuers	39	42
Total	66	106

The selection of audits of brokers and dealers considered various characteristics of brokers and dealers, such as the broker's or dealer's minimum net capital requirement and reported actual net capital under the Net Capital Rule¹¹ and whether or not the broker or dealer maintained a Special Reserve Bank Account¹² under Rule 15c3-3. The Board did not exclude any registered public accounting firms or any audits of brokers or dealers from being eligible for selection.

The 106 audits of brokers or dealers selected for inspection included 21 brokers and dealers that maintained a Special Reserve Bank Account and 85 brokers and dealers that did not. The following table presents the minimum net capital requirements and actual net capital reported at fiscal year end for these brokers and dealers:

¹¹ 17 C.F.R. § 240.15c3-1.

¹² Brokers and dealers who do not claim an exemption under Rule 15c3-3, 17 C.F.R. § 240.15c3-3, are generally required to maintain a bank account for the exclusive benefit of customers. This account is referred to in this report as "Special Reserve Bank Account."

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	Number of Audits Selected	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End
Special Reserve Bank Account	21	\$250,000 – \$2,050,000,000	\$600,000 - \$16,000,000,000
No Special Reserve Bank Account	85 ¹³	\$5,000 - \$10,000,000	\$11,000 - \$300,000,000

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

Independence Findings and Audit Deficiencies from Inspections

The inspections focused on portions of 106 audits performed pursuant to Rule 17a-5 that related to audit procedures on certain aspects of the financial statements and compliance with the Customer Protection Rule and the Net Capital Rule.

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

Independence Findings	Number of Audits with Findings	Number of Applicable Audits	Percentage of Audits with Findings
Failure to Satisfy Independence Requirements	26	106	25%

¹³ This includes the audits of two brokers and dealers who claimed an exemption from the requirement to maintain a Special Reserve Bank Account for certain portions of the broker's and dealer's business and also maintained a Special Reserve Bank Account for other portions of the broker's and dealer's business.

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Audit Deficiencies	Number of Audits with Deficiencies	Number of Applicable Audits ¹⁴	Percentage of Audits with Deficiencies
Related to the Customer Protection and Net Capital Rules:			
Report on Material Inadequacies	33	82	40%
Customer Protection Rule	10	23	43%
Net Capital Rule	41	106	39%
Related to the Financial Statement Audit:			
Risks of Material Misstatement Due to Fraud	42	100	42%
Related Party Transactions	18	85	21%
Revenue Recognition	76	106	72%
Reliance on Records and Reports	60	106	57%
Receivables and Payables	13	68	19%
Fair Value Accounting Estimates	17	39	44%
Financial Statement Presentation and Disclosures	47	106	44%
Auditor's Report	9	106	8%

The term "audit deficiencies," as used in this report, refers to failures by firms to perform, or perform sufficiently, certain required audit procedures. Audit deficiencies that exceeded a certain level of significance were communicated to the firms in writing. This report summarizes those audit deficiencies that Inspections staff determined were important to convey within this report based on their nature, severity, or frequency. An audit deficiency does not necessarily indicate that the broker's or dealer's financial statements or supporting schedules are misstated, that there are undisclosed material inadequacies or material weaknesses, or that the broker or dealer has violated the Customer Protection or Net Capital Rules. Conclusions regarding these situations are often not possible for Inspections staff to reach based only on the information available from the auditors.

The term "observations," as used in this report refers to audit deficiencies and independence findings, collectively. One or more observations described in this section of the report were identified for all of the 66 firms whose audits were selected for inspection and in portions of 92 of the 106 audits selected for inspection.

¹⁴ Some of the areas listed in the table were not covered by, or applicable to, all audits selected.

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The 14 audits with no observations in the portions of audits inspected were performed by seven firms, of which five also audited issuers. For all of these firms, more than one audit was selected for inspection and Inspections staff identified observations in one or more of each firm's other audits.

Failure to Satisfy Independence Requirements

The independence of the registered public accounting firm is required under SEC rules and plays an important role in fostering high quality audits. SEC rules require auditors of brokers and dealers to comply with SEC independence requirements,¹⁵ 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.¹⁶ In addition, an auditor is not independent if the audit client agrees to indemnify the auditor for any liability or costs resulting from negligent acts by the auditor or misrepresentations by management.¹⁷

Inspections staff identified independence findings in 26 of the 106 audits selected for inspection and communicated these to the firms in writing. Independence findings were identified in six of the audits selected for inspection performed by four firms that audited brokers and dealers and also issued audit reports for 100 or fewer issuers. Independence findings were also identified in 20 of the audits selected for inspection performed by 20 firms that audited brokers and dealers, but did not audit issuers.

Inspections staff observed 22 audits, by 21 firms, where the firms performed bookkeeping or other services related to the accounting records or financial statements of the brokers or dealers. All of these firms prepared, or assisted in the preparation of, the financial statements or supporting schedules required by Rule 17a-5. In addition, some of these firms also prepared journal entries or source data underlying the financial statements of the brokers or dealers, each of which is prohibited under the SEC

¹⁵ Rule 17a-5 provides that the auditor must be independent in accordance with Rule 2-01 of SEC Regulation S-X. At the time of the audits discussed here, that requirement had been articulated since 1972 in Rule 17a-5(f)(3). It is now articulated in Rule 17a-5(f)(1).

¹⁶ Rule 2-01(c)(4)(i) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(4)(i).

¹⁷ See SEC Codification of Financial Reporting Policies, Section 602.02.f.i.; Application of the Commission's Rules on Auditor Independence (SEC staff guidance), Question 4 under "Other Matters," available at <http://www.sec.gov/info/accountants/ocafaquaudind080607.htm>.

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independence rules. Inspections staff also observed that independence related to the performance of four audits at three firms appeared to have been impaired because the terms of the engagement included that the broker or dealer would indemnify the auditor in the event the auditor incurred certain losses or liability arising in connection with the engagement.

Audit Deficiencies Related to the Customer Protection and Net Capital Rules

Accountant's Supplemental Report on Material Inadequacies

At the time of the audits discussed here, Rule 17a-5(g)(1) required the scope of the audit and the review of the accounting system, the internal accounting controls, the 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 on material inadequacies.¹⁸

Inspections staff identified deficiencies in 33 of the 82 audits selected for inspection where the firm's procedures related to one or more of the requirements of the accountant's supplemental report on material inadequacies were assessed during the inspection. The following presents a summary of the deficiencies discussed below:

¹⁸ Effective for fiscal years ending on or after June 1, 2014, Rule 17a-5(g) requires that the auditor be engaged by the broker or dealer to prepare a report based on an examination of the financial statements and supporting schedules of the broker or dealer and, depending on the report filed by the broker or dealer, an examination of the compliance report or a review of the exemption report.

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Deficiencies Related to:	Number of Audits	Number of Audits Inspected
Exemption claimed under Rule 15c3-3	30	80 ¹⁹
Other procedures or tests related to the accountant's supplemental report on material inadequacies	3	11 ²⁰

At the time of the audits discussed here, when a broker or dealer claimed an exemption under the Customer Protection Rule, auditors were required under Rule 17a-5(g)(2) to ascertain whether the conditions of the exemption were complied with as of the examination date, and whether facts came to the auditor's attention to indicate that the broker or dealer was not in compliance with the exemption during the period since the last examination. In 30 of the 80 audits inspected of brokers and dealers that claimed an exemption from the requirement to maintain a Special Reserve Bank Account, Inspections staff found that firms failed to comply with this requirement. In several instances, Inspections staff found that firms failed to perform any procedures to ascertain that the broker or dealer complied with the conditions of the exemption. In other instances, the firms limited their procedures to inquiry alone and did not perform sufficient other inquiries or other procedures related to the exemption claimed by the broker or dealer under the Customer Protection Rule.

In addition to the deficiencies noted above, Inspections staff observed that in three audits, firms failed to perform sufficient audit procedures with respect to the accountant's supplemental report on material inadequacies. In one audit, the firm did not perform procedures to obtain reasonable assurance as to whether a material inadequacy related to the broker and dealer's practices and procedures in making the periodic computations required by Rule 15c3-3 existed at the date of the examination. The firm failed to perform procedures to determine if a material weakness related to the broker and dealer's compliance with Rule 15c3-3 identified in the previous audit was remediated. Inspections staff also noted that the firm did not sufficiently test controls related to the broker and dealer's practices and procedures in making the periodic

¹⁹ This area was inspected for 80 of the 85 audits of brokers and dealers that claimed an exemption from the requirement to maintain a Special Reserve Bank Account.

²⁰ The firms' procedures for one or more requirements in this area were assessed during the inspection covering 11 audits of brokers and dealers based on certain characteristics, including whether the broker or dealer was required to maintain a Special Reserve Bank Account or whether errors or deficiencies were identified that could have been considered indicators of a material inadequacy. Of the 11 audits, nine brokers or dealers claimed an exemption under Rule 15c3-3 and two did not.

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computations of customer reserve. Inspections staff also found that in two of the three audits, firms identified errors or deficiencies during other audit procedures but did not assess whether these errors or deficiencies indicated the existence of a material inadequacy.

Procedures Regarding Compliance with the Customer Protection Rule

At the time of the audits discussed here, Rule 17a-5(g) stated that brokers and dealers shall include supporting schedules with the financial statements that present the customer reserve computation and information relating to requirements for possession or control of securities.²¹ Rule 17a-5(g) also stated that the audit shall include all procedures necessary under the circumstances to enable the independent public accountant to express an opinion on, among other things, the customer reserve computation and information relating to the possession or control requirements under Rule 15c3-3. AU-C sec. 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. Inspections staff identified deficiencies, as discussed below, involving failures to comply with the audit requirements in Rule 17a-5(g) or AU-C sec. 725.²²

Inspections staff identified one or more deficiencies in 8 of 21 audits selected for inspection where brokers or dealers did not claim an exemption from the requirement to maintain a Special Reserve Bank Account. In addition, Inspections staff identified deficiencies in another two audits where the broker or dealer claimed an exemption for certain portions of the broker's or dealer's business, but maintained a Special Reserve Bank Account for other portions of the business. In 2 of the 10 audits with deficiencies related to the Customer Protection Rule, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Customer debits or credits	7
Special Reserve Bank Account	4
Possession or control requirements	3

²¹ This requirement became paragraph (d)(2)(ii) of Rule 17a-5 as a result of the amendments described in footnote 3.

²² See Paragraphs .05 and .07 of AU-C sec. 725.

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Customer Debits or Credits

In 7 of the 23 audits, Inspections staff noted that firms failed to sufficiently evaluate the appropriateness and completeness of customer debits or credits included in the customer reserve computation. Inspections staff observed that these firms limited their procedures to agreeing the amounts reported in the computation to schedules prepared by the broker or dealer and did not perform any other procedures to evaluate the appropriateness and completeness of customer debits or credits, including evaluating whether customer debits or credits complied with Exhibit A of Rule 15c3-3.

Special Reserve Bank Account

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

Inspections staff observed in 4 of the 23 audits, firms failed to evaluate whether the Special Reserve Bank Account existed or whether the account agreements complied with, and contained the required restrictive provisions of Rule 15c3-3(f).

Possession or Control Requirements

Rule 15c3-3(b)(1) requires a broker or dealer to promptly obtain and maintain the physical possession or control²³ of all fully-paid securities²⁴ and excess margin securities²⁵ carried by the broker or dealer for the accounts of customers.

Inspections staff observed in 3 of the 23 audits, firms failed to perform sufficient procedures to determine compliance with the possession or control requirements. Inspections staff noted that firms did not perform sufficient procedures to evaluate the appropriateness and completeness of the amounts reported in the supplemental schedule or compare and reconcile them to the underlying accounting and other records

²³ Generally, "possession" of securities means the securities are physically located at the broker or dealer and "control" of securities means the securities are located at an approved "control" location, such as a clearing corporation or depository.

²⁴ Generally, fully-paid securities are securities that are purchased in transactions for which the customer has made full payment. See Rule 15c3-3(a)(3).

²⁵ Generally, excess margin securities in a customer account are those securities with a market value greater than 140 percent of the customer's debit balance. See Rule 15c3-3(a)(5).

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used in preparing the financial statements. In two audits, the firms relied on reports from a service organization and obtained the service auditor's report, but failed to determine whether the scope of the service auditor's report covered the systems or services that calculated amounts used by the broker or dealer when monitoring possession or control requirements. In one of these audits, a firm also did not evaluate the amount reported as customer securities on the stock record.

Procedures Regarding Compliance with the Net Capital Rule

At the time of the audits discussed here, Rule 17a-5(g) stated that brokers and dealers shall include a supporting schedule to the financial statements that presents the computation of net capital.²⁶ Net capital is also generally disclosed in the notes to the financial statements. Similar to the procedures regarding compliance with the Customer Protection Rule noted above, Rule 17a-5(g) and AU-C sec. 725 were applicable to audits described in this section.

Inspections staff identified one or more deficiencies in 41 of the 106 audits selected, where one or more components of the net capital computation was selected for inspection. In 17 of the 41 audits with deficiencies related to the Net Capital Rule, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Minimum net capital requirements	15
Additions to net worth	1
Allowable assets	26
Haircuts	8
Operational charges and other deductions	8
Equity capital withdrawals	8

Minimum Net Capital Requirements

Generally, a broker's or dealer's required minimum net capital is the greater of (1) one of a number of fixed-dollar amounts prescribed in Rule 15c3-1 applicable to the broker or dealer relative to its line(s) of business,²⁷ or (2) an amount computed using one of two financial ratios.²⁸ In 15 of the 106 audits, Inspections staff found that firms

²⁶ This requirement became paragraph (d)(2)(ii) of Rule 17a-5 as a result of the amendments described in footnote 3.

²⁷ See Rule 15c3-1(a)(2).

²⁸ See Rule 15c3-1(a)(1).

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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. For example, in one audit, Inspections staff found that the firm failed to evaluate whether aggregated indebtedness was calculated in accordance with Rule 15c3-1(c)(1) because it failed to evaluate whether there was any accrued interest payable related to the broker's and dealer's reported subordinated liabilities,²⁹ and therefore, failed to evaluate whether the calculated minimum net capital was in accordance with Rule 15c3-1(a).

Additions to Net Worth

Under Rule 15c3-1, certain discretionary liabilities are allowed to be added back to net worth in the determination of net capital.³⁰ In one audit, Inspections staff found that a firm failed to evaluate whether the amount of the liability for employee bonuses that was added to net worth in the determination of net capital was payable solely at the discretion of the broker or dealer, in accordance with Rule 15c3-1.

Allowable Assets

Rule 15c3-1 requires that assets not readily convertible into cash ("non-allowable assets") be deducted from equity when computing net capital.³¹ Inspections staff observed 26 audits where firms did not perform sufficient procedures to test the broker's or dealer's classification of allowable and non-allowable assets when computing net capital.

Under Rule 15c3-1, brokers and dealers are permitted to offset certain receivables and payables when specific conditions are met. In 6 of the 26 audits, Inspections staff observed that firms failed to perform sufficient procedures to evaluate whether commissions receivable pursuant to the Investment Company Act of 1940 Rule 12b-1 ("Rule 12b-1")³² were allowable assets under Rule 15c3-1. For example, Rule 12b-1 commissions receivable can be classified as an allowable asset only to the extent the receivables are offset by Rule 12b-1 commissions payable to sales representatives. Among other things, the firms failed to obtain the signed written agreement between the

²⁹ See FINRA, Interpretations of Financial and Operational Rules, Interpretation 15c3-1(c)(1)/02.

³⁰ See FINRA, Interpretations of Financial and Operational Rules, Interpretation 15c3-1(c)(2)/02.

³¹ See Rule 15c3-1(c)(2)(iv).

³² 17 C.F.R. § 270.12b-1.

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sales representative and the broker or dealer waiving payment of their commissions until the broker or dealer is in receipt of the Rule 12b-1 commissions.³³

At the time of the audits discussed here, Rule 15c3-1 permitted a broker's or dealer's proprietary assets and clearing deposit that were held by a clearing broker in a proprietary account to be classified as allowable assets in its net capital computation provided certain conditions are met.³⁴ In 16 of the 26 audits, Inspections staff observed that brokers and dealers reported assets held by a clearing broker as allowable assets, but the firms failed to evaluate whether these assets met the requirements of an allowable asset under Rule 15c3-1(c)(2)(iv)(E).

Rule 15c3-1(c)(2)(iv)(C) states that commissions receivable from other brokers or dealers that are outstanding longer than 30 days from the date they arise are non-allowable assets. In 8 of the 26 audits, Inspections staff observed that firms failed to evaluate the aging of commissions receivable to determine whether the amount reported as an allowable asset met the requirements of Rule 15c3-1(c)(2)(iv)(C).

Haircuts

When computing net capital, Rule 15c3-1 generally requires brokers and dealers to apply percentage reductions (referred to as "haircuts") to the values of securities owned by the broker or dealer.³⁵ As a result, the valuation of the securities and the appropriate haircut percentages can be critical to the net capital computation. Inspections staff observed eight audits where firms did not perform sufficient procedures related to haircuts on securities.

In all eight 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 evaluating the relevant characteristics of the securities positions. For example, firms failed to evaluate whether haircuts on securities positions were based on the percentages applicable to the categories of securities and maturity dates, if applicable, pursuant to SEC Rule 15c3-1(c)(2)(vi). In five of the audits, Inspections staff found that the firms failed to evaluate the appropriateness and completeness of the values of the securities and their related haircuts used in the computation of net capital.

³³ See FINRA, Interpretations of Financial and Operational Rules, Interpretation 15c3-1 (c)(2)(iv)(C)/09.

³⁴ See FINRA, Interpretations of Financial and Operational Rules, Interpretation 15c3-1(c)(2)(iv)(E)/021.

³⁵ See Rule 15c3-1(c)(2)(vi).

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Operational Charges and Other Deductions

In computing net capital, Rule 15c3-1 requires brokers and dealers to deduct amounts related to operational charges such as aged fail to deliver balances³⁶ and other deductions such as excess fidelity bond coverage.³⁷ In eight audits, Inspections staff observed that firms failed to perform sufficient procedures to evaluate the appropriateness or completeness of operational charges and other deductions that were deducted from the broker's or dealer's net capital.

Equity Capital Withdrawals

Under Rule 15c3-1, brokers and dealers are required to provide timely notifications to their designated examining authority and the SEC specific to certain withdrawals of equity capital.³⁸ In six audits, Inspections staff observed that firms failed to perform sufficient procedures to evaluate compliance regarding the timely notifications of withdrawals of equity capital. For example, in one audit, Inspections staff noted that a firm limited their procedures to inquiry of management. Inspections staff also observed in three audits, including one audit noted above, that firms failed to evaluate whether the broker's or dealer's withdrawal of equity capital during the year under audit complied with the limitations on withdrawals on equity capital in accordance with Rule 15c3-1(e)(2).

Deficiencies Related to the Financial Statement Audit

Consideration of Risks of Material Misstatement Due to Fraud

An auditor conducting an audit in accordance with GAAS is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.³⁹ AU-C sec. 240 describes the auditor's responsibilities for, among other things, identifying, assessing, and responding to the risks of material misstatement due to fraud. The two types of misstatements that are relevant to the consideration of fraud in a financial statement audit are misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.⁴⁰

³⁶ See Rule 15c3-1(c)(2)(ix).

³⁷ See Rule 15c3-1(c)(2)(xiv).

³⁸ See Rule 15c3-1(e)(1).

³⁹ Paragraph .05 of AU-C sec. 240, *Consideration of Fraud in a Financial Statement Audit*.

⁴⁰ Paragraph .03 of AU-C sec. 240.

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Inspections staff identified one or more deficiencies in 42 of the 100 audits selected for inspection. In 13 of the 42 audits with deficiencies related to the consideration of risks of material misstatement due to fraud, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Identification and assessment of the risks of material misstatement due to fraud	9
Responses to the assessed risks of material misstatement due to fraud – management override	38
Responses to fraud risk related to revenue recognition	13

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

Key engagement team members, including the engagement team partner, are required to have a discussion that includes an exchange of ideas or brainstorming about how and where the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.⁴¹ In four audits, Inspection staff observed that firms did not include the engagement team partner in the brainstorming session, or the discussion did not address the required content.

When identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that risks of fraud exist in revenue recognition, evaluate which types of revenue, revenue transactions, or assertions give rise to such risks.⁴² If the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is overcome in the circumstances of the engagement, the auditor should include in the audit documentation the reasons for that conclusion.⁴³ In five audits, Inspections staff observed that although the firms did not identify a fraud risk related to revenue recognition, the firms did not perform an assessment to determine whether the circumstances of the engagements overcame the presumption that risks of fraud existed in revenue recognition.

⁴¹ Paragraph .15 of AU-C sec. 240

⁴² Paragraph .26 of AU-C sec. 240.

⁴³ Paragraph .46 of AU-C sec. 240.

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

The auditor should address the risk of management override of controls apart from any conclusions regarding the existence of more specifically identifiable risks by designing and performing audit procedures to (a) test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including entries posted directly to financial statement drafts, (b) review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud, and (c) evaluate whether the business rationale (or the lack thereof) of significant transactions that are outside the normal course of business suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.⁴⁴

Inspections staff observed in 38 audits, that firms failed to perform sufficient procedures to address risks related to management override of controls, including sufficiently testing the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. Firms failed to (i) obtain an understanding of the entity's financial reporting process and controls over journal entries and other adjustments, and the suitability of design and implementation of such controls, (ii) make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments, (iii) consider fraud risk indicators, the nature and complexity of accounts, and entries processed outside the normal course of business, (iv) select journal entries and other adjustments made at the end of a reporting period, or (v) consider the need to test journal entries and other adjustments throughout the period.⁴⁵

In 13 of the 38 audits, Inspections staff observed that firms did not test the completeness of the population of journal entries from which they selected a sample for journal entry testing.⁴⁶

Responses to Fraud Risk Related to Revenue Recognition

Inspections staff observed 13 audits where firms failed to design or perform audit procedures whose nature, timing, and extent were responsive to the assessed risks of

⁴⁴ See Paragraph .32 of AU-C sec. 240.

⁴⁵ Paragraph .32a of AU-C sec. 240.

⁴⁶ See Paragraph .09 of AU-C sec. 500, *Audit Evidence*.

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material misstatement due to fraud related to revenue recognition.⁴⁷ For example, Inspections staff noted that in instances where the firm's approach to address the identified fraud risk consisted only of substantive procedures, some firms used substantive analytical procedures but did not perform tests of details as required by AU-C sec. 330.⁴⁸

Auditing Related Party Transactions

Related parties often play a significant role in the operations of brokers and dealers; for example, through direct participation in the activities of the brokers and dealers by principals or affiliates under shared service agreements. The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.⁴⁹ For example, related parties may be improperly used by brokers and dealers in scenarios such as: overpaying for goods or services and disguising capital withdrawals; avoiding the imposition of higher capital requirements and various capital charges; structuring a broker's or dealer's business to avoid certain rules; and transferring customer assets to parties that are not approved custodians.

Auditors have a responsibility to perform audit procedures to identify, assess, and respond to the risks of material misstatement arising from a broker's or dealer's failure to appropriately account for or disclose related party relationships, transactions, or balances.⁵⁰ The auditor should design and perform audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions and should remain alert when inspecting records or documents for arrangements or other information that may indicate the existence of related party relationships or transactions that have not previously been identified or disclosed.⁵¹

If management makes an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an

⁴⁷ See Paragraph .06 of AU-C sec. 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

⁴⁸ See Paragraph .22 of AU-C sec. 330.

⁴⁹ Paragraph .03 of AU-C sec. 550, *Related Parties*.

⁵⁰ See Paragraph .04 of AU-C sec. 550.

⁵¹ See Paragraphs .16 and .21 of AU-C sec. 550.

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arm's length transaction, the auditor should obtain sufficient appropriate audit evidence about the assertion.⁵²

Inspections staff identified one or more deficiencies in 18 of the 85 audits where the auditor's procedures to test related parties and related party transactions were selected for inspection. In 2 of the 18 audits with related party deficiencies, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Existence and identification of related party relationships or transactions	4
Examining identified related party transactions	16

Inspections staff observed four audits where firms failed to perform sufficient procedures to determine the existence of related parties and material related party transactions. Inspections staff found that firms did not inspect records and documents for the purpose of identifying related party relationships or transactions that had not been previously identified or disclosed.

In 16 audits, Inspections staff observed that firms identified related parties or material related party transactions, including service agreements, fee agreements, or intercompany balances, yet the firms did not perform procedures necessary to obtain sufficient appropriate audit evidence to respond to the assessed risks of material misstatement associated with related party relationships and transactions.

In 1 of the 16 audits discussed above, Inspection staff observed that the firm failed to perform procedures to evaluate whether the broker's or dealer's disclosure of the terms of a certain related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction.

Auditing Revenue Recognition

Brokers and dealers may generate revenue from a variety of securities-related lines of business. When testing revenue, the auditor should design and perform audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level.⁵³ The auditor must obtain sufficient appropriate audit evidence to be able to draw reasonable

⁵² Paragraph .25 of AU-C sec. 550.

⁵³ See Paragraph .06 of AU-C sec. 330.

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conclusions for his or her opinion on whether the financial statements are presented fairly, in all material respects, in conformity with GAAP.⁵⁴

Inspections staff identified one or more deficiencies in 76 of the 106 audits selected for inspection. In 38 of the 76 audits with deficiencies related to revenue recognition, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Extent of testing	51
Substantive analytical procedures	20
Other procedures to test revenue recognition	48

Inspections staff observed that in 51 audits, the extent of testing was insufficient for material classes of revenue transactions, including trading gains and losses, commission revenue, and advisory fees. For example, Inspections staff observed instances where firms: (a) did not perform any procedures to test material classes of revenue transactions; or (b) did not appropriately design and perform sampling procedures to test revenue transactions because: (i) firms did not have a basis to reduce the extent of substantive tests of material classes of revenue transactions, because some of these firms did not sufficiently test controls yet reduced the extent of their substantive tests; (ii) the sample was not designed to address the relevant risk and did not adequately consider the characteristics of the population; or (iii) firms failed to select a representative sample of items for testing that was necessary to be able to extend the auditor's conclusions to the entire population (for example, firms limited their sample selections to certain days, weeks, or months during the year and did not select from the entire population).

When designing and performing analytical procedures, either alone or in combination with tests of details, as substantive procedures, the auditor should: (a) determine the suitability of substantive analytical procedures for given assertions; (b) evaluate the reliability of data from which expectations are developed; (c) develop an expectation and evaluate whether the expectation is sufficiently precise to identify a misstatement; and (d) determine the amount of difference from the expectation that can be accepted without further investigation.⁵⁵ If analytical procedures performed identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor should investigate such differences by (a) inquiring of management and obtaining appropriate audit evidence

⁵⁴ Paragraph .01 of AU-C sec. 500.

⁵⁵ See Paragraph .05 of AU-C sec. 520, *Analytical Procedures*.

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relevant to management's responses and (b) performing other audit procedures as necessary in the circumstances.⁵⁶

Inspections staff observed 20 audits where firms performed substantive analytical procedures that did not provide the intended level of assurance because the firms failed to: (a) develop expectations that were sufficiently precise to identify misstatements; (b) investigate significant unexpected differences from expectations; (c) evaluate the reliability of the data from which the auditors' expectations were developed; (d) establish an amount of difference from the expectation that could be accepted without further investigation; or (e) perform procedures to obtain evidence to corroborate management's responses regarding significant unexpected differences with other evidential matter.

Inspections staff identified deficiencies in 48 audits selected for inspection that related to the failure of firms to perform sufficient procedures to test the relevant assertions for revenue. For example, firms failed to: (a) evaluate, or evaluate sufficiently, the effect of specific terms or provisions of significant contractual arrangements related to the recognition of revenue; (b) test whether revenue was recorded in the correct period; (c) determine whether assets under management used to calculate fees were complete or accurate; (d) determine whether the commission rates used to calculate commission revenue were consistent with the underlying agreements; or (e) evaluate whether revenue recognition policies were in conformity with GAAP.

Inspections staff noted many deficiencies related to auditing revenue recognition were the result of instances where firms failed to obtain audit evidence about the accuracy and completeness of the information produced by service organizations or the brokers and dealers. Please see the next section of this report for further discussion on these deficiencies.

Procedures to Establish a Basis for Reliance on Records and Reports

Inspections staff identified one or more deficiencies in 60 of the 106 audits selected for inspection. In 16 audits with deficiencies related to establishing a basis for reliance on records and reports, Inspections staff identified more than one deficiency in the categories set forth in the table below:

⁵⁶ Paragraph .07 of AU-C sec. 520.

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Deficiencies Related to:	Number of Audits
Auditing information produced by service organizations	45
Testing records and reports produced by brokers and dealers	32

Auditing Information Produced by Service Organizations

Many brokers and dealers use the services of other brokers and dealers to perform trade processing and related back-office functions, primarily in the clearing and settling of customer transactions. AU-C sec. 402, *Audit Considerations Relating to an Entity Using a Service Organization*, applies to audits where an entity uses services from a service organization that affect the company's information system, including related business processes, relevant to financial reporting.⁵⁷ AU-C sec. 402 also discusses the user auditor's requirement to obtain an understanding of how the company uses the services of a service organization in the company's operations, the user auditor's requirement to obtain an understanding of internal control relevant to the audit, and the user auditor's response to assessed risks of material misstatement, through further audit procedures.⁵⁸ In responding to the assessed risks of material misstatement, the auditor should (a) determine whether sufficient appropriate audit evidence concerning the relevant assertions is available from records held at the broker or dealer and if not, (b) perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organization on the user auditor's behalf.⁵⁹

Inspections staff observed in 45 audits that firms did not perform sufficient procedures on information produced by service organizations that were used to perform substantive audit procedures or test of controls.

Inspections staff observed in 32 of those 45 audits that firms used information produced by a service organization, such as records or reports from a clearing broker, but failed to obtain sufficient appropriate audit evidence on such information. Some firms used clearing broker statements as audit evidence and did not perform sufficient substantive audit procedures on the statement. In several instances, firms limited their procedures to agreeing the clearing broker statement to cash receipts or the general ledger.

⁵⁷ See Paragraph .03 of AU-C sec. 402.

⁵⁸ See Paragraphs .09 through .22 of AU-C sec. 402.

⁵⁹ Paragraph .15 of AU-C sec. 402.

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Inspections staff observed that in 25 audits, firms obtained a service auditor's report, but failed to sufficiently evaluate the service auditor's report or consider whether the service auditor's report provided evidence about the design and operating effectiveness of the controls being relied upon. For example, Inspections staff observed instances where firms failed to evaluate: (a) whether the broker or dealer had designed and implemented the necessary user entity controls identified in the service auditor's report or test those controls; (b) whether the scope of the service auditor's report covered the systems or services used by the broker or dealer; and (c) whether the service auditor's report covered the period being audited.

Testing Records and Reports Produced by Brokers and Dealers

When information produced by the entity is used by the auditor in designing and performing audit procedures, the auditor should evaluate whether the information is sufficiently reliable for the auditor's purpose, including obtaining audit evidence about the accuracy and completeness of the information and evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.⁶⁰

Inspections staff observed that in 32 audits, firms failed to perform sufficient procedures to obtain evidence about the accuracy or 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 these records and reports included trade blotters, account statements, and schedules or spreadsheets prepared by broker or dealer personnel. Such records and reports were used by firms in performing tests of certain accounts or disclosures without testing the accuracy or completeness of the information in those records and reports.

Auditing Receivables and Payables

Brokers and dealers may report receivables and payables resulting from their transactions with various counterparties, customers, and clearing depositories, or securities-related financing transactions such as repurchase or reverse repurchase agreements. The auditor should design and perform audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level.⁶¹ The auditor must obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions for his or her opinion on whether the financial statements are presented fairly, in all material respects, in conformity with GAAP.⁶²

⁶⁰ Paragraph .09 of AU-C sec. 500.

⁶¹ Paragraph .06 of AU-C sec. 330.

⁶² Paragraph .01 of AU-C sec. 500.

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Inspections staff identified one or more deficiencies in 13 of the 68 audits, where certain receivables and payables were selected for inspection. In 3 of the 13 audits with deficiencies related to receivables and payables, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Extent of testing	8
External confirmations	4
Other procedures to test receivables and payables	4

Inspections staff observed that in eight audits, the extent of testing was insufficient for a receivable or payable account balance, including commission receivables and payables to brokers and dealers and clearing organizations. For example, Inspections staff observed instances where firms: (a) did not perform any procedures to test certain assertions of the account balances; or (b) did not appropriately design and perform sampling procedures to test the account balances as firms failed to select a sample that was representative of the relevant population and sufficient to reduce sampling risk to an appropriately low level.

The auditor is required to consider whether external confirmation procedures are to be performed as substantive audit procedures and is required to use external confirmation procedures for accounts receivable unless certain conditions apply.⁶³ When using external confirmation procedures, the auditor should maintain control over all external confirmation requests, including determining the information to be confirmed or requested; as well as designing the confirmation requests, including determining that the requests are properly directed to the appropriate confirming party.⁶⁴ In the case of each nonresponse, the auditor should perform alternative audit procedures to obtain relevant and reliable audit evidence.⁶⁵ The auditor should evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence or whether further audit evidence is necessary.⁶⁶

Inspections staff identified deficiencies in four audits selected for inspection that related to the failure of firms to perform sufficient external confirmation procedures. For example, Inspections staff observed instances where firms failed to: (a) appropriately

⁶³ Paragraph .03 of AU-C sec. 505, *External Confirmations*.

⁶⁴ See Paragraph .07 of AU-C sec. 505.

⁶⁵ Paragraph .12 of AU-C sec. 505.

⁶⁶ Paragraph .16 of AU-C sec. 505.

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design the confirmation request given that the confirmation procedures were performed as of an interim date and did not take into account the short-term nature of the receivable; (b) direct confirmation requests to an appropriate confirming party; (c) perform alternative procedures on nonresponses; or (d) evaluate whether the confirmation response provided relevant and reliable audit evidence by failing to compare the confirmation to the broker or dealer's records.

Inspections staff also identified other deficiencies in four audits related to the testing of receivables and payables. In three of these audits, firms performed substantive analytical procedures but failed to (a) develop expectations that were sufficiently precise; (b) establish an amount of difference from the expectation that could be accepted without further investigation; or (c) test the interim balance the analytical procedure depended upon in a manner to provide a reasonable basis for extending its conclusions from interim to year end.

Auditing Fair Value Accounting Estimates

Brokers and dealers account for and disclose securities at fair value.⁶⁷ AU-C sec. 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, describes the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, in an audit of financial statements.⁶⁸ The term accounting estimate is used for an amount measured at fair value when there is estimation uncertainty, as well as for other amounts that require estimation.⁶⁹

In responding to the assessed risks of material misstatement, taking into account the nature of the accounting estimate, the auditor should undertake one or more of the following: (a) determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimates; (b) test how management made the accounting estimate and the data on which it is based; (c) test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures; or (d) develop a point estimate or range to evaluate management's point estimate.⁷⁰

Inspections staff identified deficiencies in 17 of the 39 audits where the auditor's procedures to test securities valuation were selected for inspection. In 2 of the 39 audits

⁶⁷ See FASB ASC-820 and FASB ASC Subtopic 940-320, *Financial Services - Brokers and Dealers, Investments - Debt and Equity Securities*, ("ASC 940-320").

⁶⁸ See Paragraph .01 of AU-C sec. 540.

⁶⁹ See Paragraph .07 of AU-C sec. 540.

⁷⁰ Paragraph .13 of AU-C sec. 540.

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with deficiencies related to auditing fair value accounting estimates, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Auditing fair value accounting estimates	16
Auditing accounting for investments	3

In 16 of the 39 audits, Inspections staff observed that firms did not perform sufficient procedures to test the valuation of securities. For example, in several audits, Inspections staff observed that firms relied on the fair values provided by the brokers or dealers and failed to undertake, or sufficiently undertake, one or more of the procedures described in the second paragraph of this section.

Brokers and dealers are excluded from the scope of FASB ASC Topic 320-10-15-3, *Investments – Debt and Equity Securities* ("ASC 320"). Brokers and dealers should account for investments at fair value,⁷¹ with changes in fair value recorded as income from operations in the statement of income. In two audits, Inspections staff observed that firms failed to identify that the brokers or dealers had applied ASC 320, and therefore, had inappropriately accounted for investments as securities that were held to maturity or available for sale. In another audit, the firm failed to identify that the broker's or dealer's investments were not accounted for at fair value.

Auditing Financial Statement Presentation and Disclosures

The auditor should evaluate whether the financial statements, in conformity with GAAP, provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.⁷² In addition, the auditor should evaluate (a) the overall presentation, structure, and content of the financial statements and (b) whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.⁷³

Inspections staff reviewed the audit work performed related to financial statement disclosures for those areas included in the inspections. Inspections staff identified one or more deficiencies in 47 of 106 audits selected for inspection. In 13 of the 47 audits

⁷¹ See Paragraph .30 of ASC 940-320.

⁷² Paragraph .16e of AU-C sec. 700, *Forming an Opinion and Reporting on Financial Statements*.

⁷³ Paragraph .17 of AU-C sec. 700.

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with deficiencies related to financial statement presentation and disclosure, Inspections staff identified more than one deficiency in the categories set forth in the table below:

Deficiencies Related to:	Number of Audits
Omitted disclosures	18
Incomplete or inaccurate disclosures	25
Fair value disclosures (ASC 820)	11
Fair presentation	11

In 18 audits, Inspections staff observed instances in which firms failed to identify and evaluate the omission of required disclosures pertaining to areas such as related parties and related party transactions or revenue recognition policies.

Inspections staff also observed in 25 audits that firms failed to identify incomplete disclosures or respond to evidence that was inconsistent with disclosures included in the financial statements. In another 11 audits, Inspections staff observed that firms failed to evaluate the broker's or dealer's classification of fair value measurements of securities owned within the hierarchy required by FASB ASC 820, *Fair Value Measurement* ("ASC 820").

In addition, Inspections staff observed in 11 audits that firms failed to evaluate whether the financial statements presented and disclosed the underlying transactions in a manner that complied with GAAP. For example, in some of these audits, firms failed to identify and address that the broker or dealer reported multiple revenue streams as a single line item on the statement of income, which is inconsistent with the financial statement format contained in Form X-17-5 Part II or Part IIA in accordance with Rule 17a-5(d)(2).

Auditor's Report

Generally, brokers and dealers are required under Rule 17a-5 to file with the SEC, audited financial statements and supporting schedules on the computation of net capital, the computation of the customer reserve requirement, and information relating to the possession or control requirements of the Customer Protection Rule. At the time of the audits discussed here, Rule 17a-5 also required brokers and dealers to file an accountant's supplemental report on material inadequacies. The auditor's report on the supporting schedules should include the elements required by AU-C sec. 725,⁷⁴ including an opinion on whether the schedules are fairly stated, in all material respects, in relation to the financial statements taken as a whole.

⁷⁴ See Paragraph .09 of AU-C sec. 725.

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The auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that (a) the audit documentation has been reviewed; (b) all the statements that the financial statements comprise, including the related notes, have been prepared; and (c) management has asserted that they have taken responsibility for those financial statements.⁷⁵

Inspections staff identified deficiencies in 9 of the 106 audits selected for inspection related to the auditor's report. The following presents a summary of the deficiencies discussed below:

Deficiencies Related to:	Number of Audits
Inaccurate auditor's report	6
Insufficient audit evidence	3

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

In addition, Inspections staff observed in three audits that the auditor's report was dated prior to the date the broker and dealer asserted their responsibility for the financial statements as evidenced by the date of the broker's and dealer's management representation letter to the firms.

⁷⁵ Paragraph .41 of AU-C sec. 700.

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

Since inception of the interim inspection program through December 31, 2014, the Board has inspected 155⁷⁶ registered public accounting firms that conducted audits of the financial statements and other requirements of brokers and dealers. Thirteen of these firms were inspected more than once. These inspections covered portions of 279 audits that were required to be performed under GAAS.⁷⁷

The following discussion summarizes the selection of firms and audits made during the interim inspection program through December 31, 2014, and independence findings and audit deficiencies identified by Inspections staff from these inspections. The selection of firms and audits as well as the observations discussed in this section of the report relate to inspections of audits of brokers and dealers that were required to be performed under GAAS.

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

Nevertheless, the continued occurrence and high percentage of audits with deficiencies that relate to the fundamentals of auditing and independence findings observed during the interim inspection program are significant and provide a necessary point of reference for discussions about areas for improvement when performing audits of brokers and dealers.

⁷⁶ This number represents the inspection of 10 firms reported in the First Progress Report, 43 firms reported in the Second Progress Report, 60 firms reported in the Third Progress Report, and 66 firms covered in Part I of this report. Three firms were included in all four reports, five other firms were included in three reports, and five other firms were included in two reports.

⁷⁷ Not included in the 279 audits discussed in this section are inspections during 2014 of five firms covering portions of five audit and attestation engagements of brokers and dealers that were required to be performed under PCAOB standards and of seven firms covering portions of seven audits of brokers or dealers whose audit for a prior year was covered in a previous inspection that identified audit deficiencies.

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Selection of Firms and Audits

As described in Part I of this report and consistent with the previous progress reports, the firms and the audits were selected in order to have a cross section of firms, as well as a cross section of brokers and dealers, based on varying characteristics of both. The following table presents the number of firms inspected and audits selected for inspection stratified by the number of broker or dealer audits per firm, as determined at the time of the inspections:

Number of Broker or Dealer Audits per Firm	Number of Firms Inspected	Number of Audits Selected
1	26	26
2 to 20	89	106
21 to 50	27	60
51 to 100	9	17
More than 100	6	70
Total	155 ⁷⁸	279

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

Registered Public Accounting Firms	Number of Firms Inspected	Number of Audits Selected
Also audited issuers	53	159
Did not audit issuers	102	120
Total	155	279

The 279 audits of brokers and dealers selected for inspection had financial statement periods ended on December 31, 2010 through May 31, 2014. These audits included 64 brokers or dealers that maintained a Special Reserve Bank Account and 215 brokers or dealers that did not. The following table presents the ranges of minimum net capital requirements and actual net capital reported for these brokers and dealers:

⁷⁸ The sum of the number of firms inspected does not add to 155 because two firms that were inspected more than once are reported in multiple stratifications due to a change in the number of broker or dealer audits performed by the firm.

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	Number of Audits Selected	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End
Special Reserve Bank Account	64	\$250,000 - \$2,050,000,000	\$300,000 - \$16,000,000,000
No Special Reserve Bank Account	215 ⁷⁹	\$5,000 - \$10,000,000	\$8,000 ⁸⁰ - \$2,250,000,000

Independence Findings and Audit Deficiencies from Inspections

Observations were identified in portions of 243, or approximately 87 percent, of the 279 audits selected for inspection. The 36 audits where Inspections staff did not identify observations in the portions of these audits inspected were performed by 15 firms, of which 12 also audited issuers.

Independence Findings

Independence findings relating to a firm's involvement in the preparation of the financial statements or relating to a firm's inclusion of an indemnification clause in the executed audit engagement letters were identified in approximately 25 percent of the 279 audits selected for inspection. Inspections staff noted a significantly higher percentage of audits inspected with independence findings for the audits performed by firms that did not audit issuers. The following table presents a summary of independence findings by whether or not the firms also audited issuers at the time of the inspection:

⁷⁹ This includes the audits of two brokers and dealers who claimed an exemption from the requirement to maintain a Special Reserve Bank Account for certain portions of the broker's and dealer's business and also maintained a Special Reserve Bank Account for other portions of the broker's and dealer's business.

⁸⁰ Excluded from the range of actual net capital reported at fiscal year end is one instance of reported negative net capital.

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Exhibit 1: Independence Findings

	Number of Audits with Findings	Number of Applicable Audits	Percentage of Audits with Findings
Failure to Satisfy Independence Requirements			
Firms that also audited issuers	11 ⁸¹	159	7%
Firms that did not audit issuers	60	120	50%

Audit Deficiencies

Inspections staff identified audit deficiencies in portions of 242 of the 279 audits selected for inspection. The 37 audits where Inspections staff did not identify any audit deficiencies in the portions of audits inspected were performed by 16 firms, 12 of which also audited issuers. The following table presents a summary of certain areas that were reported in the First, Second, and Third Progress Reports and in Part I of this report.⁸²

⁸¹ These independence findings were identified at firms that issued audit reports for 100 or fewer issuers.

⁸² Audit deficiencies that were reported in only one of the three previous progress reports or Part I of this report were not included in this table, such as audit deficiencies related to understanding the entity (Second Progress Report) and Receivables and Payables (Part I of this report).

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Exhibit 2: Audit Deficiencies

	Number of Audits with Deficiencies ⁸³	Number of Applicable Audits	Percentage of Audits with Deficiencies
Related to Customer Protection and Net Capital Rules:			
Report on Material Inadequacies	135	243	56%
Customer Protection Rule	22	66	33%
Net Capital Rule	98	262	37%
Related to the Financial Statement Audit:			
Risks of Material Misstatement Due to Fraud	128	273	47%
Related Party Transactions	68	258	26%
Revenue Recognition	186	279	67%
Reliance on Records and Reports	142	279	51%
Fair Value Accounting Estimates	36	99	36%
Financial Statement Presentation and Disclosures	110	279	39%
Evaluation of Internal Control Deficiencies ⁸⁴	16	279	6%
Auditor's Report	39	279	14%

The remainder of this section presents observations stratified by certain firm characteristics or broker and dealer characteristics, a comparison of inspections performed during 2014 to inspections performed during the prior years of the interim program, and a comparison on firms inspected more than once.

Observations Stratified By Certain Firm Characteristics

Number of Broker or Dealer Audits per Firm

Inspections staff identified a high percentage of audits and areas inspected with observations. Observations were identified in 100 percent of audits selected for inspection for auditors with only one broker or dealer client, while the percentage was slightly lower for firms that audited 2 to 100 brokers and dealers, and significantly lower

⁸³ Seven audits that were reported within the Accountant's Supplemental Report on Material Inadequacies section in the First Progress Report have been re-categorized to Auditor's Report to conform to the presentation in the Second Progress Report, Third Progress Report, and this report.

⁸⁴ There were no audit deficiencies reported within Part I of this report for this area.

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for firms that audited more than 100 brokers and dealers. The following table presents the percentage of audits and areas inspected with observations stratified by the number of broker or dealer audits per firm as determined at the time of inspection:

Exhibit 3: Number of Broker or Dealer Audits per Firm

	Percentage of Audits with Observations	Percentage of Areas with Observations ⁸⁵
1	100%	50%
2 to 20	95%	43%
21 to 50	90%	41%
51 to 100	94%	39%
More than 100	66%	19%

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

Inspections staff noted that the percentage of audits and areas inspected with observations was significantly lower at firms that also audited issuers. Of the 159 audits selected for inspection that were conducted by firms that also audited issuers, there were 33 audits where Inspections staff did not identify any independence findings or audit deficiencies in the portions of the audits inspected.

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

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

	Percentage of Audits with Observations	Percentage of Areas with Observations
Firms that also audited issuers	79%	28%
Firms that did not audit issuers	98%	49%

⁸⁵ The term "areas" used within this section represents the portions of audits included in the inspection (revenue recognition, related party transactions, net capital, etc.) by Inspections staff and reported within the First, Second, and Third Progress Reports and Part I of this report, as presented in Exhibits 1 and 2. The "Percentage of Areas with Observations" presented within Exhibits 3 through 8 represents the sum of the "Number of Audits with Findings" and "Number of Audits with Deficiencies" disclosed within Exhibits 1 and 2 above divided by the sum of the "Number of Applicable Audits" disclosed within Exhibits 1 and 2 above.

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Observations Stratified by Certain Broker and Dealer Characteristics

Reported Actual Net Capital, Revenues, and Assets

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

Inspections staff noted significantly lower percentages of audits and areas with observations for the 28 audits of brokers and dealers with reported actual net capital greater than \$100,000,000 selected for inspection compared to the audits of brokers and dealers with lower amounts of reported actual net capital. Of these 28 audits, 27 were conducted by firms that also audited issuers and for 13 of these 27 Inspections staff did not identify any observations.

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

Exhibit 5: Reported Actual Net Capital by Brokers and Dealers

	Percentage of Audits with Observations ⁸⁶	Percentage of Areas with Observations
Less than \$100,000	90%	42%
\$100,000 to \$2,000,000	94%	44%
\$2,000,001 to \$15,000,000	92%	36%
\$15,000,001 to \$100,000,000	81%	32%
\$100,000,001 to \$16,000,000,000	54%	15%

Special Reserve Bank Account

Inspections staff noted a high percentage of audits and areas inspected with observations, regardless of whether the broker or dealer maintained a Special Reserve Bank Account. The percentage of audits and areas inspected with observations was higher for audits of brokers or dealers that did not maintain a Special Reserve Bank Account.

⁸⁶ The number of audits selected for inspection for each of these stratifications is 40, 96, 78, 37, and 28, respectively.

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In addition, Inspections staff noted that for firms that also audited issuers, the percentage of audits and areas inspected with observations was lower for audits of brokers and dealers that maintained a Special Reserve Bank Account compared to those that did not. For the 22 audits of brokers and dealers that maintained a Special Reserve Bank Account and reported actual net capital greater than \$100,000,000 selected for inspection, Inspections staff did not identify any observations in 9 of these audits and noted lower percentages of audit deficiencies for the Customer Protection and Net Capital Rules audit areas.

For firms that did not audit issuers, there was no discernible relationship between the percentage of audits and areas inspected with observations and these types of brokers or dealers. Inspections staff identified observations in 117 of the 120 audits of brokers and dealers conducted by firms that did not also audit issuers, including all 13 audits of brokers and dealers that maintained a Special Reserve Bank Account.

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

Exhibit 6: Special Reserve Bank Account

	Percentage of Audits with Observations	Percentage of Areas with Observations
Special Reserve Bank Account		
Firms that also audited issuers	73%	24%
Firms that did not audit issuers	100%	49%
No Special Reserve Bank Account		
Firms that also audited issuers	82%	30%
Firms that did not audit issuers	97%	49%

Comparison of Inspection Observations

The Board began conducting inspections under the interim inspection program during October 2011. The percentages of audits and areas with observations in 2014 were compared to the percentages of audits and areas with observations reported on in prior progress reports. While there was a lower percentage of audits and areas with observations in 2013 than during October 2011 through the end of 2012 ("2012/2011"), Inspections staff noted there were higher percentages in 2014 when compared to 2013.

The following table shows a comparative summary of the percentages of audits and areas inspected with observations for inspections performed during 2014, 2013, and 2012/2011:

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Exhibit 7: Comparison of Inspection Observations

	Percentage of Audits with Observations	Percentage of Areas with Observations
2014	87%	35%
2013	79%	30%
2012/2011	96%	45%

Inspections staff did not identify any observations in the portions of 14 audits inspected during 2014, the portions of 19 audits inspected during 2013, and the portions of 3 audits inspected during 2012/2011. All but 3 of the 36 audits were performed by firms that also audited issuers.

Independence Findings

Inspections staff noted that, in the 2014 inspections, the percentage of independence findings among audits that were performed by firms that did not audit issuers was slightly lower than inspections performed through 2012, however the percentage for firms that also audited issuers was slightly higher. The following table presents the percentage of audits selected for inspection during the interim inspection program with independence findings:

Exhibit 7A: Comparison of Independence Findings

	Percentage of Audits with Findings		
	2014	2013	2012/2011
Failure to Satisfy Independence Requirements			
Firms that also audited issuers	9%	4%	7%
Firms that did not audit issuers	48%	48%	55%
Total	25%	23%	29%

Audit Deficiencies

Inspections staff noted a higher percentage of audits selected for inspection with audit deficiencies when comparing 2014 to inspections during 2013 for most of the areas inspected. This higher percentage was attributed to the following areas: Customer Protection Rule, fair value accounting estimates, financial statement presentation and disclosures, and revenue recognition. The following table presents the percentage of applicable audits with deficiencies for the portions of 279 audits inspected during the interim inspection program:

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Exhibit 7B: Comparison of Audit Deficiencies

	Percentage of Applicable Audits with Deficiencies		
	2014	2013	2012/2011
Related to Customer Protection and Net Capital Rules:			
Report on Material Inadequacies	40%	49%	77%
Customer Protection Rule	43%	24%	32%
Net Capital Rule	39%	36%	37%
Related to the Financial Statement Audit:			
Risks of Material Misstatement Due to Fraud	42%	40%	60%
Related Party Transactions	21%	17%	42%
Revenue Recognition	72%	59%	69%
Reliance on Records and Reports	57%	44%	51%
Fair Value Accounting Estimates	44%	25%	39%
Financial Statement Presentation and Disclosures	44%	30%	43%
Evaluation of Internal Control Deficiencies	0%	7%	12%
Auditor's Report	8%	6%	30%

Firms Inspected More Than Once

There were 13 firms that were inspected more than once during the interim inspection program; 10 firms also audited issuers. Inspections staff noted that, for these 10 firms, the percentage of audits and areas inspected with observations was higher when comparing inspections performed during 2014 to inspections performed during 2013, but lower when compared to 2012/2011. Inspections staff also noted that, for the three firms that did not audit issuers, the percentage of audits with observations was at 100 percent for inspections during 2014 and prior to 2014, and the percentage of areas inspected with observations was higher in 2014 than previous years.

The following tables show a comparative summary of the percentage of audits and areas inspected with observations for the 10 firms that also audited issuers and the three firms that did not audit issuers that were inspected more than once:

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Exhibit 8A: Firms that also Audited Issuers Inspected More Than Once

	Number of Audits	Percentage of Audits with Observations	Percentage of Areas with Observations
2014	43	72%	23%
2013	28	57%	16%
2012/2011	33	91%	36%

Exhibit 8B: Firms that did not also Audit Issuers Inspected More Than Once

	Number of Audits	Percentage of Audits with Observations	Percentage of Areas with Observations
2014	3	100%	48%
Prior to 2014	6	100%	38%

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Part III: Observations Related to Audits with Previous Inspection Observations

The Board has reviewed actions taken by certain firms to address observations that were identified in previous inspections. During 2014, the Board selected portions of seven audits of brokers and dealers where a prior audit was found to have audit deficiencies during a previous inspection. The inspections during 2014 covered only those areas with audit deficiencies from the previous inspection and included an evaluation of whether or how the firms addressed those previously identified audit deficiencies in the firm's current audit.

The seven audits of brokers or dealers were performed by seven firms. At the time of the inspections, three of the seven firms were subject to inspection as they also audited issuers. The remaining four firms did not audit issuers and were not subject to inspection other than under the interim inspection program. The seven audits of brokers or dealers selected for inspection included one broker and dealer that maintained a Special Reserve Bank Account and six brokers and dealers that did not.

The following table presents a summary of the number of previously inspected areas with deficiencies and the number of areas identified during 2014 with deficiencies:

	Number of Previously Inspected Areas with Deficiencies	Number of Inspected Areas with Deficiencies during 2014	Percentage of Areas with Observations
Firms that also audited issuers			
Firm A	3	2	67%
Firm B	2	1	50%
Firm C	3	1	33%
Firms that did not audit issuers			
Firm D	3	3	100%
Firm E	1	1	100%
Firm F	1	1	100%
Firm G	4	3	75%

Inspections staff identified at least one audit deficiency in the same area as previously identified in each of the seven audits selected for inspection. In 12 of the 17 areas selected for inspection, or approximately 71 percent, audit deficiencies continued to be identified. These deficiencies were in the areas of revenue recognition, risks of material misstatements due to fraud, related party transactions, and the Net Capital Rule.

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The Board is concerned that the actions taken by the firms were not sufficient to have prevented audit deficiencies from recurring on a subsequent audit. The Board reminds firms of the importance of giving careful consideration to each audit deficiency communicated to them by Inspections staff, the need to consider the omitted procedures brought to their attention in accordance with GAAS⁸⁷, and the necessity of ensuring that the firm's system of quality control is designed to detect and prevent such audit deficiencies from occurring in the future.

⁸⁷ See AU-C sec. 585, *Consideration of Omitted Procedures After the Report Release Date*.

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

The Board continues to be concerned with the high number of independence findings and audit deficiencies as well as the high percentages of observations across the firms inspected and audits of brokers and dealers selected.

Despite the attention to these findings in the previous progress reports, at the Board's Forums for Auditors of Broker-Dealers, and through other outreach by the Board and Board staff, independence findings continue to be identified at a high frequency. This is especially troubling given that most of the violations relate to long-standing SEC independence rules that prohibit auditors from maintaining or preparing the audit client's accounting records; preparing the audit client's financial statements that are filed with the SEC, or that form the basis for the financial statements filed with the SEC; and preparing or originating source data underlying the audit client's financial statements.

The Board also continues to be concerned by the nature and number of the audit deficiencies. The already high percentages of audits and areas with deficiencies identified in 2013 were even higher in 2014. Many of the observations in this report continue to be similar in nature to the observations described in the three previous progress reports and relate to the fundamentals of auditing. Further, certain firms with findings during previous inspections do not appear to have taken sufficient action to prevent similar deficiencies from recurring in audits inspected during 2014. Many of the inspected firms need to significantly improve their audit work to meet the requirements of the professional standards and SEC rules.

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

On December 8, 2014, the Board announced settled disciplinary orders against seven audit firms for violating rules requiring that auditors of brokers and dealers be independent of their audit clients.⁸⁸ On July 9, 2015, the Board announced settled disciplinary orders against an additional seven audit firms for violating the independence

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http://pcaobus.org/News/Releases/Pages/12082014_Enforcement.aspx.

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rules.⁸⁹ Specifically, the Board found that each firm prepared the financial statements of its audit clients, or portions of the financial statements, by drafting them outright or by some combination of aggregating, revising, classifying, or supplementing financial information obtained from their audit clients. Under the SEC's rules, the auditor's preparation of financial statements, including preparation based on client-provided information, such as schedules or reports, impairs the auditor's independence. In addition to censure by the Board, each firm agreed to pay a civil monetary penalty and undertake significant remedial actions.⁹⁰ Further, separate from the settlements reached with the Board, eight firms not included in the PCAOB disciplinary orders reached a settlement with the SEC, whereby each firm was censured, agreed to pay monetary penalties, and agreed to undertake remedial actions to prevent future violations of the independence rules.⁹¹

Actions Needed by Firms

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

All registered public accounting firms that issue audit reports for brokers or dealers should consider whether the independence findings and audit deficiencies described in this report might be present in audits they currently perform, and should take appropriate action to prevent or correct any such deficiencies and independence findings. Although audits of brokers and dealers are now performed under PCAOB standards, many of the observations identified in this report relate to the fundamentals of auditing and remain relevant for the auditor's consideration.

When audit deficiencies are identified, the Board expects firms to take appropriate action. Under both GAAS and PCAOB standards, 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.⁹² Depending upon the circumstances, the firm may

⁸⁹ http://pcaobus.org/News/Releases/Pages/07092015_Enforcement.aspx.

⁹⁰ The Board reminds firms that the disciplinary process carries the prospect of a range of sanctions, including significant money penalties and the possible suspension or revocation of registration.

⁹¹ <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543608588>.

⁹² See AU-C sec. 585, *Consideration of Omitted Procedures After the Report Release Date*, AU-C sec. 560, *Subsequent Events and Subsequently Discovered Facts*, and, for audits performed under PCAOB standards, AU 390, *Consideration of Omitted*

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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 supplemental report on material inadequacies; or (3) take steps to prevent reliance on previously expressed audit opinions.

The Board continues to urge registered public accounting firms to be proactive in considering how to prevent similar or other deficiencies and findings by seeking ways to better anticipate and address risks that might arise in specific broker or dealer audits. The Board encourages registered public accounting firms to continually stress to their personnel the critical need to conduct audits with due professional care, including professional skepticism. In addition, the Board strongly encourages registered public accounting firms to take action now regarding the independence and audit deficiency observations identified in this report. The Board also emphasizes the importance, under PCAOB quality control standards, of having effective procedures for practice monitoring including performing effective analyses of the root causes of identified deficiencies.⁹³

Specifically, with respect to independence, registered public accounting firms should review the SEC's independence requirements and consider if the services performed for broker and dealer audit clients violate the applicable requirements. Firms should also make certain to have in place a system of quality control that is designed to provide reasonable assurance of compliance with the requirements and provide guidance and training to firm personnel. When necessary, firms should seek guidance and clarification from the SEC. The SEC encourages auditors to consult with their Office of the Chief Accountant (the "OCA"). Guidance on consulting with the OCA is available at <http://www.sec.gov/info/accountants/ocasubguidance.htm>.

The Board urges registered public accounting firms to give appropriate attention to the areas of the audit deficiencies identified in this report, including providing appropriate guidance and training to firm personnel and evaluating the appropriateness of the firm's policies on supervision and review to ensure that partners and supervisory personnel are placing appropriate attention on these areas.

The Board encourages registered public accounting firms to review the *Staff Guidance for Auditors of SEC-Registered Brokers and Dealers* issued on June 26, 2014, as well as the practice alerts issued by the Board related to areas such as auditing revenue recognition and exercising professional skepticism.⁹⁴ The Board also

Procedures After the Report Date and AU 561, Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.

⁹³ PCAOB Quality Control Standards can be found at: <http://pcaobus.org/Standards/QC/Pages/default.aspx>.

⁹⁴ <http://pcaobus.org/Standards/Pages/Guidance.aspx>.

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encourages registered public accounting firms to attend the Board's periodic Forums for Auditors of Broker-Dealers and review the webcasts archived on the Board's website. Firms should direct any inquiries regarding the standards to the PCAOB.⁹⁵

In addition to the actions needed by registered public accounting firms, 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 their audits and take steps to ensure that independence violations are avoided.

Next Steps of the Interim Inspection Program

Future Inspections

The Board will continue to conduct inspections under the interim inspection program of registered public accounting firms that audit brokers and dealers until rules for a permanent inspection program take effect. There were 629 registered public accounting firms that issued audit reports on the financial statements of 4,075 brokers and dealers⁹⁶ that were filed for fiscal periods ended during 2014.

Number of Broker or Dealer Audits per Firm	Number of Firms ⁹⁷	Percentage of Firms
1	247	39%
2 to 20	345	55%
21 to 50	22	3%
51 to 100	10	2%
More than 100	5	1%
Total	629	100%

During 2015, the Board plans to perform inspections of 75 firms covering portions of approximately 115 audit and attestation engagements of brokers and dealers to assess compliance with PCAOB standards, rules of the SEC and the Board, and the

⁹⁵ <http://pcaobus.org/About/Pages/ContactUsWebForm.aspx>.

⁹⁶ This information is based on the number of brokers and dealers who filed financial statements through May 15, 2015, for fiscal years ended during 2014, that included audit reports issued by firms registered with the PCAOB.

⁹⁷ Information about the number of firms that audited brokers and dealers and their broker or dealer audits is based on financial statements filed through May 15, 2015, for fiscal years ended during 2014. These firms were registered with the PCAOB at the time the audit reports were issued.

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Act. The audit and attestation engagements of brokers and dealers selected for inspection in 2015 were required to be conducted in accordance with PCAOB standards as a result of the amendments to Rule 17a-5. Inspections staff will focus on areas relevant to the amendments to Rule 17a-5 and on other areas unique to audits and other engagements conducted pursuant to PCAOB standards. Inspections staff will also focus on areas with noted observations from past inspections, as described in the various progress reports.⁹⁸

The information obtained from these inspections will be used to identify risk factors relevant for selecting firms and audit and attestation engagements of brokers and dealers for inspection under a permanent inspection program through the analysis of relationships between inspection observations and characteristics of the firms and the brokers and dealers that were audited.

The Board also plans to review the contents of the compliance and exemption reports and the respective auditors' reports related to, for example, the brokers' or dealers' compliance with the provisions of the Customer Protection Rule, to evaluate risk of loss to customers.

Permanent Inspection Program

The Board is continuing to take a careful and informed approach in establishing a permanent inspection program recognizing the complexity and diversity of the brokers and dealers, as well as working through the challenges in obtaining relevant information for these non-public companies. The Board continues to consider the risk of loss to customers and whether this risk can be assessed from attributes that characterize brokers and dealers in an effort to provide for differentiation of the brokers and dealers. The Board will also consider the high percentage of audit deficiencies and independence findings that have been observed during the inspections under the interim inspection program.

The Board continues to gather information regarding customer losses due to fraudulent activities or liquidations of brokers and dealers, and regulatory sanctions imposed on brokers and dealers to evaluate whether correlations exist between these matters and characteristics of the brokers and dealers.

The PCAOB staff is currently working to develop a rule proposal for the Board to consider during 2016 to establish a permanent inspection program. In connection with this proposal, the Board will consider whether to exempt any category of registered public accounting firm from inspections or any other aspect of PCAOB oversight.

⁹⁸

Refer to [PCAOB Staff Inspection Brief Vol. 2015/1](#).

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Other Board Initiatives

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

- Conduct forums for auditors of brokers and dealers that provide information about the Board, the interim inspection program, observations from the interim inspection program, audit and attestation engagements of brokers and dealers under PCAOB standards, and updates from the SEC and FINRA;
- Participate in various outreach initiatives, including conferences and other events to inform registered public accounting firms that issue audit and attestation reports for brokers and dealers about observations from the interim inspection program, and developments in the Board's standards-setting initiatives;
- Issue guidance for audit and attestation engagements of brokers and dealers, if needed, to assist with the implementation of PCAOB auditing and attestation standards; and
- Continue utilizing communication tools such as webcasts, stored media presentations, and inspection briefs to effectively deliver guidance and information to auditors of brokers and dealers.

The Board will issue future progress reports that will describe significant observations from inspections of audit and attestation engagements required to be performed in accordance with PCAOB standards, the publication of which may 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 audit and attestation engagements of brokers and dealers.

Appendix A

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

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

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

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

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