



STAFF INSPECTION BRIEF

The staff of the Public Company Accounting Oversight Board (“PCAOB” or “Board”) prepares Inspection Briefs to assist auditors, audit committees, investors, and preparers in understanding the PCAOB inspection process and its results. The statements contained in Staff Inspection Briefs do not establish rules of the Board or constitute determinations of the Board and have not been approved by the Board.

Preview of Observations from 2015 Inspections of Auditors of Brokers and Dealers

The PCAOB Division of Registration and Inspections has prepared this Inspection Brief to provide a preview of observations from its 2015 inspections, conducted under the interim inspection program,¹ of auditors of brokers and dealers registered with the Securities and Exchange Commission (“SEC”). This Brief also highlights certain requirements related to the audit and attestation engagements of brokers and dealers based on observations from these inspections.

2015 Inspections

Inspections performed during 2015 covered audit and attestation engagements of brokers and dealers that were required to be conducted in accordance with PCAOB standards.² Inspections staff inspected 75 firms during 2015 that covered 115 audit and attestation engagements. The selected audit and attestation engagements were for fiscal years ended during the period from June 1, 2014, through June 30, 2015.

The 2015 inspections focused on the following areas:³

- Auditor independence;
- Financial statement audit areas for which audit deficiencies were identified in past inspections, including revenue recognition and use of information produced by brokers or dealers or service organizations;
- Audit procedures on the supplemental schedules to the financial statements;

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 requirement to apply PCAOB standards became effective for broker and dealer annual reports with fiscal years ended on or after June 1, 2014, as a result of an amendment to SEC Exchange Act Rule 17a-5 (“Rule 17a-5”).

3 For further information, refer to Staff Inspection Brief Vol. 2015/1: *Information about 2015 Inspections of Auditors of Brokers and Dealers* (August 2015) and available at the PCAOB website at: <http://pcaobus.org/Inspections/Pages/default.aspx>.

- The examination of compliance reports and the review of exemption reports under PCAOB standards (the “attestation engagements”); and
- The engagement quality review.

Preview of Inspection Observations

The 2015 inspection fieldwork is complete. The observations that follow represent a preview of observations from our 2015 inspections.

Auditors should take note of the matters discussed in this Brief in planning and performing their audit and attestation engagements. It is particularly important for the engagement partner and senior engagement team members to focus on these areas and for engagement quality reviewers to keep these matters in mind when performing their engagement quality reviews.

Auditor Independence

Auditors must be independent of their audit clients throughout the audit and professional engagement period. In 2015, independence impairments were identified with less frequency than in the past, though Inspections staff continued to observe instances in which independence appeared to be impaired because the auditors were involved in the preparation of the financial statements or performed bookkeeping or other prohibited services related to the accounting records of their broker

and dealer clients. An auditor is not independent of its clients, including broker or dealer clients, if the auditor maintains or prepares the client’s accounting records, prepares the client’s financial statements that are filed with the SEC, or prepares or originates source data underlying the client’s financial statements.⁴

The PCAOB has issued settled orders imposing disciplinary sanctions against 22 audit firms for independence violations when auditing brokers and dealers.⁵ In addition, the SEC has settled actions for violations of independence rules against audit firms, which were not the same firms as those that reached settlements with the Board.

Financial Statement Audit Areas

During 2015, Inspections staff continued to observe deficiencies in the financial statement audit areas similar in nature to the deficiencies observed in the past. These deficiencies include, but are not limited to, deficiencies related to audit procedures over revenue recognition, financial statement presentation and disclosures, and the risks of material misstatement due to fraud.

Revenue

Inspections staff continued to observe deficiencies in the testing of revenue. For example, auditors did not:

- Obtain sufficient evidence that the controls selected for testing to support the assessment of control risk at less than the maximum operated effectively in order to support the

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

⁵ For more information on the settled disciplinary orders refer to: http://pcaobus.org/News/Releases/Pages/07092015_Enforcement.aspx, http://pcaobus.org/News/Releases/Pages/12082014_Enforcement.aspx, <http://pcaobus.org/Enforcement/Decisions/Pages/default.aspx> (orders effective October 15, 2015), and <http://pcaobus.org/News/Releases/Pages/Five-BD-independence-orders-one-cooperation-3-15-16.aspx>.

nature, timing, and extent of planned substantive procedures based on that lower assessment;^{6,7}

- Design and perform sufficient sampling procedures;⁸
- Design and perform sufficient analytical procedures to provide the intended level of assurance;⁹ and
- Perform sufficient procedures to obtain evidence about the accuracy and completeness of information that the auditor used that was produced by service organizations.¹⁰

Financial Statement Presentation and Disclosures

Inspections staff continued to observe instances in which the auditor failed to identify that required disclosures were missing from the broker's or dealer's financial statements or notes thereto, or that the disclosures were incomplete or inaccurate. In addition, Inspections staff identified instances in which certain of the broker's or dealer's transactions were not accounted for or presented in conformity with generally accepted accounting principles.

The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. As part of the evaluation of the presentation of the financial statements,

the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework. Evaluation of the information disclosed in the financial statements includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the basis of amounts set forth.¹¹

Risks of Material Misstatement Due to Fraud

Assessing and responding to risks of material misstatement due to fraud is a critical component of an audit or attestation engagement. During 2015, Inspections staff continued to observe deficiencies related to the consideration of risks of material misstatement due to fraud.

For example, auditors did not:

- Identify and test, or sufficiently test, journal entries; or
- Identify improper revenue recognition as a potential fraud risk or perform substantive procedures specifically responsive to this risk.

When performing an audit in accordance with PCAOB standards, the auditor is responsible for obtaining reasonable assurance that the

6 On March 31, 2015, the PCAOB adopted amendments that reorganize and renumber its auditing standards, effective December 31, 2016. (See PCAOB Release No. 2015-002.) The new numbering may also be used in advance of that date, and this Brief uses the prospective numbering and, the first time a standard is cited, parenthetically indicates the current number.

7 See PCAOB Auditing Standard ("AS") 2301, *The Auditor's Responses to the Risks of Material Misstatement* (currently AS No. 13).

8 See AS 2315, *Audit Sampling* (currently AU Section 350).

9 See AS 2305, *Substantive Analytical Procedures* (currently AU Section 329).

10 See AS 2601, *Consideration of an Entity's Use of a Service Organization* (currently AU Section 324), and AS 1105, *Audit Evidence* (currently AS No. 15).

11 See paragraphs 30 and 31 of AS 2810, *Evaluating Audit Results* (currently AS No. 14).

financial statements as a whole are free from material misstatement, whether caused by fraud or error. Further, auditors need to have an appropriate response to their assessed risks of material misstatements due to fraud related to management override of controls, including performing procedures to test journal entries and other adjustments.¹² Auditors also need to have an appropriate audit response to the risk of improper revenue recognition by the broker or dealer.¹³

Supplemental Information

The supporting schedules required by Rule 17a-5 include the computation of net capital, the computation of the required reserve, and information relating to the possession or control of customer securities. Auditors are required to perform procedures and report on these schedules in accordance with AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements* (currently AS No. 17). Included below are observations related to the procedures performed on the supporting schedules as well as observations related to the auditor's report on the supplemental information.

Inspections staff observed deficiencies related to the procedures performed on the supporting schedules, including:

- Auditors did not perform sufficient testing of the components of the net capital computation, such as whether assets were properly classified as allowable and whether haircuts on securities' values were appropriately determined;

- Auditors did not sufficiently test the completeness and accuracy of significant components of the customer reserve computation in accordance with SEC Exchange Act Rule 15c3-3 ("Rule 15c3-3"), such as the customer credit and debit balances, including testing the accuracy and completeness of customers' cash and margin account information obtained from a service organization report; and
- Auditors did not sufficiently test compliance with the possession or control requirements under Rule 15c3-3, including whether the broker or dealer promptly obtained and maintained the physical possession or control of fully-paid and excess margin customer securities carried by the broker or dealer for customer accounts.

In addition, the auditor's report on supplemental information accompanying audited financial statements should be in accordance with AS 2701. Observations related to the auditor's report include:

- Omission of a statement that the audit procedures performed included testing the completeness and accuracy of the information presented in the supplemental information;
- Omission of a statement that in forming the auditor's opinion, the auditor evaluated whether supplemental information, including its form and content, complied, in all material respects, with Rule 17a-5;
- Stating that the firm evaluated whether the supplemental information was presented in accordance with auditing standards generally accepted in the United States rather

¹² See paragraphs 57 through 67 of AS 2401, *Consideration of Fraud in a Financial Statement Audit* (currently AU Section 316), and paragraph 15 of AS 2301.

¹³ See paragraph 68 of AS 2110, *Identifying and Assessing Risks of Material Misstatement* (currently AS No. 12), and paragraph 13 of AS 2301.

than stating it had evaluated whether the supplemental information complied with Rule 17a-5; and

- Omission of identifying or incorrectly identifying the broker's or dealer's supplemental schedules.

Attestation Engagements

Attestation engagements under PCAOB standards are now required for brokers and dealers under Rule 17a-5. A broker or dealer that did not claim that it was exempt from Rule 15c3-3 throughout the most recent fiscal year must file a compliance report, and a broker or dealer that did claim it was exempt from Rule 15c3-3 throughout the most recent fiscal year must file an exemption report. The PCAOB's attestation standards, Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* ("AT No. 1"), and Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* ("AT No. 2"), specifically address the auditor's responsibilities for examining certain statements made by the brokers and dealers in their compliance reports or reviewing statements made by the brokers and dealers in their exemption reports as required under Rule 17a-5.

Examination Engagements

Regarding examination engagements, the auditor is required to, among other things, perform sufficient tests of controls to have a reasonable basis to determine whether the broker's or dealer's statements regarding internal control over compliance with

the financial responsibility rules are fairly stated in all material respects.¹⁴ In this regard, AT No. 1 requires the auditor to identify and test controls that are important to the auditor's conclusion about whether the broker or dealer maintained effective internal control over compliance with the financial responsibility rules throughout the fiscal year and at fiscal year-end.

Inspections staff observed instances in which the auditor did not test any controls over compliance with the financial responsibility rules. In other instances, the auditor performed tests of controls, but the tests were not sufficient. For example, Inspections staff identified audit deficiencies related to auditors' testing of controls that contain a review element. Auditors did not sufficiently evaluate the design or operating effectiveness of the controls, because they did not obtain an understanding of the actions performed during the review, the criteria used to identify deviations requiring investigation, or the actions taken to investigate those deviations.

AT No. 1 also requires the auditor to perform procedures to support the auditor's conclusions regarding whether the broker or dealer was in compliance with the net capital rule and reserve requirements rule as of the end of its most recent fiscal year. Inspections staff observed instances in which the auditor did not perform sufficient procedures related to the broker's or dealer's statement that the broker or dealer was in compliance with Rule 15c3-3(e). For example, Inspections staff identified deficiencies in the auditors' testing of the completeness and accuracy of certain components of the computations of net capital or the required reserve.

¹⁴ The SEC Release adopting amendments to Rule 17a-5 used the term "financial responsibility rules" to refer to SEC Exchange Act Rule 15c3-1, Rule 15c3-3, and SEC Exchange Act Rule 17a-13, and any rule of the designated examining authority of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer.

Review Engagements

For review engagements, AT No. 2 provides that the auditor's procedures related to the broker's or dealer's statements in the exemption report should include inquiries of individuals responsible for the broker or dealer complying with applicable rules, and other review procedures sufficient to provide moderate assurance that the statements made by the brokers and dealers in their exemption reports are fairly stated, in all material respects. Inspections staff observed that the auditors' review procedures on such statements in the exemption reports were insufficient. For example:

- Auditors did not make all required inquiries as required by paragraphs 10(b) through 10(d) of AT No. 2; and
- Auditors did not sufficiently evaluate exceptions identified in performing their review procedures, including by not evaluating whether identified exceptions were in compliance with exemption provisions, or not evaluating whether information obtained from the audit of the financial statements and supplemental schedules corroborated or contradicted the assertions regarding compliance with the exemption provisions.

In addition to observations related to the auditors' review procedures, Inspections staff had observations related to the auditors' review reports such as:

- The date of the report was not in accordance with AT No. 2 because it was before the date of:
 - the auditor's completion of all of the review procedures; or
 - the broker's or dealer's exemption report;

- The period covered by the review report was not the same as the period stated in the broker's or dealer's exemption report; and
- The auditor did not report that the broker's or dealer's exemption report had not identified, or had identified incorrectly, the exemption claimed by the broker or dealer under Rule 15c3-3.

Engagement Quality Review

Properly executed engagement quality reviews serve as important safeguards against erroneous or insufficiently supported audit opinions or inappropriate conclusions expressed in the attestation reports because they can identify, and can result in correcting, significant audit deficiencies before the reports are issued.

Inspections staff found, both at firms that also audit issuers and at firms that do not audit issuers, that firms did not have an engagement quality review performed for either the audit or the attestation engagement. For many of the engagements with inspection observations described in this Brief, the engagement quality reviewer did not sufficiently evaluate the significant judgments and conclusions reached by the engagement team in light of those observations.

Engagement quality reviewers should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusions on the audit or attestation engagement and in preparing the engagement report.¹⁵

15 See paragraphs 9 through 11 and 18A of AS 1220, *Engagement Quality Review* (currently AS No. 7).

Audit Documentation

Inspections of brokers and dealers included determining whether the audit documentation included an engagement completion document, which is required under PCAOB standards for audit and attestation engagements. Inspections staff observed, both at firms that also audit issuers and at firms that do not audit issuers, instances in which an engagement completion document was not prepared by the auditors. In other instances, an engagement completion document was prepared, but did not describe the actions taken by the auditors to address significant audit findings or issues, or the information necessary to support the final conclusions related to the significant audit matters.

Auditors should document sufficient information related to significant audit findings and issues, as required by AS 1215, *Audit Documentation* (currently AS No. 3). In this regard, the engagement completion document is required and, when prepared properly, assists the engagement quality reviewer in gaining a thorough understanding of significant audit matters in order to perform an effective engagement quality review.

Conclusion

The information in this Brief is provided to assist auditors in planning and performing their audit and attestation engagements. Observations from the inspections performed during 2015 will be covered in detail in the next Annual Report on the Interim Inspection Program Related to the Audits of Brokers and Dealers that is expected to be issued in August of 2016.

Guidance on audit and attestation engagements for brokers and dealers under PCAOB standards is available on the PCAOB's web site. See Staff Guidance for Auditors of SEC-Registered Brokers and Dealers (June 26, 2014), available at <http://pcaobus.org/Standards/Pages/Guidance.aspx>, and information for auditors of brokers and dealers at <http://pcaobus.org/Information/Pages/BrokerDealers.aspx>. Firms should not hesitate to contact the PCAOB with any questions regarding PCAOB standards by contacting Keith Wilson, Deputy Chief Auditor (202/207-9134, wilsonk@pcaobus.org); Barbara Vanich, Associate Chief Auditor (202/207-9363, vanichb@pcaobus.org); or Lisa Calandriello, Assistant Chief Auditor (202/207-9337, calandriello@pcaobus.org).

In addition to webcasts and podcasts of PCAOB open board meetings and webinars,¹⁶ the PCAOB conducts forums around the country for auditors of brokers and dealers that provide information about the Board, the interim inspection program, observations from the interim inspection program, and audit and attestation engagements of brokers and dealers.¹⁷

16 Additional information relating to inspections of brokers and dealers can be found in webcasts and podcasts of PCAOB open board meetings and webinars. See <http://pcaobus.org/News/Webcasts/Pages/default.aspx>.

17 For more information on 2016 forums for auditors of brokers and dealers refer to: <http://pcaobus.org/News/Releases/Pages/2016-broker-dealer-forums-dates-and-locations.aspx>.