



## 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.

### Information about 2016 Inspections of Auditors of Brokers and Dealers

The PCAOB Division of Registration and Inspections has developed this Inspection Brief to provide information about PCAOB inspections planned for 2016 of auditors of brokers and dealers registered with the Securities and Exchange Commission (“SEC” or the “Commission”), and to highlight important aspects of the inspection plan, scope, and objectives.

The Board adopted Rule 4020T on June 14, 2011, to establish an interim inspection program related to the audits of brokers and dealers. Under the program, the PCAOB inspects registered public accounting firms to assess compliance with the Sarbanes-Oxley Act of 2002, the rules of the Board, the rules of the SEC, and professional standards, in connection with the firm’s performance of engagements, issuance of audit and attestation reports, and related matters involving brokers and dealers.

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 inspection schedules.

This is the second year that audit and attestation engagements of brokers and dealers covered in the inspections were required to be conducted in accordance with PCAOB standards. During 2016, Inspections staff will again evaluate the degree of compliance by firms with these standards in connection with audit and attestation engagements. The inspection plan is consistent with 2015, except that, in 2016, Inspections staff will also focus on the firms’ procedures pursuant to the new auditing standard for related party transactions, Auditing Standard (“AS”) 2410, *Related Parties* (currently AS No. 18),<sup>1</sup> which became effective for audits of financial statements for fiscal years beginning on or after December 15, 2014.

1 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 report uses the prospective numbering. The first time a standard is cited, this document also parenthetically indicates the current number.

# Overview of Inspection Plan and Scope

In 2016, Inspections staff plan to inspect approximately 75 firms that audit SEC-registered brokers and dealers, covering portions of approximately 115 selected audit and attestation engagements of these brokers and dealers. This plan is consistent with the number of firms and engagements inspected during 2015.

## 2016 Inspections by the Numbers



75 firms

that audit brokers and dealers and portions of



115 audits and the related attestation engagements

All firms that audit SEC-registered brokers and dealers are eligible for selection to be inspected during 2016. The firms to be inspected and the audit and attestation engagements to be covered during the inspections are generally selected based on characteristics of the firms and the brokers and dealers taking into consideration the related risks. In addition, a portion of firms and audits are selected randomly. The firms selected are not necessarily representative of all the firms that audit brokers and dealers, nor are the engagements selected necessarily representative of the population of brokers and dealers.

The selection of firms for inspection takes into consideration certain firm characteristics including, among others:

- Number of broker or dealer audits performed;
- Whether the firms also issued audit reports for issuers;

- Observations from prior inspections;
- Experience of the firm (or firm personnel) in auditing brokers or dealers; and
- Disciplinary actions against the firm or engagement partner by the SEC, PCAOB, or other regulatory authorities.

The selection of engagements of brokers and dealers is based on various characteristics, including among others:

- Financial metrics, such as assets, revenue, and reported actual net capital under Exchange Act Rule 15c3-1;
- Whether the broker or dealer filed with the Commission a compliance report or an exemption report pursuant to Exchange Act Rule 17a-5;
- Whether the broker or dealer is a subsidiary of an issuer;
- Changes in auditors and certain circumstances related to the changes, including whether the broker or dealer has changed auditors multiple times in recent years, or whether a change relates to a former auditor ceasing to be registered with the PCAOB;
- Disciplinary actions against the broker or dealer by the SEC, Financial Industry Regulatory Authority, or other regulatory authorities; and
- Engagement partner, including consideration of the partner's workload, experience in auditing brokers or dealers, and previous inspection results.

The 2016 plan to inspect 75 firms includes five firms that audit more than 100 brokers or dealers, 13 firms that audit 21 to 100 brokers or dealers, and 57 firms that audit one to 20 brokers or dealers.

# Audit Areas and Attestation Procedures

Inspections staff will focus on the following audit areas and attestation procedures in 2016:

- Auditor independence;
- Financial statement audit areas where audit deficiencies were identified in past inspections, including revenue, the assessment and response to risks of material misstatement due to fraud, financial statement presentation and disclosures, and fair value measurements;
- Audit procedures related to related party transactions, as a new auditing standard became applicable;
- Audit procedures on the supporting schedules to the financial statements;
- The procedures for the attestation engagements: the examination of compliance reports and the review of exemption reports; and
- The engagement quality review.

Other areas are often selected specific to each engagement based on consideration of risk to customers of the broker or dealer as well as risk of material misstatement of the financial statements or required supporting schedules.

In addition to reviewing certain portions of selected audit and attestation work performed by firms,

inspection procedures may include obtaining an understanding of how certain aspects of a firm's quality control system apply to its audit and attestation engagements of brokers and dealers.

## Key Areas of Inspection Focus

This section discusses the key areas of inspection focus listed above.

### Independence

Consistent with prior years, Inspections staff will focus on firm compliance with applicable SEC and PCAOB independence requirements.<sup>2</sup> As in past years, this will include, among other things, examining whether firms performed bookkeeping or other services related to their broker-dealer audit client's accounting records, resulting in impaired independence under SEC rules.

Consistent with 2015, Inspections staff will also focus on whether firms had communications with the audit committees, or their equivalent, of the brokers or dealers concerning independence as required by PCAOB Rule 3526, *Communications with Audit Committees Concerning Independence*, which includes confirming annually, in writing, that the firm is independent of the broker or dealer in compliance with PCAOB Rule 3520.

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<sup>2</sup> Rule 17a-5(f)(1) requires auditors to be independent of their broker-dealer audit clients in accordance with Rule 2-01 of Regulation S-X (other than the provisions relating to partner rotation, compensation, audit committee pre-approval, and employment-related cooling-off periods, which apply only to issuer audits). PCAOB Rule 3520, *Auditor Independence*, requires registered firms and associated persons to be independent of the audit client, including satisfying the SEC's independence criteria and any other applicable independence criteria. Certain additional independence criteria applicable to audits of brokers and dealers are set out in PCAOB Rule 3521, *Contingent Fees*, and PCAOB Rule 3522, *Tax Transactions*. The independence criteria in PCAOB Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*, apply by their terms only to audits of issuers and do not apply to audits of brokers and dealers.

## Financial Statement Audit Areas with Recurring Observations

Inspections staff will consider deficiencies cited in previous annual reports<sup>3</sup> and evaluate how audit firms complied with the relevant standards in those areas in the current inspection cycle.

For example, some of the more frequent and recurring financial statement audit deficiencies identified in recent inspection cycles were in the following areas:

- **Revenue.** Inspections staff will consider the auditor's assessment of the risks of material misstatement at the relevant assertion level, including fraud risk assessment, and the auditor's response to those assessed risks, including tests of details where required by PCAOB standards. Among other things, Inspections staff will:
  - Consider the sufficiency of controls tested, when control risk is assessed at less than the maximum, to support the nature, timing, and extent of planned substantive procedures based on the lower control risk assessment;
  - Evaluate the design and application of sampling procedures;
  - Assess whether substantive analytical procedures provide the intended level of assurance; and
  - Consider the sufficiency of procedures performed to obtain evidence about the accuracy and completeness of information that the auditor used that was produced by the broker or dealer or a service organization.
- **Assessing and responding to risks of material misstatement due to fraud.** Inspections staff will consider how the auditor addressed the risk of management override of controls, including the sufficiency of procedures performed to test journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.
- **Financial statement presentation and disclosures.** For those focus areas included in the inspection, Inspections staff will assess the work performed by the auditor to evaluate whether financial statement presentation and disclosures are in conformity with generally accepted accounting principles. This will include assessment of the audit procedures performed to evaluate the completeness of disclosures.
- **Fair value measurements.** Inspections staff will consider the sufficiency of procedures performed by the auditor to test the valuation of securities. Substantive tests of fair value measurements may involve (a) testing management's significant assumptions, the valuation model, and the underlying data; (b) developing independent fair value estimates for corroborative purposes; or (c) reviewing subsequent events and transactions.<sup>4</sup>

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3 Descriptions of deficiencies identified in past inspections may be found in the annual reports on the interim inspection program related to the audits of brokers and dealers that are available on the PCAOB website.

4 See paragraph 23 of AS 2502, *Auditing Fair Value Measurements and Disclosures* (currently AU sec. 328).

## Related Party Transactions

Inspections staff will also review the work performed under AS 2410, which became effective for audits of fiscal years beginning on or after December 15, 2014. This standard and the related amendments to other PCAOB standards address auditors' responsibilities regarding: (i) relationships and transactions with related parties, (ii) significant unusual transactions, and (iii) financial relationships and transactions with executive officers. The standard also imposes new requirements relating to the auditor's communications with the broker's or dealer's audit committee, or the equivalent, regarding related party transactions. In 2016, Inspections staff will focus on the firms' implementation of this new standard. In addition, Inspections staff will evaluate the audit work performed to test identified related parties or material related party transactions, including service agreements, fee arrangements, or intercompany balances.

## Supporting Schedules

AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements* (currently AS No. 17), establishes the auditor's responsibilities with respect to supplemental information required to accompany the financial statements, including the supporting schedules required by Rule 17a-5 to accompany the broker's or dealer's financial statements. Supporting schedules include the computation of net capital, the computation of the required reserve, and information relating to the possession or control of customer securities.

Inspections staff will focus on the auditor's procedures to test the supporting schedules, including the auditor's procedures performed to test:

- Components of the net capital calculation, such as whether assets were properly classified as allowable and non-allowable assets, and whether haircuts on securities' values were appropriately determined;
- Components of the customer reserve computation in order to evaluate whether they were reported in accordance with Exchange Act Rule 15c3-3, such as the accuracy and completeness of customer credit and debit balances; and
- Reported information related to compliance with the possession or control requirements under Rule 15c3-3, such as whether the broker or dealer maintained control of customer fully-paid and excess margin securities.

Inspections staff will also evaluate whether the auditor's report on the supporting schedules accompanying audited financial statements is in accordance with AS 2701.

## Attestation Engagements

Attestation engagements under PCAOB standards are required for brokers and dealers under Rule 17a-5. Under the SEC Rule, 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, with certain statements in the report examined by an auditor. A broker or dealer that claimed exemption from Rule 15c3-3 throughout the most recent fiscal year must file an exemption report, with statements in the report reviewed by an auditor.

## Examination Engagements

PCAOB Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* (“AT No. 1”), establishes the requirements for auditor examination of certain statements in the compliance reports of brokers and dealers.

Inspections staff will evaluate the auditor’s procedures performed to support its opinion regarding whether the broker’s or dealer’s statements regarding internal control over compliance (“ICOC”) with the financial responsibility rules<sup>5</sup> during, and as of the end of, the most recent fiscal year are fairly stated in all material respects. Inspections staff will assess whether the auditor performed procedures 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 during, and as of the end of, the most recent fiscal year, and will evaluate the sufficiency of the testing performed. For example, Inspections staff will assess:

- Whether the auditor obtained an understanding of the broker’s or dealer’s processes, including relevant controls, regarding compliance with the financial responsibility rules, and sufficiently evaluated the design of controls;
- The auditor’s testing of controls that contain a review element, including whether the auditor obtained an understanding of the actions

performed during the review, the criteria used to identify deviations requiring investigation, and the actions taken to investigate those deviations; and

- The auditor’s testing of controls over the accuracy and completeness of underlying information upon which the design and operating effectiveness of ICOC depended.

In addition, Inspections staff will assess the sufficiency of the auditor’s procedures, under paragraphs 21 through 23 of AT No. 1, to evaluate whether the broker or dealer was in compliance with the net capital rule and reserve requirements rule.<sup>6</sup> This will include, among other things, evaluating the auditor’s procedures to test the accuracy and completeness of the information used by the broker or dealer in its computations and the auditor’s procedures to obtain evidence about the existence of funds or securities held for customers.

## Review Engagements

PCAOB Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* (“AT No. 2”), establishes the requirements for auditor review of the statements in the exemption reports of brokers and dealers.

Inspection focus will include review procedures performed to identify exceptions to the exemption provisions and consideration of risk factors associated with exemption compliance. Inspections staff will assess whether auditors made all required

<sup>5</sup> The term “financial responsibility rules,” as used here, refers to Exchange Act Rules 15c3-1, 15c3-3, and 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. [See](#) footnote 10 in the note to paragraph 4 of AT No. 1.

<sup>6</sup> [See](#) Rules 15c3-1 and 15c3-3(e).

inquiries,<sup>7</sup> including those which involve obtaining an understanding of management’s controls and monitoring activities in place to comply with the claimed exemption provisions, and performed the required procedures. Inspections staff will assess whether auditors sufficiently evaluated whether the evidence obtained and the results of the procedures performed supported the auditor’s conclusions regarding the statements in the exemption report.

## **Engagement Quality Review**

Inspections staff will continue to focus on whether auditors complied with AS 1220, *Engagement Quality Review* (currently AS No. 7), including the reviewer’s evaluation of the engagement team’s significant judgments and conclusions – including the assessment of, and responses to, significant risks; the reviewer’s identification of significant engagement deficiencies; and the qualifications of the reviewer.

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<sup>7</sup> See paragraphs 10(b) through 10(d) of AT No. 2.

## Additional Information

More information regarding the interim inspection program, auditing and attestation standards, webcasts, and forums for auditors of brokers and dealers can be found on the PCAOB website:

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| Annual Reports:  |
| <a href="#">Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers (August 18, 2015)</a>                         |
| <a href="#">Third Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers (August 18, 2014)</a>          |
| <a href="#">Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers (August 19, 2013)</a>         |
| <a href="#">Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers (August 20, 2012)</a>                |
| Staff Inspection Briefs:   |
| <a href="#">Staff Inspection Brief, Vol. 2016/2: Preview of Observations from 2015 Inspections of Auditors of Brokers and Dealers (April 2016)</a> |
| <a href="#">Staff Inspection Brief, Vol. 2015/1: Information About 2015 Inspections of Auditors of Brokers and Dealers (August 2015)</a>           |
| Other:   |
| <a href="#">Staff Guidance for Auditors of SEC-Registered Brokers and Dealers</a>  |
| <a href="#">Information for Auditors of Broker-Dealers</a>   |
| <a href="#">Webcasts</a>   |
| <a href="#">Forums for Auditors of Broker-Dealers</a>  |

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