

Webinar: PCAOB Inspections of Auditors of Brokers and Dealers

January 11, 2016

Introductory Remarks

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Office of Outreach and Small Business Liaison

Caveat

The views we express today are our own and do not necessarily reflect the views of the Board, individual Board members, or other members of the Board's staff.

PCAOB Inspections of Auditors of Brokers and Dealers

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Division of Registration and Inspections

January 11, 2016

Agenda

- ❑ Summary of Interim Inspection Program
- ❑ 2015 Interim Inspection Program
- ❑ Inspections Observations - 2014
- ❑ Actions for Auditors
- ❑ Questions

Interim Inspection Program - Objectives

- ❑ Assess compliance with applicable Board and Commission rules and professional standards
- ❑ Help inform the Board's eventual determinations about the scope and elements of a permanent inspection program
- ❑ Assist in the development of the approach to inspections under a permanent inspection program

Interim Inspection Process

- ❑ Communication and scheduling
- ❑ Inspection of audit work
- ❑ Information gathering
- ❑ Communication of findings/observations
- ❑ Firm response to findings and responsibilities
- ❑ Reporting
- ❑ Communication with the SEC and other regulators
- ❑ Enforcement

Interim Inspection Process – Polling

Question #1

- ❑ Which PCAOB standard is applicable when the auditor becomes aware after the auditor's report was issued that necessary audit procedures had not been performed?
 - A. AU 324
 - B. AS 7
 - C. AU 390
 - D. AS 18

Interim Inspection Process – Polling

Question #1

- ❑ Which PCAOB standard is applicable when the auditor becomes aware after the auditor's report was issued that necessary audit procedures had not been performed?
 - A. AU 324
 - B. AS 7
 - C. **AU 390**
 - D. AS 18

2015 Interim Inspection Program

- ❑ Audits of brokers and dealers, which are required to be performed in accordance with PCAOB standards
- ❑ Examination and Review Engagements, also to be performed in accordance with PCAOB standards
- ❑ Continue to increase inspection coverage
 - 75 firms and portions of 115 audit and attestation engagements

2015 Interim Inspection Program (continued) – Areas of Inspection Focus

- ❑ Audit deficiencies in the financial statement audit
- ❑ Attestation standards
- ❑ Auditing supplemental information accompanying audited financial statements
- ❑ Engagement Quality Review
- ❑ Auditor independence

2015 Inspections

- ❑ Financial Statement Audit
- ❑ Attestation standards
- ❑ Supplemental information
- ❑ Engagement Quality Review
- ❑ Independence

Engagement Quality Reviewer Qualifications

Engagement quality reviewers:

☐ Must:

- Have competence, independence, integrity, and objectivity.
- Be an associated person of a registered public accounting firm.

☐ May:

- Be a partner or another individual in an equivalent position from the firm that issues the report; or
- Be an individual from outside the firm.

Engagement Quality Review (EQR) – Polling Question #2

The objective of the EQR is to evaluate the significant judgments made by the engagement team and the related conclusions reached. Given this objective, which of the following do you believe the EQR should review?

- A. Rationale for risk assessment for occurrence of underwriting revenue as high, and the audit evidence obtained to respond to the risk.
- B. Walkthrough of commissions expense controls.
- C. Substantive testing of level 3 securities valuation.
- D. Both A and C.

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Interim Inspection Program – Reporting

❑ Past Annual Reports

- 2011 - inspected 10 Firms and portions of 23 audits
- 2012 - inspected 43 Firms and portions of 60 audits
- 2013 - inspected 60 Firms and portions of 90 audits

❑ Supplemental Report

- Inspected 5 firms and portions of 5 audits

❑ Inspections – 2015 Annual Report

- 2014 - inspected 66 firms and portions of 106 audits

2014 Inspections - PCAOB Standards

- ❑ Inspected five firms covering one audit at each
- ❑ Observations:
 - Audit Opinion
 - Examination Report / AT1
 - Review Report / AT2
 - Engagement Quality Review / AS7
 - Engagement Completion Document / AS3
 - Other Deficiencies Similar to Previously Reported

Auditing Standard No. 3 - Audit Documentation

AS 3 paragraph 2 describes the objectives of audit documentation:

...Audit documentation also **facilitates the planning, performance, and supervision of the engagement**, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes **records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached** by the auditor...

Documentation of Significant Findings or Issues – Polling Question #3

Which does not represent a significant finding or issue that must be documented in the engagement completion document as required by paragraph 12 of AS No. 3?

- A. Significant deficiencies in internal control over recognition and/or deferral of revenue recognition.
- B. Audit adjustments – recorded and unrecorded.
- C. Alternative audit procedures performed in conjunction with non-replies to customer account confirmations which revealed no exceptions.
- D. Audit evidence obtained relating to valuation of private-label mortgage-backed securities, an area of significant risk.

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Scenario 1, Materiality - Facts

- ❑ Trusted Securities Inc. (TSI) is an introducing broker-dealer and also trades for its own account and has a clearing and custody arrangement with Clearview Clearing
- ❑ Historically reported \$100,000 minimum net capital requirement
- ❑ Excess net capital is several times actual minimum net capital requirement
- ❑ Historically claimed an exemption under Rule 15c3-3 under paragraph (k)(2)(ii)
- ❑ TSI's customer base is primarily individuals, with some institutional customers
- ❑ TSI receives a significant number of securities orders (both fixed income and equity) each month

Scenario 1, Materiality - Facts (continued)

- ❑ ABC Accounting Firm (ABC) was engaged to audit the financial statements and supplemental information of TSI as of an for the year-ended December 31, 2015
- ❑ ABC was also engaged to review TSI's 2015 exemption report ("Exemption Report") prepared pursuant to SEC Rule 17a-5
- ❑ ABC established overall materiality for the financial statements at \$40,000 and tolerable misstatement was set at \$30,000
- ❑ ABC also used \$40,000 as materiality for its audit of supplemental information

Scenario 1, Materiality – Polling Question #4

- ❑ Does the relationship between the overall materiality established for the financial statement audit and that for the audit of the supplemental information appear appropriate?
 - A. Yes
 - B. No

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Scenario 1, Part 2, Exemption Report - Facts

ABC considered the following when planning its review procedures:

- Key personnel are experienced, competent and have not changed
- All key personnel and processes operate from corporate location
- Written procedures regarding handling of customer funds and securities
- TSI identified two exceptions to the identified exemption provisions in its Exemption report
- Unaware of instances of non-compliance from previous years
- Risk of misappropriation of assets considered low

Scenario 1, Part 2, Exemption Report – Polling Question #5

- ❑ Has the engagement team considered the relevant risk factors included in AT No. 2 Review Engagements Regarding Exemption Reports of Brokers and Dealers?
 - A. Yes – Personnel, operations, exemptions claimed, exceptions identified, and risk of misappropriation of customer assets are all relevant risk factors.
 - B. No – Misappropriation of customer assets is not a relevant risk factor for the review engagement.

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Scenario 1, Part 2 – Polling Question #6

- ❑ Which of the audit procedures make sense to coordinate between the review engagement, the audit of the financial statements and the audit procedures performed on supplemental information of the broker or dealer?
 - A. Reading the current year FINRA examination letter
 - B. Inquiring of the President, FINOP, Accounting personnel, and two registered representatives to update the understanding of the business and regulatory environment of the broker or dealer
 - C. Reading the customer complaint file
 - D. All of the above

Scenario 1, Part 2 – Polling Question #6

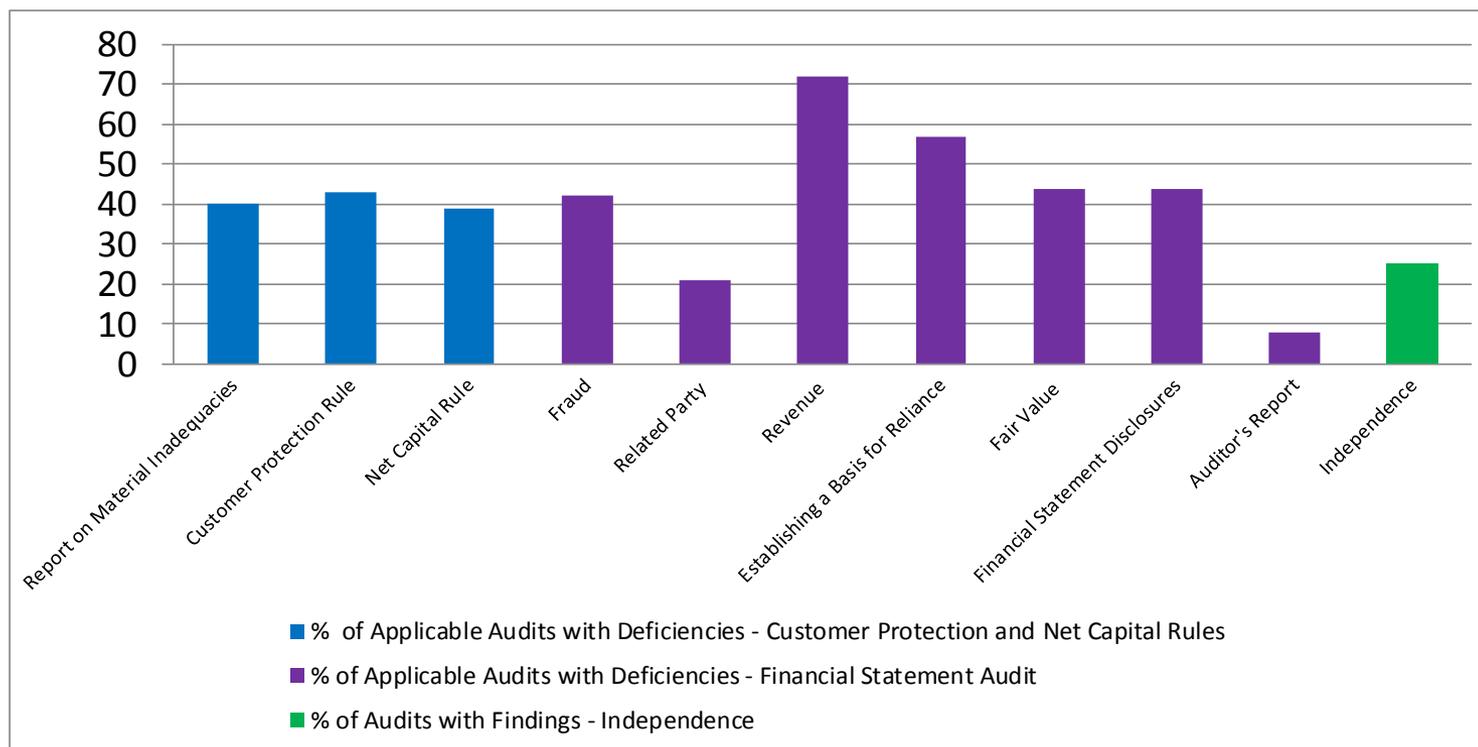
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 - C. Reading the customer complaint file
 - D. **All of the above**

Interim Inspection Program - Disclaimer

The information presented in the following slides is not necessarily indicative of the 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.

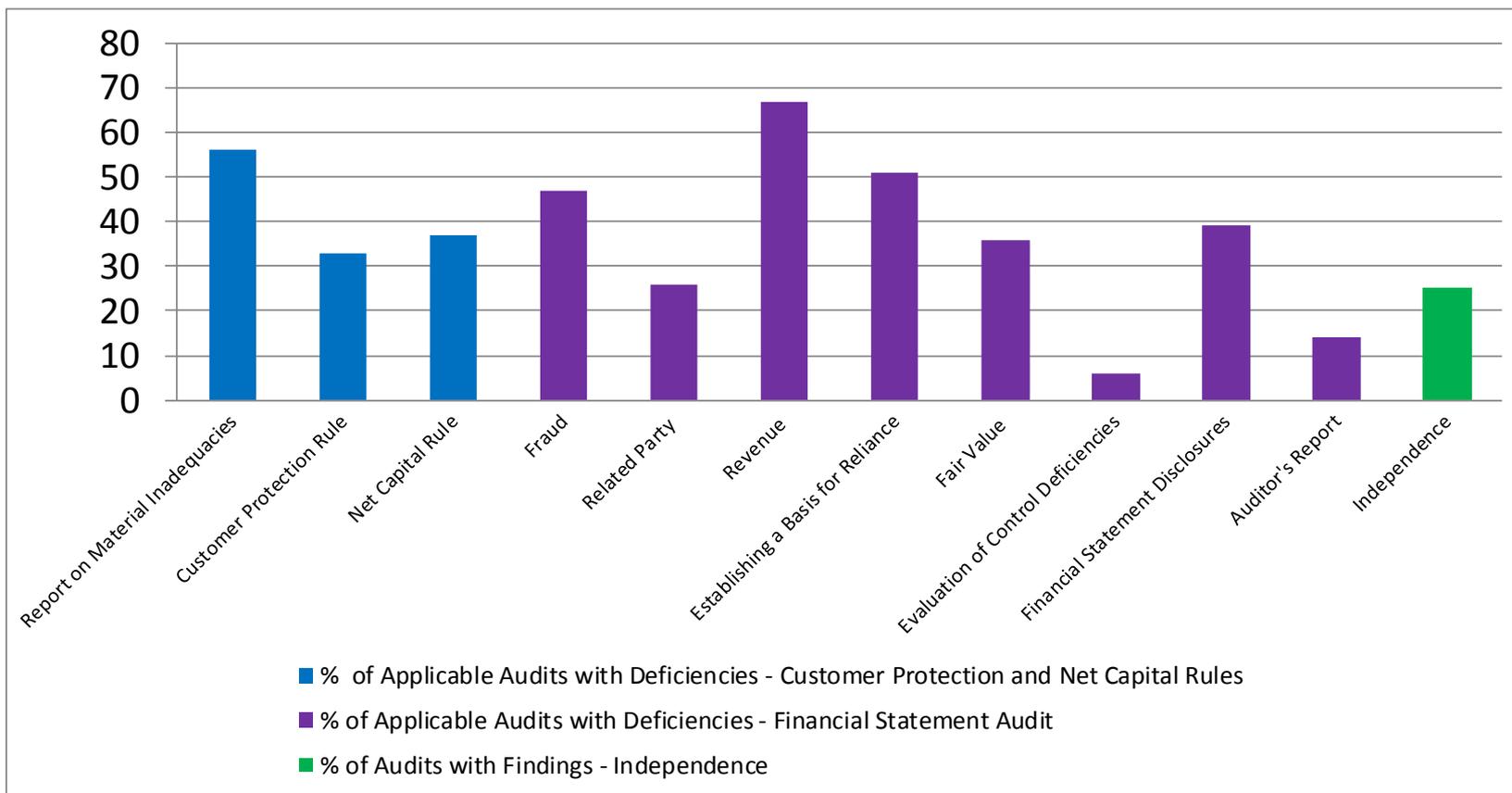
Inspections Observations by Audit Area - 2014

% of Applicable Audits with Observations



Inspections Observations by Audit Area - Inception of the Program Through 2014

% of Applicable Audits with Observations



Break
(5 minutes)

Compliance with Independence Requirements - 2014

24 out of 66 Firms failed to satisfy independence requirements by:

- ❑ Preparing, or assisting in the preparation of financial statements or supporting schedules
- ❑ Preparing journal entries or source data underlying the financial statements
- ❑ Including indemnity clauses in the engagement letter

Compliance with Independence Requirements - 2014 (continued)

- ❑ PCAOB announced settled disciplinary orders:
 - ❑ On December 8, 2014 against seven audit firms for independence violations
 - ❑ On July 9, 2015 against seven additional firms and two associated persons for independence violations
 - ❑ On July 9, 2015 determined not to commence disciplinary action against an eighth audit firm based on firm's extraordinary cooperation
 - ❑ On October 15, 2015, against three additional firms and one associated person for independence violations

Compliance with Independence Requirements - 2014 (continued)

- ❑ On December 8, 2014, the Securities and Exchange Commission sanctioned eight firms for violating auditor independence rules.
 - Prepared the financial statements of their audit clients
 - Censure and cease and desist from committing or causing any violations of Exchange Act Section 17(a) and Rule 17a-5
 - Collectively, \$140,000 in penalties and required remedial undertakings

Scenario 2 - Facts

- ❑ ABC Accounting Firm was hired to perform an audit of the financial statements of XYZ Broker Dealer
- ❑ XYZ prepares the financial statements and provides them to ABC
- ❑ During the audit, ABC identifies that XYZ did not include a revenue recognition policy disclosure in footnotes to the financial statement
- ❑ XYZ acknowledges that they need to add this disclosure
- ❑ ABC provides XYZ with a disclosure template for this footnote which it had previously created to assist clients in these matters.

Scenario 2 – Polling Question #7

Should ABC be concerned that given the facts as described, its independence as an auditor may be impaired?

- A. No, as XYZ prepared the financial statements.
- B. Yes, as ABC prepared the financial statements for XYZ.
- C. No, while ABC provided a template to XYZ it did not prepare the missing disclosure.
- D. Yes, because ABC provided its own template to XYZ and not one that was obtained from a source that was available to the general public.

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Net Capital Requirements and Customer Protection Rule - 2014

Deficiencies noted related to testing compliance with net capital requirements:

- ❑ Minimum net capital requirements
- ❑ Allowable assets
- ❑ Haircuts

Deficiencies noted related to testing compliance with the customer protection rule:

- ❑ Customer credits or debits
- ❑ Special Reserve Bank Account
- ❑ Possession or control requirements

Financial Statement Audit - 2014

The most frequent audit deficiencies related to:

- ❑ Revenue (72%)
- ❑ Reliance on Records and Reports (57%)
- ❑ Fair Value Accounting Estimates (44%)
- ❑ Financial Statement Presentation and Disclosures (44%)

Scenario 3, Revenue - Facts

- ❑ Affiliated Securities Inc. (ASI) is a registered broker dealer which claims exemption from Rule 15c3-3 and is an audit client of ABC
- ❑ All trades (about 1,000 per month / 12,000 per year) are executed through the clearing broker, Clearview Clearing
- ❑ ASI has a standard customer agreement with standard commission rates
- ❑ ASI trades appear similar in nature (mainly equity securities)
- ❑ ASI maintains a blotter of trades and records of aggregate trade volume by security type
- ❑ Clearview statements include both trade-level detail and monthly totals

Scenario 3, Revenue – Facts

Understanding of ASI's Revenue Recognition Process

- ❑ The Owner of XYZ Brokers, Inc. has 20 years of industry experience and previously was a FINOP at another broker-dealer
- ❑ The Chief Financial Officer (CFO) is a CPA and FINOP who previously worked at an audit firm with several broker-dealer clients.
- ❑ Accounting staff consist of a bookkeeper and bookkeeping assistant. Each has taken basic accounting classes. The bookkeeper also has 10 years of industry experience.
- ❑ The CFO prepares monthly financial statements, net capital computations, and reviews the monthly reconciliations.
- ❑ Accounting staff use monthly statements from Clearview to recording commission revenue and use the trade blotter to review the revenue reported by Clearview

Scenario 3, Revenue – Polling Question #8

- ❑ Does the engagement team have enough information to evaluate the design effectiveness of the identified revenue controls?
 - A. Yes - Management appears to have relevant experience and is qualified.
 - B. Yes - The CFO performs a monthly review of reconciliations prepared by Accounting staff.
 - C. No - The auditor does not have a sufficient understanding of the CFO's review, including the nature of the review and whether it is designed to prevent or detect misstatement of revenue.
 - D. Yes – given both A and B.

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 - D. Yes – given both A and B.

Scenario 3, Part 2, Revenue – Facts

- ❑ ABC performed risk assessment procedures for revenue
- ❑ Annual commission revenue exceeded ABC's materiality
- ❑ Inherent risk for commission revenue was considered moderate
- ❑ Control risk was assessed at "moderate to low"
- ❑ Controls in operation at December 31, 2015, the audit year-end, over all relevant assertions for commission revenue were identified and tested for design and operating effectiveness, without exception

Scenario 3, Part 2 – Polling Question #9

- ❑ Has ABC performed sufficient tests of controls to modify the nature, timing, and extent of planned substantive procedures over relevant assertions for commission revenue?
 - A. Yes – Controls over all relevant assertions were identified and tested for both design and operating effectiveness.
 - B. Yes - Controls were tested without exception.
 - C. Yes – both A and B.
 - D. No - The auditor did not test controls throughout the intended period of reliance.

Scenario 3, Part 2 – Polling Question #9

- ❑ Has ABC performed sufficient tests of controls to modify the nature, timing, and extent of planned substantive procedures over relevant assertions for commission revenue?
 - A. Yes – Controls over all relevant assertions were identified and tested for both design and operating effectiveness.
 - B. Yes - Controls were tested without exception.
 - C. Yes – both A and B.
 - D. No - The auditor did not test controls throughout the intended period of reliance.**

Scenario 3, Part 3, Revenue – Facts

- ❑ Inherent risk for commission revenue was considered moderate and control risk high for all assertions.
- ❑ ABC did not obtain a service auditor's report but based on inquiries determined that Clearview was a well-known organization with a positive reputation and no known operational issues.
- ❑ ABC tested commission rates by:
 - Comparing the commission rates applied per Clearview statements during the audit period to a current commission schedule maintained by ASI
 - Comparing the commission schedule to one obtained during the prior audit and observing that no changes had occurred
 - Inquiring of Accounting staff and the CFO regarding any changes to rates, noting none.

Scenario 3, Part 3, Revenue – Polling

Question #10

In addition to testing commission rates and evaluating the professional reputation of Clearview, ABC also sent an audit confirmation to Clearview, requesting confirmation of the number of customer transactions processed by security type for the year and received a reply with the requested trade data.

Do the substantive procedures in this scenario provide sufficient appropriate audit evidence for commissions revenue?

- A. Yes
- B. No

Scenario 3, Part 3, Revenue – Polling

Question #10

In addition to testing commission rates and evaluating the professional reputation of Clearview, ABC also sent an audit confirmation to Clearview, requesting confirmation of the number of customer transactions processed by security type for the year and received a reply with the requested trade data.

Do the substantive procedures in this scenario provide sufficient appropriate audit evidence for commissions revenue?

- A. Yes
- B. No**

PCAOB Risk Assessment Standards

- ❑ Auditing Standard No. 8, *Audit Risk*
- ❑ Auditing Standard No. 9, *Audit Planning*
- ❑ Auditing Standard No. 10, *Supervision of the Audit Engagement*
- ❑ Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*
- ❑ Auditing Standard No. 12, *Identifying and Assessing the Risks of Material Misstatement*
- ❑ Auditing Standard No. 13, *The Auditor's Responses to the Risk of Material Misstatement*
- ❑ Auditing Standard No. 14, *Evaluating Audit Results*
- ❑ Auditing Standard No. 15, *Audit Evidence*

Actions for Auditors

- ❑ Take appropriate action when audit deficiencies are discovered after the date of the audit report
- ❑ Be proactive – seek ways to better anticipate and address risks
- ❑ Take action now regarding identified independence and audit deficiency observations
- ❑ Review PCAOB guidance and participate in periodic Forums and webcasts

Questions?