

Broker-Dealer Audit Focus

Review Engagements Regarding Exemption Reports



PCAOB staff (“staff”) continues to identify deficiencies related to the review procedures required by [Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers](#) (“AT No. 2”). This edition of Broker-Dealer Audit Focus highlights key reminders for auditors from AT No. 2, provides the staff’s perspectives on common deficiencies observed in auditors’ work, and shares good practices that staff has observed.

APPLICABLE PCAOB STANDARD

AT No. 2 establishes requirements that apply when an auditor is engaged to perform a review of the statements (assertions) made by a broker-dealer in an exemption report prepared pursuant to the Securities Exchange Act of 1934 (“SEA”) Rule 17a-5. AT No. 2 requires the auditor to plan and coordinate the review engagement with the audit of the financial statements and the audit procedures performed on supplemental information of the broker-dealer. The auditor is to obtain moderate assurance by performing, with due professional care, the inquiries and other procedures required by the standard. The auditor’s objective is to state whether one or more conditions exist that would

About the Broker-Dealer Audit Focus Series

Broker-Dealer Audit Focus is a series of PCAOB publications that aims to provide easy-to-digest information to auditors of registered brokers and dealers (“broker-dealers”). Each edition of Broker-Dealer Audit Focus reiterates the applicable auditing or attestation standards, rules, and/or staff guidance, as well as offers reminders and good practices tailored to PCAOB-registered auditors of smaller broker-dealers – all with an eye toward protecting investors and improving audit quality.

cause one or more of the broker-dealer’s assertions not to be fairly stated, in all material respects.

A review engagement performed in accordance with AT No. 2 includes the following procedures:

- Reading the exemption report to determine the provisions under which the broker-dealer asserts its exemption and the identified exceptions to the exemption provisions;

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- Performing inquiries and other review procedures set forth in AT No. 2; and
- Evaluating whether the evidence indicates that there should be modifications to the broker-dealer's assertions based on the results of the procedures performed.

Required inquiries designed to help the auditor review the broker-dealer's assertions include:

- Inquiry of management, and, if applicable, other individuals at the broker-dealer regarding compliance with the exemption provisions throughout the year under review or whether exceptions have been identified;
- Inquiry of individuals at the broker-dealer who have relevant knowledge of controls relevant to the broker's-dealer's compliance with the exemption provisions; and
- Inquiry of individuals who are responsible for monitoring compliance with the exemption provisions or controls over compliance.

As required by AT No. 2, the auditor should evaluate whether the evidence obtained, and the results of the procedures performed in the audit of the financial statements and the audit procedures performed on supplemental information, corroborate or contradict the broker-dealer's assertions regarding compliance with the exemption provisions. Examples of procedures performed include (i) testing related to customer trades, (ii) testing of specially designated cash accounts, (iii) testing investment inventory or transactions related to the broker-dealer's trading for its own account, and (iv) reading the clearing agreement in connection with testing trade fee or commission revenue or expenses.

In addition, AT No. 2 identifies specific elements that must be included in the auditor's review report (See AT No. 2.16), modified as necessary (See AT No. 2.19-20).

Common Deficiencies

When it comes to performing AT No. 2 procedures, the following are some of the common deficiencies that the PCAOB has observed in its inspections of audit firms who audit broker-dealers:



Not obtaining an understanding of the exemption conditions

that are relevant to the broker-dealer's assertions.



Not evaluating evidence that the exemption provisions in broker-dealer exemption reports were inaccurate,

such as erroneous descriptions of exemptive provisions.

Not properly applying the requirements of prompt transmittal

when assessing whether customer checks received by the broker-dealer should have been reported as exceptions.



Not performing inquiries regarding controls

in place to maintain compliance with exemptions claimed, and those regarding the nature, frequency, and results of related monitoring activities.



Not evaluating whether evidence obtained in connection with the audit of the financial statements contradicted broker-dealer assertions

such as:

- For a broker-dealer that only claims the (k)(2)(ii) exemption, evidence that the broker-dealer participates in investment banking, private placements, or the sale of mutual fund products and variable annuities that are not carried out through a clearing broker-dealer; and
- For a broker-dealer that claims the (k)(2)(i) exemption, evidence that the broker-dealer effectuates financial transactions between the broker-dealer and its customers without using a special bank account that has no liens.



Not correctly identifying in the audit firm's review report the assertions made by the broker-dealer

in its exemption report.

Not obtaining one or more required written representations

required by AT No. 2 from management of the broker-dealer.



REMINDERS

Evaluating Evidence About the Broker-Dealer's Assertions

Auditors should evaluate whether information has come to the auditor's attention that causes the auditor to believe that one or more of the broker-dealer's assertions are not fairly stated in all material respects.

The auditor should take into account relevant evidence from the audit of the financial statements, and the audit procedures performed on supplemental information, in obtaining an understanding of controls or other activities relevant to the broker-dealer's compliance with the exemption provisions.

This includes obtaining an understanding of the nature of the broker-dealer's activities and its principal source(s) of revenues. Audit procedures that provide evidence about the relevance of the broker-dealer's assertions include the testing of customer trades, specially designated cash accounts, and transactions related to the broker-dealer's trading for its own account. Evidence is also obtained by reviewing the broker-dealer's agreements with customers, clearing broker-dealers, and other third parties, such as mutual fund companies and investment advisors.

The auditor should evaluate whether the evidence obtained and the results of the procedures performed corroborate or contradict the appropriateness of the exemption provisions identified by the broker-dealer in its exemption report.

Performing Inquiries and Other Review Procedures

Auditors should (1) make inquiries to management and other individuals who have relevant knowledge regarding compliance with the exemption provisions and (2) perform other procedures based upon consideration of risk factors.

Management and other individuals at the broker-dealer who may have relevant knowledge about

compliance could include the financial and operations principal (FINOP), compliance officers, registered representatives, or internal audit personnel, in addition to the executive and financial officers at the broker-dealer.

The auditor should perform inquiries of management and other individuals regarding (i) whether the broker-dealer met the provisions of the exemption throughout the year, (ii) examinations and correspondence by the U.S. Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA), and (iii) events that occurred after the period covered by the exemption report that might have a material effect on the broker-dealer's assertions.

The auditor should also make inquiries to individuals who have relevant knowledge regarding controls relevant to compliance with the exemption provisions, including controls over prompt transmittal of customer funds and prompt transmittal or delivery of customer securities, and the recording of exceptions. Further, inquiries should be made to individuals responsible for monitoring compliance with the exemption provisions regarding the nature, frequency, and results of their monitoring activities and the nature and frequency of customer complaints that are relevant to the broker-dealer's compliance with the exemption provisions.

The nature, timing, and extent of the necessary inquiries and other review procedures depend on risk factors including, but not limited to, the broker-dealer's history of instances of noncompliance with the exemption provisions, the competence of, and changes in, personnel who are responsible for compliance with the exemption provisions or who perform important controls over compliance, and potential fraud and misappropriation of customer assets. For example, after consideration of these risk factors, an engagement team may determine to perform procedures to assess whether customer funds received by the broker-dealer should be reported as exceptions in the broker-dealer's exemption report. In such cases, the engagement team should consider the applicable prompt transmittal requirements for the customer funds and use information suitable for making that assessment. Broker-dealers are

generally required to transmit customer funds by noon of the business day following receipt, except in certain circumstances, for example, when sales of securities on a subscription-way basis under certain conditions allow broker-dealers to hold customer funds for an additional period to complete suitability reviews.

Documentation of inquiries and other review procedures performed must meet the requirements of [AS 1215, *Audit Documentation*](#), including sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the nature, timing, extent, and results of the procedures performed, the evidence obtained, and the conclusions reached.

Reporting on the Review Engagement

The auditor's review report must include an identification of the exemption report and the broker-dealer's assertions.

The auditor's review report must include the identification of the exemption report and accurately describe the broker-dealer's assertions, including whether the broker-dealer met the provisions of the exemption throughout the most recent fiscal year without exception, or as described in the exemption report.

If one or more of the broker-dealer's assertions are not fairly stated, the auditor must modify the review report to describe the reasons the assertions are not fairly stated.

A broker-dealer's assertions are not fairly stated when the broker-dealer claims an exemption for which it is not eligible, or when a broker-dealer omits an exemption such that the broker-dealer's assertions are materially incomplete. To be fairly stated, assertions in the broker-dealer's exemption report should also state whether the broker-dealer met the provisions of the exemption claimed, with or without exception, throughout the year. Further, the broker-dealer's assertions are not fairly stated when the broker-dealer indicates that provisions of the exemption are met throughout the year without exception, when they are not.

The auditor should date the review report no earlier than the date on which the review procedures have been completed by the auditor and the date of the auditor's report on the financial statement and supplemental information.

Good Practices

The following good practices may assist audit firms who audit broker-dealers with the review procedures required by AT No. 2:



AT No. 2 Practice Aid

Use of a practice aid that includes guidance on the requirements of AT No. 2 and specifies procedures to be performed based on those requirements. An effective practice aid would also aid engagement teams in identifying the applicable exemption(s) based upon the broker-dealer's business activities and revenue streams, and incorporate relevant regulatory and industry guidance applicable to broker-dealers, such as the SEC staff's **"Frequently Asked Questions Concerning the Amendments to Certain Broker-Dealer Financial Responsibility Rules."**

AT No. 2 Structured Template

Use of a template that addresses all requirements of AT No. 2, including the required content of the management representation letter, and that aligns the audit firm's review report with the elements described in the illustrative example included in AT No. 2.17.

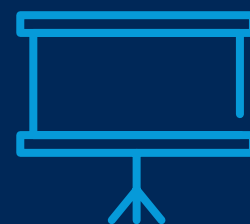


AT No. 2 Resource

Designation of audit firm staff member(s) with responsibility to develop and maintain technical knowledge and provide support to engagement teams relating to AT No. 2, the broker-dealer's exemption report, and the audit firm's review report.

Training

Periodic training regarding the scope and requirements of each of the exemption provisions included in paragraph (k) of the Customer Protection Rule that a broker-dealer includes in the exemption report.



STAY CONNECTED

Auditors and others can find more PCAOB resources and perspectives on our **Information for Auditors of Broker-Dealers**, **Information for Smaller Firms**, and **Staff Publications** pages. Sign up for **targeted email updates** through our Communications to Auditors and Communications to Small Audit Firm Practitioners mailing lists.