



## 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 2017 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 2017, conducted under the interim inspection program,<sup>1</sup> of auditors of brokers and dealers registered with the Securities and Exchange Commission (“SEC”). This Inspection Brief also highlights important aspects of the inspection plan, scope, and objectives.

#### Overview of Inspection Plan and Scope

During 2017, Inspections staff will evaluate the degree of auditors’ compliance with the Sarbanes-Oxley Act of 2002, the rules of the Board, the rules of the SEC, and PCAOB standards in connection with broker and dealer audit and attestation engagements.

In 2017, Inspections staff plans to inspect approximately 75 firms that audit SEC-registered brokers and dealers, covering portions of approximately 115 selected audits and the related attestation engagements of these brokers and

dealers. This plan is consistent with the number of firms and engagements inspected during 2016.

All firms that audit SEC-registered brokers and dealers are eligible for selection to be inspected during 2017. 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 audit and attestation engagements that represent elements of risk. 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.

<sup>1</sup> See PCAOB Rule 4020T, *Interim Inspection Program Related to Audits of Brokers and Dealers*.

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

- Number of broker and dealer audits performed, including any significant increases;
- Whether a firm 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 partners by the SEC, PCAOB, or other regulatory authorities.

The selection of audit and attestation engagements is based on their various characteristics, including those of the brokers and dealers, such as:

- Financial metrics of the broker or dealer, such as assets, revenue, and reported actual net capital under Exchange Act Rule 15c3-1 (“Rule 15c3-1”);
- Whether the broker or dealer filed with the SEC a compliance report or an exemption report pursuant to Exchange Act Rule 17a-5 (“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 or its personnel by the SEC, Financial Industry Regulatory Authority, or other regulatory authorities; and

- Engagement partner assigned to the broker or dealer engagement, including consideration of the partner’s workload, experience in auditing brokers or dealers, and previous inspection results.

The number of broker or dealer audits for the 75 firms included in the 2017 plan is as follows:

Number of Broker or Dealer Audits per Firm	Number of Firms
More than 100	4
21 - 100	16
1 - 20	55
TOTAL	75

## Audit Areas and Attestation Procedures

Inspections staff will focus on the following audit areas and attestation procedures in 2017, which are consistent with 2016:

- Auditor independence;
- Financial statement audit areas where deficiencies were identified in past inspections, including revenue, the assessment and response to risks of material misstatement due to fraud, financial statement presentation and disclosure, fair value measurements, and related party transactions;
- Audit procedures on the supporting schedules that accompany the financial statements;
- Procedures for the attestation engagements: the examinations of compliance reports and the reviews of exemption reports; and
- Engagement quality reviews.

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. Inspections staff will consider the complexity of the broker or dealer and the types of transactions executed by the broker or dealer, as these factors are often relevant when considering risks, including risks of misappropriation of customer assets or material misstatement. Misappropriation of customer assets can occur in a number of ways, such as falsifying customer account statements, withdrawing or transferring funds out of customer accounts without authorization, and transmitting customer funds to an alternate address not designated by the customer. Risks of material misstatement can be associated with complex expense sharing and shared services agreements with related parties, other related party transactions, less liquid harder-to-value securities, and international custody arrangements.<sup>2</sup>

In addition to reviewing certain portions of selected audits and the related 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.

## Areas of Inspection Focus

### Auditor Independence

Consistent with prior years, Inspections staff will focus on firm compliance with applicable SEC and PCAOB independence requirements.<sup>3</sup> This will include, among other things, examining whether firms impaired their independence under SEC rules because they performed bookkeeping or other services related to their broker or dealer audit client's accounting records.

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, *Communication with Audit Committees Concerning Independence*.

### Financial Statement Audit Areas

Inspections staff will consider deficiencies cited in previous annual reports<sup>4</sup> related to financial statement audit areas and evaluate how audit firms complied with the relevant standards in those areas. For example, some of the more frequent or recurring financial statement audit areas with deficiencies identified in recent inspection years are the following:

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- 2 [See PCAOB Staff Guidance for Auditors of SEC-Registered Brokers and Dealers](#) issued on June 26, 2014 and available on the PCAOB website.
  - 3 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, as Exchange Act Release No. 34-70073 states that these requirements 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.
  - 4 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.

- **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. Inspections staff will evaluate:
  - The sufficiency of risk assessment procedures performed, including whether the auditor obtained a sufficient understanding of the aspects of internal control over financial reporting relevant to revenue and sufficiently evaluated the design of the controls intended to address fraud risks;<sup>5</sup>
  - The sufficiency of procedures performed for significant classes of revenue transactions, including the design and application of sampling procedures;<sup>6</sup>
  - Whether substantive analytical procedures provide the necessary level of assurance;<sup>7</sup> and
  - The sufficiency of procedures performed to obtain appropriate evidence about the accuracy and completeness of information that the auditor used that was produced by the broker or dealer or a service organization used by the broker or dealer.<sup>8</sup>
- **Assessing and responding to risks of material misstatement due to fraud.** Inspections staff will evaluate the auditor’s procedures to assess and respond to risks of material misstatement due to fraud, including the sufficiency of the auditor’s procedures to address the risk of management override of controls. Inspections staff will evaluate 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.<sup>9</sup>
- **Financial statement presentation and disclosures.** For those audit areas included in the inspection, Inspections staff will assess the work performed by the auditor to evaluate whether financial statement presentation and disclosure are in conformity, in all material respects, with generally accepted accounting principles (“GAAP”).<sup>10</sup> Inspections staff will assess the audit procedures performed by the auditor to evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with GAAP.<sup>11</sup>
- **Fair value measurements.** Inspections staff will assess 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

5 See Auditing Standard (“AS”) 2110, *Identifying and Assessing Risks of Material Misstatement*.

6 See AS 2315, *Audit Sampling*.

7 See AS 2305, *Substantive Analytical Procedures*.

8 See AS 2601, *Consideration of an Entity’s Use of a Service Organization*, and AS 1105, *Audit Evidence*.

9 See paragraphs .57-.58 of AS 2401, *Consideration of Fraud in a Financial Statement Audit*.

10 See paragraph .30 of AS 2810, *Evaluating Audit Results*.

11 See AS 2810.31.

valuation model, and the underlying data; (b) developing independent fair value estimates for corroborative purposes; or (c) reviewing subsequent events and transactions.<sup>12</sup>

- **Related party transactions.** Inspections staff will review the work performed under AS 2410, *Related Parties*. Inspections staff will evaluate the procedures performed by the auditor to identify, assess, and respond to the risks of material misstatement associated with related parties and relationships and transactions with related parties, including service agreements, fee arrangements, or intercompany accounts.

## Supporting Schedules

AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements*, establishes the auditor's responsibilities with respect to supplemental information required to accompany the financial statements, including the supporting schedules required by paragraph (d)(2)(ii) of Rule 17a-5 to accompany the broker's or dealer's financial statements filed with the SEC. Supporting schedules include the computation of net capital, the computation for the determination of the required reserve, and information relating to the possession or control of customer securities.

Inspections staff will assess the auditor's procedures to test the supporting schedules, including the auditor's procedures to test:

- Components of the net capital calculation supporting schedule, such as whether assets were properly classified as allowable or non-allowable assets, the accuracy and completeness of the reported amounts of

operational charges and other deductions to arrive at the broker's or dealer's net capital, and whether haircuts on securities' values were appropriately determined;

- Components of the customer reserve computation supporting schedule in order to evaluate whether they were reported in accordance with Exchange Act Rule 15c3-3 ("Rule 15c3-3"), such as the accuracy and completeness of customer credit and debit balances; and
- Information presented in the supporting schedule related to compliance with the possession or control requirements under Rule 15c3-3, including procedures performed to test the accuracy and completeness of information presented in the schedule.

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 performed in accordance with PCAOB standards are required for annual reports of brokers and dealers under paragraphs (d)(1)(i) and (g) of 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, with certain statements in the report examined by the auditor. A broker or dealer that claimed that it was exempt from Rule 15c3-3 throughout the most recent fiscal year must file an exemption report, with statements in the report reviewed by the auditor.

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<sup>12</sup> See paragraph .23 of AS 2502, *Auditing Fair Value Measurements and Disclosures*.

## 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 made by brokers and dealers in their compliance reports.

Inspections staff will assess whether the auditor sufficiently planned the examination engagement, as required by paragraphs 9 and 10 of AT No.

1. In addition, 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>13</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, including whether the auditor obtained an understanding of the nature of the control, including for

review controls, understanding and evaluating management’s expectations and criteria used to identify matters for investigation, and the nature and resolution of the investigation procedures performed; 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.

Further, 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 at year end.<sup>14</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 made by brokers and dealers in their exemption reports.

Inspections staff will assess the review procedures performed by the auditor to identify exceptions to the exemption provisions and consideration of risk factors associated with exemption compliance. Inspections staff will assess whether auditors made

13 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 .04 of AT No. 1.

14 See Rules 15c3-1 and 15c3-3(e).

all required inquiries,<sup>15</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 assess whether the audit firm complied with AS 1220, *Engagement Quality Review*, including the reviewer's evaluation of the engagement team's significant judgments and conclusions (including the assessment of, and audit responses to, significant risks identified by the engagement team); the reviewer's identification of significant engagement deficiencies; and the qualifications of the reviewer.

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<sup>15</sup> See paragraphs .10(b)-.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:

<b>Annual Reports:</b>
<a href="#">Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers (August 18, 2016)</a>
<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>
<b>Staff Inspection Briefs:</b>
<a href="#">Staff Inspection Brief, Vol. 2017/1: Preview of Observations from 2016 Inspections of Auditors of Brokers and Dealers (June 2017)</a>
<a href="#">Staff Inspection Brief, Vol. 2016/4: Information About 2016 Inspections of Auditors of Brokers and Dealers (July 2016)</a>
<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>
<b>Other:</b>
<a href="#">Staff Guidance for Auditors of SEC-Registered Brokers and Dealers</a>
<a href="#">Information for Auditors of Broker-Dealers</a>
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