

PCAOB Inspections Overview and Illustrative Examples: Broker-Dealers

Mike Walters, Greg MacCune, and Violet Wojtczuk
Division of Registration and Inspections
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DISCLAIMER

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OBJECTIVES

At the end of this session participants will be able to:

- Identify relevant PCAOB publications for auditors of broker-dealers
- Discuss some of the observations from 2022 inspections
- Understand requirements of PCAOB standards, deficiency examples, and good practices for selected areas
- Understand insights regarding recent inspection results
- Understand the status of 2023 and 2024 inspection activities

OVERVIEW OF RELEVANT PCAOB PUBLICATIONS

- Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers (“4020T Annual Report”) – August 2023
- Supplementary Information Related to Audits of Brokers and Dealers – August 2023
- Spotlight: Insights Into the PCAOB’s Interim Inspection Program Related to Audits of Broker-Dealers – January 2024
- Staff Guidance for Auditors of SEC-Registered Brokers and Dealers – June 2014

OVERVIEW OF RELEVANT PCAOB PUBLICATIONS (CONT'D)

- Spotlight: Root Cause Analysis – An Effective Practice to Drive Audit Quality – April 2024
- Spotlight: Inspection Observations Related to Use of Data and Reports – April 2024
- Spotlight: Staff Priorities for 2024 Inspections and Interactions with Audit Committees (“Priorities Spotlight”) – December 2023
- Staff Guidance – Insights for Auditors: Evaluating the Relevance and Reliability of Audit Evidence Obtained from External Sources – October 2021

INSPECTION RESULTS 2020 - 2022

Inspection year	Percentage of audits with independence findings	Percentage of audits with deficiencies	Percentage of audit areas with deficiencies	Percentage of examination engagements with deficiencies	Percentage of review engagements with deficiencies
2022	11%	58%	20%	50%	40%
2021	0%	49%	15%	64%	28%
2020	9%	61%	18%	67%	23%

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COMMON DEFICIENCIES – AUDITING REVENUE

- Responses to the risks of material misstatement
 - Commissions
 - Investment advisory fees
 - Trading gains and losses
 - Investment banking fees
 - M&A and other advisory fees
- Other deficiencies
 - Risk assessment
 - Information produced by the broker-dealer
 - Audit sampling
 - ASC 606 considerations



COMMON DEFICIENCIES – AT NO. 2

- Reporting on review engagements, including mischaracterization of broker-dealer assertions
 - Role of due professional care
 - Resolve inconsistencies
- Consideration of contradictory evidence
 - Broker-dealers that claim an exemption under (k)(2)(ii)
 - Consideration of evidence obtained through the audit

COMMON DEFICIENCIES – AT NO. 1

Testing internal control over compliance with the financial responsibility rules:

- Reserve Requirements Rule
- Possession or control requirements
- Account Statement Rule
- Quarterly Security Counts Rule
- Net Capital Rule

ILLUSTRATIVE EXAMPLES

- Revenue presentation and disclosure
- Journal entry testing
- AT No. 1 – Internal control over compliance (ICOC)
- AT No. 2 – Review reporting



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REVENUE PRESENTATION AND DISCLOSURE SCENARIO

- A broker-dealer reported commissions revenue of \$6 million on its statement of income
- Commissions income comprised commissions from the sale of mutual funds \$2 million, mutual fund 12b-1 distribution fees of \$2 million, and merger and acquisition advisory fees of \$2 million
- The broker-dealer disclosed the following in its notes to its financial statements:
 - *Commissions - Commission revenues primarily include commissions from the initial sale of mutual fund products and are recognized at a point in time on the trade date*

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JOURNAL ENTRY TESTING SCENARIO

- The auditor identified management override of controls to be a fraud risk
- As part of obtaining an understanding of the broker-dealer's financial reporting process and controls over journal entries and other adjustments, the auditor learned that journal entries are not required to have descriptions
- The auditor identified fraud risk factors in the journal entry population, including incomplete journal entry descriptions
- The auditor performed procedures to test the completeness of the population of journal entries and observed journal entries with and without descriptions

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AT NO. 1 ICOC SCENARIO

- A broker-dealer provides all customers who consent to electronic delivery access to their account statements in electronic form
- The broker-dealer generates the customer account statements using information obtained from its internal systems and maintains the application used to store the account statements and make them available to customers (the “portal”)
- The auditor determines controls over electronic delivery of account statements to be important to the auditor’s conclusion about whether the broker-dealer maintained effective internal control over compliance (ICOC) with the Account Statement Rule

POLLING QUESTION 3

Which of the following is true regarding the auditor's responsibility to test the design and operating effectiveness of controls?

- a. Because the auditor understands that the broker-dealer's process is to make the account statements available to customers on the portal, the auditor does not need to test controls over the completeness of the population of customers who are to receive account statements
- b. If the broker-dealer makes the account statements available to customers on the portal regardless of consent, the auditor does not need to test controls over customer consent to electronic delivery
- c. The auditor only needs to test controls over the completeness and accuracy of information included in the account statements
- d. The auditor should test controls over customer ability to access their account statements via the portal

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AT NO. 2 REPORTING SCENARIO

- A broker-dealer files an exemption report that includes the following statements:
 - It is relying on Footnote 74 of the SEC Release No. 34-70073 adopting amendments to 17 C.F.R. § 240.17a-5
 - It limits its business activities exclusively to underwriting and merger and acquisition activity
 - Throughout the fiscal year, it did not:
 - Directly or indirectly receive, hold, or otherwise owe funds or securities for or to customers
 - Carry accounts of or for customers
 - Carry PAB accounts (as defined in Rule 15c3-3)

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SPOTLIGHT – INSIGHTS INTO THE INTERIM INSPECTION PROGRAM

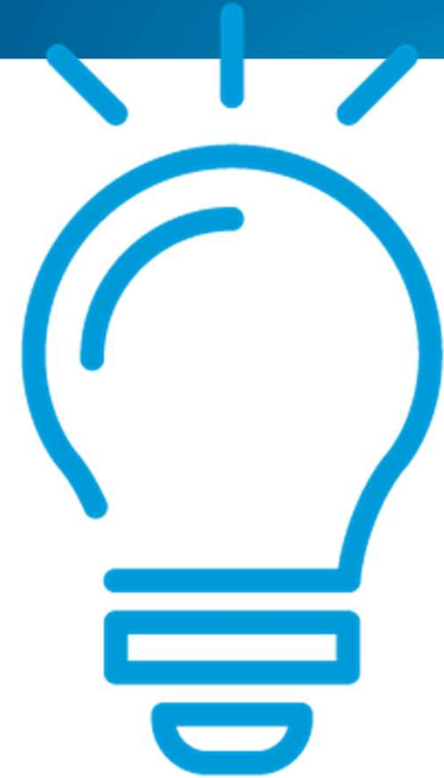
- Provides additional related insights regarding potential factors contributing to high deficiency rates in broker-dealer engagements
- Covers topics ranging from understanding of the broker-dealer industry to low-cost providers and pace of auditor changes



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INSIGHT – INSUFFICIENT UNDERSTANDING OF THE BROKER-DEALER INDUSTRY

- Understanding of the financial responsibility rules
- Broker-dealer operations and related revenue recognition policies can vary
- Auditing risks related to the use of information from clearing brokers
- Broker-dealer specific training can include a mix of inhouse and alternative sources.



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INSIGHT – LACK OF PROFESSIONAL SKEPTICISM

- Exercise due professional care in planning and performance of audit and attestation engagements
- Example areas where skepticism may be lacking:
 - Inquiries of management
 - Risk assessment
 - Testing significant accounts
 - Auditor's reports
 - GAAP departures



INSIGHT – LACK OF RIGOR IN RISK ASSESSMENT

- Risk of material misstatement in financial statements assessed to be low without properly completing the required risk assessment procedures at the financial statement and assertion levels
- Citing of high degrees of automation and reliance on technology factors supporting lower-risk assessments
- “Default” control risk assessments at the maximum

INSIGHT – LACK OF RIGOR IN RISK ASSESSMENT (CONT'D)

- Insufficient assessment of external factors, broker-dealer-specific factors
- Lack of qualitative factors when assessing significant accounts
- Insufficient understanding of how assessed risks of material misstatement (low / medium / high) is used to determine the nature, timing, and extent of audit procedures on significant accounts

INSIGHT – OVERRELIANCE ON STANDARDIZED AUDIT PROGRAMS

- Risks associated with use of standardized audit programs
 - May not be all encompassing
 - May not reflect all requirements in the standards
 - May be limited in the scope of procedures to be performed
- Need to tailor to reflect the nature of the broker-dealers' business operations, internal controls, financial reporting, and attestation risks
- Need to evaluate how well the firm's methodology and audit programs address the applicable PCAOB auditing standards

INSIGHT – INEFFECTIVE EQR

- Lack of EQR partners or individuals in equivalent positions with the knowledge and experience in the broker-dealer industry
- Deficiencies associated with EQRs include:
 - Insufficient evaluation of the engagement team's responses to significant risks identified by the engagement team
 - EQR procedures performed were limited to:
 - Brief discussions with the engagement team
 - cursory review of work papers, financial statements, reports
 - Proofreading of the auditor reports
- Consider developing capabilities through more technical firm training, vendor sessions, conferences, and self-study

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INSIGHT – INEXPERIENCE WITH PCAOB STANDARDS

- Audit firms may not have made the necessary investment in training and methodology to comply with the PCAOB standards
- Over 1,000 broker-dealers audits are performed by 162 audit firms that do not audit public companies
- Many auditors are in a challenging market, with approximately one-third of these audits performed in less than 40 hours

INSIGHT – INEXPERIENCE WITH PCAOB STANDARDS (CONT'D)

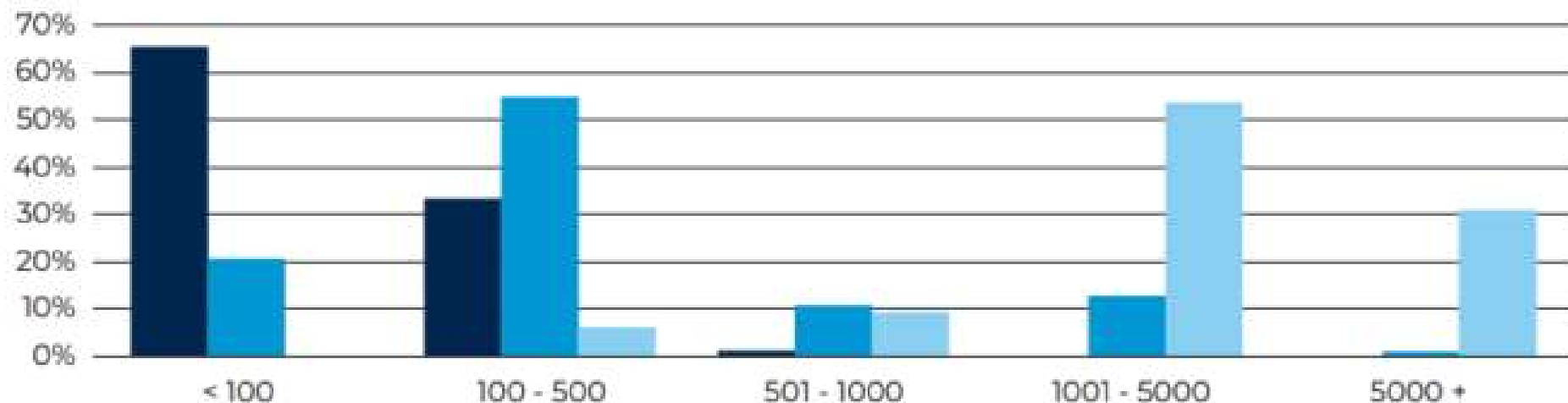
- Percentage of audits reviewed with deficiencies was 86% for audit firms that do not audit public companies, compared to 49% for audit firms that audit public companies
- High rates of non-compliance with PCAOB standards on examination engagements by audit firms that audit fewer than 100-broker-dealers

INSIGHT – INEXPERIENCE WITH PCAOB STANDARDS (CONT'D)

Hours Reported by Audit Firms on Engagements Reviewed by the PCAOB

(Combined 2020–2022 inspection periods)

- Firms that audited broker-dealers, but did not audit public companies
- Firms that audited fewer than 100 broker-dealers and fewer than 100 public companies
- Firms that audited more than 100 broker-dealers and more than 100 public companies



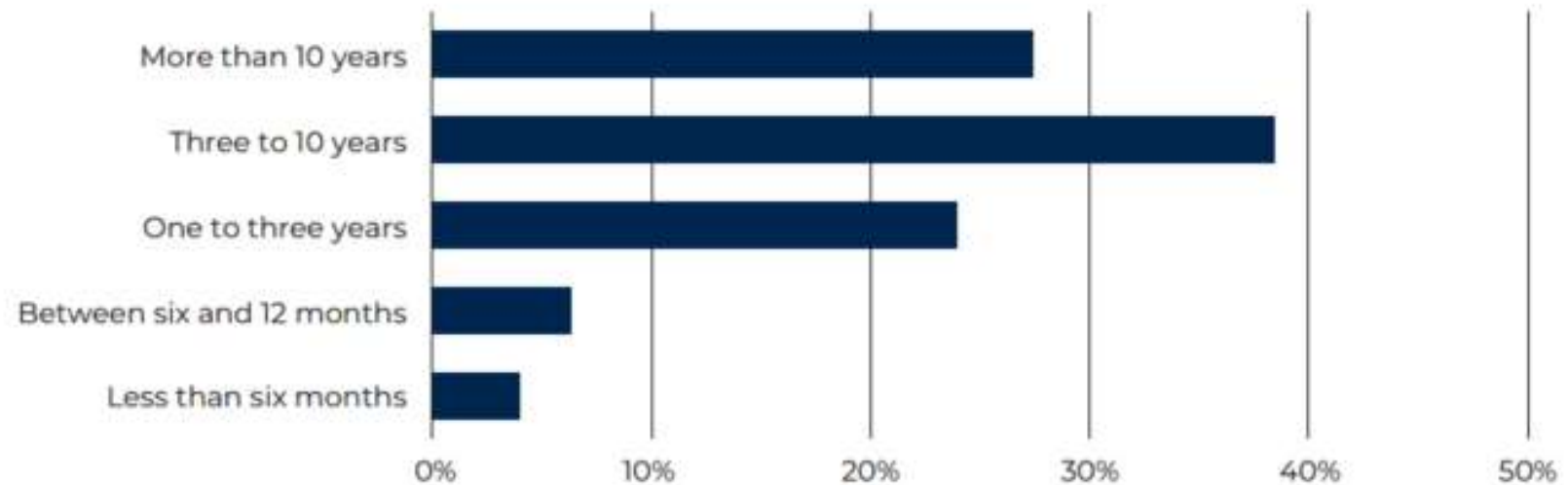
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INSIGHT – PACE OF AUDITOR CHANGES

Auditor Tenure Reported by Inspected Firms

(2022 inspection year)

■ Percentage of all broker-dealer clients

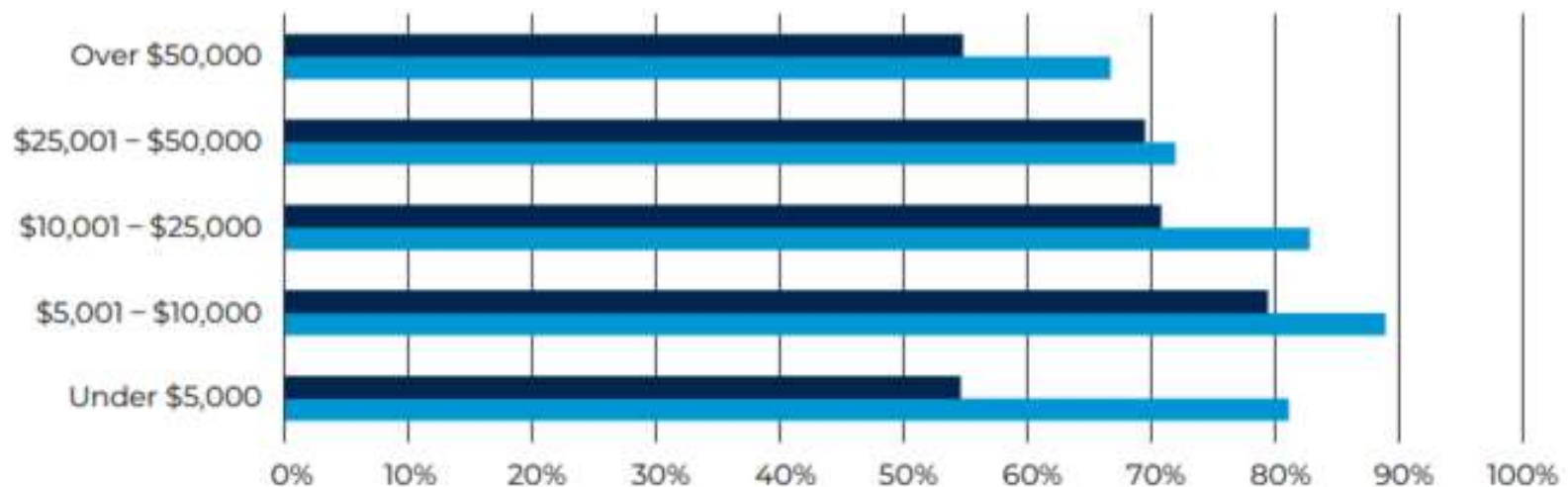


INSIGHT – AUDIT FEES AND DEFICIENCY RATES

Audit Engagement Deficiency Rates by Fee Range

(Excludes firms that audited more than 100 broker-dealers and more than 100 public companies)

■ 2020 – 2022 inspection period ■ All inspection periods since PCAOB standards became effective



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2023 AND 2024 INSPECTIONS UPDATE

	2023 Inspections	2024 Inspections
Selections – Status	Complete	In Process
Selections – Extent	60 Firms and 103 Audits	Comparable to 2023
Fieldwork – Status	Completed	Continuing Through December
Fieldwork – Location	Mixture of In-Person, Remote, and Hybrid	More Frequently In-Person
Reporting – Status	By August 2024	To Be Determined

QUESTIONS

