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SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 19b-4

Proposed Rules

By

Public Company Accounting Oversight Board

In accordance with Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of the Proposed Rules

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") proposed rules, Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, and related amendments to PCAOB standards (collectively, the "proposed rules"). The proposed rules changes are attached as Exhibit A to this rule filing. In addition, since the attestation standards will apply solely in connection with audits of registered brokers and dealers pursuant to the Rule 17a-5 of the Securities Exchange Act of 1934, the Board defers to the SEC, pursuant to Section 103(a)(3)(c) of the Sarbanes-Oxley Act, on the applicability of Attestation Standards No. 1 and No. 2 to audits of emerging growth companies ("EGCs"), as that term is defined in Section 3(a)(80) of the Securities Exchange Act of 1934.¹ See Exhibit 3.

(b) Not applicable.

(c) Not applicable.

¹ Section 104 of the Jumpstart Our Business Startups Act provides that any additional rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGSs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the actions will promote efficiency, competition, and capital formation." As a result, Attestation Standards No. 1 and No. 2, which were adopted by the Board after April 5, 2012, is subject to a separate determination by the SEC regarding its applicability to audits of EGCs.

2. Procedures of the Board

(a) The Board approved the proposed rules, and authorized them for filing with the SEC, at its open meeting on October 10, 2013. No other action by the Board is necessary for the filing of the proposed rules.

(b) Questions regarding this rule filing may be directed to Keith Wilson, Deputy Chief Auditor (202-207-9134, wilsonk@pcaobus.org), Barbara Vanich, Associate Chief Auditor (202-207-9363, vanichb@pcaobus.org), Nicolas Grillo, Assistant Chief Auditor (202-207-9104, grillon@pcaobus.org), or Jennifer Williams, Assistant General Counsel (202-591-4173, williamsjg@pcaobus.org).

3. Board's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rules Change

(a) Purpose

Section 103 of the Sarbanes-Oxley Act directs the Board, by rule, to establish, among other things, "auditing and related attestation standards . . . to be used by registered public accounting firm in the preparation and issuance of audit reports, as required by th[e] [Sarbanes-Oxley] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act amended the Sarbanes-Oxley Act to give the Board oversight authority with respect to audits of brokers and dealers that are registered with the Commission. On July 30, 2013, the SEC adopted amendments to Rule 17a-5² under the Securities Exchange Act of 1934 ("Exchange Act") to strengthen and clarify broker and dealer annual financial reporting

² See Rule 17a-5, 17 CFR § 240.17a-5 ("SEC Rule 17a-5") and SEC Exchange Act Release No. 34-70073, *Broker-Dealer Reports* (July 30, 2013), 78 Federal Register 51910 (August 21, 2013) ("SEC Release"), available at <http://www.sec.gov/rules/final/2013/34-70073.pdf>.

requirements and also facilitate the ability of the PCAOB to implement the oversight of independent public accountants of brokers³ and dealers⁴ provided by Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").⁵

As discussed more fully in Exhibit 3, the Board is adopting two attestation standards, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* (the "examination standard") and *Review Engagements Regarding Exemption Reports of Brokers and Dealers* (the "review standard") (collectively, the "attestation standards"). These attestation standards will apply to examination engagements regarding compliance reports of brokers and dealers ("examination engagements") and review engagements regarding exemption reports of brokers and dealers ("review engagements"), pursuant to requirements contained in SEC Rule 17a-5.⁶ Pursuant to SEC Rule 17a-5, the audits of brokers and dealers, including the attestation engagements covered by this release, are required to be performed under PCAOB standards.⁷ Before these amendments to SEC Rule 17a-5, audits of brokers and dealers were required to be performed under generally accepted auditing standards ("GAAS") established by the American

³ According to PCAOB Rule 1001(b)(iii), the term "broker" means a broker (as defined in Section 3(a)(4) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

⁴ According to PCAOB Rule 1001(d)(iii), the term "dealer" means a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

⁵ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁶ See paragraphs (g)(2)(i) and (ii) of SEC Rule 17a-5.

⁷ See paragraph (g) of SEC Rule 17a-5.

Institute of Certified Public Accountants ("AICPA"). The attestation standards will be effective, subject to approval by the SEC, for examination engagements and review engagements for fiscal years ending on or after June 1, 2014. This effective date would coincide with the effective date for the corresponding amendments to SEC Rule 17a-5.

Sections 17(a) and (e) of the Exchange Act and SEC Rule 17a-5 together generally require a broker or dealer to, among other things, file an annual report⁸ with the SEC and the broker's or dealer's designated examining authority ("DEA").⁹ SEC Rule 17a-5 requires the annual report to contain, among other things:

- a. A financial report consisting of audited financial statements and supporting schedules;¹⁰ and
- b. A compliance report or an exemption report.¹¹

⁸ Paragraph (d) of SEC Rule 17a-5 contains general requirements for annual reports to be filed by SEC-registered brokers and dealers. Paragraphs (d)(1)(iii) and (iv) of SEC Rule 17a-5 provide certain limited exceptions to the requirement to file an annual report.

⁹ Under SEC Rule 17d-1, 17 CFR § 240.17d-1, a registered broker or dealer that is a member of more than one securities self-regulatory organization may be assigned a "designated examining authority" or "DEA" that is responsible for examining the broker or dealer for compliance with SEC financial responsibility rules. An example of a securities self-regulatory organization that is a designated examining authority is the Financial Industry Regulatory Authority.

¹⁰ See paragraph (d)(2) of SEC Rule 17a-5. Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements* (PCAOB Release No. 2013-008) (October 10, 2013), applies to the audit procedures performed and the audit report on supporting schedules.

¹¹ See paragraphs (d)(3) and (4) of SEC Rule 17a-5. Attestation Standard No. 1 applies to an examination of certain statements made by the broker or dealer in the compliance report. Attestation Standard No. 2 applies to a review of the statements made by the broker or dealer in the exemption report.

The requirements for the compliance report and the exemption report are new requirements that are the result of the Commission's amendments to SEC Rule 17a-5. According to the SEC, these reports contain information regarding broker and dealer compliance with key SEC financial responsibility rules¹² that enhance the ability of the SEC to oversee the financial responsibility practices of registered brokers and dealers and, in particular, the safekeeping of customer assets.

Generally, SEC Rule 17a-5 provides that brokers or dealers that did not claim an exemption from SEC Rule 15c3-3 throughout the most recent fiscal year must prepare and file the compliance report. A broker or dealer must prepare and file the exemption report if the broker or dealer did claim that it was exempt from SEC Rule 15c3-3 throughout the most recent fiscal year.

Brokers and dealers also must generally file reports prepared by a PCAOB-registered independent public accountant covering the financial report and the compliance report or exemption report, as applicable.¹³

The auditor's examination report or review report would replace the prior requirement in SEC Rule 17a-5 that the auditor report on material inadequacies identified in the broker's or dealer's accounting system, internal accounting controls, procedures of the broker or dealer for

¹² The SEC Release used the term "financial responsibility rules" to refer to: 17 CFR § 240.15c3-1 ("SEC Rule 15c3-1" or the "net capital rule"); 17 CFR § 240.15c3-3 ("SEC Rule 15c3-3"); 17 CFR § 240.17a-13 ("SEC Rule 17a-13"); and any rule of the DEA of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer (an "account statement rule"). See the SEC Release at 8-9. The terms "financial responsibility rules" and "account statement rule" have the same meaning in these standards as they have in the SEC Release.

¹³ See paragraph (d)(1)(i)(C) of SEC Rule 17a-5.

safeguarding securities, and certain practices and procedures related to customer protection and securities.

The Board is adopting the attestation standards to establish requirements aligned with the auditor's responsibilities under SEC Rule 17a-5.¹⁴ Specifically, the attestation standards establish requirements for examining certain statements in a broker's or dealer's compliance report and reviewing a broker's or dealer's statements in an exemption report. The Board is also adopting related amendments to certain PCAOB standards, including amendments regarding documentation and amendments to require engagement quality reviews of the examination and the review engagements.¹⁵

The attestation standards for the examination and review engagements represent stand-alone standards that are based on existing concepts and principles in the existing attestation standards but are tailored for the specific requirements under SEC Rule 17a-5.¹⁶

¹⁴ See paragraphs (g) and (h) of SEC Rule 17a-5.

¹⁵ In addition, on February 28, 2012, the Board proposed to update certain of its rules to conform to the Dodd-Frank Act amendments to the Sarbanes-Oxley Act of 2002. See *Proposed Amendments to Conform the Board's Rules and Forms to the Dodd-Frank Act and Make Certain Updates and Clarifications*, PCAOB Release No. 2012-002 (February 28, 2012). Among other things, these proposed amendments would amend the Board's rules to require that registered firms comply with the Board's interim standards in broker or dealer engagements. See proposed amendments to Rule 1001(a)(v), Rule 1001(a)(vi), Rule 3200T, and Rule 3300T, Rule 3400T, Rule 3500T, and Rule 3600T. The Board expects to act on these proposed amendments in a separate rulemaking in the near future.

¹⁶ The requirements in the examination standard are generally consistent with the requirements of AT sec. 101, *Attest Engagements*, and AT sec. 601, *Compliance Attestation*. Similarly, the requirements in the review standard are generally consistent with AT sec. 101. However, when an auditor performs an engagement pursuant to the examination standard or a review pursuant to the review standard, AT sec. 101 and AT sec. 601 would not apply.

In general, both standards set forth a framework of specific procedures that are required for auditors to opine or conclude on a broker's or dealer's statements – referred to in the standards as "assertions"¹⁷ – in compliance reports and exemption reports required by SEC Rule 17a-5, respectively.¹⁸

Furthermore, both of the attestation standards emphasize coordination between the examination engagement or review engagement, the audit of the broker's or dealer's financial statements and audit procedures performed on the supporting schedules (referred to in this release as "supplemental information"). This emphasis on coordination, when properly executed, can promote overall audit effectiveness and avoid redundancy in the work performed. For example, auditors can take into account, when appropriate, evidence obtained while planning and performing the audit of the financial statements and the audit procedures performed on supplemental information in planning and performing the attestation engagement.

This emphasis on coordination is also a key aspect of Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements* (the "auditing standard"),¹⁹ which the Board is separately adopting. Auditing Standard No. 17 will apply when the auditor of the financial statements is engaged to perform audit procedures and report on supplemental information accompanying audited financial statements in accordance with

¹⁷ These standards use the term "assertion" to refer to the broker's or dealer's individual statements that are covered by the examination and review. In the examination standard, the term "assertion" also distinguishes the portion of the statements in the broker's or dealer's compliance report that are covered by the examination.

¹⁸ See paragraphs (i)(3)(iii)(A) and (B) of SEC Rule 17a-5 for the specific requirement for an opinion or conclusion to be expressed in the auditor's report.

¹⁹ See Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*, PCAOB Release No. 2013-008 (October 10, 2013).

PCAOB standards, including supporting schedules prepared pursuant to SEC Rule 17a-5.²⁰ The auditing standard also includes requirements for the procedures on the supplemental information to be planned and performed in conjunction with the audit of the financial statements, and for the audits of brokers and dealers to be coordinated with the attestation engagements related to compliance or exemption reports.²¹

In the Board's view, the attestation standards further the public interest and promote investor protection because they are tailored to the corresponding requirements of SEC Rule 17a-5, which are designed to provide safeguards with respect to broker and dealer custody of customer securities and funds. For example, the specific requirements in the examination standard for evaluating Internal Control Over Compliance²² can help auditors to identify deficiencies in a broker's or dealer's internal controls for safeguarding customer securities and funds or maintaining necessary capital or reserves. Similarly, the specific requirements in the review standard should focus auditors on whether the broker or dealer appropriately meets the exemption provisions in paragraph (k) of SEC Rule 15c3-3.

Also, the SEC Release states that SEC enforcement actions alleging fraudulent conduct by brokers and dealers highlight the need for enhancements to the rules governing broker and dealer custody of customer assets, including increased focus on compliance and internal compliance controls by brokers and dealers and their auditors.²³ The attestation standards include

²⁰ See paragraph (d)(2) of SEC Rule 17a-5.

²¹ See the note to paragraph 3.c. of Auditing Standard No. 17.

²² Consistent with SEC Rule 17a-5, the examination standard defines "Internal Control Over Compliance" as "internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with the [financial responsibility rules], will be prevented or detected on a timely basis." See paragraph (d)(3)(ii) of SEC Rule 17a-5.

²³ See the SEC Release at 206–207.

requirements related to the auditor's consideration of fraud risks, including the risk of misappropriation of customer assets. The new standard includes requirements for testing controls of the broker or dealer for safeguarding customer assets and funds and for performing procedures to obtain evidence about the existence of customer funds and securities held for customers.

Furthermore, PCAOB inspections staff in their inspections of broker and dealer audits have identified auditing deficiencies in 57 of 60 audits that were conducted under GAAS and the prior SEC Rule 17a-5.²⁴ The attestation standards – tailored for the new audit and reporting requirements under SEC Rule 17a-5 – establish an approach specific to examining compliance reports and reviewing exemption reports that should provide greater clarity as to the procedures that should be used and facilitate consistent compliance for auditors of SEC registered brokers and dealers.

The financial responsibility rules serve an important investor protection function by requiring brokers and dealers to maintain minimum levels of net capital and take steps to safeguard customer securities and cash.²⁵ As described in the SEC Release, the new requirements for engagement of accountants should result in higher levels of compliance with the financial responsibility rules by increasing the focus of carrying brokers and dealers and their independent public accountants on specific statements made in compliance reports and increasing the focus of non-carrying brokers and dealers and their independent public accountants regarding whether the broker or dealer meets applicable exemption provisions.²⁶ Moreover, in the Board's view, the involvement of auditors, under the attestation standards and PCAOB oversight, should enhance

²⁴ See *Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers*, PCAOB Release No. 2013-006 (August 19, 2013) at 6.

²⁵ See the SEC Release at 255.

²⁶ See the SEC Release at 238.

the quality of the compliance information provided to the SEC and used in its regulatory oversight, which is important to the protection of investors who entrust their cash and securities with brokers and dealers.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Sarbanes-Oxley Act.

4. Board's Statement on Burden on Competition

Not applicable.

5. Board's Statement on Comments on the Proposed Rules Change Received from Members, Participants or Others

The Board initially released the proposed rules for public comment on July 12, 2011. See Exhibit 2(a)(A). The Board received 11 written comment letters relating to its initial proposed rules. See Exhibits 2(a)(B) and 2(a)(C).

6. Extension of Time Period for Commission Action

The Board does not consent to an extension of the time period specified in Section 19(b)(2) of the Securities Exchange Act of 1934.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

Not applicable.

9. Exhibits

Exhibit A – Text of the Proposed Rules.

Exhibit 1 – Form of Notice of Proposed Rules for Publication in the Federal Register.

Exhibit 2(a)(A) – PCAOB Release No. 2011-004 (Proposed Release).

Exhibit 2(a)(B) – Alphabetical List of Comments on the Rules Proposed in PCAOB Release No. 2011-004.

Exhibit 2(a)(C) – Written Comments on the Rules Proposed in PCAOB Release No. 2011-004.

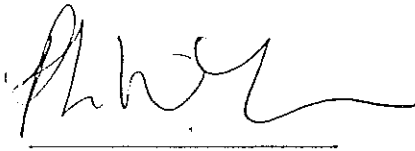
Exhibit 3 – PCAOB Release No. 2013-007 (Adopting Release)

10. Signatures

Pursuant to the requirements of the Sarbanes-Oxley Act and the Securities Exchange Act of 1934, as amended, the Board has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

By: _____



Phoebe W. Brown

Secretary

October 30, 2013

EXHIBIT A – TEXT OF THE PROPOSED RULES

Below is Attestation Standard No. 1, Attestation Standard No. 2, and amendments to the Board's interim standards.

Attestation Standard No. 1***Examination Engagements Regarding Compliance Reports of Brokers and Dealers******Introduction***

1. This standard establishes requirements that apply when an auditor is engaged to perform an examination¹ of certain statements made by a broker² or dealer³ in a compliance report ("compliance report") prepared pursuant to Securities and Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 CFR § 240.17a-5 ("SEC Rule 17a-5") of the U.S. Securities and Exchange Commission ("SEC").⁴
2. SEC Rule 17a-5 requires a broker's or dealer's compliance report to include the following statements (hereinafter referred to as "assertions") by the broker or dealer as to whether:⁵

¹ See paragraphs (d)(1)(i)(C) and (g)(2)(i) of SEC Rule 17a-5, which require that certain brokers or dealers file with the SEC a report prepared by an independent accountant based on an examination of the compliance report, if the broker or dealer is required to file a compliance report with the SEC.

² According to PCAOB Rule 1001(b)(iii), the term "broker" means a broker (as defined in Section 3(a)(4) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

³ According to PCAOB Rule 1001(d)(iii), the term "dealer" means a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

⁴ See paragraph (g)(2)(i) of SEC Rule 17a-5.

⁵ The scope of the auditor's examination does not encompass the statement required by paragraph (d)(3)(i)(A)(1) of SEC Rule 17a-5, which is a statement as to whether the broker or

- a. The **Internal Control Over Compliance**⁶ of the broker or dealer was effective during the most recent fiscal year;
- b. The Internal Control Over Compliance of the broker or dealer was effective as of the end of the most recent fiscal year;⁷
- c. The broker or dealer was in compliance with 17 CFR §§ 240.15c3-1 (the "net capital rule") and 240.15c3-3(e) (the "reserve requirements rule") as of the end of the most recent fiscal year; and
- d. The information the broker or dealer used to state whether it was in compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer.

Objective

3. When performing an examination of the assertions made by a broker or dealer in a compliance report (an "examination engagement"), the auditor's objective is to express an opinion regarding whether the assertions made by the broker or dealer in its compliance report are fairly stated, in all material respects.

dealer has established and maintained Internal Control Over Compliance as that term is defined in paragraph (d)(3)(ii) of SEC Rule 17a-5. See paragraphs (d)(3) and (g)(2)(i) of SEC Rule 17a-5.

⁶ Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear. The definitions of the terms in Appendix A are consistent with paragraphs (d)(3)(ii) and (iii) of SEC Rule 17a-5.

⁷ See paragraph (d)(3)(iii) of SEC Rule 17a-5, which provides that "a broker or dealer is not permitted to conclude that its Internal Control Over Compliance was effective during the most recent fiscal year if there were one or more material weaknesses in its Internal Control Over Compliance during the most recent fiscal year. The broker or dealer is not permitted to conclude that its Internal Control Over Compliance was effective as of the end of the most recent fiscal year if there were one or more material weaknesses in its Internal Control Over Compliance as of the end of the most recent fiscal year."

4. To express an opinion on the assertions made by a broker or dealer in a compliance report, the auditor must plan and perform the examination engagement to obtain appropriate evidence that is sufficient⁸ to obtain reasonable assurance⁹ about whether (1) one or more **Material Weaknesses** existed during the most recent fiscal year specified in the broker's or dealer's assertion; (2) one or more Material Weaknesses existed as of the end of the most recent fiscal year specified in the broker's or dealer's assertion; and (3) one or more instances of non-compliance with the net capital rule or the reserve requirements rule existed as of the end of the most recent fiscal year specified in the broker's or dealer's assertion.

Note: Because the broker's or dealer's assertions include assertions regarding Internal Control Over Compliance and its compliance with both the net capital rule and the reserve requirements rule, the auditor's examination should evaluate (a) the effectiveness of Internal Control Over Compliance with each financial responsibility rule¹⁰ during, and as of the end of, the most recent fiscal year, and (b) compliance with the net capital rule and with the reserve requirements rule as of the end of the most recent fiscal year.

Note: The auditor is not required to express an opinion on the process the broker or dealer used to arrive at the conclusions stated in the broker's or dealer's assertions.

5. The auditor also must plan and perform the examination engagement to obtain appropriate evidence that is sufficient to obtain reasonable assurance to support the auditor's opinion regarding whether the assertion by the broker or dealer that the information used to

⁸ See the description of "sufficiency" and "appropriateness" in Auditing Standard No. 15, *Audit Evidence*.

⁹ Although not absolute assurance, reasonable assurance is a high level of assurance.

¹⁰ The term "financial responsibility rules" refers to: 17 CFR § 240.15c3-1 ("SEC Rule 15c3-1" or the "net capital rule"); 17 CFR § 240.15c3-3 ("SEC Rule 15c3-3"); 17 CFR § 240.17a-13 ("SEC Rule 17a-13"); and any rule of the designated examining authority ("DEA") of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer. The financial responsibility rules are the same as the rules cited in paragraph (d)(3)(ii) of SEC Rule 17a-5.

assert compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer, is fairly stated, in all material respects.

Performing the Examination Engagement

General Requirements

6. An auditor who performs an examination engagement pursuant to this standard must:
 - a. Have adequate technical proficiency in attestation engagements;
 - b. Obtain an understanding of the financial responsibility rules and other rules and regulations that are relevant to the broker's or dealer's assertions;
 - c. Determine the auditor's compliance with independence and ethics requirements;
and
 - d. Exercise due professional care, which includes application of professional skepticism, in planning and performing the examination and the preparation of the report.

Note: Due professional care imposes a responsibility on each engagement team member to comply with this standard. The exercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including preparing the report.¹¹

Note: Auditing Standard No. 3, *Audit Documentation*, establishes the documentation requirements for examination engagements performed pursuant to this standard.

7. The engagement partner is responsible for the examination engagement and performance of the examination procedures. Accordingly, the engagement partner is responsible for proper planning of the examination engagement, proper supervision of the work of engagement team

¹¹ The auditor's responsibility to exercise due professional care is consistent with the description in paragraphs .40–.41 of AT sec. 101, *Attest Engagements*.

members, and compliance with the requirements of this standard. The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Note: For purposes of this standard, the term "engagement partner" means the member of the engagement team with primary responsibility for the examination engagement.

Note: Proper planning includes establishing an overall strategy for the examination engagement and developing a plan for the engagement, which includes, in particular, the nature, timing, and extent of procedures necessary to obtain reasonable assurance. Proper supervision includes supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Relationship Between the Examination Engagement and the Audit of the Financial Statements and the Audit Procedures Performed on Supplemental Information

8. The examination engagement should be coordinated with the audit of the financial statements and the audit procedures performed on supplemental information of the broker or dealer.¹² In planning and performing procedures for, and evaluating the results of the procedures performed in, the examination engagement, the auditor should take into account relevant evidence from the audit of the financial statements and the audit procedures performed on the supplemental information. However, the objectives of the financial statement audit and the examination engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.

¹² Under the definition of supplemental information included in Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*, supplemental information includes the supporting schedules described in paragraph (d)(2) of SEC Rule 17a-5, which are required to be filed with the SEC, DEA, and the Securities Investor Protection Corporation ("SIPC") by brokers and dealers. Such supporting schedules include a Computation of Net Capital Under SEC Rule 15c3-1, a Computation for Determination of the Reserve Requirements under Exhibit A of SEC Rule 15c3-3, and Information Relating to Possession or Control Requirements Under SEC Rule 15c3-3.

Planning the Examination Engagement

9. The auditor should plan the examination engagement to perform procedures that are sufficient to provide a reasonable basis for determining whether the broker's or dealer's assertions are fairly stated, in all material respects. In planning the examination engagement, the auditor should:

- a. Evaluate the nature of instances of non-compliance with the financial responsibility rules and **Deficiencies in Internal Control Over Compliance** identified during previous examination engagements;
- b. Obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the financial responsibility rules;¹³

Note: The nature, timing, and extent of procedures that are necessary to obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the financial responsibility rules depend on the size and complexity of the broker or dealer; the auditor's existing knowledge of the broker's or dealer's processes and controls; the degree to which the broker's or dealer's compliance depends on the completeness and accuracy of the broker's or dealer's internally generated data; the nature and extent of changes in systems and operations, if any; and the nature of the broker's or dealer's documentation of its processes and controls.

Note: Obtaining an understanding of the broker's or dealer's processes, including relevant controls, includes evaluating the design of controls that are relevant to the examination and determining whether the controls have been implemented.

- c. Obtain an understanding of instances of non-compliance with the financial responsibility rules and **Deficiencies in Internal Control Over Compliance** identified by management during the most recent fiscal year;

¹³ Appendix B of this standard discusses considerations for brokers and dealers with multiple divisions or branches.

- d. Assess the risks associated with related parties,¹⁴ including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship, that are relevant to compliance and controls over compliance;
- e. Obtain an understanding of management's competence regarding the relevant rules and regulations;
- f. Read the Financial and Operational Combined Uniform Single Reports ("FOCUS Reports")¹⁵ filed by the broker or dealer and obtain an understanding of the reasons for resubmissions, if any;
- g. Read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's assertions;
- h. Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to the broker's or dealer's assertions;
- i. Read correspondence and notifications regarding non-compliance that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA that are relevant to the broker's or dealer's assertions, and, when necessary in the circumstances, make inquiries of the regulatory agencies; and

¹⁴ The auditor should look to the definition in the applicable financial reporting framework with respect to the term "related parties."

¹⁵ The FOCUS Reports are: Form X-17A-5 Schedule I; Form X-17A-5 Part II; Form X-17A-5 Part IIa; Form X-17A-5 Part IIb; and Form X-17A-5 Part III.

- j. Obtain an understanding of the nature and frequency of customer complaints that are relevant to compliance with the financial responsibility rules.
10. In addition, in planning the examination engagement, the auditor should assess the risk of fraud, including the risk of misappropriation of customer assets, relevant to compliance with the net capital rule and the reserve requirements rule and the effectiveness of the broker's or dealer's Internal Control Over Compliance.

Testing Controls over Compliance

11. The auditor must test those controls that are important to the auditor's conclusion about whether the broker or dealer maintained effective Internal Control Over Compliance for each financial responsibility rule during the fiscal year and as of the end of the fiscal year. The auditor must obtain evidence that the controls over compliance selected for testing are designed effectively and operated effectively during the fiscal year and as of the fiscal year end.
12. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a Material Weakness would result. As the risk associated with the control being tested increases, the persuasiveness of the evidence that the auditor should obtain also increases.

Note: Although the auditor must obtain evidence about the effectiveness of the selected controls for each financial responsibility rule, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control.

13. Factors that affect the risk associated with a control include:
- The nature of the financial responsibility rule;
 - The risk associated with non-compliance with the financial responsibility rule and the significance of potential non-compliance;

- Changes in the broker's or dealer's policies or procedures or personnel that might adversely affect control design or operating effectiveness;
- The broker's or dealer's history of instances of non-compliance with the financial responsibility rule that the control is intended to prevent or detect;
- The existence and effectiveness of controls that monitor other controls;
- The risk of management override of controls over compliance;
- The nature of the control and the frequency with which it operates;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- The extent of use of part-time personnel to perform controls over compliance;
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and
- The complexity of the control and the significance of the judgments made in connection with its operation.

Testing Design Effectiveness

14. The auditor should test the design effectiveness of the selected controls by determining whether the broker's or dealer's controls, if they are operating as prescribed by persons possessing the necessary authority and competence to perform the control effectively, can

effectively prevent or detect instances of non-compliance with the financial responsibility rules on a timely basis.

Note: If a broker or dealer makes changes to its policies and procedures or key personnel during the fiscal year, the auditor should obtain evidence regarding the design effectiveness of the selected controls before and after the change.

15. Procedures the auditor performs to obtain evidence about design effectiveness include inquiry of appropriate personnel, observation of the broker's or dealer's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

16. The auditor should test the operating effectiveness of the selected controls by determining whether each selected control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

Note: The auditor should obtain evidence regarding the operating effectiveness of the selected controls throughout the entire year and as of the end of the fiscal year.

17. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the broker's or dealer's operations, inspection of relevant documentation, and re-performance of the control.

18. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing might provide sufficient evidence in relation to the risk associated with the control.

Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

Using Evidence Obtained in Past Examination Engagements

19. The auditor should obtain evidence during the current fiscal year about the design and operating effectiveness of controls selected for testing. If controls selected for testing in the current year were tested in past examination engagements, and if the auditor plans to use evidence about the effectiveness of those controls that was obtained in prior years, the auditor should take into account the factors discussed in paragraph 13 and the following factors to determine the evidence needed during the current fiscal year examination:

- The nature, timing, and extent of procedures performed in previous examination engagements;
- The results of the previous years' testing of the control; and
- Changes in the control or the process in which the control operates since the previous examination engagement.

Using Tests of Controls that are Modified During the Year

20. A broker or dealer might implement changes to controls over compliance to make them more effective or efficient or to address control deficiencies. The auditor should obtain an understanding of the reason for the change and obtain evidence regarding the design and operating effectiveness of the new and superseded controls. The nature, timing, and extent of the testing of new and superseded controls depend on the evidence needed to support the auditor's conclusions about the effectiveness of Internal Control Over Compliance during and as of the end of the fiscal year.

Performing Compliance Tests

21. The auditor must perform procedures ("compliance tests") that are sufficient to support the auditor's conclusions regarding whether the broker or dealer was in compliance with the net

capital rule and reserve requirements rule as of the end of its most recent fiscal year. This includes performing the following procedures on the schedules¹⁶ the broker or dealer used to determine compliance with the net capital rule and the reserve requirements rule as of its fiscal year end:

- a. Evaluate whether the amounts in the schedules were determined in accordance with the net capital rule or reserve requirements rule, as applicable;
- b. Test the accuracy and completeness of the information in the schedules;
- c. Determine whether the broker or dealer maintained the required level of net capital in accordance with the net capital rule;
- d. Determine whether the broker or dealer maintained a special reserve bank account for the exclusive benefit of customers and deposited funds in at least the required amount in accordance with the reserve requirements rule;
- e. Determine whether the information in the schedules was derived from the books and records of the broker or dealer; and
- f. Determine whether the broker or dealer made the notifications, if any, required by the net capital rule and reserve requirements rule as of the end of the most recent fiscal year.

Note: Procedures performed as part of the audit of the financial statements and audit procedures performed on supplemental information also might provide evidence regarding the broker's or dealer's compliance with the net capital rule and the reserve requirements rule.

22. The auditor should plan and perform compliance tests that are responsive to the risks, including fraud risks, associated with non-compliance with the net capital rule and the reserve

¹⁶ The term "schedules" used in this paragraph refers to the computations of the broker or dealer, in whatever form, that are performed to determine the broker's or dealer's compliance with the net capital rule and the reserve requirements rule.

requirements rule. As the risk associated with non-compliance with the net capital rule or the reserve requirements rule increases, the persuasiveness of the evidence that the auditor should obtain from compliance tests also increases. The evidence provided by the auditor's compliance tests depends upon the mix of the nature, timing, and extent of those procedures. Inquiry alone does not provide sufficient appropriate evidence to support the auditor's conclusions about the broker's or dealer's compliance with the net capital rule or the reserve requirements rule.

23. In conjunction with performing the compliance tests pursuant to paragraphs 21 and 22, the auditor must perform procedures to obtain evidence about the existence of customer funds or securities held for customers.

Note: Examples of procedures that provide evidence about the existence of customer assets include: (1) counting customer securities or observing and testing the broker's or dealer's procedures for physical inspection and (2) confirming customer security positions directly with depositories and clearing organizations. Procedures performed in the audit of the financial statements and the audit procedures performed on supplemental information to test the existence of assets held for customers also may provide evidence that is relevant to the requirement in this paragraph.

Effect of Tests of Internal Controls on Compliance Tests

24. The auditor should take into account the results of the auditor's tests of controls over compliance with the net capital rule and the reserve requirements rule in determining the necessary nature, timing, and extent of compliance tests. If the test results indicate that the controls are effective, less evidence is needed from compliance tests. If the test results indicate that the controls are ineffective, the auditor should revise the planned compliance tests as necessary to obtain more persuasive evidence regarding compliance.

Evaluating the Results of the Examination Procedures

25. In forming an opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects, the auditor should evaluate all

evidence obtained, regardless of whether the evidence corroborates or contradicts the broker's or dealer's assertions.

26. The auditor should evaluate:
- a. Identified instances of non-compliance with the net capital rule and the reserve requirements rule to determine whether any instance of non-compliance existed as of the end of the most recent fiscal year;
 - b. Identified instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived from the broker's or dealer's books and records to determine whether they are material, individually or in combination; and
 - c. Identified Deficiencies in Internal Control Over Compliance to determine whether the deficiencies, individually or in combination, are Material Weaknesses.

Note: A Material Weakness can exist even when no instances of non-compliance exist. However, instances of non-compliance might indicate the existence of one or more Deficiencies in Internal Control Over Compliance.

Note: The auditor cannot assume that an identified instance of non-compliance or an identified Deficiency in Internal Control Over Compliance is an isolated occurrence. The auditor should evaluate the effect of any instance of non-compliance or identified control deficiency on the auditor's assessment of the risks associated with controls and non-compliance.

Note: The auditor also should evaluate the effect on the audit of the financial statements and audit procedures performed on supplemental information of any non-compliance, Material Weaknesses, or instances in which the information used to assert compliance with the net capital rule or reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records.

27. The auditor should evaluate whether he or she has obtained sufficient appropriate evidence to support the conclusions to be presented in the examination report taking into account

the risks associated with controls and non-compliance, the results of the examination procedures performed, and the appropriateness (i.e., the relevance and reliability) of the evidence obtained.

28. If the auditor has not obtained sufficient appropriate evidence about an assertion or has substantial doubt about an assertion, the auditor should perform procedures to obtain further evidence to address the matter.

29. If the auditor is unable to obtain sufficient appropriate evidence about an assertion, the auditor should express a disclaimer of opinion.¹⁷

Subsequent Events

30. For the period from the end of the period specified in the broker's or dealer's assertions to the date of the auditor's examination report (the "subsequent period"), the auditor should perform procedures to identify subsequent events relevant to the auditor's conclusions about the assertions made by the broker or dealer in the compliance report. Such procedures should include, but are not limited to:

- a. Reading relevant reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors, and correspondence that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA during the subsequent period that is relevant to the broker's or dealer's assertions; and
- b. Evaluating information obtained through other engagements performed by the auditor for the broker or dealer, including subsequent events procedures

¹⁷ See Appendix C of this standard, "*Examination Report Modifications*," which describes the situations in which the auditor should modify his or her examination report and the specific modifications to be made to the auditor's examination report. The requirement in paragraph 29 does not preclude the auditor from withdrawing from the examination engagement.

performed in the audit of the financial statements and the audit procedures performed on supplemental information.

31. The auditor should evaluate the results of the procedures described in the previous paragraph to determine whether the results corroborate or contradict the broker's or dealer's assertions.

Obtaining a Representation Letter

32. The auditor should obtain written representations from management of the broker or dealer:

- a. Acknowledging management's responsibility for establishing and maintaining a system of internal control with the objective of providing the broker or dealer with reasonable assurance that any instances of non-compliance with the financial responsibility rules will be prevented or detected on a timely basis;
- b. Stating the broker's or dealer's assertions included in the compliance report are the responsibility of management;
- c. Stating that management has made available to the auditor all records and other information relevant to the broker's or dealer's assertions, including all known matters contradicting the assertions, and all communications from regulatory agencies, internal auditors, others who perform an equivalent function, compliance functions, and other auditors, that are relevant to the broker's or dealer's assertions, received through the date of the auditor's report; and
- d. Stating whether there were, subsequent to the period addressed in the broker's or dealer's assertions, any known events or other factors that might significantly affect the broker's or dealer's assertions.

33. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the engagement, as described in Appendix C of this standard.

Communication Requirements

34. The auditor should communicate to management all identified Deficiencies in Internal Control Over Compliance.

35. The auditor should communicate to management and the audit committee¹⁸ identified instances of non-compliance with the financial responsibility rules, identified Material Weaknesses, and identified instances in which information used to determine compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records.

Note: The auditor also must comply with the requirements of paragraph (h) of SEC Rule 17a-5, which contains notification requirements that apply to auditors of brokers and dealers.

Reporting on the Examination Engagement

36. The auditor's examination report must include the following elements, modified as necessary in the circumstances and manner discussed in Appendix C:

- a. A title that includes the word *independent*;
- b. An identification of the compliance report and the broker's or dealer's assertions regarding the effectiveness of Internal Control Over Compliance during the fiscal year and as of the fiscal year end, compliance with the net capital rule and the reserve requirements rule as of the fiscal year end, and whether the information

¹⁸ For purposes of this standard, the term "audit committee" has the same definition as that in Auditing Standard No. 16, *Communications with Audit Committees*.

used to assert compliance with those rules was derived from the broker's or dealer's books and records;

- c. A statement that management of the broker or dealer is responsible for establishing and maintaining a system of internal control that has the objective of providing the broker or dealer with reasonable assurance that any instances of non-compliance with the financial responsibility rules will be prevented or detected on a timely basis;
- d. A statement that the auditor's responsibility is to express an opinion on the broker's or dealer's assertions based on his or her examination;
- e. A statement that the examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);
- f. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the examination engagement to obtain reasonable assurance about whether the broker's or dealer's Internal Control Over Compliance was effective during and as of the end of the most recent fiscal year, whether the broker or dealer complied with the net capital rule and the reserve requirements rule as of the end of the most recent fiscal year, and whether the information used to assert compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer;
- g. A statement that an examination engagement includes evaluating the design and operating effectiveness of Internal Control Over Compliance; testing and evaluating the broker's or dealer's compliance with the net capital rule and the

reserve requirements rule; determining whether the information used to assert compliance with the net capital rule and reserve requirements rule was derived from the broker's or dealer's books and records; and performing such other procedures as the auditor considered necessary in the circumstances;

- h. A statement that the auditor believes the examination provides a reasonable basis for his or her opinion;¹⁹
- i. The auditor's opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects;
- j. The manual signature of the auditor's firm;
- k. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's examination report has been issued; and
- l. The date of the examination report.

37. The following example examination report expressing an unqualified opinion on the assertions made by a broker or dealer in a compliance report illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[Introductory paragraph]

We have examined W Broker's statements, included in the accompanying [*title of the compliance report*], that (1) W Broker's internal control over compliance was effective during the most recent fiscal year ended [date]; (2) W Broker's internal control over compliance was effective as of [date]; (3) W Broker was in

¹⁹ When management has made an interpretation of the financial responsibility rules and the auditor has determined that it is necessary to emphasize this interpretation in the auditor's report, the auditor may include a paragraph stating the description and the source of the interpretation made directly following the scope paragraph.

compliance with 17 CFR §§ 240.15c3-1 and 240.15c3-3(e) as of [date]; and (4) the information used to state that W Broker was in compliance with 17 CFR §§ 240.15c3-1 and 240.15c3-3(e) was derived from W Broker's books and records. W Broker's management is responsible for establishing and maintaining a system of internal control over compliance that has the objective of providing W Broker with reasonable assurance that non-compliance with 17 CFR § 240.15c3-1, 17 CFR § 240.15c3-3, 17 CFR § 240.17a-13, or Rule [fill in name/number] of [fill in DEA] that requires account statements to be sent to the customers of W Broker will be prevented or detected on a timely basis. Our responsibility is to express an opinion on W Broker's statements based on our examination.

[Scope paragraph]

We conducted our examination in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the examination to obtain reasonable assurance about whether W Broker's internal control over compliance was effective as of and during the most recent fiscal year ended [date]; W Broker complied with 17 CFR §§ 240.15c3-1 and 240.15c3-3(e) as of [date]; and the information used to assert compliance with 17 CFR §§ 240.15c3-1 and 240.15c3-3(e) as of [date] was derived from W Broker's books and records. Our examination includes testing and evaluating the design and operating effectiveness of internal control over compliance, testing and evaluating W Broker's compliance with 17 CFR §§ 240.15c3-1 and 240.15c3-3(e), determining whether the information used to assert compliance with 240.15c3-1 and 240.15c3-3(e) was derived from W Broker's books and records, and performing such other procedures as we considered

necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[Opinion paragraph]

In our opinion, W Broker's statements referred to above are fairly stated, in all material respects.

[Signature]

[City and State or Country]

[Date]

Examination Report Date

38. The auditor should date the examination report no earlier than the date on which the auditor obtains sufficient appropriate evidence to support his or her opinion.

Note: Because of the coordination between the examination engagement, the audit of the financial statements and the audit procedures performed on supplemental information, the date of the examination report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

APPENDIX A – DEFINITIONS

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Deficiency in Internal Control Over Compliance – A Deficiency in Internal Control Over Compliance exists when the design or operation of a control does not allow the management or employees of the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect on a timely basis non-compliance with 17 CFR § 240.15c3-1, § 240.15c3-3, § 240.17a-13 or 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.¹

A3. Internal Control Over Compliance – Internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with 17 CFR § 240.15c3-1, § 240.15c3-3, § 240.17a-13, or 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, will be prevented or detected on a timely basis.²

A4. Material Weakness – A Material Weakness is a deficiency, or a combination of deficiencies, in Internal Control Over Compliance such that there is a reasonable possibility that non-compliance with 17 CFR §240.15c3-1 or 17 CFR § 240.15c3-3(e) will not be prevented or detected on a timely basis or that non-compliance to a material extent with 17 CFR §240.15c3-3, except for paragraph (e), 17 CFR § 240.17a-13, or any rule of the designated examining

¹ The definition of "Deficiencies in Internal Control Over Compliance" is consistent with the same term in paragraph (d)(3)(iii) of SEC Rule 17a-5.

² The definition of "Internal Control Over Compliance" is consistent with the same term in paragraph (d)(3)(ii) of SEC Rule 17a-5.

authority of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer will not be prevented or detected on a timely basis.³

³ The definition of a "Material Weakness" is consistent with the same term in paragraph (d)(3)(iii) of SEC Rule 17a-5.

APPENDIX B – CONSIDERATIONS FOR BROKERS AND DEALERS WITH MULTIPLE DIVISIONS OR BRANCHES

B1. When the broker or dealer has multiple divisions or branches, the auditor should determine the extent to which he or she should perform examination procedures at selected divisions or branches to obtain sufficient appropriate evidence to support the conclusions expressed in the auditor's examination report. This includes determining the divisions or branches at which to perform examination procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual divisions or branches. In determining the extent of the examination procedures to be performed, the auditor should take into account:

- a. The degree to which the financial responsibility rules relate to activities at the division or branch level;
- b. The nature and significance of the related assets, transactions, or activities at the division or branch to the financial responsibility rules;
- c. The degree of centralization of records or information processing relevant to the financial responsibility rules; and
- d. The degree and effectiveness of management supervision and monitoring of the relevant activities of the division or branch.

APPENDIX C – EXAMINATION REPORT MODIFICATIONS

C1. The auditor should modify his or her examination report if any of the following conditions exist:

- a. There is non-compliance with the net capital rule or the reserve requirements rule as of the end of the most recent fiscal year, one or more Material Weaknesses in Internal Control Over Compliance during or as of the end of the most recent fiscal year, or the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer (paragraphs C2–C3).
- b. There is a restriction on the scope of the examination engagement (paragraphs C4–C8).
- c. There is information other than the assertions and descriptions required under paragraph (d)(3)(i) of SEC Rule 17a-5 contained in the compliance report (paragraphs C9–C10).

Non-Compliance, Material Weakness, or Instance in which Information Used to Assert Compliance was not Derived from the Broker's or Dealer's Books and Records

C2. If (1) one or more instances of non-compliance with the net capital rule or the reserve requirements rule exist as of the end of the fiscal year; (2) one or more Material Weaknesses in Internal Control Over Compliance exist during or as of the end of the fiscal year; or (3) the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer, the auditor must express an adverse opinion directly on the subject matter of the respective assertions, rather than on the assertions themselves, unless there is a restriction on the scope of the examination engagement.

Note: The requirement in this paragraph to express an adverse opinion applies regardless of whether the non-compliance, Material Weakness, or other matters preventing the unqualified opinion were identified by management or by the auditor.

C3. When expressing such an adverse opinion, the auditor's examination report should include, as applicable:

- a. A statement that non-compliance with the net capital rule or the reserve requirements rule has been identified and an identification of each instance of non-compliance described in the broker's or dealer's compliance report as of the end of the most recent fiscal year.
- b. A statement that one or more Material Weaknesses in Internal Control Over Compliance have been identified during the fiscal year and an identification of each Material Weakness described in the compliance report.
- c. A statement that one or more Material Weaknesses in Internal Control Over Compliance have been identified as of the end of the fiscal year and an identification of each Material Weakness described in the compliance report.
- d. A statement that one or more instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records have been identified.

Note: If a description of all identified instances of non-compliance with the net capital rule or the reserve requirements rule and all identified Material Weaknesses has not been included in the broker's or dealer's compliance report, the examination report must be modified to describe those instances of non-compliance or

Material Weaknesses that the auditor has identified but that are not described in the broker's or dealer's compliance report.¹

Scope Limitations

C4. The auditor can express an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects, only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the examination engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion should state that the auditor does not express an opinion on the assertions made by the broker or dealer in the compliance report.

C5. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the examination engagement was not sufficient for the auditor to express an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer, including the procedures that were deemed necessary by the auditor that have been omitted and the reason for their omission. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an examination engagement.

C6. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that: (1) one or more instances of non-compliance with the net capital rule or the reserve requirements rule existed as of the end of the fiscal year; (2) one or more Material Weaknesses in Internal Control Over Compliance existed during or as of the end of the most recent fiscal year; or (3) the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the

¹ Paragraphs (d)(3)(i)(B) and (C) of SEC Rule 17a-5 require the broker's or dealer's compliance report to contain a description of each material weakness in Internal Control Over Compliance during the most recent fiscal year and any instance of non-compliance with the net capital rule or the reserve requirements rule as of the end of the most recent fiscal year.

books and records of the broker or dealer, the auditor's report also must include the matters described in paragraph C3, as applicable.

C7. The auditor may issue a report disclaiming an opinion on the assertions made by a broker or dealer in a compliance report as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work before issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

Note: In this case, in following the direction in paragraph 38 of this standard regarding dating the auditor's examination report, the report date is the date on which the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

C8. If the auditor concludes that he or she cannot express an opinion because of a limitation on the scope of the examination engagement, the auditor should communicate on a timely basis, in writing, to management and the audit committee that the examination engagement cannot be satisfactorily completed.

Other Information in the Compliance Report

C9. If the compliance report contains other information besides the statements and descriptions required by SEC Rule 17a-5,² the auditor should disclaim an opinion on the other information.

C10. If the auditor believes that the other information in the compliance report contains a material misstatement of fact, he or she should discuss the matter with management of the broker or dealer. If, after discussing the matter with management, the auditor concludes that a material

² See paragraph (d)(3)(i) of SEC Rule 17a-5.

misstatement of fact remains, the auditor should notify management and the audit committee of the auditor's views concerning the information.³

³ See also AU sec. 317, *Illegal Acts by Clients*, which describes the auditor's responsibilities in a financial statement audit regarding illegal acts.

Attestation Standard No. 2***Review Engagements Regarding Exemption Reports of Brokers and Dealers******Introduction***

1. This standard establishes requirements that apply when an auditor is engaged to perform a review¹ of the statements made by a broker² or dealer³ in an exemption report ("exemption report") prepared pursuant to Securities and Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 CFR § 240.17a-5 ("SEC Rule 17a-5") of the U.S. Securities and Exchange Commission ("SEC").⁴
2. SEC Rule 17a-5 requires a broker's or dealer's exemption report to contain the following statements by the broker or dealer:
 - a. A statement that identifies the provisions in paragraph (k) of SEC Rule 15c3-3⁵ (the "exemption provisions") under which the broker or dealer claimed an exemption from SEC Rule 15c3-3 (the "identified exemption provisions");

¹ See paragraphs (d)(1)(i)(C) and (g)(2)(ii) of SEC Rule 17a-5, which require that certain brokers or dealers file with the SEC a report prepared by an independent accountant based on a review of the statements in the exemption report, if the broker or dealer is required to file an exemption report with the SEC.

² According to PCAOB Rule 1001(b)(iii), the term "broker" means a broker (as defined in Section 3(a)(4) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

³ According to PCAOB Rule 1001(d)(iii), the term "dealer" means a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

⁴ See paragraph (g)(2)(ii) of SEC Rule 17a-5.

⁵ See 17 CFR § 240.15c3-3 ("SEC Rule 15c3-3").

- b. A statement that the broker or dealer (1) met the identified exemption provisions throughout the most recent fiscal year without exception or (2) met the identified exemption provisions throughout the most recent fiscal year except as described in the exemption report; and
- c. If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions (an "exception") and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.⁶

Objective

- 3. When performing a review of the statements (hereinafter referred to as "assertions") made by a broker or dealer in an exemption report (a "review engagement"), the auditor's objective is to state whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertions for the assertions to be fairly stated, in all material respects.
- 4. The auditor must plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance⁷ about whether one or more conditions exist that would cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects. Such conditions include:

⁶ See paragraph (d)(4) of SEC Rule 17a-5.

⁷ Moderate assurance is obtained by performing with due professional care the inquiries and other procedures required by this standard in order to reach a conclusion about whether there is a need to modify the broker's or dealer's assertions regarding the exemption provisions for the assertions to be fairly stated, in all material respects. Further, this standard is consistent with the concept of moderate assurance as described in paragraph .55 of AT sec. 101, *Attest Engagements*.

- a. The broker's or dealer's assertion that identifies the provisions in paragraph (k) of SEC Rule 15c3-3 under which the broker or dealer claimed an exemption for SEC Rule 15c3-3 is inaccurate;
- b. The broker or dealer asserts that it met the identified exemption provisions in paragraph (k) of SEC Rule 15c3-3 without exception when the auditor is aware of exceptions in meeting the exemption provisions; or
- c. The broker's or dealer's assertion that identifies and describes each exception during the most recent fiscal year in meeting the identified exemption provisions in paragraph (k) of SEC Rule 15c3-3 is inaccurate or incomplete.

Performing the Review Engagement

General Requirements

5. An auditor who performs a review engagement must:
 - a. Have adequate technical proficiency in attestation engagements;
 - b. Obtain an understanding of the exemption conditions and other rules and regulations that are relevant to the broker's or dealer's assertions;
 - c. Determine the auditor's compliance with independence and ethics requirements;
and
 - d. Exercise due professional care, which includes application of professional skepticism, in planning and performing the review and preparation of the report.

Note: Due professional care imposes a responsibility on each engagement team member to comply with this standard. The exercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including preparing the report.⁸

⁸ The auditor's responsibility to exercise due professional care is consistent with the description in paragraphs .40–.41 of AT sec. 101.

Note: Auditing Standard No. 3, *Audit Documentation*, establishes the documentation requirements for review engagements performed pursuant to this standard.

6. The engagement partner is responsible for the review engagement and performance of the review procedures. Accordingly, the engagement partner is responsible for proper planning of the review engagement, proper supervision of the work of engagement team members, and compliance with the requirements of this standard. The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Note: For purposes of this standard, the term "engagement partner" means the member of the engagement team with primary responsibility for the review engagement.

Note: Proper planning includes determining the nature, timing, and extent of procedures necessary to obtain moderate assurance. Proper supervision includes supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Relationship Between the Review Engagement and the Audit of Financial Statements and the Audit Procedures Performed on Supplemental Information

7. The review engagement should be coordinated with the audit of the financial statements and the audit procedures performed on supplemental information of the broker or dealer.⁹ In planning and performing procedures for, and evaluating the results of the procedures performed in, the review engagement, the auditor should take into account relevant evidence from the audit of the financial statements and the procedures performed on the supplemental information.

⁹ Under the definition of supplemental information included in Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*, supplemental information includes the supporting schedules described in paragraph (d)(2) of SEC Rule 17a-5, which are required to be filed by brokers and dealers with the SEC and the broker's and dealer's designated examining authority ("DEA") and the Securities Investor Protection Corporation ("SIPC"). Such supporting schedules consist of, as applicable, a Computation of Net Capital Under Rule 15c3-1, a Computation for Determination of the Reserve Requirements under Exhibit A of SEC Rule 15c3-3, and Information Relating to Possession or Control Requirements Under SEC Rule 15c3-3.

However, the objectives of the financial statement audit and the review engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.

Review Procedures

8. A review engagement includes the following procedures:
 - a. Reading the exemption report to determine the exemption provisions under which the broker or dealer asserts its exemption and the identified exceptions to the exemption provisions;
 - b. Performing inquiries and other review procedures set forth in this standard; and
 - c. Evaluating whether the evidence indicates that there should be modifications to the broker's or dealer's assertions based on the results of the procedures performed.

9. The nature, timing, and extent of the necessary inquiries and other review procedures depend on:
 - a. The following risk factors:
 - (1) The broker's or dealer's history of instances of non-compliance with the exemption provisions;
 - (2) Changes in the broker's or dealer's procedures, controls, or the environment in which the controls operate since the prior year;
 - (3) Changes in the broker's or dealer's operations that are relevant to compliance with the exemption provisions;
 - (4) Competence of the personnel who are responsible for compliance with the exemption provisions or who perform important controls over compliance, and whether there have been changes in those personnel during the period of the review;

- (5) The risk of fraud, including the risk of misappropriation of customer assets, relevant to the exemption provisions;
 - (6) Potential non-compliance associated with related parties,¹⁰ including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship;
 - (7) The degree to which the broker's or dealer's processes that relate to the exemption provisions are performed, monitored, or controlled in a centralized or decentralized environment; and
- b. Evidence about the broker's or dealer's compliance with the exemption provisions or about the effectiveness of controls over compliance with the exemption provisions obtained from the audit of the financial statements and the audit procedures performed on supplemental information.
10. The auditor should perform procedures to identify exceptions to the exemption provisions, including the following:
- a. If the broker or dealer identified exceptions to the exemption provisions during the year under review, the auditor should read the broker's or dealer's documentation regarding the exceptions to the exemption provisions and compare it to the information included in the exemption report.
 - b. Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding:

¹⁰ The auditor should look to the definition in the applicable financial reporting framework with respect to the term "related parties."

- (1) Whether the broker or dealer was in compliance with the exemption provisions throughout the year under review or whether exceptions have been identified.
- (2) Regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to compliance with the exemption provisions.

Note: If the broker or dealer has sent or received correspondence with the SEC or the broker's or dealer's DEA that is relevant to compliance with the exemption provisions, the auditor should read such correspondence and, when necessary in the circumstances, make inquiries of the regulatory agencies.

- (3) Subsequent events through the date of the auditor's review report that might have a material effect on the broker's or dealer's assertions.

c. Inquire of individuals at the broker or dealer who have relevant knowledge of controls relevant to the broker's or dealer's compliance with the exemption provisions regarding:

- (1) The controls that are in place to maintain compliance with the exemption provisions, including the nature of the controls and their frequency of operation.

Note: The auditor should take into account procedures performed during 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's or dealer's compliance with the exemption provisions.

- (2) Whether the individual is aware of:

- i. Any exceptions to the exemption provisions and, if so, the nature, frequency, timing, and cause (if known) of the exceptions to the exemption provisions, during the year under review.
 - ii. Any deficiencies in controls over compliance with the exemption provisions and, if so, the nature, frequency, and cause (if known) of the control deficiencies during the year under review.
- d. Inquire of individuals who are responsible for monitoring compliance with the exemption provisions or the controls over compliance regarding:
 - (1) The nature and frequency of the monitoring activities.
 - (2) The results of those monitoring activities, including the nature, frequency, timing, and cause (if known) of any exceptions to the exemption provisions or deficiencies in controls over compliance.
 - (3) The nature and frequency of customer complaints that are relevant to the broker's or dealer's compliance with the exemption provisions.
- e. Read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's compliance with the exemption provisions.
- f. Read regulatory filings of the broker or dealer that are relevant to the broker's or dealer's compliance with the exemption provisions.
- g. 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's or dealer's assertions regarding compliance with the exemption provisions.

Note: Examples of procedures performed during the audit of the financial statements that might provide evidence relevant to the broker's or dealer's compliance with the exemption provisions include: (i) testing related to customer trades; (ii) testing of specially designated cash accounts; (iii) testing investment inventory or transactions related to the broker's or dealer's trading for its own account; and (iv) reading the clearing agreement in connection with testing trade fee or commission revenue or expenses.

- h. Perform other procedures as necessary in the circumstances to obtain moderate assurance regarding whether a material modification should be made to the broker's or dealer's assertions for the assertions to be fairly stated, in all material respects.

Evaluating the Results of the Review Procedures

11. The auditor should evaluate whether information has come to the auditor's attention that causes the auditor to believe that one or more of the broker's or dealer's assertions are not fairly stated, in all material respects.¹¹ If a broker's or dealer's assertion is not fairly stated, in all material respects, the auditor should:

- a. Modify the review report, as discussed in paragraph 19 of this standard; and
- b. Evaluate the effect of the matter on the audit of the financial statements and the audit procedures performed on supplemental information.

12. If information coming to the auditor's attention indicates that one or more exceptions to the exemption provisions occurred during the year under review or might exist at year-end, other than exceptions disclosed in the exemption report, that might cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects, or if the auditor has

¹¹ See paragraph 4 of this standard, which provides examples of conditions that would cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects.

substantial doubt about one or more of the broker's or dealer's assertions, the auditor should perform additional procedures as necessary to address the matter.

Obtaining a Representation Letter

13. The auditor should obtain written representations from management of the broker or dealer:

- a. Acknowledging management's responsibility for compliance with the identified exemption provisions throughout the fiscal year;
- b. Stating the broker's or dealer's assertions and that they are the responsibility of management;
- c. Stating that management has made available to the auditor all records and other information relevant to the broker's or dealer's assertions, including all communications from regulatory agencies, internal auditors, others who perform an equivalent function, compliance functions, and other auditors concerning possible exceptions to the exemption provisions, received through the date of the auditor's review report; and
- d. Stating whether there were, subsequent to the period addressed in the broker's or dealer's assertions, any known events or other factors that might significantly affect the broker's or dealer's compliance with the identified exemption provisions.

14. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the review engagement as described in paragraph 20 of this standard.

Communication Requirements

15. The auditor should communicate to management and to the audit committee¹² any exceptions to the exemption provisions identified by the auditor and information that causes the broker's or dealer's assertions about the exemption provisions not to be fairly stated, in all material respects.

Note: The auditor must also comply with the requirements of paragraph (h) of SEC Rule 17a-5, which contains notification requirements that apply to auditors of brokers and dealers.

Reporting on the Review Engagement

16. The auditor's review report must include the following elements, modified as necessary in the circumstances and manner discussed in paragraphs 19–20:

- a. A title that includes the word *independent*;
- b. An identification of the exemption report and the broker's or dealer's assertions;
- c. A statement that management of the broker or dealer is responsible for compliance with the identified exemption provisions throughout the fiscal year and for its assertions;
- d. A statement that the review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included inquiries and other required procedures to obtain evidence about the broker's or dealer's compliance with the exemption provisions;
- e. A statement that a review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assertions, and accordingly, no such opinion is expressed;

¹² For purposes of this standard, the term "audit committee" has the same definition as that in Auditing Standard No. 16, *Communications with Audit Committees*.

- f. A statement about whether the auditor is aware of any material modifications that should be made to the assertions for them to be fairly stated, in all material respects;
 - g. The manual signature of the auditor's firm;
 - h. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's review report has been issued; and
 - i. The date of the review report.
17. The following example report illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[Introductory paragraph – no exceptions to the exemption provisions included in the broker's or dealer's assertion]

We have reviewed management's statements, included in the accompanying *[title of the exemption report]*, in which (1) Z Broker identified the following provisions of 17 CFR § 15c3-3(k) under which Z Broker claimed an exemption from 17 CFR § 240.15c3-3: (*[fill in which exemption provision – (1), (2)(i), (2)(ii), or (3)]*) (the "exemption provisions") and (2) Z Broker stated that Z Broker met the identified exemption provisions throughout the most recent fiscal year without exception. Z Broker's management is responsible for compliance with the exemption provisions and its statements.

[Introductory paragraph – exceptions to the exemption provisions included in the broker's or dealer's assertion]

We have reviewed management's statements, included in the accompanying *[title of the exemption report]*, in which (1) Z Broker identified the following provisions of 17 CFR § 15c3-3(k) under which Z Broker claimed an exemption

from 17 CFR § 240.15c3-3: (*fill in which exemption provision – (1), (2)(i), (2)(ii), or (3)*)) (the "exemption provisions") and (2) Z Broker stated that Z Broker met the identified exemption provisions throughout the most recent fiscal year except as described in its exemption report. Z Broker's management is responsible for compliance with the exemption provisions and its statements.

[Scope paragraph]

Our review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included inquiries and other required procedures to obtain evidence about Z Broker's compliance with the exemption provisions. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's statements. Accordingly, we do not express such an opinion.

[Review results paragraph]

Based on our review, we are not aware of any material modifications that should be made to management's statements referred to above for them to be fairly stated, in all material respects, based on the provisions set forth in paragraph (k)(*fill-in which exemption provision – (1), (2)(i), (2)(ii), or (3)*) of Rule 15c3-3 under the Securities Exchange Act of 1934.

[Signature]

[City and State or Country]

[Date]

Review Report Date

18. The auditor should date the review report no earlier than the date on which the auditor has completed his or her review procedures.

Note: Because of the coordination between the review engagement and the audit of the financial statements and the audit procedures performed on supplemental information, the date of the review report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

Modifications of the Report

19. If one or more of the broker's or dealer's assertions are not fairly stated, in all material respects, the auditor must modify the review report to describe the reasons the assertions are not fairly stated, in all material respects. If a broker's or dealer's assertion is not fairly stated, in all material respects, because of one or more omitted exceptions, the auditor's review report should disclose each omitted exception.

20. *Scope Limitations.* If the auditor cannot perform the procedures required by this standard or other procedures that the auditor deems necessary in the circumstances, the review is incomplete because of the scope limitation. An incomplete review is not a sufficient basis for stating a conclusion regarding the broker's or dealer's assertions. In those circumstances, the auditor should withdraw from the engagement or should modify the review report to:

- a. Describe the scope limitation and any review procedures deemed necessary by the auditor that have been omitted and the reason for their omission;
- b. State that the auditor does not express any form of assurance on the broker's or dealer's assertions; and, if applicable,
- c. Describe any circumstances that cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects.

Amendments to PCAOB Standards

Auditing Standards

Auditing Standard No. 3, "Audit Documentation"

Auditing Standard No. 3, "Audit Documentation," as amended, is amended as follows:

- a. The following is added at the end of footnote 2 in paragraph 6:
- In an engagement conducted pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the relevant assertions are the assertions expressed by management or the responsible party regarding the subject matter of the attestation engagement. The documentation requirements in this standard regarding assertions apply to the aspects of the subject matter to which the assertions relate.
- b. The following note is added at the end of paragraph 12:
- Note: In an engagement conducted pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, significant findings or issues include, when applicable: (a) the assessment of, and the responses to, risks requiring special consideration by the auditor; (b) significant matters involving systems, processes, and controls to ensure the appropriateness of the subject matter and management's related assertions; and (c) the evaluation of identified instances of nonconformity with the evaluation criteria (e.g., errors, instances of non-compliance, or control deficiencies).
- c. The following note is added as the second note to paragraph 13:
- Note: When conducting an attestation engagement pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the auditor may include the documentation of significant findings or issues

related to the attestation engagement in the engagement completion document prepared in connection with the audit of the financial statements.

Auditing Standard No. 7, "Engagement Quality Review"

Auditing Standard No. 7, "Engagement Quality Review," is amended as follows:

- a. Paragraph 1 is replaced with:

An engagement quality review and concurring approval of issuance are required for the following engagements conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB"): (a) an audit engagement; (b) a review interim financial information; and (c) an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*.

- b. Paragraph 18A. is added:

Engagement Quality Review for an Attestation Engagement Performed Pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*

In an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the engagement

quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the attestation engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should, taking into account the procedures performed in the engagement quality review of the financial statement audit, (1) hold discussions with the engagement partner and other members of the engagement team, (2) read the engagement report and the document containing management's assertions, and (3) review the engagement completion document and other relevant documentation.

- c. Paragraph 18B. is added:

In an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency.

- d. The following note is added after paragraph 18B.:

Note: A *significant engagement deficiency* in an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, exists when (1) the engagement team

failed to perform attestation procedures necessary in the circumstances of the engagement, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

e. Paragraph 18C. is added:

In an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.

Auditing Standard No. 16, "Communications with Audit Committees"

Auditing Standard No. 16, "Communications with Audit Committees," is amended as follows:

- a. The following bullets are inserted after the third bullet in Appendix B:
- Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, paragraphs 34 and 35.
 - Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, paragraph 15.

Attestation Standards

AT sec. 101, "Attestation Engagements"

AT sec. 101, "Attestation Engagements," as amended, is amended as follows:

- a. The following is added at the end of paragraph .04:

- g. Engagements in which a practitioner is engaged to perform an examination of certain statements of a broker or dealer in a compliance report that is prepared pursuant to SEC Rule 17a-5. Such engagements must be conducted pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*.
- h. Engagements in which a practitioner is engaged to perform a review of statements of a broker or dealer in an exemption report that is prepared pursuant to SEC Rule 17a-5. Such engagements must be conducted pursuant to Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*.

AT sec. 601, "Compliance Attestation"

AT sec. 601, "Compliance Attestation," is amended as follows:

- a. Within paragraph .02, subparagraph e. is replaced with:
Apply to examination engagements of brokers and dealers covered by Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*.
- b. Footnote 2 to paragraph .02.e. is deleted.
- c. The last sentence of paragraph .06 is deleted.
- d. Paragraph .07 is replaced with:
When a practitioner is engaged to perform a review of statements made by a broker or dealer in an exemption report that is prepared pursuant to SEC Rule 17a-5, the practitioner must conduct the review engagement pursuant to Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. PCAOB-2013-01)

[Date]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers, Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers, and Related Amendments to PCAOB Standards

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), notice is hereby given that on October 30, 2013, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or the "SEC") the proposed rules described in items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rules

On October 10, 2013, the Board adopted Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers, Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers, and related amendments to PCAOB standards (collectively, the "proposed rules"). The text of the proposed rules is set out below.

Attestation Standard No. 1Examination Engagements Regarding Compliance Reports of Brokers and DealersIntroduction

1. This standard establishes requirements that apply when an auditor is engaged to perform

an examination¹ of certain statements made by a broker² or dealer³ in a compliance report ("compliance report") prepared pursuant to Securities and Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 CFR § 240.17a-5 ("SEC Rule 17a-5") of the U.S. Securities and Exchange Commission ("SEC").⁴

2. SEC Rule 17a-5 requires a broker's or dealer's compliance report to include the following statements (hereinafter referred to as "assertions") by the broker or dealer as to whether:⁵

- a. The Internal Control Over Compliance⁶ of the broker or dealer was effective during the most recent fiscal year;

¹ See paragraphs (d)(1)(i)(C) and (g)(2)(i) of SEC Rule 17a-5, which require that certain brokers or dealers file with the SEC a report prepared by an independent accountant based on an examination of the compliance report, if the broker or dealer is required to file a compliance report with the SEC.

² According to PCAOB Rule 1001(b)(iii), the term "broker" means a broker (as defined in Section 3(a)(4) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

³ According to PCAOB Rule 1001(d)(iii), the term "dealer" means a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

⁴ See paragraph (g)(2)(i) of SEC Rule 17a-5.

⁵ The scope of the auditor's examination does not encompass the statement required by paragraph (d)(3)(i)(A)(1) of SEC Rule 17a-5, which is a statement as to whether the broker or dealer has established and maintained Internal Control Over Compliance as that term is defined in paragraph (d)(3)(ii) of SEC Rule 17a-5. See paragraphs (d)(3) and (g)(2)(i) of SEC Rule 17a-5.

⁶ Terms defined in Appendix A, Definitions, are set in boldface type the first time they appear. The definitions of the terms in Appendix A are consistent with paragraphs (d)(3)(ii) and (iii) of SEC Rule 17a-5.

- b. The Internal Control Over Compliance of the broker or dealer was effective as of the end of the most recent fiscal year;⁷
- c. The broker or dealer was in compliance with 17 CFR §§ 240.15c3-1 (the "net capital rule") and 240.15c3-3(e) (the "reserve requirements rule") as of the end of the most recent fiscal year; and
- d. The information the broker or dealer used to state whether it was in compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer.

Objective

- 3. When performing an examination of the assertions made by a broker or dealer in a compliance report (an "examination engagement"), the auditor's objective is to express an opinion regarding whether the assertions made by the broker or dealer in its compliance report are fairly stated, in all material respects.
- 4. To express an opinion on the assertions made by a broker or dealer in a compliance report, the auditor must plan and perform the examination engagement to obtain appropriate evidence that is sufficient⁸ to obtain reasonable assurance⁹ about whether (1) one or more

⁷ See paragraph (d)(3)(iii) of SEC Rule 17a-5, which provides that "a broker or dealer is not permitted to conclude that its Internal Control Over Compliance was effective during the most recent fiscal year if there were one or more material weaknesses in its Internal Control Over Compliance during the most recent fiscal year. The broker or dealer is not permitted to conclude that its Internal Control Over Compliance was effective as of the end of the most recent fiscal year if there were one or more material weaknesses in its Internal Control Over Compliance as of the end of the most recent fiscal year."

⁸ See the description of "sufficiency" and "appropriateness" in Auditing Standard No. 15, Audit Evidence.

⁹ Although not absolute assurance, reasonable assurance is a high level of assurance.

Material Weaknesses existed during the most recent fiscal year specified in the broker's or dealer's assertion; (2) one or more Material Weaknesses existed as of the end of the most recent fiscal year specified in the broker's or dealer's assertion; and (3) one or more instances of non-compliance with the net capital rule or the reserve requirements rule existed as of the end of the most recent fiscal year specified in the broker's or dealer's assertion.

Note: Because the broker's or dealer's assertions include assertions regarding Internal Control Over Compliance and its compliance with both the net capital rule and the reserve requirements rule, the auditor's examination should evaluate (a) the effectiveness of Internal Control Over Compliance with each financial responsibility rule¹⁰ during, and as of the end of, the most recent fiscal year, and (b) compliance with the net capital rule and with the reserve requirements rule as of the end of the most recent fiscal year.

Note: The auditor is not required to express an opinion on the process the broker or dealer used to arrive at the conclusions stated in the broker's or dealer's assertions.

5. The auditor also must plan and perform the examination engagement to obtain appropriate evidence that is sufficient to obtain reasonable assurance to support the auditor's opinion regarding whether the assertion by the broker or dealer that the information used to

¹⁰ The term "financial responsibility rules" refers to: 17 CFR § 240.15c3-1 ("SEC Rule 15c3-1" or the "net capital rule"); 17 CFR § 240.15c3-3 ("SEC Rule 15c3-3"); 17 CFR § 240.17a-13 ("SEC Rule 17a-13"); and any rule of the designated examining authority ("DEA") of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer. The financial responsibility rules are the same as the rules cited in paragraph (d)(3)(ii) of SEC Rule 17a-5.

assert compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer, is fairly stated, in all material respects.

Performing the Examination Engagement

General Requirements

6. An auditor who performs an examination engagement pursuant to this standard must:
 - a. Have adequate technical proficiency in attestation engagements;
 - b. Obtain an understanding of the financial responsibility rules and other rules and regulations that are relevant to the broker's or dealer's assertions;
 - c. Determine the auditor's compliance with independence and ethics requirements;
and
 - d. Exercise due professional care, which includes application of professional skepticism, in planning and performing the examination and the preparation of the report.

Note: Due professional care imposes a responsibility on each engagement team member to comply with this standard. The exercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including preparing the report.¹¹

Note: Auditing Standard No. 3, Audit Documentation, establishes the documentation requirements for examination engagements performed pursuant to this standard.

¹¹ The auditor's responsibility to exercise due professional care is consistent with the description in paragraphs .40–.41 of AT sec. 101, Attest Engagements.

7. The engagement partner is responsible for the examination engagement and performance of the examination procedures. Accordingly, the engagement partner is responsible for proper planning of the examination engagement, proper supervision of the work of engagement team members, and compliance with the requirements of this standard. The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Note: For purposes of this standard, the term "engagement partner" means the member of the engagement team with primary responsibility for the examination engagement.

Note: Proper planning includes establishing an overall strategy for the examination engagement and developing a plan for the engagement, which includes, in particular, the nature, timing, and extent of procedures necessary to obtain reasonable assurance. Proper supervision includes supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Relationship Between the Examination Engagement and the Audit of the Financial Statements and the Audit Procedures Performed on Supplemental Information

8. The examination engagement should be coordinated with the audit of the financial statements and the audit procedures performed on supplemental information of the broker or dealer.¹² In planning and performing procedures for, and evaluating the results of the procedures

¹² Under the definition of supplemental information included in Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements, supplemental information includes the supporting schedules described in paragraph (d)(2) of SEC Rule 17a-5, which are required to be filed with the SEC, DEA, and the Securities Investor Protection Corporation ("SIPC") by brokers and dealers. Such supporting schedules include a Computation of Net Capital Under SEC Rule 15c3-1, a Computation for Determination of the Reserve Requirements under Exhibit A of SEC Rule 15c3-3, and Information Relating to Possession or Control Requirements Under SEC Rule 15c3-3.

performed in, the examination engagement, the auditor should take into account relevant evidence from the audit of the financial statements and the audit procedures performed on the supplemental information. However, the objectives of the financial statement audit and the examination engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.

Planning the Examination Engagement

9. The auditor should plan the examination engagement to perform procedures that are sufficient to provide a reasonable basis for determining whether the broker's or dealer's assertions are fairly stated, in all material respects. In planning the examination engagement, the auditor should:

- a. Evaluate the nature of instances of non-compliance with the financial responsibility rules and Deficiencies in Internal Control Over Compliance identified during previous examination engagements;
- b. Obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the financial responsibility rules¹³;

Note: The nature, timing, and extent of procedures that are necessary to obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the financial responsibility rules depend on the size and complexity of the broker or dealer; the auditor's existing knowledge of the broker's or dealer's processes and controls; the degree to which the

¹³ Appendix B of this standard discusses considerations for brokers and dealers with multiple divisions or branches.

broker's or dealer's compliance depends on the completeness and accuracy of the broker's or dealer's internally generated data; the nature and extent of changes in systems and operations, if any; and the nature of the broker's or dealer's documentation of its processes and controls.

Note: Obtaining an understanding of the broker's or dealer's processes, including relevant controls, includes evaluating the design of controls that are relevant to the examination and determining whether the controls have been implemented.

- c. Obtain an understanding of instances of non-compliance with the financial responsibility rules and Deficiencies in Internal Control Over Compliance identified by management during the most recent fiscal year;
- d. Assess the risks associated with related parties,¹⁴ including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship, that are relevant to compliance and controls over compliance;
- e. Obtain an understanding of management's competence regarding the relevant rules and regulations;

¹⁴ The auditor should look to the definition in the applicable financial reporting framework with respect to the term "related parties."

- f. Read the Financial and Operational Combined Uniform Single Reports ("FOCUS Reports")¹⁵ filed by the broker or dealer and obtain an understanding of the reasons for resubmissions, if any;
 - g. Read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's assertions;
 - h. Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to the broker's or dealer's assertions;
 - i. Read correspondence and notifications regarding non-compliance that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA that are relevant to the broker's or dealer's assertions, and, when necessary in the circumstances, make inquiries of the regulatory agencies; and
 - j. Obtain an understanding of the nature and frequency of customer complaints that are relevant to compliance with the financial responsibility rules.
10. In addition, in planning the examination engagement, the auditor should assess the risk of fraud, including the risk of misappropriation of customer assets, relevant to compliance with the net capital rule and the reserve requirements rule and the effectiveness of the broker's or dealer's Internal Control Over Compliance.

Testing Controls over Compliance

¹⁵ The FOCUS Reports are: Form X-17A-5 Schedule I; Form X-17A-5 Part II; Form X-17A-5 Part IIa; Form X-17A-5 Part IIb; and Form X-17A-5 Part III.

11. The auditor must test those controls that are important to the auditor's conclusion about whether the broker or dealer maintained effective Internal Control Over Compliance for each financial responsibility rule during the fiscal year and as of the end of the fiscal year. The auditor must obtain evidence that the controls over compliance selected for testing are designed effectively and operated effectively during the fiscal year and as of the fiscal year end.

12. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a Material Weakness would result. As the risk associated with the control being tested increases, the persuasiveness of the evidence that the auditor should obtain also increases.

Note: Although the auditor must obtain evidence about the effectiveness of the selected controls for each financial responsibility rule, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control.

13. Factors that affect the risk associated with a control include:

- The nature of the financial responsibility rule;
- The risk associated with non-compliance with the financial responsibility rule and the significance of potential non-compliance;
- Changes in the broker's or dealer's policies or procedures or personnel that might adversely affect control design or operating effectiveness;
- The broker's or dealer's history of instances of non-compliance with the financial responsibility rule that the control is intended to prevent or detect;
- The existence and effectiveness of controls that monitor other controls;

- The risk of management override of controls over compliance;
- The nature of the control and the frequency with which it operates;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- The extent of use of part-time personnel to perform controls over compliance;
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and
- The complexity of the control and the significance of the judgments made in connection with its operation.

Testing Design Effectiveness

14. The auditor should test the design effectiveness of the selected controls by determining whether the broker's or dealer's controls, if they are operating as prescribed by persons possessing the necessary authority and competence to perform the control effectively, can effectively prevent or detect instances of non-compliance with the financial responsibility rules on a timely basis.

Note: If a broker or dealer makes changes to its policies and procedures or key personnel during the fiscal year, the auditor should obtain evidence regarding the design effectiveness of the selected controls before and after the change.

15. Procedures the auditor performs to obtain evidence about design effectiveness include inquiry of appropriate personnel, observation of the broker's or dealer's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

16. The auditor should test the operating effectiveness of the selected controls by determining whether each selected control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

Note: The auditor should obtain evidence regarding the operating effectiveness of the selected controls throughout the entire year and as of the end of the fiscal year.

17. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the broker's or dealer's operations, inspection of relevant documentation, and re-performance of the control.

18. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing might provide sufficient evidence in relation to the risk associated with the control.

Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

Using Evidence Obtained in Past Examination Engagements

19. The auditor should obtain evidence during the current fiscal year about the design and operating effectiveness of controls selected for testing. If controls selected for testing in the

current year were tested in past examination engagements, and if the auditor plans to use evidence about the effectiveness of those controls that was obtained in prior years, the auditor should take into account the factors discussed in paragraph 13 and the following factors to determine the evidence needed during the current fiscal year examination:

- The nature, timing, and extent of procedures performed in previous examination engagements;
- The results of the previous years' testing of the control; and
- Changes in the control or the process in which the control operates since the previous examination engagement.

Using Tests of Controls that are Modified During the Year

20. A broker or dealer might implement changes to controls over compliance to make them more effective or efficient or to address control deficiencies. The auditor should obtain an understanding of the reason for the change and obtain evidence regarding the design and operating effectiveness of the new and superseded controls. The nature, timing, and extent of the testing of new and superseded controls depend on the evidence needed to support the auditor's conclusions about the effectiveness of Internal Control Over Compliance during and as of the end of the fiscal year.

Performing Compliance Tests

21. The auditor must perform procedures ("compliance tests") that are sufficient to support the auditor's conclusions regarding whether the broker or dealer was in compliance with the net capital rule and reserve requirements rule as of the end of its most recent fiscal year. This

includes performing the following procedures on the schedules¹⁶ the broker or dealer used to determine compliance with the net capital rule and the reserve requirements rule as of its fiscal year end:

- a. Evaluate whether the amounts in the schedules were determined in accordance with the net capital rule or reserve requirements rule, as applicable;
- b. Test the accuracy and completeness of the information in the schedules;
- c. Determine whether the broker or dealer maintained the required level of net capital in accordance with the net capital rule;
- d. Determine whether the broker or dealer maintained a special reserve bank account for the exclusive benefit of customers and deposited funds in at least the required amount in accordance with the reserve requirements rule;
- e. Determine whether the information in the schedules was derived from the books and records of the broker or dealer; and
- f. Determine whether the broker or dealer made the notifications, if any, required by the net capital rule and reserve requirements rule as of the end of the most recent fiscal year.

Note: Procedures performed as part of the audit of the financial statements and audit procedures performed on supplemental information also might provide evidence regarding the broker's or dealer's compliance with the net capital rule and the reserve requirements rule.

¹⁶ The term "schedules" used in this paragraph refers to the computations of the broker or dealer, in whatever form, that are performed to determine the broker's or dealer's compliance with the net capital rule and the reserve requirements rule.

22. The auditor should plan and perform compliance tests that are responsive to the risks, including fraud risks, associated with non-compliance with the net capital rule and the reserve requirements rule. As the risk associated with non-compliance with the net capital rule or the reserve requirements rule increases, the persuasiveness of the evidence that the auditor should obtain from compliance tests also increases. The evidence provided by the auditor's compliance tests depends upon the mix of the nature, timing, and extent of those procedures. Inquiry alone does not provide sufficient appropriate evidence to support the auditor's conclusions about the broker's or dealer's compliance with the net capital rule or the reserve requirements rule.

23. In conjunction with performing the compliance tests pursuant to paragraphs 21 and 22, the auditor must perform procedures to obtain evidence about the existence of customer funds or securities held for customers.

Note: Examples of procedures that provide evidence about the existence of customer assets include: (1) counting customer securities or observing and testing the broker's or dealer's procedures for physical inspection and (2) confirming customer security positions directly with depositories and clearing organizations. Procedures performed in the audit of the financial statements and the audit procedures performed on supplemental information to test the existence of assets held for customers also may provide evidence that is relevant to the requirement in this paragraph.

Effect of Tests of Internal Controls on Compliance Tests

24. The auditor should take into account the results of the auditor's tests of controls over compliance with the net capital rule and the reserve requirements rule in determining the necessary nature, timing, and extent of compliance tests. If the test results indicate that the

controls are effective, less evidence is needed from compliance tests. If the test results indicate that the controls are ineffective, the auditor should revise the planned compliance tests as necessary to obtain more persuasive evidence regarding compliance.

Evaluating the Results of the Examination Procedures

25. In forming an opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects, the auditor should evaluate all evidence obtained, regardless of whether the evidence corroborates or contradicts the broker's or dealer's assertions.

26. The auditor should evaluate:

- a. Identified instances of non-compliance with the net capital rule and the reserve requirements rule to determine whether any instance of non-compliance existed as of the end of the most recent fiscal year;
- b. Identified instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived from the broker's or dealer's books and records to determine whether they are material, individually or in combination; and
- c. Identified Deficiencies in Internal Control Over Compliance to determine whether the deficiencies, individually or in combination, are Material Weaknesses.

Note: A Material Weakness can exist even when no instances of non-compliance exist. However, instances of non-compliance might indicate the existence of one or more Deficiencies in Internal Control Over Compliance.

Note: The auditor cannot assume that an identified instance of non-compliance or an identified Deficiency in Internal Control Over Compliance is an isolated occurrence. The auditor should evaluate the effect of any instance of non-compliance or identified control deficiency on the auditor's assessment of the risks associated with controls and non-compliance.

Note: The auditor also should evaluate the effect on the audit of the financial statements and audit procedures performed on supplemental information of any non-compliance, Material Weaknesses, or instances in which the information used to assert compliance with the net capital rule or reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records.

27. The auditor should evaluate whether he or she has obtained sufficient appropriate evidence to support the conclusions to be presented in the examination report taking into account the risks associated with controls and non-compliance, the results of the examination procedures performed, and the appropriateness (i.e., the relevance and reliability) of the evidence obtained.

28. If the auditor has not obtained sufficient appropriate evidence about an assertion or has substantial doubt about an assertion, the auditor should perform procedures to obtain further evidence to address the matter.

29. If the auditor is unable to obtain sufficient appropriate evidence about an assertion, the auditor should express a disclaimer of opinion.¹⁷

Subsequent Events

30. For the period from the end of the period specified in the broker's or dealer's assertions to the date of the auditor's examination report (the "subsequent period"), the auditor should perform procedures to identify subsequent events relevant to the auditor's conclusions about the assertions made by the broker or dealer in the compliance report. Such procedures should include, but are not limited to:

- a. Reading relevant reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors, and correspondence that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA during the subsequent period that is relevant to the broker's or dealer's assertions; and
- b. Evaluating information obtained through other engagements performed by the auditor for the broker or dealer, including subsequent events procedures performed in the audit of the financial statements and the audit procedures performed on supplemental information.

31. The auditor should evaluate the results of the procedures described in the previous paragraph to determine whether the results corroborate or contradict the broker's or dealer's assertions.

¹⁷ See Appendix C of this standard, "Examination Report Modifications," which describes the situations in which the auditor should modify his or her examination report and the specific modifications to be made to the auditor's examination report. The requirement in paragraph 29 does not preclude the auditor from withdrawing from the examination engagement.

Obtaining a Representation Letter

32. The auditor should obtain written representations from management of the broker or dealer:
- a. Acknowledging management's responsibility for establishing and maintaining a system of internal control with the objective of providing the broker or dealer with reasonable assurance that any instances of non-compliance with the financial responsibility rules will be prevented or detected on a timely basis;
 - b. Stating the broker's or dealer's assertions included in the compliance report are the responsibility of management;
 - c. Stating that management has made available to the auditor all records and other information relevant to the broker's or dealer's assertions, including all known matters contradicting the assertions, and all communications from regulatory agencies, internal auditors, others who perform an equivalent function, compliance functions, and other auditors, that are relevant to the broker's or dealer's assertions, received through the date of the auditor's report; and
 - d. Stating whether there were, subsequent to the period addressed in the broker's or dealer's assertions, any known events or other factors that might significantly affect the broker's or dealer's assertions.
33. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the engagement, as described in Appendix C of this standard.

Communication Requirements

34. The auditor should communicate to management all identified Deficiencies in Internal Control Over Compliance.

35. The auditor should communicate to management and the audit committee¹⁸ identified instances of non-compliance with the financial responsibility rules, identified Material Weaknesses, and identified instances in which information used to determine compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records.

Note: The auditor also must comply with the requirements of paragraph (h) of SEC Rule 17a-5, which contains notification requirements that apply to auditors of brokers and dealers.

Reporting on the Examination Engagement

36. The auditor's examination report must include the following elements, modified as necessary in the circumstances and manner discussed in Appendix C:

- a. A title that includes the word independent;
- b. An identification of the compliance report and the broker's or dealer's assertions regarding the effectiveness of Internal Control Over Compliance during the fiscal year and as of the fiscal year end, compliance with the net capital rule and the reserve requirements rule as of the fiscal year end, and whether the information used to assert compliance with those rules was derived from the broker's or dealer's books and records;

¹⁸ For purposes of this standard, the term "audit committee" has the same definition as that in Auditing Standard No. 16, Communications with Audit Committees.

- c. A statement that management of the broker or dealer is responsible for establishing and maintaining a system of internal control that has the objective of providing the broker or dealer with reasonable assurance that any instances of non-compliance with the financial responsibility rules will be prevented or detected on a timely basis;
- d. A statement that the auditor's responsibility is to express an opinion on the broker's or dealer's assertions based on his or her examination;
- e. A statement that the examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);
- f. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the examination engagement to obtain reasonable assurance about whether the broker's or dealer's Internal Control Over Compliance was effective during and as of the end of the most recent fiscal year, whether the broker or dealer complied with the net capital rule and the reserve requirements rule as of the end of the most recent fiscal year, and whether the information used to assert compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer;
- g. A statement that an examination engagement includes evaluating the design and operating effectiveness of Internal Control Over Compliance; testing and evaluating the broker's or dealer's compliance with the net capital rule and the reserve requirements rule; determining whether the information used to assert compliance with the net capital rule and reserve requirements rule was derived

from the broker's or dealer's books and records; and performing such other procedures as the auditor considered necessary in the circumstances;

- h. A statement that the auditor believes the examination provides a reasonable basis for his or her opinion;¹⁹
 - i. The auditor's opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects;
 - j. The manual signature of the auditor's firm;
 - k. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's examination report has been issued; and
 - l. The date of the examination report.
37. The following example examination report expressing an unqualified opinion on the assertions made by a broker or dealer in a compliance report illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[Introductory paragraph]

We have examined W Broker's statements, included in the accompanying [title of the compliance report], that (1) W Broker's internal control over compliance was effective during the most recent fiscal year ended [date]; (2) W Broker's internal control over compliance was effective as of [date]; (3) W Broker was in compliance with 17 CFR §§ 240.15c3-1 and 240.15c3-3(e) as of [date]; and (4)

¹⁹ When management has made an interpretation of the financial responsibility rules and the auditor has determined that it is necessary to emphasize this interpretation in the auditor's report, the auditor may include a paragraph stating the description and the source of the interpretation made directly following the scope paragraph.

the information used to state that W Broker was in compliance with 17 CFR §§ 240.15c3-1 and 240.15c3-3(e) was derived from W Broker's books and records. W Broker's management is responsible for establishing and maintaining a system of internal control over compliance that has the objective of providing W Broker with reasonable assurance that non-compliance with 17 CFR § 240.15c3-1, 17 CFR § 240.15c3-3, 17 CFR § 240.17a-13, or Rule [fill in name/number] of [fill in DEA] that requires account statements to be sent to the customers of W Broker will be prevented or detected on a timely basis. Our responsibility is to express an opinion on W Broker's statements based on our examination.

[Scope paragraph]

We conducted our examination in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the examination to obtain reasonable assurance about whether W Broker's internal control over compliance was effective as of and during the most recent fiscal year ended [date]; W Broker complied with 17 CFR §§ 240.15c3-1 and 240.15c3-3(e) as of [date]; and the information used to assert compliance with 17 CFR §§ 240.15c3-1 and 240.15c3-3(e) as of [date] was derived from W Broker's books and records. Our examination includes testing and evaluating the design and operating effectiveness of internal control over compliance, testing and evaluating W Broker's compliance with 17 CFR §§ 240.15c3-1 and 240.15c3-3(e), determining whether the information used to assert compliance with 240.15c3-1 and 240.15c3-3(e) was derived from W Broker's books and records, and performing such other procedures as we considered

necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[Opinion paragraph]

In our opinion, W Broker's statements referred to above are fairly stated, in all material respects.

[Signature]

[City and State or Country]

[Date]

Examination Report Date

38. The auditor should date the examination report no earlier than the date on which the auditor obtains sufficient appropriate evidence to support his or her opinion.

Note: Because of the coordination between the examination engagement, the audit of the financial statements and the audit procedures performed on supplemental information, the date of the examination report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. Deficiency in Internal Control Over Compliance – A Deficiency in Internal Control Over Compliance exists when the design or operation of a control does not allow the management or employees of the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect on a timely basis non-compliance with 17 CFR § 240.15c3-1, § 240.15c3-3,

§ 240.17a-13 or 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.²⁰

A3. Internal Control Over Compliance – Internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with 17 CFR § 240.15c3-1, § 240.15c3-3, § 240.17a-13, or 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, will be prevented or detected on a timely basis.²¹

A4. Material Weakness – A Material Weakness is a deficiency, or a combination of deficiencies, in Internal Control Over Compliance such that there is a reasonable possibility that non-compliance with 17 CFR §240.15c3-1 or 17 CFR § 240.15c3-3(e) will not be prevented or detected on a timely basis or that non-compliance to a material extent with 17 CFR §240.15c3-3, except for paragraph (e), 17 CFR § 240.17a-13, or 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 will not be prevented or detected on a timely basis.²²

APPENDIX B – Considerations for Brokers and Dealers with Multiple Divisions or Branches

B1. When the broker or dealer has multiple divisions or branches, the auditor should determine the extent to which he or she should perform examination procedures at selected divisions or branches to obtain sufficient appropriate evidence to support the conclusions

²⁰ The definition of "Deficiencies in Internal Control Over Compliance" is consistent with the same term in paragraph (d)(3)(iii) of SEC Rule 17a-5.

²¹ The definition of "Internal Control Over Compliance" is consistent with the same term in paragraph (d)(3)(ii) of SEC Rule 17a-5.

²² The definition of a "Material Weakness" is consistent with the same term in paragraph (d)(3)(iii) of SEC Rule 17a-5.

expressed in the auditor's examination report. This includes determining the divisions or branches at which to perform examination procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual divisions or branches. In determining the extent of the examination procedures to be performed, the auditor should take into account:

- a. The degree to which the financial responsibility rules relate to activities at the division or branch level;
- b. The nature and significance of the related assets, transactions, or activities at the division or branch to the financial responsibility rules;
- c. The degree of centralization of records or information processing relevant to the financial responsibility rules; and
- d. The degree and effectiveness of management supervision and monitoring of the relevant activities of the division or branch.

APPENDIX C – Examination Report Modifications

C1. The auditor should modify his or her examination report if any of the following conditions exist:

- a. There is non-compliance with the net capital rule or the reserve requirements rule as of the end of the most recent fiscal year, one or more Material Weaknesses in Internal Control Over Compliance during or as of the end of the most recent fiscal year, or the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer (paragraphs C2–C3).
- b. There is a restriction on the scope of the examination engagement (paragraphs C4–C8).

- c. There is information other than the assertions and descriptions required under paragraph (d)(3)(i) of SEC Rule 17a-5 contained in the compliance report (paragraphs C9–C10).

Non-Compliance, Material Weakness, or Instance in which Information Used to Assert Compliance was not Derived from the Broker's or Dealer's Books and Records

C2. If (1) one or more instances of non-compliance with the net capital rule or the reserve requirements rule exist as of the end of the fiscal year; (2) one or more Material Weaknesses in Internal Control Over Compliance exist during or as of the end of the fiscal year; or (3) the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer, the auditor must express an adverse opinion directly on the subject matter of the respective assertions, rather than on the assertions themselves, unless there is a restriction on the scope of the examination engagement.

Note: The requirement in this paragraph to express an adverse opinion applies regardless of whether the non-compliance, Material Weakness, or other matters preventing the unqualified opinion were identified by management or by the auditor.

- C3. When expressing such an adverse opinion, the auditor's examination report should include, as applicable:
 - a. A statement that non-compliance with the net capital rule or the reserve requirements rule has been identified and an identification of each instance of non-compliance described in the broker's or dealer's compliance report as of the end of the most recent fiscal year.

- b. A statement that one or more Material Weaknesses in Internal Control Over Compliance have been identified during the fiscal year and an identification of each Material Weakness described in the compliance report.
- c. A statement that one or more Material Weaknesses in Internal Control Over Compliance have been identified as of the end of the fiscal year and an identification of each Material Weakness described in the compliance report.
- d. A statement that one or more instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records have been identified.

Note: If a description of all identified instances of non-compliance with the net capital rule or the reserve requirements rule and all identified Material Weaknesses has not been included in the broker's or dealer's compliance report, the examination report must be modified to describe those instances of non-compliance or Material Weaknesses that the auditor has identified but that are not described in the broker's or dealer's compliance report.²³

Scope Limitations

C4. The auditor can express an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects, only if the auditor has been able

²³ Paragraphs (d)(3)(i)(B) and (C) of SEC Rule 17a-5 require the broker's or dealer's compliance report to contain a description of each material weakness in Internal Control Over Compliance during the most recent fiscal year and any instance of non-compliance with the net capital rule or the reserve requirements rule as of the end of the most recent fiscal year.

to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the examination engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion should state that the auditor does not express an opinion on the assertions made by the broker or dealer in the compliance report.

C5. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the examination engagement was not sufficient for the auditor to express an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer, including the procedures that were deemed necessary by the auditor that have been omitted and the reason for their omission. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an examination engagement.

C6. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that: (1) one or more instances of non-compliance with the net capital rule or the reserve requirements rule existed as of the end of the fiscal year; (2) one or more Material Weaknesses in Internal Control Over Compliance existed during or as of the end of the most recent fiscal year; or (3) the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer, the auditor's report also must include the matters described in paragraph C3, as applicable.

C7. The auditor may issue a report disclaiming an opinion on the assertions made by a broker or dealer in a compliance report as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work before issuing a disclaimer when the

auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

Note: In this case, in following the direction in paragraph 38 of this standard regarding dating the auditor's examination report, the report date is the date on which the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

C8. If the auditor concludes that he or she cannot express an opinion because of a limitation on the scope of the examination engagement, the auditor should communicate on a timely basis, in writing, to management and the audit committee that the examination engagement cannot be satisfactorily completed.

Other Information in the Compliance Report

C9. If the compliance report contains other information besides the statements and descriptions required by SEC Rule 17a-5,²⁴ the auditor should disclaim an opinion on the other information.

C10. If the auditor believes that the other information in the compliance report contains a material misstatement of fact, he or she should discuss the matter with management of the broker or dealer. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee of the auditor's views concerning the information.²⁵

Attestation Standard No. 2

Review Engagements Regarding Exemption Reports of Brokers and Dealers

²⁴ See paragraph (d)(3)(i) of SEC Rule 17a-5.

²⁵ See also AU sec. 317, Illegal Acts by Clients, which describes the auditor's responsibilities in a financial statement audit regarding illegal acts.

Introduction

1. This standard establishes requirements that apply when an auditor is engaged to perform a review²⁶ of the statements made by a broker²⁷ or dealer²⁸ in an exemption report ("exemption report") prepared pursuant to Securities and Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 CFR § 240.17a-5 ("SEC Rule 17a-5") of the U.S. Securities and Exchange Commission ("SEC").²⁹
2. SEC Rule 17a-5 requires a broker's or dealer's exemption report to contain the following statements by the broker or dealer:
 - a. A statement that identifies the provisions in paragraph (k) of SEC Rule 15c3-3³⁰ (the "exemption provisions") under which the broker or dealer claimed an exemption from SEC Rule 15c3-3 (the "identified exemption provisions");
 - b. A statement that the broker or dealer (1) met the identified exemption provisions throughout the most recent fiscal year without exception or (2) met the identified

²⁶ See paragraphs (d)(1)(i)(C) and (g)(2)(ii) of SEC Rule 17a-5, which require that certain brokers or dealers file with the SEC a report prepared by an independent accountant based on a review of the statements in the exemption report, if the broker or dealer is required to file an exemption report with the SEC.

²⁷ According to PCAOB Rule 1001(b)(iii), the term "broker" means a broker (as defined in Section 3(a)(4) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

²⁸ According to PCAOB Rule 1001(d)(iii), the term "dealer" means a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

²⁹ See paragraph (g)(2)(ii) of SEC Rule 17a-5.

³⁰ See 17 CFR § 240.15c3-3 ("SEC Rule 15c3-3").

exemption provisions throughout the most recent fiscal year except as described in the exemption report; and

- c. If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions (an "exception") and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.³¹

Objective

3. When performing a review of the statements (hereinafter referred to as "assertions") made by a broker or dealer in an exemption report (a "review engagement"), the auditor's objective is to state whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertions for the assertions to be fairly stated, in all material respects.

4. The auditor must plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance³² about whether one or more conditions exist that would cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects. Such conditions include:

- a. The broker's or dealer's assertion that identifies the provisions in paragraph (k) of SEC Rule 15c3-3 under which the broker or dealer claimed an exemption for SEC Rule 15c3-3 is inaccurate;

³¹ See paragraph (d)(4) of SEC Rule 17a-5.

³² Moderate assurance is obtained by performing with due professional care the inquiries and other procedures required by this standard in order to reach a conclusion about whether there is a need to modify the broker's or dealer's assertions regarding the exemption provisions for the assertions to be fairly stated, in all material respects. Further, this standard is consistent with the concept of moderate assurance as described in paragraph .55 of AT sec. 101, Attest Engagements.

- b. The broker or dealer asserts that it met the identified exemption provisions in paragraph (k) of SEC Rule 15c3-3 without exception when the auditor is aware of exceptions in meeting the exemption provisions; or
- c. The broker's or dealer's assertion that identifies and describes each exception during the most recent fiscal year in meeting the identified exemption provisions in paragraph (k) of SEC Rule 15c3-3 is inaccurate or incomplete.

Performing the Review Engagement

General Requirements

- 5. An auditor who performs a review engagement must:
 - a. Have adequate technical proficiency in attestation engagements;
 - b. Obtain an understanding of the exemption conditions and other rules and regulations that are relevant to the broker's or dealer's assertions;
 - c. Determine the auditor's compliance with independence and ethics requirements;
and
 - d. Exercise due professional care, which includes application of professional skepticism, in planning and performing the review and preparation of the report.

Note: Due professional care imposes a responsibility on each engagement team member to comply with this standard. The exercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including preparing the report.³³

³³ The auditor's responsibility to exercise due professional care is consistent with the description in paragraphs .40–.41 of AT sec. 101.

Note: Auditing Standard No. 3, Audit Documentation, establishes the documentation requirements for review engagements performed pursuant to this standard.

6. The engagement partner is responsible for the review engagement and performance of the review procedures. Accordingly, the engagement partner is responsible for proper planning of the review engagement, proper supervision of the work of engagement team members, and compliance with the requirements of this standard. The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Note: For purposes of this standard, the term "engagement partner" means the member of the engagement team with primary responsibility for the review engagement.

Note: Proper planning includes determining the nature, timing, and extent of procedures necessary to obtain moderate assurance. Proper supervision includes supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Relationship Between the Review Engagement and the Audit of Financial Statements and the Audit Procedures Performed on Supplemental Information

7. The review engagement should be coordinated with the audit of the financial statements and the audit procedures performed on supplemental information of the broker or dealer.³⁴ In planning and performing procedures for, and evaluating the results of the procedures performed

³⁴ Under the definition of supplemental information included in Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements, supplemental information includes the supporting schedules described in paragraph (d)(2) of SEC Rule 17a-5, which are required to be filed by brokers and dealers with the SEC and the broker's and dealer's designated examining authority ("DEA") and the Securities Investor Protection Corporation ("SIPC"). Such supporting schedules consist of, as applicable, a

in, the review engagement, the auditor should take into account relevant evidence from the audit of the financial statements and the procedures performed on the supplemental information. However, the objectives of the financial statement audit and the review engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.

Review Procedures

8. A review engagement includes the following procedures:
 - a. Reading the exemption report to determine the exemption provisions under which the broker or dealer asserts its exemption and the identified exceptions to the exemption provisions;
 - b. Performing inquiries and other review procedures set forth in this standard; and
 - c. Evaluating whether the evidence indicates that there should be modifications to the broker's or dealer's assertions based on the results of the procedures performed.

9. The nature, timing, and extent of the necessary inquiries and other review procedures depend on:
 - a. The following risk factors:
 - (1) The broker's or dealer's history of instances of non-compliance with the exemption provisions;
 - (2) Changes in the broker's or dealer's procedures, controls, or the environment in which the controls operate since the prior year;

- (3) Changes in the broker's or dealer's operations that are relevant to compliance with the exemption provisions;
 - (4) Competence of the personnel who are responsible for compliance with the exemption provisions or who perform important controls over compliance, and whether there have been changes in those personnel during the period of the review;
 - (5) The risk of fraud, including the risk of misappropriation of customer assets, relevant to the exemption provisions;
 - (6) Potential non-compliance associated with related parties,³⁵ including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship;
 - (7) The degree to which the broker's or dealer's processes that relate to the exemption provisions are performed, monitored, or controlled in a centralized or decentralized environment; and
- b. Evidence about the broker's or dealer's compliance with the exemption provisions or about the effectiveness of controls over compliance with the exemption provisions obtained from the audit of the financial statements and the audit procedures performed on supplemental information.
10. The auditor should perform procedures to identify exceptions to the exemption provisions, including the following:
 - a. If the broker or dealer identified exceptions to the exemption provisions during the year under review, the auditor should read the broker's or dealer's

³⁵ The auditor should look to the definition in the applicable financial reporting framework with respect to the term "related parties."

documentation regarding the exceptions to the exemption provisions and compare it to the information included in the exemption report.

- b. Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding:
 - (1) Whether the broker or dealer was in compliance with the exemption provisions throughout the year under review or whether exceptions have been identified.
 - (2) Regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to compliance with the exemption provisions.

Note: If the broker or dealer has sent or received correspondence with the SEC or the broker's or dealer's DEA that is relevant to compliance with the exemption provisions, the auditor should read such correspondence and, when necessary in the circumstances, make inquiries of the regulatory agencies.
 - (3) Subsequent events through the date of the auditor's review report that might have a material effect on the broker's or dealer's assertions.
- c. Inquire of individuals at the broker or dealer who have relevant knowledge of controls relevant to the broker's or dealer's compliance with the exemption provisions regarding:

- (1) The controls that are in place to maintain compliance with the exemption provisions, including the nature of the controls and their frequency of operation.

Note: The auditor should take into account procedures performed during 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's or dealer's compliance with the exemption provisions.

- (2) Whether the individual is aware of:
 - i. Any exceptions to the exemption provisions and, if so, the nature, frequency, timing, and cause (if known) of the exceptions to the exemption provisions, during the year under review.
 - ii. Any deficiencies in controls over compliance with the exemption provisions and, if so, the nature, frequency, and cause (if known) of the control deficiencies during the year under review.

- d. Inquire of individuals who are responsible for monitoring compliance with the exemption provisions or the controls over compliance regarding:

- (1) The nature and frequency of the monitoring activities.
- (2) The results of those monitoring activities, including the nature, frequency, timing, and cause (if known) of any exceptions to the exemption provisions or deficiencies in controls over compliance.

- (3) The nature and frequency of customer complaints that are relevant to the broker's or dealer's compliance with the exemption provisions.
- e. Read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's compliance with the exemption provisions.
 - f. Read regulatory filings of the broker or dealer that are relevant to the broker's or dealer's compliance with the exemption provisions.
 - g. 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's or dealer's assertions regarding compliance with the exemption provisions.

Note: Examples of procedures performed during the audit of the financial statements that might provide evidence relevant to the broker's or dealer's compliance with the exemption provisions include: (i) testing related to customer trades; (ii) testing of specially designated cash accounts; (iii) testing investment inventory or transactions related to the broker's or dealer's trading for its own account; and (iv) reading the clearing agreement in connection with testing trade fee or commission revenue or expenses.

- h. Perform other procedures as necessary in the circumstances to obtain moderate assurance regarding whether a material modification should be made to the

broker's or dealer's assertions for the assertions to be fairly stated, in all material respects.

Evaluating the Results of the Review Procedures

11. The auditor should evaluate whether information has come to the auditor's attention that causes the auditor to believe that one or more of the broker's or dealer's assertions are not fairly stated, in all material respects.³⁶ If a broker's or dealer's assertion is not fairly stated, in all material respects, the auditor should:

- a. Modify the review report, as discussed in paragraph 19 of this standard; and
- b. Evaluate the effect of the matter on the audit of the financial statements and the audit procedures performed on supplemental information.

12. If information coming to the auditor's attention indicates that one or more exceptions to the exemption provisions occurred during the year under review or might exist at year-end, other than exceptions disclosed in the exemption report, that might cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects, or if the auditor has substantial doubt about one or more of the broker's or dealer's assertions, the auditor should perform additional procedures as necessary to address the matter.

Obtaining a Representation Letter

13. The auditor should obtain written representations from management of the broker or dealer:

- a. Acknowledging management's responsibility for compliance with the identified exemption provisions throughout the fiscal year;

³⁶ See paragraph 4 of this standard, which provides examples of conditions that would cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects.

- b. Stating the broker's or dealer's assertions and that they are the responsibility of management;
- c. Stating that management has made available to the auditor all records and other information relevant to the broker's or dealer's assertions, including all communications from regulatory agencies, internal auditors, others who perform an equivalent function, compliance functions, and other auditors concerning possible exceptions to the exemption provisions, received through the date of the auditor's review report; and
- d. Stating whether there were, subsequent to the period addressed in the broker's or dealer's assertions, any known events or other factors that might significantly affect the broker's or dealer's compliance with the identified exemption provisions.

14. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the review engagement as described in paragraph 20 of this standard.

Communication Requirements

15. The auditor should communicate to management and to the audit committee³⁷ any exceptions to the exemption provisions identified by the auditor and information that causes the broker's or dealer's assertions about the exemption provisions not to be fairly stated, in all material respects.

³⁷ For purposes of this standard, the term "audit committee" has the same definition as that in Auditing Standard No. 16, Communications with Audit Committees.

Note: The auditor must also comply with the requirements of paragraph (h) of SEC Rule 17a-5, which contains notification requirements that apply to auditors of brokers and dealers.

Reporting on the Review Engagement

16. The auditor's review report must include the following elements, modified as necessary in the circumstances and manner discussed in paragraphs 19–20:

- a. A title that includes the word independent;
- b. An identification of the exemption report and the broker's or dealer's assertions;
- c. A statement that management of the broker or dealer is responsible for compliance with the identified exemption provisions throughout the fiscal year and for its assertions;
- d. A statement that the review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included inquiries and other required procedures to obtain evidence about the broker's or dealer's compliance with the exemption provisions;
- e. A statement that a review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assertions, and accordingly, no such opinion is expressed;
- f. A statement about whether the auditor is aware of any material modifications that should be made to the assertions for them to be fairly stated, in all material respects;
- g. The manual signature of the auditor's firm;

- h. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's review report has been issued; and
 - i. The date of the review report.
17. The following example report illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[Introductory paragraph – no exceptions to the exemption provisions included in the broker's or dealer's assertion]

We have reviewed management's statements, included in the accompanying [title of the exemption report], in which (1) Z Broker identified the following provisions of 17 CFR § 15c3-3(k) under which Z Broker claimed an exemption from 17 CFR § 240.15c3-3: ([fill in which exemption provision – (1), (2)(i), (2)(ii), or (3)]) (the "exemption provisions") and (2) Z Broker stated that Z Broker met the identified exemption provisions throughout the most recent fiscal year without exception. Z Broker's management is responsible for compliance with the exemption provisions and its statements.

[Introductory paragraph – exceptions to the exemption provisions included in the broker's or dealer's assertion]

We have reviewed management's statements, included in the accompanying [title of the exemption report], in which (1) Z Broker identified the following provisions of 17 CFR § 15c3-3(k) under which Z Broker claimed an exemption from 17 CFR § 240.15c3-3: ([fill in which exemption provision – (1), (2)(i), (2)(ii), or (3)]) (the "exemption provisions") and (2) Z Broker stated that Z Broker met the identified exemption provisions throughout the most recent fiscal year

except as described in its exemption report. Z Broker's management is responsible for compliance with the exemption provisions and its statements.

[Scope paragraph]

Our review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included inquiries and other required procedures to obtain evidence about Z Broker's compliance with the exemption provisions. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's statements. Accordingly, we do not express such an opinion.

[Review results paragraph]

Based on our review, we are not aware of any material modifications that should be made to management's statements referred to above for them to be fairly stated, in all material respects, based on the provisions set forth in paragraph (k)([fill-in which exemption provision – (1), (2)(i), (2)(ii), or (3)]) of Rule 15c3-3 under the Securities Exchange Act of 1934.

[Signature]

[City and State or Country]

[Date]

Review Report Date

18. The auditor should date the review report no earlier than the date on which the auditor has completed his or her review procedures.

Note: Because of the coordination between the review engagement and the audit of the financial statements and the audit procedures performed on supplemental

information, the date of the review report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

Modifications of the Report

19. If one or more of the broker's or dealer's assertions are not fairly stated, in all material respects, the auditor must modify the review report to describe the reasons the assertions are not fairly stated, in all material respects. If a broker's or dealer's assertion is not fairly stated, in all material respects, because of one or more omitted exceptions, the auditor's review report should disclose each omitted exception.

20. Scope Limitations. If the auditor cannot perform the procedures required by this standard or other procedures that the auditor deems necessary in the circumstances, the review is incomplete because of the scope limitation. An incomplete review is not a sufficient basis for stating a conclusion regarding the broker's or dealer's assertions. In those circumstances, the auditor should withdraw from the engagement or should modify the review report to:

- a. Describe the scope limitation and any review procedures deemed necessary by the auditor that have been omitted and the reason for their omission;
- b. State that the auditor does not express any form of assurance on the broker's or dealer's assertions; and, if applicable,
- c. Describe any circumstances that cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects.

Amendments to PCAOB Standards

Auditing Standards

Auditing Standard No. 3, "Audit Documentation"

Auditing Standard No. 3, "Audit Documentation," as amended, is amended as follows:

- a. The following is added at the end of footnote 2 in paragraph 6:
- In an engagement conducted pursuant to Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers, or Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers, the relevant assertions are the assertions expressed by management or the responsible party regarding the subject matter of the attestation engagement. The documentation requirements in this standard regarding assertions apply to the aspects of the subject matter to which the assertions relate.
- b. The following note is added at the end of paragraph 12:
- Note: In an engagement conducted pursuant to Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers, or Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers, significant findings or issues include, when applicable: (a) the assessment of, and the responses to, risks requiring special consideration by the auditor; (b) significant matters involving systems, processes, and controls to ensure the appropriateness of the subject matter and management's related assertions; and (c) the evaluation of identified instances of nonconformity with the evaluation criteria (e.g., errors, instances of non-compliance, or control deficiencies).
- c. The following note is added as the second note to paragraph 13:
- Note: When conducting an attestation engagement pursuant to Attestation Standard No. 1, Examination Engagements Regarding Compliance

Reports of Brokers and Dealers, or Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers, the auditor may include the documentation of significant findings or issues related to the attestation engagement in the engagement completion document prepared in connection with the audit of the financial statements.

Auditing Standard No. 7, "Engagement Quality Review"

Auditing Standard No. 7, "Engagement Quality Review," is amended as follows:

- a. Paragraph 1 is replaced with:

An engagement quality review and concurring approval of issuance are required for the following engagements conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB"): (a) an audit engagement; (b) a review interim financial information; and (c) an attestation engagement performed pursuant to Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers, or Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers.

- b. Paragraph 18A. is added:

Engagement Quality Review for an Attestation Engagement Performed Pursuant to Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers, or Attestation

Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers

In an attestation engagement performed pursuant to Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers, or Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers, the engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the attestation engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should, taking into account the procedures performed in the engagement quality review of the financial statement audit, (1) hold discussions with the engagement partner and other members of the engagement team, (2) read the engagement report and the document containing management's assertions, and (3) review the engagement completion document and other relevant documentation.

- c. Paragraph 18B. is added:

In an attestation engagement performed pursuant to Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers, or Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers, the engagement quality reviewer may provide concurring approval of issuance only if,

after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency.

- d. The following note is added after paragraph 18B.:

Note: A significant engagement deficiency in an attestation engagement performed pursuant to Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers, or Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers, exists when (1) the engagement team failed to perform attestation procedures necessary in the circumstances of the engagement, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

- e. Paragraph 18C. is added:

In an attestation engagement performed pursuant to Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers, or Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.

Auditing Standard No. 16, "Communications with Audit Committees"

Auditing Standard No. 16, "Communications with Audit Committees," is amended as follows:

- a. The following bullets are inserted after the third bullet in Appendix B:
- Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers, paragraphs 34 and 35.
 - Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers, paragraph 15.

Attestation Standards

AT sec. 101, "Attestation Engagements"

AT sec. 101, "Attestation Engagements," as amended, is amended as follows:

- a. The following is added at the end of paragraph .04:
- g. Engagements in which a practitioner is engaged to perform an examination of certain statements of a broker or dealer in a compliance report that is prepared pursuant to SEC Rule 17a-5. Such engagements must be conducted pursuant to Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers.
 - h. Engagements in which a practitioner is engaged to perform a review of statements of a broker or dealer in an exemption report that is prepared pursuant to SEC Rule 17a-5. Such engagements must be conducted pursuant to Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers.

AT sec. 601, "Compliance Attestation"

AT sec. 601, "Compliance Attestation," is amended as follows:

- a. Within paragraph .02, subparagraph e. is replaced with:

Apply to examination engagements of brokers and dealers covered by Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers.

- b. Footnote 2 to paragraph .02.e. is deleted.
- c. The last sentence of paragraph .06 is deleted.
- d. Paragraph .07 is replaced with:

When a practitioner is engaged to perform a review of statements made by a broker or dealer in an exemption report that is prepared pursuant to SEC Rule 17a-5, the practitioner must conduct the review engagement pursuant to Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements. In addition, since the attestation standards will apply solely in connection with audits of registered brokers and dealers pursuant to the Rule 17a-5 under the Securities Exchange Act of 1934, the Board defers to the SEC, pursuant to Section 103(a)(3)(c) of the Sarbanes-Oxley Act, on the applicability of Attestation Standards No. 1 and No. 2 to audits of emerging growth companies ("EGCs"), as that term is defined in Section 3(a)(80) of the Securities Exchange Act of 1934. The Board's economic analysis is set forth in section C.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

(a) Purpose

Section 103 of the Sarbanes-Oxley Act directs the Board, by rule, to establish, among other things, "auditing and related attestation standards . . . to be used by registered public accounting firm in the preparation and issuance of audit reports, as required by th[e] [Sarbanes-Oxley] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act amended the Sarbanes-Oxley Act to give the Board oversight authority with respect to audits of brokers and dealers that are registered with the Commission. On July 30, 2013, the SEC adopted amendments to Rule 17a-5³⁸ under the Securities Exchange Act of 1934 ("Exchange Act") to strengthen and clarify broker and dealer annual financial reporting requirements and also facilitate the ability of the PCAOB to implement the oversight of independent public accountants of brokers³⁹ and dealers⁴⁰ provided by Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").⁴¹

³⁸ See Rule 17a-5, 17 CFR § 240.17a-5 ("SEC Rule 17a-5") and SEC Exchange Act Release No. 34-70073, Broker-Dealer Reports (July 30, 2013), 78 Federal Register 51910 (August 21, 2013) ("SEC Release"), available at <http://www.sec.gov/rules/final/2013/34-70073.pdf>.

³⁹ According to PCAOB Rule 1001(b)(iii), the term "broker" means a broker (as defined in Section 3(a)(4) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

⁴⁰ According to PCAOB Rule 1001(d)(iii), the term "dealer" means a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

⁴¹ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

The Board is adopting two attestation standards, Examination Engagements Regarding Compliance Reports of Brokers and Dealers (the "examination standard") and Review Engagements Regarding Exemption Reports of Brokers and Dealers (the "review standard") (collectively, the "attestation standards"). These attestation standards will apply to examination engagements regarding compliance reports of brokers and dealers ("examination engagements") and review engagements regarding exemption reports of brokers and dealers ("review engagements"), pursuant to requirements contained in SEC Rule 17a-5.⁴² Pursuant to SEC Rule 17a-5, the audits of brokers and dealers, including the attestation engagements, are required to be performed under PCAOB standards.⁴³ Before these amendments to SEC Rule 17a-5, audits of brokers and dealers were required to be performed under generally accepted auditing standards ("GAAS") established by the American Institute of Certified Public Accountants ("AICPA"). The attestation standards will be effective, subject to approval by the SEC, for examination engagements and review engagements for fiscal years ending on or after June 1, 2014. This effective date would coincide with the effective date for the corresponding amendments to SEC Rule 17a-5.

Background

Sections 17(a) and (e) of the Exchange Act and SEC Rule 17a-5 together generally require a broker or dealer to, among other things, file an annual report⁴⁴ with the SEC and the

⁴² See paragraphs (g)(2)(i) and (ii) of SEC Rule 17a-5.

⁴³ See paragraph (g) of SEC Rule 17a-5.

⁴⁴ Paragraph (d) of SEC Rule 17a-5 contains general requirements for annual reports to be filed by SEC-registered brokers and dealers. Paragraphs (d)(1)(iii) and (iv) of SEC Rule 17a-5 provide certain limited exceptions to the requirement to file an annual report.

broker's or dealer's designated examining authority ("DEA").⁴⁵ SEC Rule 17a-5 requires the annual report to contain, among other things:

- a. A financial report consisting of audited financial statements and supporting schedules;⁴⁶ and
- b. A compliance report or an exemption report.⁴⁷

The requirements for the compliance report and the exemption report are new requirements that are the result of the Commission's amendments to SEC Rule 17a-5. According to the SEC, these reports contain information regarding broker and dealer compliance with key SEC financial responsibility rules⁴⁸ that enhance the ability of the SEC to oversee the financial responsibility practices of registered brokers and dealers and, in particular, the safekeeping of customer assets.

⁴⁵ Under SEC Rule 17d-1, 17 CFR § 240.17d-1, a registered broker or dealer that is a member of more than one securities self-regulatory organization may be assigned a "designated examining authority" or "DEA" that is responsible for examining the broker or dealer for compliance with SEC financial responsibility rules. An example of a securities self-regulatory organization that is a designated examining authority is the Financial Industry Regulatory Authority.

⁴⁶ See paragraph (d)(2) of SEC Rule 17a-5. Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements (PCAOB Release No. 2013-008) (October 10, 2013), applies to the audit procedures performed and the audit report on supporting schedules.

⁴⁷ See paragraphs (d)(3) and (4) of SEC Rule 17a-5. Attestation Standard No. 1 applies to an examination of certain statements made by the broker or dealer in the compliance report. Attestation Standard No. 2 applies to a review of the statements made by the broker or dealer in the exemption report.

⁴⁸ The SEC Release used the term "financial responsibility rules" to refer to: 17 CFR § 240.15c3-1 ("SEC Rule 15c3-1" or the "net capital rule"); 17 CFR § 240.15c3-3 ("SEC Rule 15c3-3"); 17 CFR § 240.17a-13 ("SEC Rule 17a-13"); and any rule of the DEA of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer (an "account statement rule"). See the SEC Release at 8-9. The terms "financial responsibility rules" and "account statement rule" have the same meaning in these standards as they have in the SEC Release.

Generally, SEC Rule 17a-5 provides that brokers or dealers that did not claim an exemption from SEC Rule 15c3-3 throughout the most recent fiscal year must prepare and file the compliance report. A broker or dealer must prepare and file the exemption report if the broker or dealer did claim that it was exempt from SEC Rule 15c3-3 throughout the most recent fiscal year.

Brokers and dealers also must generally file reports prepared by a PCAOB-registered independent public accountant covering the financial report and the compliance report or exemption report, as applicable.⁴⁹

The auditor's examination report or review report would replace the prior requirement in SEC Rule 17a-5 that the auditor report on material inadequacies identified in the broker's or dealer's accounting system, internal accounting controls, procedures of the broker or dealer for safeguarding securities, and certain practices and procedures related to customer protection and securities.

Considerations in Adopting the Attestation Standards

The Board is adopting the attestation standards to establish requirements aligned with the auditor's responsibilities under SEC Rule 17a-5.⁵⁰ Specifically, the attestation standards establish requirements for examining certain statements in a broker's or dealer's compliance report and reviewing a broker's or dealer's statements in an exemption report. The Board is also adopting related amendments to certain PCAOB standards, including amendments regarding

⁴⁹ See paragraph (d)(1)(i)(C) of SEC Rule 17a-5.

⁵⁰ See paragraphs (g) and (h) of SEC Rule 17a-5.

documentation and amendments to require engagement quality reviews of the examination and the review engagements.⁵¹

The attestation standards for the examination and review engagements represent standalone standards that are based on existing concepts and principles in the existing attestation standards but are tailored for the specific requirements under SEC Rule 17a-5.⁵²

In general, both standards set forth a framework of specific procedures that are required for auditors to opine or conclude on a broker's or dealer's statements – referred to in the standards as "assertions"⁵³ – in compliance reports and exemption reports required by SEC Rule 17a-5, respectively.⁵⁴

Furthermore, both of the attestation standards emphasize coordination between the examination engagement or review engagement, the audit of the broker's or dealer's financial

⁵¹ In addition, on February 28, 2012, the Board proposed to update certain of its rules to conform to the Dodd-Frank Act amendments to the Sarbanes-Oxley Act of 2002. See Proposed Amendments to Conform the Board's Rules and Forms to the Dodd-Frank Act and Make Certain Updates and Clarifications, PCAOB Release No. 2012-002 (February 28, 2012). Among other things, these proposed amendments would amend the Board's rules to require that registered firms comply with the Board's interim standards in broker or dealer engagements. See proposed amendments to Rule 1001(a)(v), Rule 1001(a)(vi), Rule 3200T, and Rule 3300T, Rule 3400T, Rule 3500T, and Rule 3600T. The Board expects to act on these proposed amendments in a separate rulemaking in the near future.

⁵² The requirements in the examination standard are generally consistent with the requirements of AT sec. 101, Attest Engagements, and AT sec. 601, Compliance Attestation. Similarly, the requirements in the review standard are generally consistent with AT sec. 101. However, when an auditor performs an engagement pursuant to the examination standard or a review pursuant to the review standard, AT sec. 101 and AT sec. 601 would not apply.

⁵³ These standards use the term "assertion" to refer to the broker's or dealer's individual statements that are covered by the examination and review. In the examination standard, the term "assertion" also distinguishes the portion of the statements in the broker's or dealer's compliance report that are covered by the examination.

⁵⁴ See paragraphs (i)(3)(iii)(A) and (B) of SEC Rule 17a-5 for the specific requirement for an opinion or conclusion to be expressed in the auditor's report.

statements and audit procedures performed on the supporting schedules (referred to as "supplemental information"). This emphasis on coordination, when properly executed, can promote overall audit effectiveness and avoid redundancy in the work performed. For example, auditors can take into account, when appropriate, evidence obtained while planning and performing the audit of the financial statements and the audit procedures performed on supplemental information in planning and performing the attestation engagement.

This emphasis on coordination is also a key aspect of Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements (the "auditing standard"),⁵⁵ which the Board is separately adopting. Auditing Standard No. 17 will apply when the auditor of the financial statements is engaged to perform audit procedures and report on supplemental information accompanying audited financial statements in accordance with PCAOB standards, including supporting schedules prepared pursuant to SEC Rule 17a-5.⁵⁶ The auditing standard also includes requirements for the procedures on the supplemental information to be planned and performed in conjunction with the audit of the financial statements, and for the audits of brokers and dealers to be coordinated with the attestation engagements related to compliance or exemption reports.⁵⁷

In the Board's view, the attestation standards further the public interest and promote investor protection because they are tailored to the corresponding requirements of SEC Rule 17a-5, which are designed to provide safeguards with respect to broker and dealer custody of

⁵⁵ See Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements, PCAOB Release No. 2013-008 (October 10, 2013).

⁵⁶ See paragraph (d)(2) of SEC Rule 17a-5.

⁵⁷ See the note to paragraph 3.c. of Auditing Standard No. 17.

customer securities and funds. For example, the specific requirements in the examination standard for evaluating Internal Control Over Compliance⁵⁸ can help auditors to identify deficiencies in a broker's or dealer's internal controls for safeguarding customer securities and funds or maintaining necessary capital or reserves. Similarly, the specific requirements in the review standard should focus auditors on whether the broker or dealer appropriately meets the exemption provisions in paragraph (k) of SEC Rule 15c3-3.

Also, the SEC Release states that SEC enforcement actions alleging fraudulent conduct by brokers and dealers highlight the need for enhancements to the rules governing broker and dealer custody of customer assets, including increased focus on compliance and internal compliance controls by brokers and dealers and their auditors.⁵⁹ The attestation standards include requirements related to the auditor's consideration of fraud risks, including the risk of misappropriation of customer assets. The new standard includes requirements for testing controls of the broker or dealer for safeguarding customer assets and funds and for performing procedures to obtain evidence about the existence of customer funds and securities held for customers.

Furthermore, PCAOB inspections staff in their inspections of broker and dealer audits have identified auditing deficiencies in 57 of 60 audits that were conducted under GAAS and the prior SEC Rule 17a-5.⁶⁰ The attestation standards – tailored for the new audit and reporting requirements under SEC Rule 17a-5 – establish an approach specific to examining compliance

⁵⁸ Consistent with SEC Rule 17a-5, the examination standard defines "Internal Control Over Compliance" as "internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with the [financial responsibility rules], will be prevented or detected on a timely basis." See paragraph (d)(3)(ii) of SEC Rule 17a-5.

⁵⁹ See the SEC Release at 206–207.

⁶⁰ See Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers, PCAOB Release No. 2013-006 (August 19, 2013) at 6.

reports and reviewing exemption reports that should provide greater clarity as to the procedures that should be used and facilitate consistent compliance for auditors of SEC registered brokers and dealers.

The financial responsibility rules serve an important investor protection function by requiring brokers and dealers to maintain minimum levels of net capital and take steps to safeguard customer securities and cash.⁶¹ As described in the SEC Release, the new requirements for engagement of accountants should result in higher levels of compliance with the financial responsibility rules by increasing the focus of carrying brokers and dealers and their independent public accountants on specific statements made in compliance reports and increasing the focus of non-carrying brokers and dealers and their independent public accountants regarding whether the broker or dealer meets applicable exemption provisions.⁶² Moreover, in the Board's view, the involvement of auditors, under the attestation standards and PCAOB oversight, should enhance the quality of the compliance information provided to the SEC and used in its regulatory oversight, which is important to the protection of investors who entrust their cash and securities with brokers and dealers.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Sarbanes-Oxley Act.

B. Board's Statement on Burden on Competition

Not applicable.

C. Board's Statement on Comments on the Proposed Rules Received from Members, Participants or Others

⁶¹ See the SEC Release at 255.

⁶² See the SEC Release at 238.

The Board released the proposed rule amendment for public comment in PCAOB Release 2011-004 (July 12, 2011). The Board received eleven written comment letters. The Board has carefully considered all comments received. The Board's response to the comments it received and the changes made to the rules in response to the comments received are discussed below.

Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers

As discussed more fully below, the examination standard has been designed specifically for an auditor's examination of certain statements made by a broker or dealer in a compliance report required by SEC Rule 17a-5. As a result of amendments to SEC Rule 17a-5, certain brokers and dealers (e.g., those that maintain custody of customer funds) must file a compliance report with the Commission making statements regarding compliance with and controls over certain financial responsibility rules.⁶³ Specifically, SEC Rule 17a-5 also requires the broker or dealer to engage an independent public accountant registered with the PCAOB to examine, and independently report on, certain statements made by the broker or dealer in the compliance report.⁶⁴

According to the Commission, the amendments to SEC Rule 17a-5 strengthen audit requirements for brokers and dealers as well as provide additional safeguards with respect to brokers' and dealers' custody of customers' assets.⁶⁵ Previously, audits of brokers and dealers

⁶³ The examination standard and the SEC Release use the term "financial responsibility rules" to refer to 17 CFR § 240.15c3-1 ("SEC Rule 15c3-1" or the "net capital rule"); 17 CFR § 240.15c3-3 ("SEC Rule 15c3-3"); and 17 CFR § 240.17a-13 ("SEC Rule 17a-13"); and any rule of the designated examining authority ("DEA") of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer (an "account statement rule"). See the SEC Release at 8-9.

⁶⁴ See paragraph (g)(2)(i) of SEC Rule 17a-5.

⁶⁵ See generally the SEC Release at 206-209.

were subject to generally accepted auditing standards ("GAAS") established by the American Institute of Certified Public Accountants ("AICPA"). The examination standard the Board is adopting has been designed to align with the requirements of SEC Rule 17a-5. The examination standard includes specific procedures for auditors performing examinations of certain statements required in a compliance report prepared by brokers and dealers as required under SEC Rule 17a-5. In the Board's view, this approach is consistent with the objectives of SEC oversight and is warranted in view of the importance of brokers' and dealers' compliance with the financial responsibility rules and to the protection of investors. In developing the standard, the Board has emphasized coordination with the financial statement audit and audit procedures performed on supplemental information. This approach should enhance overall audit effectiveness and also help avoid unnecessary duplication of work.

The following discussion provides background regarding the attestation standards, including significant comments received on the proposed standards and changes made to the standards.

SEC Rule 17a-5 and Related Changes

SEC Rule 17a-5 requires a broker's or dealer's compliance report to include the following statements by the broker or dealer as to whether:⁶⁶

- a. The Internal Control Over Compliance of the broker or dealer was effective during the most recent fiscal year;
- b. The Internal Control Over Compliance of the broker or dealer was effective as of the end of the most recent fiscal year;

⁶⁶ See paragraph (d)(3)(i)(A) of SEC Rule 17a-5. SEC Rule 17a-5 also requires the compliance report to contain a statement as to whether the broker or dealer has established and maintained Internal Control Over Compliance. However, the auditor is not required by SEC Rule 17a-5 to examine and report on that statement.

- c. The broker or dealer was in compliance with the net capital rule and 17 CFR § 240.15c3-3(e) (the "reserve requirements rule") as of the end of the most recent fiscal year; and
- d. The information the broker or dealer used to state whether it was in compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer.

As noted above, SEC Rule 17a-5 also requires the broker or dealer to engage an independent public accountant registered with the PCAOB to examine, and independently report on, certain statements made by a broker or dealer in the compliance report. Neither the SEC Rule nor the examination standard require the auditor to opine on the broker's or dealer's process for arriving at the conclusions in the statements made in the compliance report.⁶⁷ Thus, the auditor need not opine on the evaluation procedures that a broker or dealer may have performed in order to make the statements in the compliance report.

As amended by the Commission, SEC Rule 17a-5 includes modifications from the SEC's proposed amendments,⁶⁸ including changes that are reflected in the examination standard. Amendments made to SEC Rule 17a-5 included narrowing the scope of the compliance assertion,⁶⁹ eliminating the concepts of "material non-compliance" and "compliance in all

⁶⁷ See the SEC Release at 38 and the second note to paragraph 5 of the examination standard.

⁶⁸ See SEC Exchange Act Release No. 34-64676, Broker-Dealer Reports (June 15, 2011), 76 Federal Register 37572 (June 27, 2011) ("SEC Proposing Release").

⁶⁹ These standards use the term "assertion" to refer to the broker's or dealer's statements that are covered by the examination and review. In the examination standard, the term "assertion" also distinguishes the portion of the statements in the broker's or dealer's compliance report that are covered by the examination.

material respects;" and requiring the auditor to opine on Internal Control Over Compliance as of the end of the fiscal year, as well as during the fiscal year.⁷⁰

The Commission's narrowing of the scope of the compliance assertion and changes to the evaluation of Internal Control Over Compliance affected the scope of the examination procedures required to be performed by the auditor and the auditor's report, and therefore resulted in conforming changes to the final examination standard. These and other modifications to the examination standard are discussed further below.

Changes to the Examination Standard to Align with SEC Rule 17a-5

The proposed examination standard was designed specifically for the examination of the compliance report required by the proposed amendments to SEC Rule 17a-5. As noted earlier, the examination standard reflects conforming changes based on the Commission's revision of its amendments to SEC Rule 17a-5 in the following areas: narrowing the scope of the compliance assertion; eliminating the concepts of "material non-compliance" and "compliance in all material respects;" and requiring the auditor to opine on Internal Control Over Compliance as of the end of the fiscal year, as well as during the fiscal year.

Changes to the Scope of the Compliance Assertion

The SEC's Adopting Release states:

[T]he final rule [SEC Rule 17a-5] requires a statement as to whether the broker-dealer was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 as

⁷⁰ See paragraph (d)(3)(ii) of SEC Rule 17a-5, which states that the term "Internal Control Over Compliance" means internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with §§ 240.15c3-1, 240.15c3-3, 240.17a-13, or 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 will be prevented or detected on a timely basis.

of the end of the most recent fiscal year and, if applicable, a description of any instances of non-compliance with these rules as of the fiscal year end. This is a modification from the proposed assertion that the broker-dealer is in compliance with the financial responsibility rules in all material respects and proposed description of any material non-compliance with the financial responsibility rules. Thus, the final rule reflects two changes from the proposal: (1) elimination of the concepts of "material non-compliance" and "compliance in all material respects" for the purposes of reporting in the compliance report; and (2) a narrowing of these statements and requirements from compliance with all of the financial responsibility rules to compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3.⁷¹

The narrowing of the scope of the broker's or dealer's assertion to include only compliance with the net capital rule and reserve requirements rule resulted in several changes to the performance and reporting requirements in the examination standard. As the final rule limits the broker's or dealer's assertion regarding compliance to SEC Rule 15c3-1 and paragraph (e) of SEC Rule 15c3-3, the examination standard requires tests of compliance tailored to compliance with the net capital rule and the reserve requirements rule.

Because the broker's or dealer's assertion relates to compliance with the net capital rule rather than compliance "in all material respects," the concept of material non-compliance has been removed from the provisions of the examination standard regarding testing compliance. Also, the auditor cannot opine that a broker's or dealer's assertion that it is in compliance with the net capital rule and reserve requirements rule is fairly stated, in all material respects, if one or

⁷¹ See the SEC Release at 32.

more instances of non-compliance with either the net capital rule or reserve requirements rule exist as of the end of the most recent fiscal year.

Materiality Considerations

As discussed previously, the SEC's elimination of the concepts of "material non-compliance" and "compliance in all material respects" from the provisions of SEC Rule 17a-5 related to asserting compliance has been carried over to the examination standard, which no longer refers to "material non-compliance" or the "risk of material non-compliance." However, most of the procedures set forth in the proposal for assessing the risks of material non-compliance have been retained in paragraph 9 of the examination standard as planning procedures because they remain relevant for determining the necessary nature, timing, and extent of procedures to be performed in the examination.

Also, consistent with SEC Rule 17a-5, the examination standard retains the concept of a Material Weakness in Internal Control Over Compliance, and the requirements regarding performing procedures to determine whether Material Weaknesses exist in Internal Control Over Compliance.

The concept of materiality also remains relevant when evaluating whether the information the broker or dealer used to assert compliance with the net capital rule and reserve requirements rule is derived from the broker's or dealer's books and records, is fairly stated, in all material respects.

The Board received a number of comments on the proposed examination standard that are no longer applicable given the narrowing of the scope of the compliance assertion. These comments included requests for additional guidance related to the determination of material non-compliance and requests for specific examples regarding the consideration of qualitative and

quantitative factors in the context of each of the rules included in the compliance assertion, as well as matters within each of those rules that the PCAOB considers to be most significant to compliance.

Evaluating Internal Control Over Compliance During the Fiscal Year and as of the End of the Fiscal Year

The SEC Release states that SEC Rule 17a-5 requires that the compliance report contain, among other things, statements as to whether (1) the broker or dealer has established and maintained Internal Control Over Compliance, (2) the Internal Control Over Compliance of the broker or dealer was effective during the most recent fiscal year, and (3) the Internal Control Over Compliance of the broker or dealer was effective as of the end of the most recent fiscal year.⁷²

To align with SEC Rule 17a-5, the examination standard requires the auditor to express an opinion regarding whether the specified assertions made by the broker or dealer in its compliance report are fairly stated, in all material respects, including whether the broker's or dealer's Internal Control Over Compliance was effective during and as of the end of the most recent fiscal year. This change from the proposed SEC Rule 17a-5 resulted in conforming changes to the examination standard relating to the requirements for testing controls and the scope of the examination report. For example, the examination standard addresses the effect of changes in controls on the auditor's testing.

Further, Appendix A to the examination standard defines certain terms used in the examination standard, including "Internal Control Over Compliance," "Deficiency in Internal Control Over Compliance," and "Material Weakness." The definitions of these terms in the examination standard are consistent with the definitions of these terms in SEC Rule 17a-5.

⁷² See the SEC Release at 29–30.

Performing the Examination Engagement (Paragraphs 6 – 33 of Attestation Standard No. 1)General Requirements (Paragraphs 6 – 7 of Attestation Standard No. 1)

The examination standard retains the general requirements as proposed. These requirements are consistent with AT sec. 101, Attest Engagements. Briefly, paragraph 6 of the examination standard sets forth general requirements for an auditor performing an engagement pursuant to the examination standard. Paragraph 6 requires that an auditor: have adequate technical proficiency in attestation engagements; obtain an understanding of the financial responsibility rules and other rules and regulations that are relevant to the broker's or dealer's assertions; determine the auditor's compliance with independence and ethics requirements;⁷³ and exercise due professional care.

Some commenters stated that the general requirements in the examination engagement were sufficiently clear as proposed. One commenter recommended that the examination standard specify the level of understanding of the financial responsibility rules that auditors are expected to have. The commenter also recommended deleting the reference to "other rules and regulations that are relevant to the broker's or dealer's assertions," asserting that the requirement is too broad to allow auditors to identify suitable criteria and express an opinion on management's assertion. Additionally, that commenter recommended that the examination standard specify how the auditor's understanding of the financial responsibility rules should be documented.

The requirement for the auditor to obtain an understanding of the financial responsibility rules is similar to an existing requirement in AT sec. 101, which includes a requirement for the

⁷³ Determining the auditor's compliance with independence and ethics requirements includes determining that the auditor complied with relevant requirements of the PCAOB and the SEC. Paragraph (f)(1) of SEC Rule 17a-5 requires the auditor to be independent in accordance with 17 CFR § 210.2-01.

engagement to be performed by an auditor "having adequate knowledge of the subject matter."⁷⁴ In addition, understanding the requirements in other rules and regulations is important to enable the auditor to form conclusions on the broker's or dealer's assertions, as well as aiding the auditor's own compliance with the requirements in the examination standard and SEC Rule 17a-5. For example, paragraph (h) of SEC Rule 17a-5 requires a broker or dealer to provide notification to the Commission and other securities regulators when the auditor notifies the broker or dealer that the auditor has determined that the broker or dealer is not in compliance with SEC Rule 15c3-1 as required by SEC Rule 17a-11, Notification Provisions for Brokers and Dealers. In addition to the financial responsibility rules, it is of course important that the auditor understands the requirements of SEC Rule 17a-5, including the notification requirements when an instance of non-compliance is identified. As such, the requirement was retained substantially as proposed.

With respect to documentation, the attestation engagements are subject to the requirements of Auditing Standard No. 3, Audit Documentation, which applies to engagements conducted pursuant to the standards of the PCAOB. Auditing Standard No. 3 states that as audit documentation is the written record that provides the support for the representations in the auditor's report, it should demonstrate that the engagement complied with the standards of the PCAOB.⁷⁵ Further, as there are potentially a variety of ways for the auditor to document their understanding of the financial responsibility rules and other rules and regulations, the examination standard does not prescribe any specific manner to do so. A note has been added to

⁷⁴ See AT sec. 101.21.

⁷⁵ See paragraph 4 of Auditing Standard No. 3.

paragraph 6 of the examination standard to remind auditors of their responsibility to comply with Auditing Standard No. 3.

The proposed examination standard included a footnote which stated that "due professional care" referred to in that paragraph was the same term in paragraph .40 of AT sec. 101. One commenter stated that while the commenter did not disagree with the meaning of "due professional care," referencing AT sec. 101 from the examination standard may be confusing, especially as AT sec. 101 would not be applicable to engagements in which the examination standard is applicable. In the examination standard, a note has been added to state that due professional care imposes a responsibility on each engagement team member to comply with the examination standard and that the exercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report. A footnote to that note states that the auditor's responsibility to exercise due professional care is consistent with the description in paragraphs .40–.41 of AT sec. 101.

The Board did not receive other significant comments on the general requirements of the proposed examination standard. As such, the general requirements are being adopted substantially as proposed.

Relationship Between the Examination Engagement and the Audit of the Financial Statements and Audit Procedures Performed on Supplemental Information (Paragraph 8 of Attestation Standard No. 1)

By its terms, SEC Rule 17a-5 requires the financial statement audit and the compliance examination to be performed by the same auditor.⁷⁶ Accordingly, the examination standard includes a requirement for the auditor to coordinate the examination engagement with the audit

⁷⁶ See paragraph (g) of SEC Rule 17a-5.

of the financial statements and the audit procedures performed on supplemental information. The emphasis on appropriately coordinating the examination engagement with the audit of the financial statements and the audit procedures performed on supplemental information should promote overall audit effectiveness and avoid redundancy in the auditor's work.

For example, the examination standard includes a requirement for the auditor to take into account evidence from the audit of the financial statements in planning and performing procedures for the examination engagement and in evaluating the results of the procedures performed in the examination. This enables the auditor to plan, perform, and evaluate the results of the examination engagement concurrent with the audit of the financial statements because the examination standard is structured similarly to, and contains many of the same concepts included in, auditing standards related to the auditor's assessment of and response to risk.⁷⁷

The proposing release requested comments on other ways the Board could promote coordination of the examination engagement with the audit of the financial statements and the audit procedures performed on supplemental information. Commenters generally stated that requirements regarding the coordination of the examination engagement with the audit of the financial statements were appropriate.

One commenter stated that the Board should require the auditor of the financial statements to perform the examination engagement and issue the examination report. As noted previously, SEC Rule 17a-5 includes this requirement.⁷⁸ Thus, the attestation standards do not include specific requirements for performing the examination or review if the auditor did not audit the financial statements.

⁷⁷ See generally, Auditing Standards Nos. 8–15.

⁷⁸ See paragraph (g) of SEC Rule 17a-5.

Another commenter stated that it is inappropriate to require that the auditor plan and perform the work to meet the objectives of both the examination engagement and the financial statement audit, and that the auditor's obligation under the examination standard is to meet the objectives of the examination engagement. The language in the standard was retained as proposed. The auditor should plan and perform the work to meet the objectives of both the examination engagement as well as the financial statement audit. Existing auditing standards require the auditor to properly plan and perform the financial statement audit.⁷⁹ Since the objectives are not identical, the auditor must plan and perform the work to achieve the objectives of both engagements. Further, the examination standard does require the auditor to take into account the evidence obtained and the results of procedures performed during the audit of the financial statements and the audit procedures performed on the supplemental information in planning and performing procedures for the examination engagement and in evaluating the results of the procedures performed in the examination engagement.

Consideration of Fraud (Paragraph 10 of Attestation Standard No. 1)

The auditor's consideration of fraud is an important part of the examination engagement. Fraud risks particularly relevant to a broker's or dealer's non-compliance with the financial responsibility rules include the risk of misappropriation of customer funds or securities held for customers and intentional manipulation of the books and records to conceal material misappropriations or other non-compliance. The SEC Release notes that the amendments to SEC Rule 17a-5, which include requiring the examination and review engagements, are designed to

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See Auditing Standard No. 9, Audit Planning.

provide additional safeguards with respect to broker and dealer custody of customer securities and funds.⁸⁰

Paragraph 10 of the examination standard includes a requirement for the auditor to assess the risk of fraud, and specifically refers to the risk of misappropriation of customer assets, which is relevant to compliance with the net capital rule and the reserve requirements rule, as well as the broker's or dealer's Internal Control Over Compliance.

The requirement to coordinate the examination engagement with the audit of the financial statements and audit procedures performed on supplemental information is also important for the proper assessment of fraud risk in the examination engagement. The auditor's assessment of fraud risk in the examination engagement will be informed to a substantial degree by the procedures performed and the fraud risk assessments in the audit of the financial statements and audit procedures performed on supplemental information. Many of the fraud risk factors identified in the financial statement audit regarding (1) incentives or pressures to misappropriate assets or commit fraudulent financial reporting, and (2) attitudes and rationalizations that justify such fraudulent actions,⁸¹ are relevant when identifying and assessing risks of misappropriation of customer assets or intentional manipulation of the books and records to conceal misappropriation of customer assets or non-compliance with the financial responsibility rules. Also, weaknesses in controls regarding safeguarding of assets or stock records can result in opportunities for misappropriation of customer assets or non-compliance. In addition, the evaluation of misstatements for indications of fraud or matters identified during the audit that

⁸⁰ See the SEC Release at 206.

⁸¹ See paragraphs 65–66 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and paragraph 85 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

might affect the assessment of fraud risks in the audit of the financial statements also might affect the assessment of fraud risks in the examination engagement.⁸²

Paragraph 9.d. of the examination standard includes a requirement for the auditor to assess the risks associated with related parties, including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship, that are relevant to compliance and controls over compliance. Given the nature of the transactions with related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship, they are particularly relevant to the auditor's consideration of the risks associated with related parties in the examination engagement and in considering both the broker's or dealer's assertions related to Internal Control Over Compliance, as well as to the broker's or dealer's assertion related to compliance with the net capital rule and the reserve requirements rule.

Likewise, paragraph 9.j. of the examination standard includes a requirement for the auditor to obtain an understanding of the nature and frequency of customer complaints that are relevant to compliance with the financial responsibility rules, which can provide evidence relevant to the assessment of fraud risks, especially if there is a high incidence of customer complaints, thematic issues in the complaints that indicate the potential for misappropriation of customer assets, or specific allegations of fraud or misfeasance by the broker's or dealer's customers.

Other paragraphs in the examination standard address the auditor's responsibilities for responding to fraud risks. For example, paragraph 22 of the examination standard retains an important requirement from the proposed examination standard for the auditor to perform

⁸² See paragraphs 19–22, 28–29 and Appendix C of Auditing Standard No. 14, Evaluating Audit Results.

compliance tests that are responsive to risks, including fraud risks. Also, paragraph 23 of the examination standard retains from the proposal the requirement for the auditor to perform procedures to obtain evidence about the existence of customer funds or securities held for customers. This is an important responsibility in an audit of a broker or dealer that has access to customer assets. It affects compliance with the net capital rule and the reserve requirements rule, and it has the potential to result in contingent liability to the broker or dealer that requires recognition or disclosure in the financial statements.

Because the examination standard requires the auditor to perform tests that are responsive to fraud risks, the nature, timing, and extent of procedures to obtain evidence about the existence of assets held for customers should be commensurate with the risk of misappropriation of customer assets. Determining the necessary procedures involves considering relevant risk factors, including, but not limited to, the amount of cash and securities held for customers and the results of testing and evaluation of the relevant controls. Examples of procedures that provide evidence about the existence of customer assets include (1) counting customer securities or observing and testing the broker's or dealer's procedures for physical inspection and (2) confirming customer security positions directly with depositories and clearing organizations. Procedures performed in the audit of the financial statements and the audit procedures performed on supplemental information to test the existence of assets held for customers also provide relevant evidence in the examination engagement.

The Board requested comment regarding whether specific requirements should be added to either of the proposed attestation standards to further enhance protection of customer assets. One commenter stated that generally the attestation standards are adequate to enhance protection

of customer assets. Another commenter stated that the principles in the examination standard for performing compliance tests are sufficiently clear.

One commenter recommended that the Board clarify the extent and timing of procedures included as examples in paragraph 26 of the proposed examination standard regarding procedures that provide evidence about the existence of customer assets. The examination standard requires the auditor to perform procedures to obtain evidence of customer funds or securities held for customers, but the standard does not prescribe specific procedures for the auditor to perform to obtain such evidence. The procedures included in the note to paragraph 23 of the examination standard are examples of procedures that the auditor might perform to obtain such evidence. The necessary extent and timing of those procedures depends on, among other things, the complexity of the operations of the broker's or dealer's business, the nature of carrying and clearing arrangements, and the design and effectiveness of controls related to the existence assertion. As such, the examination standard has not been changed to reflect this comment.

Testing Controls over Compliance (Paragraphs 11 – 20 of Attestation Standard No. 1)

SEC Rule 17a-5 requires the broker's or dealer's compliance report to include an assertion regarding the effectiveness of Internal Control Over Compliance during the most recent fiscal year and as of the end of the fiscal year.⁸³ Accordingly, the examination standard requires the auditor to obtain evidence about the design and operating effectiveness of relevant controls over compliance throughout the fiscal year and as of the end of the fiscal year.

The examination standard requires the auditor to test those controls that are important to the auditor's conclusion about whether the broker or dealer maintained effective Internal Control

⁸³ See paragraphs (d)(3)(i)(A)(2) and (3) of SEC Rule 17a-5, which requires the broker or dealer to assert on the effectiveness of its Internal Control Over Compliance with the financial responsibility rules throughout the fiscal year and as of the end of the most recent fiscal year.

Over Compliance for each financial responsibility rule during the fiscal year and as of the end of the fiscal year. The examination standard also requires the auditor to obtain evidence that the controls over compliance selected for testing are designed effectively and operated effectively during the fiscal year and as of the fiscal year end.⁸⁴

As the broker's or dealer's assertion regarding Internal Control Over Compliance relates to each financial responsibility rule individually, the auditor should obtain evidence about the effectiveness of the selected controls for each financial responsibility rule. However, when testing controls over compliance, the auditor's objective is not to support an opinion about the effectiveness of each individual control, rather, the objective is to form an opinion about whether the broker's or dealer's assertions regarding Internal Control Over Compliance are fairly stated, in all material respects. This allows the auditor to focus his or her effort on the controls that are important to each of the financial responsibility rules and to vary the level of evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

One commenter recommended that the examination standard include guidance regarding the identification of controls important to the auditor's conclusion about whether the broker or dealer maintained effective internal controls over compliance for each financial responsibility rule. As the financial responsibility rules outline the requirements necessary to be in compliance, the auditor can identify the controls for testing by understanding the controls the broker or dealer has implemented to assure compliance with the respective requirements.

⁸⁴ See paragraphs (d)(3)(i)(A)(2) and (3) of SEC Rule 17a-5, which requires the broker or dealer to assert on the effectiveness of its Internal Control Over Compliance throughout the fiscal year and as of the broker's or dealer's fiscal year end. See also paragraphs (d)(3)(i)(B) and (C) of SEC Rule 17a-5, which require the broker or dealer to describe each material weakness in Internal Control Over Compliance and any instance of non-compliance with the net capital rule or reserve requirements rule.

Additionally, the examination standard identifies certain factors that affect the risk associated with a control. One factor included in paragraph 13 is the broker's or dealer's history of instances of non-compliance with the financial responsibilities rules that the control is intended to prevent or detect. A recent history of non-compliance generally indicates higher risk associated with the control. Factors that affect the risk associated with a control include, but are not limited to, those described in paragraph 13 of the examination standard.

Another factor included in paragraph 13 includes the extent of use of part-time personnel. Some commenters stated that they did not agree that the use of part-time personnel is a factor that affects the risk associated with a control. Those commenters stated that this risk factor is incorporated in another risk factor regarding the competence of the personnel who perform the control or monitor its performance. One commenter stated that, in their opinion, it would be more appropriate to evaluate the competence and objectivity of personnel executing the controls and their knowledge of the financial responsibility rules.

In considering these comments, the Board took into account the SEC's June 2007 compliance alert,⁸⁵ which noted that SEC examinations found that many part-time financial and operational principals did not actually supervise or create and maintain various books and records. In light of risks illustrated in the SEC compliance alert, the use of part-time personnel has been retained in the examination standard as a risk factor for the auditor to consider when testing internal controls over compliance. The auditor's understanding of the role and responsibilities of the part-time personnel is important to evaluating the associated risks.

Paragraphs 14–18 of the examination standard provide requirements for the auditor to test the design and operating effectiveness of the selected controls over compliance. These

⁸⁵ See Compliance Alert, June 2007, available at <http://www.sec.gov/about/offices/ocie/complialert.htm>.

requirements for testing design and operating effectiveness of controls over compliance are analogous to the requirements for testing controls in Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement.

Under the examination standard, the auditor should obtain evidence about the effectiveness of controls each year. Similar to testing controls in a financial statement audit, the examination standard provides factors for the auditor to take into account if the auditor plans to use evidence obtained in prior years in determining the extent of testing in the current year.

One commenter recommended that paragraph 16 of the proposed examination standard, which stated "[a]s the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases," be replaced with paragraph 18 of Auditing Standard No. 13, which states that [t]he auditor should obtain more persuasive audit evidence. . . ." The suggested revision is consistent with the intent of the requirement, so it has been included in paragraph 12 of the examination standard. This change will focus the auditor on the persuasiveness of audit evidence, rather than quantity, and avoid unnecessary differences between the examination standard and the auditing standards. Similar changes are reflected in paragraphs 22 and 24 of the examination standard.

Paragraphs 19 and 20 of the examination standard describe the auditor's use of evidence obtained in past examination engagements and using tests of controls that are modified during the year. One commenter suggested that as changes to controls occur throughout the period, the examination standard should require the auditor to determine with management what types of changes could materially affect control effectiveness. That commenter stated that the auditor should then test and evaluate management's documentation of the changes to controls and perform procedures to test the broker's or dealer's implementation of that change. SEC Rule 17a-

5 requires that the broker or dealer assert that its controls were effective during the most recent fiscal year. As stated in the examination standard, to evaluate controls over compliance throughout the period, the auditor should obtain evidence regarding the design effectiveness of the selected controls before and after the change. Further, the examination standard also requires that, if a broker or dealer makes changes to its policies and procedures or key personnel during the fiscal year, the auditor should obtain an understanding of the reason for the change and obtain evidence regarding the design and operating effectiveness of the superseded and new controls before and after the change.

One commenter stated that the phrase within paragraph 20 of the proposed examination standard which stated, "whether each control is operating as designed" might be confusing and recommended revising the paragraph to state "each control selected for testing." The suggested revision is consistent with the intent of the requirement, so it has been included in paragraph 16 of the examination standard.

Performing Compliance Tests (Paragraphs 21 – 24 of Attestation Standard No. 1)

Paragraphs 21–24 set forth requirements for performing tests of compliance with the net capital rule and reserve requirements rule.

With respect to compliance tests, the auditor's objective is to form a conclusion about whether the broker's or dealer's assertion regarding compliance with the net capital rule and the reserve requirements rule is fairly stated, in all material respects. To satisfy this objective, the examination standard requires the auditor to perform procedures that are sufficient to support the auditor's conclusions regarding whether the broker or dealer was in compliance with the net capital rule and reserve requirements rule as of the end of its most recent fiscal year.

The examination standard requires the auditor to perform specific procedures on the schedules the broker or dealer used to determine compliance with the net capital rule and the reserve requirements rule as of the end of its fiscal year, including:

- a. Evaluating whether the amounts in the schedule were determined in accordance with the net capital rule or reserve requirements rule, as applicable;
- b. Testing the accuracy and completeness of the information in the schedule;
- c. Determining whether the broker or dealer maintained the required level of net capital in accordance with the net capital rule;
- d. Determining whether the broker or dealer maintained a special reserve bank account for the exclusive benefit of customers and deposited funds in at least the required amount in accordance with the reserve requirements rule;
- e. Determining whether the information in the schedule was derived from the books and records of the broker or dealer; and
- f. Determining whether the broker or dealer made the notifications, if any, required by the net capital rule and reserve requirements rule as of the end of the most recent fiscal year.

Paragraph 21.e. of the examination standard requires the auditor to perform procedures to determine whether the information used to assert compliance with the net capital rule and the reserve requirements rule was derived from the broker's or dealer's books and records. Proper coordination of these procedures with the audit of the financial statements and audit procedures performed on supplemental information should allow the auditor to avoid redundancy in the auditor's work and increase the effectiveness of the procedures performed. For example, Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial

Statements, includes a requirement for the auditor to determine that the supplemental information reconciles to the underlying accounting and other records or to the financial statements themselves, as applicable. Such supplemental information includes the supporting schedules that brokers or dealers are required to include in their financial reports pursuant to SEC Rule 17a-5.⁸⁶

To test compliance pursuant to paragraph 21, the auditor will need to design his or her procedures to test the provisions of the net capital rule and reserve requirements rule that have a bearing on the broker's or dealer's compliance with that rule. For example, the current requirements in the net capital rule generally include:

- a. The requirement to maintain minimum net capital and tentative net capital, as applicable, at all times.⁸⁷
- b. The requirement for certain brokers or dealers not to let a specified amount of certain accounts it carries exceed a specified threshold for more than five business days.⁸⁸
- c. The requirement for brokers or dealers carrying accounts of listed options specialists not to let the amount of certain deductions required under Appendix A of the net capital rule to exceed a specified threshold for more than three business days.⁸⁹
- d. The notification requirement relating to paragraph (c)(2)(x)(C) of the net capital

⁸⁶ See paragraph (d)(2) of SEC Rule 17a-5.

⁸⁷ See paragraph (a) of 17 CFR § 240.15c3-1.

⁸⁸ See paragraph (a)(6)(v) of 17 CFR § 240.15c3-1.

⁸⁹ See paragraph (c)(2)(x)(C) of 17 CFR § 240.15c3-1.

rule.⁹⁰

- e. The requirement for brokers or dealers carrying accounts of listed options specialists to liquidate accounts when a liquidating deficit exists which includes a notice requirement.⁹¹
- f. The requirement that the total of outstanding principal amounts of satisfactory subordination agreements cannot exceed 70% of the broker's or dealer's debt-equity total for a period in excess of 90 days.⁹²
- g. The notification requirements relating to withdrawals of equity capital.⁹³
- h. The limitations on withdrawal of equity capital.⁹⁴
- i. The requirements regarding temporary restrictions on net capital withdrawals.⁹⁵

Other provisions of the rule also may apply depending on the particular activities or elections of the broker or dealer. Auditors should look to the requirements of the individual rules in order to test compliance.⁹⁶

The requirements for testing compliance with the net capital rule and the reserve requirements rule should facilitate the coordination of the examination engagement and the audit

⁹⁰ See paragraph (c)(2)(x)(C)(1) of 17 CFR § 240.15c3-1.

⁹¹ See paragraph (c)(2)(x)(D) of 17 CFR § 240.15c3-1.

⁹² See paragraph (d) of 17 CFR § 240.15c3-1.

⁹³ See paragraph (e)(1) of 17 CFR § 240.15c3-1.

⁹⁴ See paragraph (e)(2) of 17 CFR § 240.15c3-1.

⁹⁵ See paragraph (e)(3) of 17 CFR § 240.15c3-1.

⁹⁶ See paragraph 6.b. of the examination standard, which requires the auditor to obtain an understanding of the financial responsibility rules and other rules and regulations that are relevant to the broker's or dealer's assertions.

procedures performed on supplemental information. The compliance procedures, if properly planned and performed, should provide substantial evidence to satisfy the requirements of Auditing Standard No. 17.

As discussed earlier, in view of the amendments to SEC Rule 17a-5 adopted by the Commission, the examination standard was revised to more closely align the auditor's performance requirements with the scope of the compliance assertion in SEC Rule 17a-5. It is appropriate to include specific procedures the auditor should perform on the schedules the broker or dealer used to determine compliance with the net capital rule and the reserve requirements rule as of the end of its fiscal year.

In addition to those procedures that the auditor would perform on the broker's or dealer's schedules when planning and performing compliance tests, the auditor should take into account the evidence obtained from procedures performed as part of the audit of the financial statements and the audit procedures performed on supplemental information. For example, certain audit procedures performed to test the valuation and classification of the broker's or dealer's investments as of the end of the fiscal year may provide relevant evidence regarding the broker's or dealer's compliance with the net capital rule. Further, when testing the broker's or dealer's cash and cash equivalents, certain audit procedures may provide evidence regarding the existence of special reserve bank accounts for the exclusive benefit of customers, as well as evidence about the deposits to, and withdrawals from, those bank accounts. Such evidence may be relevant to the broker's or dealer's compliance with the reserve requirements rule. However, as the objectives of the audit and the examination engagement are not the same, the auditor must plan and perform the work to meet the objectives of both engagements.

Evaluating the Results of the Examination Procedures (Paragraphs 25 – 29 of Attestation Standard No. 1)

Paragraph 25 of the examination standard states that in forming an opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects, the auditor should evaluate all evidence obtained, regardless of whether the evidence corroborates or contradicts the broker's or dealer's assertions. Paragraph 26 of the examination standard provides that the auditor should evaluate: (1) identified instances of non-compliance⁹⁷ with the net capital rule and reserve requirements rule, to determine whether any instances of non-compliance existed as of the end of the most recent fiscal year; (2) identified instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived from the broker's or dealer's books and records to determine whether they are material, individually or in combination; and (3) identified Deficiencies in Internal Control Over Compliance to determine whether the deficiencies, individually or in combination, are Material Weaknesses. Identified instances of non-compliance might be an indication of a Deficiency in Internal Control Over Compliance.

The auditor's evaluation of the materiality of instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived from the broker's or dealer's books and records is based on relevant quantitative and qualitative factors, including, in particular, the importance of the information not derived from the books and records to the broker's or dealer's compliance with the corresponding requirement in the net capital rule or the reserve requirements rule. For example, when a broker or dealer asserts that

⁹⁷ In evaluating the results of compliance testing, an error in a broker's or dealer's computation used to determine compliance with a provision of the net capital rule or reserve requirements rule is not an instance of non-compliance if, after giving consideration to the effect of the error, the broker or dealer still met the requirements of that provision, e.g., maintained at least the required minimum level of net capital or at least the minimum level on deposit in the special reserve account. However, such an instance might be an indication of a Deficiency in Internal Control Over Compliance that requires evaluation pursuant to this standard.

the information used to state whether it was in compliance with the net capital rule was derived from its books and records, and the auditor identifies an amount not derived from a broker's or dealer's books and records, the broker or dealer may still be able to support its assertion that it maintained the required net capital using information that was derived from the books and records of the broker or dealer. However, such an instance might be an indication of a Deficiency in Internal Control Over Compliance.

Paragraph 28 of the examination standard applies when the auditor has not obtained sufficient appropriate evidence about an assertion or has substantial doubt about an assertion. Pursuant to paragraph 28, the auditor in those situations is required to perform additional procedures to address the matter. Performing the examination with due professional care requires an auditor conducting an examination to take appropriate actions when becoming aware of non-compliance or Material Weaknesses not included in the broker's or dealer's assertions or when substantial doubt remains. This requirement is similar to the requirement in paragraph 35 of Auditing Standard No. 14, which states that if the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter.

Obtaining a Representation Letter (Paragraphs 32 – 33 of Attestation Standard No. 1)

The examination standard includes a requirement for the auditor to obtain written representations from management of the broker or dealer. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the examination engagement. See Reporting on the Examination Engagement below for further discussion regarding scope limitations.

Overall, commenters were supportive of the requirement for the auditor to obtain representations from management and stated that obtaining representations from management is a necessary part of the auditor's ability to support the auditor's opinion. One commenter recommended that the auditor obtain a written representation from the broker or dealer that acknowledges the broker's or dealer's responsibility for the assertions in the compliance report. This recommendation has been incorporated into paragraph 32.b. of the examination standard.

Commenters suggested additional representations that the auditor should obtain from management during an examination engagement, including representations regarding management's responsibility for compliance with the financial responsibility rules, that management has performed an evaluation of compliance, that management did not use the auditor's procedures performed during the audit of the financial statements or procedures performed on supplemental information as part of the basis for management's assertions and that management has disclosed to the auditor all known instances of non-compliance and fraud. While many of these additional representations might be appropriate based on the facts and circumstances of the examination engagement, the examination standard was not modified to include them as they are either duplicative of management's assertions or not necessary to meet the requirements of the standard. However, the examination standard does not preclude the auditor from obtaining additional representations from management in situations in which the auditor believes additional representations are appropriate.

Communication Requirements (Paragraphs 34 – 35 of Attestation Standard No. 1)

The examination standard requires the auditor to communicate certain matters to management and the audit committee. These requirements reflect changes from the proposed communication requirements to conform to SEC Rule 17a-5. In addition, rather than defining the

term "audit committee," the examination standard states that the term "audit committee" has the same definition as that in Auditing Standard No. 16, Communication with Audit Committees.

One commenter stated that communication requirements in the proposed examination standard are sufficient. Another commenter requested that the Board clarify the meaning of "identified" as used in paragraph 36 of the proposed examination standard. That commenter questioned whether an "identified" instance of non-compliance referred to the moment the auditor becomes aware of its existence or only after the auditor concludes it represented a significant deficiency. The language in the standard was retained as proposed. In the context of the examination standard, the term "identified instance of non-compliance" is meant to clarify that the communication requirement applies to instances of non-compliance identified by the auditor.⁹⁸ A note has been included to paragraph 35 of the examination standard reminding auditors of their obligation to comply with the requirements of paragraph (h) of SEC Rule 17a-5. Reporting on the Examination Engagement (Paragraphs 36 – 38 of Attestation Standard No. 1)

The examination standard requires the auditor to issue a single report that expresses an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects, when expressing an unqualified opinion. Paragraph 36 of the standard includes basic report elements, while paragraph 37 includes an illustrative report.

The reporting requirements in the examination standard have been revised to align with the compliance report that is required by SEC Rule 17a-5. This includes reporting on the broker's or dealer's assertions regarding the effectiveness of Internal Control Over Compliance during and as of the end of the most recent fiscal year, compliance with the net capital rule and the reserve

⁹⁸ See also the discussion of the notification requirements in the SEC Release at 101-107.

requirements rule, and whether the information used to assert compliance with those rules was derived from the broker's or dealer's books and records.

Legal Determinations, Discussion of Inherent Limitation of the Examination, Discussion of Interpretations of Rules and Regulations, and Restrictions on the Use of the Examination Report

One commenter stated that the report clearly communicates the auditor's responsibilities. Other commenters suggested that the examination standard should address additional reporting matters, such as including a caveat about legal determinations, discussion of inherent limitations of the examination, discussion of interpretations of rules and regulations, and restrictions on the use of the examination report.

Legal Determinations

Some commenters stated that the auditor's examination report should be modified to include language indicating that the auditor's examination does not provide for a legal determination of a broker's or dealers compliance with financial responsibility rules. When the auditor is engaged to perform an examination, it is necessary for the auditor to read and make judgments regarding the application of the regulatory requirements, as applicable to the engagement. The auditor's report issued pursuant to the examination standard does not provide a legal determination, nor does it purport to provide a legal determination, of a broker's or dealer's compliance with the net capital rule or the reserve requirements rule. However, such a report may be useful to legal counsel or others in making such determinations. In the context of an examination, the auditor expresses an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects. Accordingly, the Board did not add the suggested language to the examination standard.

Inherent Limitations of the Examination

Some commenters stated that the examination report should be revised to include language discussing the inherent limitations of the examination, similar to language contained in other PCAOB auditing standards. Those commenters recommended including a statement similar to the statement contained in the audit report on internal control over financial reporting, which states that because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements.⁹⁹

The examination standard does not prescribe reporting language regarding the inherent limitations of the examination. Such language might be confusing to users who interpret such a statement as a limitation on the opinion expressed in the auditor's examination report, rather than the nature of internal controls over compliance. Also, an inherent limitation statement about internal control over financial reporting, which is management's responsibility and the subject of the audit, is different from a limitation statement about the auditor's examination itself.

Interpretations of Rules and Regulations

Several commenters stated that evaluating a broker's or dealer's compliance with regulatory requirements may be based upon interpretations of regulations or rules established by the Commission and/or DEAs. Commenters recommended that the examination standard permit the inclusion of a statement within the examination report stating the description and the source of interpretations made by the brokers and dealer's management. After considering these comments, a footnote has been added to paragraph 36.h. of the examination standard. The statement in the footnote is consistent with the existing requirements of paragraph .59 of AT sec. 601, Compliance Attestation, which allows the auditor to include a paragraph stating the

⁹⁹ Paragraph 85.j. of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

description and the source of interpretations made by the entity's management immediately after the scope paragraph of the auditor's report. The following is an example of such a paragraph:

We have been informed that, under X Broker's interpretation of [identify the compliance requirement, e.g. SEC Rule 15c3-1], [explain the source and nature of the relevant interpretation].

One commenter recommended that the auditor's examination report should include a statement that the assertions are the responsibility of the broker or dealer. The examination standard does not include this language because the first sentence in the auditor's examination report clarifies that the assertions are the responsibility of the broker or dealer.

Restriction of Use of the Examination Report

The proposed examination standard did not include provisions for restricting the use of the examination report to specified parties. Some commenters stated that audit firms previously have often restricted the use of reports required by SEC Rule 17a-5 to the board of directors, management, the Commission, and other regulatory agencies that rely on SEC Rule 17a-5. Some commenters stated that a restriction on the use of an auditor's examination or review report is appropriate, given that general users of these reports may not have a sufficient understanding of the subject matter to which they relate, such as the financial responsibility rules.

SEC Rule 17a-5 specifies the required reports, assertions, and the compliance requirements related to these engagements. The reports pursuant to this rule are generally filed only with the Commission, the broker's or dealer's DEA, and the Securities Investor Protection Corporation ("SIPC"). Accordingly, these criteria are suitable and available for purposes of these engagements.

As the reporting criteria have been established by the Commission and those reporting criteria are publicly available, including language restricting the auditor's examination report in the examination standard is unnecessary. As such, no additional language is included in the examination standard.

Examination Report Date (Paragraph 38 of Attestation Standard No. 1)

Under paragraph 38 of the examination standard, the auditor should date the examination report no earlier than the date on which the auditor obtains sufficient appropriate evidence to support his or her opinion. Because of the coordination between the examination engagement, the audit of the financial statements and the audit procedures performed on supplemental information, the date of the examination report should not be earlier than the date of the auditor's report on the financial statements and supplemental information. The Board did not receive comments on the proposed dating of the report. As such, these requirements are adopted as proposed.

Examination Report Modifications (Appendix C of Attestation Standard No. 1)

The examination standard includes an appendix ("Appendix C") that builds on existing concepts described in AT sec. 101 regarding report modifications and adapts them as appropriate to the requirements of the examination engagement.

Under the examination standard, if one or more instances of non-compliance with the net capital rule or the reserve requirements rule exist as of the end of the most recent fiscal year, one or more Material Weaknesses in Internal Control Over Compliance exist during or as of the end of the most recent fiscal year, or the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer, the auditor must express an adverse opinion directly on the

subject matter of the respective assertions, rather than on the assertions themselves, unless there is a restriction on the scope of the examination engagement.¹⁰⁰ For example, if the broker or dealer is not in compliance with the net capital rule, the auditor's report would include an adverse opinion on compliance and would identify the instance of non-compliance regardless of whether it was described in the broker's or dealer's compliance report.

This requirement is different from AT sec. 101, which states that "[r]eservations about the subject matter . . . can result in either a qualified or an adverse opinion, depending on the materiality of the departure from the criteria against which the subject matter . . . was evaluated."¹⁰¹ Qualified opinions are not appropriate because any instance of non-compliance as of the end of the fiscal year, any Material Weakness in Internal Control Over Compliance during or as of the end of the fiscal year, or any instance in which the information used to assert compliance with the net capital rule and the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records, is by definition material and, as such, must result in an adverse opinion.

The examination standard describes specific matters that the auditor should include in the examination report when expressing an adverse opinion. For example, when expressing an adverse opinion because one or more Material Weaknesses exist, the auditor's examination report must include a statement that one or more Material Weaknesses have been identified and an identification of the description of the Material Weaknesses in the compliance report.

¹⁰⁰ The requirement to express an adverse opinion applies regardless of whether the instance of non-compliance, material weakness, or other matters preventing an unqualified opinion were identified by management or the auditor.

¹⁰¹ See AT sec. 101.76.

The requirement to express an adverse opinion applies only to the subject matter for the respective assertion. It does not require an adverse opinion on the subject matter of all assertions in every instance. For example, if a Material Weakness was identified during the year but not at year end, and there were no instances of non-compliance or instances in which the information used to assert compliance with the net capital rule and the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records, the examination report should include an adverse opinion on Internal Control Over Compliance during the year and an unqualified opinion on the other three assertions.

Several commenters recommended that the examination standard include examples of modified examination reports. Appendix C to the examination standard describes examination report modifications. Additional report examples may be considered, if guidance is issued in the future.

Further, paragraph C6 of the examination standard states that, when the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to make certain conclusions, the auditor's report also must include the matters described in paragraph C3 of the examination standard. Those conclusions include that: (1) one or more instances of non-compliance with the net capital rule or the reserve requirements rule existed as of the end of the fiscal year, (2) one or more Material Weaknesses existed during or as of the end of the most recent fiscal year, or (3) the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer.

The examination standard states that the auditor may issue a report disclaiming an opinion on the assertions made by a broker or dealer in a compliance report as soon as the

auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work before issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

In addition, unlike AT sec. 101, if the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the examination engagement, under the examination standard, the auditor should communicate on a timely basis, in writing, to management and the audit committee that the examination engagement cannot be satisfactorily completed.

Some commenters stated that when the auditor expresses an adverse opinion, the auditor should report directly on the subject matter for all assertions, rather than the respective assertion necessitating the adverse opinion. As discussed, the examination standard aligns with the requirements of SEC Rule 17a-5, which requires the auditor to report on the respective management assertion.

Under the examination standard, if the broker's or dealer's compliance report contains other information in addition to the statements and descriptions, if applicable, required by SEC Rule 17a-5,¹⁰² the auditor should disclaim an opinion on the other information. For example, if the broker's or dealer's compliance report states that an identified Material Weakness no longer exists because controls have been implemented after the end of the fiscal year that address the Material Weakness, the auditor should disclaim an opinion on this information.

One commenter recommended that the examination standard address instances when there is a misstatement of fact in management's assertion, particularly when management's

¹⁰² See paragraphs (d)(3) and (g)(2) of SEC Rule 17a-5.

assertion is improperly presented. SEC Rule 17a-5 establishes the assertions brokers and dealers are required to make regarding compliance with the financial responsibility rules. The auditor's responsibility is to express an opinion on management's assertions. SEC Rule 17a-5 specifically describes the content of the statements to be made by the broker or dealer.¹⁰³ Further, a misstatement of fact by the broker or dealer in its assertion would likely result in an adverse opinion on one or more of the broker's or dealer's assertions. As the examination standard provides requirements relating to adverse opinions, no further changes were made based on this comment. Furthermore, as stated in the proposing release, if the auditor believes that additional information in the compliance report contains a material misstatement of fact, the auditor should discuss the matter with management of the broker or dealer. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee of the auditor's views concerning the information.

Appendix B. Considerations for Brokers and Dealers with Multiple Divisions or Branches

When a broker or dealer conducts its operations through multiple divisions and branch offices, the examination standard includes, in Appendix B, a requirement for the auditor to determine the extent to which examination procedures should be performed at selected divisions or branches to obtain sufficient appropriate evidence to support the conclusions expressed in the auditor's examination report. This includes determining the divisions or branches at which to perform examination procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual divisions or branches. The same requirements were included in the body of the proposed examination standard.

¹⁰³ See paragraph (d)(3) of SEC Rule 17a-5.

One commenter recommended certain additional factors that should be taken into account when determining the extent of the examination procedures to be performed at divisions or branches, including judgments about materiality of the division or branch and the similarity of operations over compliance for different divisions or branches. These factors were considered during the development of the examination standard. The requirement in the examination standard for the auditor to take into account the degree to which the financial responsibility rules relate to activities at the division or branch level is broader than judgments based solely on the materiality of a specific division. Adding another factor regarding materiality within paragraph 13 of the examination standard might limit an auditor's consideration of the procedures to be performed to only quantitative factors rather than risks related to non-compliance. As such, this factor has not been included in the examination standard.

One commenter recommended including the similarity of operations over compliance for different divisions or branches as a factor within the examination standard. Similar to the discussion in the preceding paragraph, the requirement in the examination standard for the auditor to take into account the degree to which the financial responsibility rules relate to activities at the division or branch level includes considerations regarding the similarity of operations over compliance for different divisions or branches. Including this factor within paragraph 13 of the examination standard might limit the auditor's consideration of the procedures to be performed to identify differences between different divisions or branches, rather than assessing the risk that different divisions or branches with similar operations over compliance might have instances of non-compliance.

Other Comments

Use of the Work of Other Auditors

Some commenters stated that situations could exist in which the auditor that is engaged to perform an examination engagement might use the work of other auditors. Those commenters stated that the examination standard should include a reference to AU sec. 543, Part of Audit Performed by Other Independent Auditors. Other commenters stated that references to the Board's auditing standards were inappropriate within the attestation standards. By its terms, AU sec. 543 applies when one auditor uses the work and reports of another auditor of the financial statements of a component. As this situation does not apply to a compliance examination engagement, the standard does not refer to AU sec. 543. Nonetheless, auditors can use the work of other auditors if such work is performed under their supervision.

Interaction with an Audit of Internal Control Over Financial Reporting

Some commenters stated that additional guidance relating to the relationship between internal control over financial reporting and Internal Control Over Compliance would be beneficial. Those commenters stated that while SEC Proposed Rule 17a-5 is clear that the attestation reports do not extend to internal control over financial reporting, there may be certain controls over financial reporting that could overlap with Internal Control Over Compliance with the financial responsibility rules.

Several commenters stated that the Board should coordinate with the SEC to provide further guidance regarding the relationship between the evaluation of Deficiencies in Internal Control Over Compliance and the evaluation of Material Weaknesses and significant deficiencies in internal control over financial reporting. The SEC Release contains relevant

discussion regarding the interaction between Internal Control Over Compliance and internal control over financial reporting.¹⁰⁴

Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers

As previously described, the review standard has been designed specifically for an auditor's review of statements made by a broker or dealer in an exemption report required by the Commission's amendments to SEC Rule 17a-5.

Briefly, certain brokers and dealers claim exemption from the Commission's requirements contained in SEC Rule 15c3-3, the SEC rule relating to the custody of customer funds, pursuant to exemption provisions contained in paragraph (k) of SEC Rule 15c3-3 (the "exemption provisions"). In the exemption report, the broker or dealer identifies (i) the exemption provision of paragraph (k) of SEC Rule 15c3-3 under which the broker or dealer claimed exemption from the SEC's custody requirements (the "identified exemption provisions"), and (ii) states that the broker or dealer met the exemption provisions throughout the most recent fiscal year without exception or, if applicable, states that exceptions to the identified exemption provisions were identified, including a description of any such exceptions and the approximate date on which the exception existed. SEC Rule 17a-5 requires the broker or dealer to engage an independent public accountant registered with the PCAOB to review, and independently report on, the statements in the broker's or dealer's exemption report.

¹⁰⁴ See the SEC Release at 38, which notes, among other things, that internal control over financial reporting is focused on the reliability of financial reporting and preparation of financial statements in accordance with generally accepted accounting principles, whereas the compliance report should focus on oversight of net capital, custody arrangements, and protection of customer assets, and, therefore should be focused on compliance with the financial responsibility rules.

Because brokers and dealers claiming an exemption from SEC Rule 15c3-3 requirements under paragraph (k) of that rule might have access to customer funds, a review engagement focusing on the identification of exceptions to the exemption provisions claimed by brokers and dealers is important to the protection of investors. Notably, a recent PCAOB report on the progress of its interim inspection program of broker and dealer audits noted that in a significant number of audits of brokers and dealers that claimed an exemption from SEC Rule 15c3-3, auditors did not perform sufficient procedures to ascertain that the broker or dealer complied with the conditions of the exemption.¹⁰⁵ The review standard includes specific procedures for auditors performing compliance reviews of a broker's or dealer's assertions in an exemption report with an emphasis on coordination with the auditor's work on the financial statement audit and the audit procedures performed relating to supplemental information. This approach should enhance overall audit effectiveness and also help avoid unnecessary duplication of work.

The following discussion provides background regarding the review standard, including significant comments received on the proposed review standard and changes made to the standard.

Overview of SEC Rule 17a-5 and Related Changes

As amended by the Commission, SEC Rule 17a-5 includes modifications from the SEC's proposed amendments, including a number of changes that focus the auditor more directly on the exemption provisions claimed by the broker or dealer and the identification of any exceptions. These modifications resulted in corresponding changes to the review standard. Principally, the changes involve:

¹⁰⁵ See Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers, PCAOB Release No. 2013-006 (August 19, 2013), at 9.

- The introduction of certain terms, including "exemption provisions," and "exceptions;"
- Changes to the broker's or dealer's assertions, as set forth in SEC Rule 17a-5, to include more detailed information regarding the exemption provision claimed asserted by the broker or dealer and any exceptions identified; and
- Changes to the auditor's reporting requirements, and the example report, including requirements for auditors to modify their reports in situations in which the broker or dealer fails to disclose an exception in the exemption report.

As noted above, the review standard was designed specifically to implement the auditor's requirements in SEC Rule 17a-5. The review standard establishes requirements that apply when an auditor is engaged to perform an exemption review of the statements made by a broker or dealer in an exemption report prepared pursuant to SEC Rule 17a-5.

Paragraph 2 states that SEC Rule 17a-5 requires a broker's or dealer's exemption report to contain the following statements¹⁰⁶ by the broker or dealer:

- a. A statement that identifies the exemption provisions under which the broker or dealer claimed an exemption from SEC Rule 15c3-3;
- b. A statement that the broker or dealer (1) met the identified exemption provisions throughout the most recent fiscal year without exception or (2) met the identified exemption provisions throughout the most recent fiscal year except as described in the exemption report; and
- c. If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions (an "exception") and

¹⁰⁶ See paragraph (d)(4) of SEC Rule 17a-5.

that briefly describes the nature of each exception and the approximate dates on which the exception existed.

The changes reflected in SEC Rule 17a-5 to include exceptions to the exemption provisions in the exemption report did not result in significant changes to the procedural requirements in the proposed review standard. The review standard, similar to the proposed review standard, requires the auditor to state a conclusion regarding whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertions for the assertions to be fairly stated, in all material respects.¹⁰⁷ To state such a conclusion, the auditor must plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance about whether one or more conditions exist that would cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects.

Moderate Assurance

The requirement that the auditor obtain moderate assurance¹⁰⁸ to support his or her opinion has not been changed from the Board's proposal. The approach taken in the review standard is in contrast to the examination standard, in which the auditor obtains reasonable assurance to support his or her opinion on the broker's or dealer's assertions. In the review

¹⁰⁷ The review standard largely carries forward the requirement from prior SEC Rule 17a-5 that the independent public accountant engaged by the broker or dealer "must ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the independent public accountant's attention to indicate that the exemption had not been complied with during the period since the last examination." See the SEC Release at 72.

¹⁰⁸ Obtaining moderate assurance in a review engagement is consistent with both existing PCAOB standards and the SEC Release. AT sec. 101.55 describes a review as an attest engagement designed to provide a moderate level of assurance. See the SEC Release at 88, which states that a "moderate level of assurance [is] contemplated by the required review."

engagement contemplated by the review standard, the auditor must obtain moderate assurance regarding the broker's or dealer's assertions.

Review engagements typically involve the performance of inquiries and analytical procedures,¹⁰⁹ and the auditor's conclusions typically are expressed in the report in the form of negative assurance.¹¹⁰

The proposing release noted that, in a review engagement covered by the proposed review standard, analytical procedures are not feasible for evaluating compliance with the exemption conditions, as the conditions are based on activities of the broker or dealer rather than on financial statement amounts. Thus, the review standard establishes specific procedural requirements that are commensurate with the responsibility to obtain moderate assurance. This approach is consistent with AT sec 101.55–.56 which states that ". . . there will be circumstances in which inquiry and analytical procedures . . . cannot be performed. . . . In [this] circumstance, the practitioner should perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided."

Commenters generally stated that the requirements in the review standard were appropriate for obtaining moderate assurance. Further, some commenters stated that the term "moderate assurance" as used in the review standard is consistent with how the term "moderate

¹⁰⁹ AT sec. 101.55 states that "[i]n an attest engagement designed to provide a moderate level of assurance (referred to as a review), the objective is to accumulate sufficient evidence to restrict attestation risk to a moderate level. To accomplish this, the types of procedures performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures)."

¹¹⁰ See AT sec. 101.68.

assurance" is presently used in practice and with how auditors are currently performing engagements to obtain moderate assurance.

One commenter stated that the review standard could clarify that the auditor plans and performs the review engagement in the context of obtaining a moderate level of assurance. In considering this comment, the Board noted that the objective of the review standard states ". . . the auditor must plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance. . . ." As such, additional clarification is not necessary.

One commenter stated that an "agreed-upon procedures" engagement would be more appropriate than a review engagement for a broker's or dealer's assertion that it is exempt from SEC Rule 15c3-3. SEC Rule 17a-5 requires a broker or dealer that claimed exemption from the requirements of SEC Rule 15c3-3 to file a report from their independent public accountants that includes the results of a review of the broker's or dealer's assertions. As adopted, the review standard establishes requirements that are designed specifically to provide auditors with a standard for performing the review required by SEC Rule 17a-5.

Performing the Review Engagement (Paragraphs 5 – 14 of Attestation Standard No. 2)

General Requirements (Paragraphs 5 – 6 of Attestation Standard No. 2)

Paragraphs 5 and 6 of the review standard set forth general requirements for an auditor performing the review standard. The Board did not receive significant comments on the general requirements of the proposed review standard. As such, the general requirements are being adopted largely as proposed.

Paragraph 5 of the review standard requires that an auditor performing a review engagement have adequate technical proficiency in attestation engagements, obtain an understanding of the exemption conditions and other rules and regulations that are relevant to the

broker's or dealer's assertion, determine the auditor's compliance with independence and ethics requirements,¹¹¹ and exercise due professional care.

The proposed review standard included a footnote which stated that "due professional care" referred to in that paragraph was the same term in paragraph .40 of AT sec. 101. One commenter stated that while they did not disagree with the meaning of "due professional care," they believe that referencing AT sec. 101 from the review standard may be confusing, especially as AT sec. 101 would not be applicable to engagements in which the review standard is applicable. In response, a note has been added to state that due professional care imposes a responsibility¹¹¹ on each engagement team member to comply with the review standard and that the exercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report. A footnote to that note states that the auditor's responsibility to exercise due professional care is consistent with the description in paragraphs .40–.41 of AT sec. 101.

With respect to documentation, the review engagement is subject to the requirements of Auditing Standard No. 3, which applies to engagements conducted pursuant to the standards of the PCAOB. Auditing Standard No. 3 states that as audit documentation is the written record that provides the support for the representations in the auditor's report, it should demonstrate that the engagement complied with the standards of the PCAOB.¹¹² A note has been added to paragraph 5

¹¹¹ Determining the auditor's compliance with independence and ethics requirements includes determining whether the auditor complied with relevant requirements of the PCAOB and the SEC. Paragraph (f)(1) of SEC Rule 17a-5 requires the auditor to be independent in accordance with 17 CFR § 210.2-01.

¹¹² See paragraph 4 of Auditing Standard No. 3.

of the review standard to remind auditors of their responsibility to comply with Auditing Standard No. 3.

Review Procedures (Paragraphs 8 – 10 of Attestation Standard No. 2)

The review standard requires the auditor to perform procedures consistent with a review engagement; however, the procedures have been tailored for the exemption report required by SEC Rule 17a-5.

Nature, Timing, and Extent of Procedures (Paragraph 9 of Attestation Standard No. 2)

Under the proposed review standard, the nature, timing, and extent of the review procedures were dependent on certain risk factors and evidence about the broker's or dealer's compliance with the exemption conditions or about the effectiveness of controls over the exemption conditions obtained from the audit of the financial statements and the audit procedures performed on supplemental information. For example, one risk factor is potential non-compliance associated with related parties. Risks associated with related parties that are investment advisors or with which the broker or dealer has a custodial or clearing relationship may be especially relevant to the exemption provisions.

Evidence about the broker's or dealer's compliance with the exemption provisions or about the effectiveness of controls over the exemption provisions obtained from the audit of the financial statements and the audit procedures performed on supplemental information also affect the nature, timing, and extent of the necessary inquiries and other review procedures. For example, if the broker or dealer claims an exemption under Rule 15c3-3(k)(1), the auditor, among other things, needs to obtain evidence that the broker's or dealer's transactions are limited to those in redeemable securities of investment companies or of interests or participations in an

insurance company separate account.¹¹³ Audit procedures regarding the broker's or dealer's investment inventory or investment transactions related to the broker's or dealer's trading for its own account, including confirmation of investment inventory with the custodian and testing investment transactions, can provide evidence relevant to the broker's or dealer's compliance with these exemption conditions.

As another example, if the broker or dealer claims exemption under section (k)(1) of Rule 15c3-3, the auditor needs to obtain evidence about whether the broker or dealer promptly transmits all funds and delivers all securities received in connection with his activities as a

¹¹³ Paragraph (k)(1) of SEC Rule 15c3-3, states that "the provisions of [Rule 15c3-3] shall not be applicable to a broker or dealer meeting all of the following conditions:

- (i) His dealer transactions (as principal for his own account) are limited to the purchase, sale, and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company; except that a broker or dealer transacting business as a sole proprietor may also effect occasional transactions in other securities for his own account with or through another registered broker or dealer;
- (ii) His transactions as broker (agent) are limited to: (a) The sale and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company; (b) the solicitation of share accounts for savings and loan associations insured by an instrumentality of the United States; and (c) the sale of securities for the account of a customer to obtain funds for immediate reinvestment in redeemable securities of registered investment companies; and
- (iii) He promptly transmits all funds and delivers all securities received in connection with his activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.
- (iv) Notwithstanding the foregoing, this section shall not apply to any insurance company which is a registered broker [or] dealer, and which otherwise meets all of the conditions in paragraphs (k)(1) (i), (ii), and (iii) of this section, solely by reason of its participation in transactions that are a part of the business of insurance, including the purchasing, selling, or holding of securities for or on behalf of such company's general and separate accounts."

broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.¹¹⁴ Audit procedures regarding customer trade and transaction activities can provide evidence relevant to these exemption provisions.

Other procedures performed during the audit that are relevant to the broker's or dealer's compliance with the exemption provisions include testing of specially designated cash accounts and reading clearing agreements between the broker or dealer and clearing brokers and dealers in connection with testing trade fee or commission revenues and expenses.¹¹⁵

One commenter recommended incorporating the discussion in the proposing release relating to the risk of fraud into the review standard to provide further guidance. The proposing release stated that in considering the risk of fraud relevant to the exemption conditions, the auditor also considers whether the broker or dealer has misrepresented its activities, for example, the broker or dealer claims to be operating as a non-carrying broker or dealer but, based on other evidence appears to hold customer funds or securities. The Board considered this comment and determined, as it has done in other projects, to include performance requirements in the standard and to provide additional discussion and examples in the release. Therefore, the release discussion regarding the risk of fraud has not been incorporated into the review standard. The request for guidance regarding the risk of fraud may be taken into account if additional guidance is issued.

¹¹⁴ See paragraph (k)(1)(iii) of SEC Rule 15c3-3.

¹¹⁵ Refer to "Relationship Between the Examination Engagement and the Audit of the Financial Statements and Audit Procedures Performed on Supplemental Information" for further discussion.

The Board did not receive extensive comment on these requirements. Two commenters stated that the factors are appropriate. In general, these requirements are being adopted substantially as proposed.

Review Procedures (Paragraph 10 of Attestation Standard No. 2)

Paragraph 10 of the review standard sets forth the required procedures for the review engagement. Specifically, the procedures required by the standard are consistent with a review engagement, including making inquiries of management and relevant personnel of the broker or dealer; reading relevant reports from internal auditors or regulatory correspondence; evaluating evidence from the audit of the financial statements and the audit procedures performed on supplemental information; and performing additional procedures for identified exceptions.

While the review standard requires the auditor to perform procedures consistent with a review engagement, the procedures in the standard have been modified in a number of ways to reflect changes made to SEC Rule 17a-5, including to reflect terms used in SEC Rule 17a-5. The following discussion highlights some of the key aspects of, comments on, and changes made to, the required review procedures.

Commenters generally supported the requirements as proposed. However, one commenter stated the proposed review standard does not clearly describe the procedures or the extent of evidence necessary to obtain moderate assurance. Another commenter stated that the language in paragraph 10.h. of the proposed review standard, "perform other procedures as necessary in the circumstances to obtain moderate assurance," is an overly broad requirement.

As previously discussed, obtaining moderate assurance in a review engagement is consistent with both existing PCAOB standards and the SEC Release. AT sec. 101.55 describes a review as an attest engagement designed to provide a moderate level of assurance. The SEC

Release states that a "moderate level of assurance [is] contemplated by the required review."¹¹⁶

The procedures required by the review standard have been designed to assist the auditor in obtaining moderate assurance in a review engagement. These procedures largely focus on making inquiries and reading information relevant to the broker's or dealer's assertions. In the Board's view, such procedures are consistent with AT sec. 101.56, given that analytical procedures would not provide relevant evidence in light of the broker's or dealer's assertions required by SEC Rule 17a-5. For example, paragraph 10.g. of the review standard states that in performing the review engagement, 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 information in the broker's or dealer's assertions. Further, paragraph 10.h. of the review standard has been revised to state that in performing the review engagement, the auditor should perform other procedures as necessary in the circumstances to obtain moderate assurance regarding whether a material modification should be made to the broker's or dealer's assertions for the assertions to be fairly stated, in all material respects.

One commenter stated that, while the review procedures and the matters affecting their nature, timing, and extent are, for the most part, appropriate for an engagement to obtain a moderate level of assurance, they did have certain specific recommendations, including clarifying the note in paragraph 10.g. of the review standard to explicitly indicate that the examples of procedures are those that may be performed during the audit of the financial statements. The Board considered this comment and agrees that such a revision would clarify that the note is referring to examples of procedures performed during the audit of the financial

¹¹⁶ See the SEC Release at 88.

statements that might provide relevant evidence to the review engagement. As such, the note to paragraph 10.g. of the review standard has been revised.

In addition, if the broker or dealer has sent to or received correspondence from the SEC or the broker's or dealer's DEA that is relevant to compliance with the exemption conditions, the review standard includes a requirement for the auditor to read such correspondence and, when necessary in the circumstances, make inquiries of the regulatory agencies. These procedures can provide the auditor with relevant information about a broker's or dealer's compliance with the exemption provisions. Under the circumstances when a need arises to make inquiries of the regulatory agencies, the Board acknowledges that auditors may need authorization from the broker or dealer before contacting the regulatory authority.

One commenter suggested that the Board provide guidance related to the interaction between auditors and a company's regulatory examiners consistent with the AICPA Audit and Accounting Guide for Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies. The guidance in that publication is specific to the interaction between the auditor and federal bank examiners, and might differ from the DEAs of the broker or dealer. As such, additional requirements in this area have not been included in the review standard.

Evaluating the Results of the Review Procedures (Paragraphs 11 – 12 of Attestation Standard No. 2)

Under paragraph 11 of the review standard, the auditor should evaluate whether information has come to the auditor's attention that cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects. For example, a broker's or dealer's failure to disclose an exception in the exemption report would cause the assertion not to be fairly

stated, in all material respects, which would require modification of the review report. This paragraph has been modified to align with the amendments to SEC Rule 17a-5.

Additionally, the proposed standard required the auditor to perform additional procedures if information came to the auditor's attention that indicated that one or more instances of non-compliance might exist that might cause the broker's or dealer's assertion not to be fairly stated or if the auditor had substantial doubt about the assertion. The review standard has been revised to align with the requirements in SEC Rule 17a-5.

One commenter requested clarification of the relationship between paragraphs 10.h. and 12 of the review standard. Those two requirements address different situations, as discussed below.

As previously noted, paragraph 10.h. of the review standard requires auditors to perform other procedures as necessary in the circumstances to obtain moderate assurance. This applies when the auditor determines the nature, timing, and extent of review procedures to be performed, such as in planning the review.

Paragraph 12 of the review standard applies when information comes to the auditor's attention during the engagement indicating that the broker's or dealer's assertions might not be fairly stated or if the auditor has substantial doubt about the assertion. Pursuant to paragraph 12, the auditor in those situations is required to perform additional procedures to address the matter. Performing the review with due professional care requires an auditor conducting a review to take appropriate actions when becoming aware of exceptions to the exemption provisions not included in the broker's or dealer's assertion or when substantial doubt remains. The phrase "substantial doubt" has the same meaning as the phrase "substantial doubt" in paragraph 35 of Auditing Standard No. 14, which states that if the auditor has not obtained sufficient appropriate

audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter. In the context of a review engagement, these additional procedures could include, but are not limited to, making additional inquiries, reading documents, or performing search and verification procedures, as necessary.¹¹⁷

One commenter recommended incorporating the examples in the preceding paragraph, e.g., making additional inquiries, reading documents, or performing search and verification procedures, as necessary, and the discussion in AT sec. 101.56, into the review standard. That discussion and the examples have not been included in the review standard as they are provided to illustrate the nature of procedures that might be appropriate in such circumstances. Including these as examples in the review standard might limit auditors' consideration of additional procedures to only these procedures, when other procedures might be appropriate.

Obtaining a Representation Letter (Paragraphs 13 – 14 of Attestation Standard No. 2)

The review standard includes a requirement for the auditor to obtain written representations from management of the broker or dealer that relate to the review engagement. The purpose of such representations is to provide the auditor with necessary information for, and context regarding, the engagement. The auditor should not rely inappropriately on management's representations.

The review standard also provides that the failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the review engagement. If a limitation on the scope of the review engagement exists, the

¹¹⁷ See, e.g., AT sec. 101.56.

auditor should withdraw from the engagement or should modify the review report.¹¹⁸

Additionally, the review standard also includes a list of written representations that the auditor should obtain from management.

Commenters stated that obtaining representations from management is a necessary part of the auditor's ability to express an opinion. One commenter recommended that the list of required written representations include a representation from management that acknowledges its responsibility for the assertions in the exemption report. The suggested additional representation has been included in the review standard.

Further, in the review standard, several of the representations were updated to align with the language in SEC Rule 17a-5.

Communication Requirements (Paragraph 15 of Attestation Standard No. 2)

The review standard requires the auditor to communicate to management and to the audit committee any exceptions to the exemption provisions identified by the auditor or information that causes the broker's or dealer's assertions about its exemption provisions not to be fairly stated, in all material respects. In addition, rather than defining the term audit committee, the review standard states that the term "audit committee" has the same definition as that in Auditing Standard No. 16.

The Board did not receive significant comments on the communication requirements included in the proposed review standard. However, the communication requirements in the standard have been modified to align closely with SEC Rule 17a-5. Additionally, a note has been

¹¹⁸ See paragraph 20 of the review standard for auditor requirements when a scope limitation exists.

added to paragraph 15 of the review standard reminding auditors of their obligation to comply with the requirements of paragraph (h) of SEC Rule 17a-5.¹¹⁹

Reporting on the Review Engagement (Paragraphs 16 – 18 of Attestation Standard No. 2)

The review standard includes requirements for the auditor's review report to include certain elements that are important for a reader of the review report to understand regarding the auditor's responsibilities. This includes a statement that the review was conducted in accordance with the standards of the PCAOB and, accordingly, includes inquiries and other required procedures to obtain evidence about the broker's or dealer's compliance with the exemption provisions. These are largely the same elements as in the proposed standard.

The review standard includes an example of the auditor's standard review report when the broker or dealer asserted that it met the identified exemption provisions throughout the most recent fiscal year without exception and an example of the auditor's standard review report when the broker or dealer includes exceptions to the exemption provisions in the exemption report. A change was made to the review results paragraph in the example review report to align the reporting language more closely to the corresponding reporting element, which was not modified from the proposed review standard.

Some commenters stated concerns similar to those for the examination report regarding the use of the review report as a legal determination, interpretation of rules and regulations, restrictions on use of the review report, and limitations of an engagement to obtain moderate assurance. When the auditor is engaged to perform a review engagement, it is necessary for the auditor to read and make judgments regarding the application of regulatory requirements, as

¹¹⁹ See also the discussion of the notification requirements in the SEC Release at 101–107.

applicable to the engagement. The review report issued pursuant to the review standard does not provide a legal determination, nor does it purport to provide a legal determination, of a broker's or dealer's compliance exemption provision. However, such a report may be useful to legal counsel or others in making such determinations.

Modifications of the Report (Paragraphs 19 – 20 of Attestation Standard No. 2)

The review standard requires that if one or more of the broker's or dealer's assertions are not fairly stated, in all material respects, the auditor must modify the review report to describe the reasons why the assertions are not fairly stated, in all material respects. If the broker's or dealer's assertion is not fairly stated because of one or more omitted exceptions, the auditor's review report should disclose each omitted exception.

Paragraph 20 of the review standard sets forth circumstances involving scope limitations. Under the review standard, if the auditor cannot perform the procedures required by the review standard or other procedures that the auditor deems necessary in the circumstances, the review is incomplete because of the scope limitation. An incomplete review is not a sufficient basis for stating a conclusion regarding the broker's or dealer's assertions. In the case of a scope limitation, the auditor should withdraw from the engagement or should modify the review report to:

- a. Describe the scope limitation and any review procedures deemed necessary by the auditor that have been omitted and the reason for their omission;
- b. State that the auditor does not express any form of assurance on the broker's or dealer's assertions; and, if applicable,
- c. Describe the circumstances which cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects.

One commenter stated that auditors should use judgment in drafting an appropriate modification to the review report. Other commenters stated that the attestation standards should contain examples of report modifications. The standard sets forth the necessary reporting elements for modified reports. Additional report examples may be considered if guidance is issued in the future.

One commenter questioned the appropriateness of the requirement in paragraph 20 of the proposed review standard for the auditor to describe the omitted procedures and the reason for their omission. The commenter stated that as the reason for the omission of the review procedures is required in the description of the scope limitation itself, describing the omitted review procedures might overshadow the scope limitation. The commenter recommended that it would be more appropriate to generally describe the effect of the scope limitation on the engagement, without providing a list of omitted procedures that may have been considered necessary. Including in the review report a description of the scope limitation, the omitted procedures, and the reason for their omission are important elements of a modified review report given the nature of the procedures and the specificity of the exemption provisions. The discussion of the omitted procedures generally would provide the reader with additional information beyond the description of the scope limitation. As such, this recommendation has not been incorporated into the review standard.

The same commenter also recommended that the review standard address the auditor's responsibility as it relates to report modifications when management's assertion is improperly presented or contains additional information. That commenter suggested that, in such circumstances, an explanatory paragraph should be included in the auditor's report. Paragraph 19 of the review standard requires the auditor to modify the review report to describe the reasons the

assertions are not fairly stated, in all material respects, if one or more of the broker's or dealer's assertions are not fairly stated. This would include circumstances in which management's assertion is improperly presented, and other PCAOB standards address additional information.¹²⁰

Amendments

Auditing Standard No. 3

The Board is adopting certain amendments to Auditing Standard No. 3, Audit Documentation, to clarify that its requirements apply to examination engagements and review engagements. Auditing Standard No. 3 establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to standards of the PCAOB, including the attestation standards of the PCAOB. The Board is amending Auditing Standard No. 3 to help auditors properly apply the relevant requirements in Auditing Standard No. 3 to attestation engagements, including the attestation engagements covered by the attestation standards. For example, paragraph 6 of Auditing Standard No. 3 includes a requirement for the auditor to document procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions. An amendment to footnote 2 of paragraph 6 clarifies that, with respect to an engagement conducted pursuant to the attestation standards of the PCAOB, the relevant assertions are the assertions expressed by management or the responsible party regarding the subject matter of the attestation engagement.

In addition, paragraph 12 of Auditing Standard No. 3 includes requirements regarding significant findings or issues and provides certain examples of significant findings or issues. Further, paragraph 13 of Auditing Standard No. 3 requires the auditor to identify all significant findings or issues in an engagement completion document.

¹²⁰ See, e.g., AU sec. 550, Other Information in Documents Containing Audited Financial Statements.

The Board did not receive comments requiring revision to the amendments to Auditing Standard No. 3. As such, the amendments are adopted largely as proposed.

Auditing Standard No. 7

The Board is adopting certain amendments to Auditing Standard No. 7, Engagement Quality Review, to extend the requirements for an engagement quality review and concurring approval of issuance for the examination engagements and review engagements of brokers and dealers covered by these attestation standards. The proposal also included amendments that set forth certain procedures to be applied in an engagement quality review of the examination and review under these attestation standards.

Commenters expressed a range of views. Some commenters generally supported the engagement quality review requirement for these attestation engagements as well as the required procedures. One commenter did not support requiring an engagement quality review for either an examination engagement or a review. Other commenters did not support engagement quality reviews for review engagements. Some commenters stated that additional guidance is necessary to implement the proposed amendments.

Other commenters stated that as the audit and attestation standards have been separate bodies of literature, audit and attest standards should be kept separate. Those comments stated that to promote compliance with PCAOB standards, they believe that the Board should continue to maintain this structure. They also believe that the use of an amendment to adopt such significant changes in the literature may not sufficiently take into account a broader consideration of the affected engagements. For those firms that do not audit brokers or dealers, such changes also may go unnoticed.

The Board considered the comments received regarding the amendments to Auditing Standard No. 7 and is adopting the amendments as proposed for both a compliance examination and a compliance review.

Given the importance of the attestation engagements to investor protection and the high level of deficiencies observed by PCAOB inspection staff in areas that would be covered by the attestation engagements,¹²¹ the Board believes that engagement quality reviews can enhance the consistency of compliance with the SEC's rule. An effective engagement quality review can increase the likelihood of identifying significant engagement deficiencies before the examination or review report is issued. Additionally, the Board took note of the fact that, in a February 2011 AICPA Peer Review Alert, the AICPA designated audits of carrying brokers or dealers as a "must select" for peer review, recognizing the significant public interest in audits of such firms.¹²²

Also, the emphasis in the attestation engagements regarding the coordination of the attestation engagement with the financial statement audit should reduce the audit effort required to complete the engagement quality review. To emphasize the coordination of the attestation engagement with the financial statement audit in performing an engagement quality review, the proposed amendment to paragraph 18A of Auditing Standard No. 7 was modified to reflect that

¹²¹ See PCAOB Release 2013-006, which reports that PCAOB inspection staff identified auditing deficiencies in 57 of the 60 audits of brokers and dealers selected for inspection and that deficiencies in compliance with audit requirements for brokers and dealers under the Exchange Act that were among the most frequently noted by PCAOB inspection staff included deficiencies in audit procedures related to net capital and customer reserve supporting schedules, compliance with the conditions of the exemption claimed by the broker or dealer, and the accountant's supplemental report on material inadequacies. See PCAOB Release 2013-006, Executive Summary, at ii.

¹²² See AICPA Peer Review Alert 11-01 (February 2011).

to evaluate significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the attestation engagement and in preparing the engagement report, the engagement quality review should take into account the procedures performed in the engagement quality review of the financial statement audit. The knowledge that the engagement quality reviewer gains from the engagement quality review of the audit and the specific steps in paragraph 18A should enable the engagement quality reviewer to identify whether there are any significant engagement deficiencies, or any indications of potential significant engagement deficiencies that warrant further investigation.

Other Areas of Comment

The Board requested comment from interested parties on all aspects of the proposal. Several commenters included additional recommendations that have not yet been discussed. Those suggestions are discussed below.

Scalability of the Attestation Standards

The Board requested comment regarding whether the proposed attestation standards are tailored appropriately for examinations and reviews related to compliance and exemption reports of brokers and dealers. Commenters who responded to the question generally agreed that the proposed attestation standards are tailored appropriately for examinations and reviews related to compliance and exemption reports of brokers and dealers. One commenter stated that they generally support the proposals and noted that the proposed standards had been clearly aligned with the SEC's proposed rule amendments.

The Board also requested comment regarding whether the proposed attestation standards were appropriately scalable based on the size and complexity of the broker or dealer. Some commenters stated that the standards are proportionate and appropriately scalable based on the

size and complexity of the broker or dealer, noting that paragraphs 11 and 12 of Attestation Standard No. 1 are particularly helpful. Some commenters recommended that the Board provide additional guidance, including specific examples, regarding the application of scalability to these examination engagements. Other commenters expressed concern that without such guidance, application of the audit scalability concept could vary greatly across the audit profession. The requests for guidance may be taken into account if additional staff guidance is issued.

Commodity Futures Trading Commission Rules

One commenter stated that for brokers and dealers that are also registered as a Futures Commission Merchant with the Commodity Futures Trading Commission ("CFTC"), it will be necessary for the PCAOB to recognize and address the requirements related to CFTC Rule 1.16 for the auditor to report on compliance therewith. The Commission stated in the SEC Release that its staff "is in discussions with the CFTC staff concerning ways to align the reporting and audit requirements for dually registered broker-dealers/Futures Commissions Merchants with the goal of coordinating these requirements."¹²³

Independence

Several commenters recommended that the discussion in the proposing release stating that auditors of non-issuer brokers and dealers are not subject to PCAOB Rules 3521 through Rule 3526 be included in the attestation standards. On February 28, 2012, the Board proposed amendments to require that registered firms that audit brokers and dealers comply with certain of the Board's professional practice standards including the Board's Rules relating to

¹²³

See the SEC Release at 8.

independence.¹²⁴The Board will consider relevant comments applicable to the Board's independence rules in connection with adopting final amendments.

Period of the Examination and Review

Some commenters stated that brokers and dealers should be allowed to assert compliance with the financial responsibility rules if it can identify deficiencies, implement effective controls, and test their operating effectiveness prior to year-end, and if the auditor also can adequately test the operating effectiveness of the remediated controls. SEC Rule 17a-5 requires the broker or dealer to assert that Internal Control Over Compliance was effective during the most recent fiscal year and as of the end of the most recent fiscal year. While this would require a broker or dealer to identify in its report Material Weaknesses in internal control that occurred during the most recent fiscal year, if those Material Weaknesses are remediated, it would allow the broker or dealer to assert that Internal Control Over Compliance was effective as of the end of the most recent fiscal year.

Some commenters requested clarification about the time period for the assertion regarding exemption from the requirements of SEC Rule 15c3-3 and indicate that they believe a point-in-time assertion would be sufficient. SEC Rule 17a-5 requires the broker or dealer to assert that it met, or met with exception, the identified exemption provisions in paragraph (k) of SEC Rule 15c3-3 throughout the most recent fiscal year end. The review standard has been updated to reflect this time period.

Providing Additional Guidance and Including Examples from the Proposing Release in the Examination Standard

¹²⁴ See Proposed Amendments to Conform PCAOB Rules and Forms to the Dodd-Frank Act and Make Certain Updates and Clarifications, PCAOB Release No. 2012-002 (February 28, 2012).

Several commenters recommended incorporating the additional discussion and examples included in the proposing release into the standard. The examples are not included in the attestation standards. Those examples were illustrative and did not impose requirements or define engagement requirements. Additional report examples may be considered, if guidance is issued in the future.

Other Considerations

Agreed-Upon Procedures Engagements

SEC Rule 17a-5 largely carries forward the requirement that the broker or dealer file with SIPC a supplemental report that includes an accountant's report on applying agreed-upon procedures based on the performance of the procedures outlined in SEC Rule 17a-5.¹²⁵

These attestation standards do not affect the requirements for those agreed-upon procedures engagements. Auditors should continue to look to AT sec. 101, AT sec. 201, Agreed-Upon Procedures, and AT sec. 601,¹²⁶ for the requirements applicable to those engagements.

Relationship to the Interim Attestation Standards

In general terms, the requirements in the examination standard are consistent with the requirements of AT sec. 101 and AT sec. 601. However, when an auditor performs an engagement pursuant to the examination standard, AT sec. 101 and AT sec. 601 would not apply. For this reason, the examination standard includes, for example, a section on general requirements that are consistent with those in AT sec. 101.

The examination standard focuses specifically on performing an examination of the statements made by a broker or dealer in a compliance report and allows auditors to perform

¹²⁵ See paragraph (e)(4)(ii) of SEC Rule 17a-5.

¹²⁶ See paragraphs .16–.29 of AT sec. 601.

such engagements without looking to multiple attestation standards. In addition, the emphasis in the examination standard on appropriately coordinating the examination engagement with the audit of the financial statements and supplemental information should avoid unnecessary redundancy in the auditor's work.

Economic Considerations, including Audits of Emerging Growth Companies

Economic Considerations

As noted above, in developing the attestation standards, the Board's objective was to consider the SEC's amendments to SEC Rule 17a-5 and evaluate whether its standards were appropriate for the SEC's requirements for examinations of compliance reports and reviews of exemption reports.

As part of its process, the Board also considered the SEC's economic analysis related to its amendments to SEC Rule 17a-5. The SEC's analysis considers the economic effects, including the benefits and costs, of the new examinations of compliance reports and reviews of exemption reports that are now required by the SEC to be filed by registered brokers and dealers pursuant to SEC Rule 17a-5 and includes considerations relating to efficiency, competition, and capital formation.¹²⁷

The SEC's economic analysis considered the Board's proposed attestation standards. As described in the SEC Release, after considering the views of commenters relating to anticipated costs, including with respect to the Board's proposed attestation standards, the SEC concluded that, while the total costs associated with the new compliance and review requirements would depend on the final PCAOB standards for attestation engagements, "as the PCAOB's proposed standards were tailored to the proposed amendments, nothing in those standards causes the

¹²⁷ See the SEC Release, which discusses costs and benefits of the requirements for examined compliance reports and reviewed exemption reports at 226-245.

Commission to change its estimates of the costs associated with these requirements, or to question that the benefits will justify the costs."¹²⁸ The Board notes that, as adopted, the new attestation standards are aligned with SEC Rule 17a-5, and most of the differences between the proposed standards and the attestation standards, as adopted, result from changes to conform to the SEC's final amendments to SEC Rule 17a-5.

In addition to considering the SEC's requirements and economic analysis, the Board also took into account other related economic considerations as discussed below.

Economic Baseline

The SEC made the determination to require brokers and dealers to include in their annual reports either a compliance report that is examined by an auditor or an exemption report that is reviewed by an auditor.

Therefore, the SEC Release contains a discussion of the economic baseline in its economic analysis. Aspects of the SEC's discussion of the baseline that are relevant to the attestation standards include:

- Before the SEC's amendments, Rule 17a-5 required that the audit under GAAS include a "review" of the broker's or dealer's accounting system, internal accounting control, and procedures for safeguarding securities.¹²⁹ The scope of the auditor's work was required to be sufficient to provide reasonable assurance

¹²⁸ See the SEC Release at 241.

¹²⁹ See the SEC Release at 70.

that any material inadequacies¹³⁰ existing as of the date of the examination would be disclosed.

- Before the SEC's amendments, if the broker or dealer was exempt from the reserve requirements rule, the auditor was required to ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the auditor's attention to indicate that the exemption had not been complied with during the period since the last examination.

Under the SEC's amendments, audits of brokers and dealers are now required to be conducted in accordance with PCAOB standards, the material inadequacy report has been replaced with an examination of the compliance report, and the requirement to ascertain compliance with the exemption conditions has been replaced with a review of the exemption report.

Consideration of Alternatives and Additional Considerations

In general, the Board sought to evaluate whether its attestation standards were appropriate for performing and reporting on the newly required examinations and reviews. The SEC is a key user of the new reports, which serve to facilitate the SEC's compliance oversight function. Accordingly, the Board's standards for those engagements needed to reflect a compliance focus and needed to be aligned with the requirements in SEC Rule 17a-5.

¹³⁰ Prior to the SEC's amendments, paragraph (g)(3) of Rule 17a-5 described a "material inadequacy" in a broker's or dealer's accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures to include "any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to: (i) inhibit a broker-dealer from promptly completing securities transactions or promptly discharging its responsibilities to customers, other broker-dealers or creditors; (ii) result in material financial loss; (iii) result in material misstatements of the broker-dealer's financial statements; or (iv) result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in [(i) through (iii)] above." See the SEC Release at 70, footnote 287.

The Board considered two principal alternatives: (1) issuing guidance on applying existing PCAOB attestation standards to the new examination and review engagements, or (2) developing standards tailored to the requirements of SEC Rule 17a-5. In considering the first alternative, the Board observed that auditors performing examinations of compliance reports would need to look to a patchwork of requirements in existing attestation standards, including AT sec. 101 and AT sec. 601, and apply them to the new examination of the compliance report and review of the exemption report. This could lead to more inconsistencies in compliance with the SEC's rule as compared to a tailored standard that sets forth the necessary procedures for complying with the SEC's rule.

The Board preliminarily determined that a broker and dealer specific approach to examining compliance reports and reviewing exemption reports that is tailored to the SEC's rule would promote consistent audit practices and compliance with the SEC's rule because auditors could more readily determine the procedures necessary to meet the requirements for reasonable assurance in the examination and moderate assurance in the review. The greater clarity also can help facilitate more efficient use of audit resources, which can help mitigate the associated costs. Since the Board's initial proposal, the high level of auditing deficiencies observed by PCAOB inspections of audits of brokers and dealers under pre-existing standards have underscored the Board's initial concerns about the need for standards that facilitate more consistent compliance with the SEC's rule.¹³¹

¹³¹ See PCAOB Release 2013-006, which reports that PCAOB inspection staff identified auditing deficiencies in 57 of the 60 audits of brokers and dealers selected for inspection and that deficiencies in compliance with audit requirements for brokers and dealers under the Exchange Act that were among the most frequently noted by PCAOB inspection staff included deficiencies in audit procedures related to net capital and customer reserve supporting schedules, compliance with the conditions of the exemption claimed by the broker or dealer, and

In developing the new standards, the Board took into account economic considerations, including taking note of commenters' views on the proposed attestation standards. The Board's approach is intended to focus and streamline the auditor's work in order to promote overall audit effectiveness and avoid duplicative procedures. The Board sought to ease the transition to the new standards and help lessen the effect of associated costs by:

- Building on principles and concepts in existing attestation standards, such as the general requirements in AT sec. 101, and the risk-based principles for testing controls as set forth in Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, and Auditing Standard No. 13, The Auditor's Responses to the Risks of Material Misstatement;
- Focusing the auditor's attention on the most important matters related to the objective of the examination or review, as applicable, including addressing the risk of misappropriation of customer assets;
- Requiring coordination of the attestation standards with the audit of the financial statements and audit procedures on the supplemental information, to enhance the effectiveness of the coordinated work and avoid unnecessary duplication of work;¹³² and

the accountant's supplemental report on material inadequacies. See PCAOB Release 2013-006, Executive Summary, at ii.

¹³² By its terms, SEC Rule 17a-5 requires the financial statement audit and the compliance examination or review to be performed by the same auditor. See paragraph (g) of SEC Rule 17a-5.

- Establishing risk-based approaches for the examination and review that are scalable – that is, the required audit effort is commensurate with the broker's or dealer's size and complexity¹³³ – and that facilitate consistent compliance with SEC Rule 17a-5.

The Board also considered commenters' views. Commenters on the Board's proposed attestation standards generally agreed that the proposed standards were appropriately tailored for the SEC's proposed amendments to Rule 17a-5. Notably, when the attestation standards were proposed, the PCAOB requested comment on whether the standards were appropriately scalable based on the size and complexity of the broker or dealer. Some commenters specifically agreed that the standards are scalable, and no commenters asserted that the standards are not scalable. Additionally, several comments on the proposed standards were no longer relevant because of changes the SEC made when it adopted the amendments.

Some commenters on the proposed standards expressed concerns about costs associated with extending the requirements for engagement quality reviews to encompass the attestation engagements covered by these standards. In light of the importance of the attestation engagements to investor protection and the high level of deficiencies observed by PCAOB inspection staff in areas that would be covered by the attestation engagements, the Board believes that engagement quality reviews can enhance the consistency of compliance with the

¹³³ This view is also analogous to the SEC's view for preparation of the compliance report discussed in the SEC Release. In the SEC Release, the SEC observed that the controls necessary for a carrying broker or dealer that engages in limited custodial activities generally should be less complex than the controls necessary for a carrying broker or dealer that engages in more extensive custodial activities, so a carrying broker or dealer with limited custodial activities should have to expend less effort to make the statements in the compliance report regarding Internal Control Over Compliance. See the SEC Release at 229. Similarly, the necessary audit effort related to test controls should be less for brokers and dealers with limited custodial activities.

SEC's rule. An effective engagement quality review can increase the likelihood of identifying significant engagement deficiencies before the examination report or review report is issued. Additionally, the Board took note of the fact that, in a February 2011 AICPA Peer Review Alert, the AICPA designated audits of carrying brokers or dealers as a "must select" for peer review, recognizing the significant public interest in audits of such firms.¹³⁴

Regarding the incremental costs of engagement quality reviews, because engagement quality reviews are required for audits of financial statements under PCAOB standards, the requirements for auditors to coordinate their audits of the financial statements and attestation engagements should facilitate the engagement quality review of the attestation engagement and help mitigate incremental costs. Furthermore, the Board anticipates that incremental costs for an engagement quality review of an attest engagement will vary with the nature of the attest engagement. For example, the required effort for an engagement quality review of a review engagement generally would be less than for an examination engagement, and the required effort for an examination of a smaller, less complex broker or dealer generally would be less than for a larger, more complex broker or dealer.

Applicability to Audits of Emerging Growth Companies

The Board is adopting the attestation standards pursuant to its authority under the Sarbanes-Oxley Act.¹³⁵

¹³⁴ See AICPA Peer Review Alert 11-01 (February 2011).

¹³⁵ Pub. L. 107-204, 116 Stat. 745 (2002). Under Section 101 of the Sarbanes-Oxley Act, the mission of the PCAOB is to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Section 103 of the Sarbanes-Oxley Act authorizes the Board to adopt auditing standards for use by registered public accounting firms in the preparation and issuance of audit reports "as required

Before rules adopted by the Board can take effect, they must be approved by the SEC.

Pursuant to Section 107(b)(3) of Sarbanes-Oxley Act, the SEC shall approve a proposed rule if it finds that the rule is "consistent with the requirements of [the] Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors."

Additionally, Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act")¹³⁶ amended Sarbanes-Oxley Act to provide that any additional rules adopted by the PCAOB after April 5, 2012 do not apply to audits of emerging growth companies ("EGCs")¹³⁷ unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation".¹³⁸

As previously discussed, the attestation standards will apply solely in connection with audits of registered brokers and dealers pursuant to SEC Rule 17a-5. PCAOB staff has discussed the applicability of the JOBS Act to this rulemaking with the SEC staff. The PCAOB is not aware of any EGCs that are also registered brokers or dealers.¹³⁹ Moreover, the reporting regimes

by [the] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors."

¹³⁶ Pub. L. No. 112-106, 126 Stat. 306 (2012).

¹³⁷ Section 3(a)(80) of the Exchange Act defines the term "emerging growth company."

¹³⁸ See Section 103(a)(3)(C) of the Sarbanes-Oxley Act (15 U.S.C. §7213(a)(3)), as amended by Section 104 of the JOBS Act, Pub. L. No. 112-106 (2012).

¹³⁹ PCAOB staff has reviewed the reported industry classifications in the most recent filings of those companies and read SEC filings of self-identified EGCs as necessary to ascertain whether any EGCs were brokers or dealers. For those companies for which audited financial statements were available and based on information included in the most recent audited financial statements filed as of May 15, 2013, PCAOB staff has observed that none of the EGCs is a broker or dealer.

for registered brokers and dealers under SEC Rule 17a-5 are separate and distinct from those for companies subject to reporting requirements pursuant to Section 13 and 15 of the Exchange Act or for a Securities Act registration statement. The Board defers to the SEC on the applicability of the JOBS Act to this rulemaking and stands ready to assist the SEC with any additional analysis that may become necessary.

Effective Date

The attestation standards will be effective, subject to approval by the SEC, for examination engagements and review engagements for fiscal years ending on or after June 1, 2014. This effective date coincides with the effective date for the corresponding amendments to SEC Rule 17a-5.¹⁴⁰

III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents, the Commission will:

- (A) by order approve or disapprove such proposed rules; or
- (B) institute proceedings to determine whether the proposed rules should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rules are consistent with the requirements of Title I of the Sarbanes-Oxley Act. Comments may be submitted by any of the following methods:

¹⁴⁰ See the SEC Release at 2.

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/pcaob.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number PCAOB-2013-01 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number PCAOB-2013-01. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/pcaob.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rules that are filed with the Commission, and all written communications relating to the proposed rules between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without charge; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. PCAOB-2013-01 and should be submitted on or before [insert 21 days from publication in the Federal Register].

By the Commission.

Elizabeth M. Murphy
Secretary



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PROPOSED STANDARDS FOR ATTESTATION)	PCAOB Release No. 2011-004
ENGAGEMENTS RELATED TO BROKER AND)	July 12, 2011
DEALER COMPLIANCE OR EXEMPTION)	
REPORTS REQUIRED BY THE U.S. SECURITIES)	PCAOB Rulemaking
AND EXCHANGE COMMISSION)	Docket Matter No. 035
)	
AND RELATED AMENDMENTS TO PCAOB)	
STANDARDS)	
)	
)	
)	

Summary: The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is proposing two new attestation standards, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, and *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, and related amendments to certain PCAOB standards. The proposed attestation standards and related amendments would be applicable to all registered firms conducting attestation engagements related to broker and dealer compliance or exemption reports required by the U.S. Securities and Exchange Commission.

Public
Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 035 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on September 12, 2011.

Board
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I. Introduction

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is proposing two attestation standards, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* ("examination engagements") and *Review Engagements Regarding Exemption Reports of Brokers and Dealers* ("review engagements"). These attestation standards would apply to compliance examination engagements or review engagements, respectively, of brokers^{1/} and dealers,^{2/} whichever is required, pursuant to proposed Exchange Act Rule 17a-5, *Reports to be made by certain brokers and dealers* ("SEC Proposed Rule 17a-5").

On July 21, 2010, Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amended various provisions of the Sarbanes-Oxley Act of 2002, and granted the Board oversight of the audits of brokers and dealers registered with the U.S. Securities and Exchange Commission ("SEC" or "Commission").^{3/} Specifically, the PCAOB now has the authority to carry out the same type of oversight responsibilities it has carried out with respect to issuer audits, including standard-setting.

On June 15, 2011, the Commission proposed amendments to its Rule 17a-5 regarding the annual reporting by brokers and dealers to, among other things, update the existing requirements of Rule 17a-5 and facilitate the ability of the PCAOB to implement oversight of independent public accountants of brokers and dealers, as

^{1/} Section 110(3) of the Sarbanes-Oxley Act of 2002 (the "Act") defines the term "broker" to mean a broker (as defined in Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act")) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{2/} Section 110(4) of the Act defines the term "dealer" to mean a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{3/} Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).



required by the Dodd-Frank Act.^{4/} Further, these amendments "are intended to encourage, in connection with broker-dealer audits, greater focus by the auditor on internal control over compliance as it pertains to key regulatory requirements, including, in particular, greater focus on broker-dealer custody practices under the [f]inancial [r]esponsibility [r]ules" specified in the amendments.^{5/}

Sections 17(a) and (e) of the Exchange Act and Rule 17a-5 together require a broker or dealer to, among other things, file an annual report with the SEC and the broker's or dealer's designated examining authority ("DEA").^{6/} SEC Proposed Rule 17a-5 would require the broker's or dealer's annual report to include a financial report and a compliance report or an exemption report.^{7/}

The compliance report generally would be filed by a broker or dealer that maintains custody of customer funds or securities and would include assertions by the broker or dealer that address:

- (i) Whether it was in compliance, in all material respects, with specified SEC rules related to net capital requirements, customer protection, including reserves and custody of securities, and quarterly security counts,^{8/} as well

^{4/} See 17 CFR § 240.17a-5, *Reports to be made by certain brokers and dealers* and Section I. of SEC Release No. 34-64676 ("SEC Proposing Release").

^{5/} See Section II.B.1. of the SEC Proposing Release.

^{6/} See Section II.A. of the SEC Proposing Release.

^{7/} The financial report required by SEC Proposed Rule 17a-5 would include financial statements and supporting schedules. The audit of the financial statements and supporting schedules would be conducted in accordance with PCAOB standards. In particular, Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements* (PCAOB Release No. 2011-005), would apply to the audit of the supporting schedules. The proposed attestation standard in Appendix 1 of this release would apply to an examination of the assertions in the compliance report. The proposed attestation standard in Appendix 2 of this release would apply to a review of the assertion in the exemption report.

^{8/} See 17 CFR § 240.15c3-1, *Net capital requirements for brokers or dealers*, 17 CFR § 240.15c3-3, *Customer protection – reserves and custody of securities*, and 17 CFR § 240.17a-13, *Quarterly security counts to be made by certain exchange members, brokers, and dealers*, for the complete text of these SEC rules. Also, refer to Appendix 4 of this release for further discussion of these SEC rules.



as the rules of its DEA that require account statements to be sent to customers of the broker or dealer (referred to collectively in this release as "the specified Financial Responsibility Rules") as of the fiscal year end;

- (ii) Whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the books and records of the broker or dealer; and
- (iii) Whether internal control over compliance with the specified Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness.^{9/}

The exemption report would be filed by a broker or dealer that claims exemption from the requirements of the SEC rule related to the safeguarding of customer assets and would identify the specific conditions that are the basis for claiming the exemption (referred to collectively in this release as "the exemption conditions").^{10/}

In addition, the SEC's proposed amendments would require the broker or dealer to include in its annual report an examination report from an independent public accountant regarding the assertions in the compliance report or a review report regarding the assertion in the exemption report, as applicable.^{11/} The auditor's examination report or review report would replace the existing requirement in Rule 17a-5 to report on material inadequacies identified in the accounting system, internal accounting controls, procedures of the broker or dealer for safeguarding securities, and certain practices and procedures related to customer protection and securities.^{12/}

The requirement under existing Rule 17a-5 that brokers and dealers file a report consisting of audited financial statements and supporting schedules would remain unchanged.^{13/} However, SEC Proposed Rule 17a-5 would require that financial

^{9/} See paragraph (d)(3)(i)(B) of SEC Proposed Rule 17a-5. The term "specified Financial Responsibility Rules" as used in this release and the proposed examination standard has the same meaning as the term "Financial Responsibility Rules" used in the SEC Proposing Release.

^{10/} See paragraph (d)(4) of SEC Proposed Rule 17a-5.

^{11/} See paragraph (d)(1)(i)(C) of SEC Proposed Rule 17a-5.

^{12/} See 17 CFR § 240.17a-5(g)(1).

^{13/} See Section II.B. of the SEC Proposing Release.



statement audits and examination and review engagements of brokers and dealers be performed in accordance with the standards of the PCAOB, instead of the standards or guidance of the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA").^{14/}

II. Reasons for the Proposed Attestation Standards

The Board is proposing two attestation standards to align its attestation standards more closely with the auditor's responsibilities under SEC Proposed Rule 17a-5.^{15/} Specifically, these proposed attestation standards would establish requirements for examining the assertions in a broker's or dealer's compliance report and reviewing a broker's or dealer's assertion in an exemption report. These proposed attestation standards are tailored to the requirements in SEC Proposed Rule 17a-5.

Also, the proposed attestation standard for compliance examinations of brokers and dealers ("proposed examination standard") would revise the existing reporting to report on whether the broker's or dealer's assertions are fairly stated, in all material respects.^{16/}

The requirement in the proposed examination standard for the auditor to obtain reasonable assurance in order to opine on whether the broker's or dealer's assertions are fairly stated, in all material respects, is similar to the requirement to obtain reasonable assurance in existing Rule 17a-5, which states that "[t]he scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in (a) the accounting system; (b) the internal accounting controls; (c) procedures for safeguarding securities; and (d) the practices and procedures whose review is specified [in Rule 17a-5] would be disclosed."^{17/} Currently, however, under applicable guidance from the AICPA, instead of

^{14/} See paragraph (g) of SEC Proposed Rule 17a-5 and Section II.B. of the SEC Proposing Release.

^{15/} See paragraph (g) of SEC Proposed Rule 17a-5.

^{16/} See paragraph (g)(2)(i) of SEC Proposed Rule 17a-5.

^{17/} See 17 CFR § 240.17a-5(g)(1). 17 CFR § 240.17a-5(g)(1) also states that "[a]dditionally, as specific objectives, the audit shall include reviews of the practices and procedures followed by the client: (i) In making the periodic computations of aggregate indebtedness and net capital under 17 CFR § 240.17a-3(a)(11) and the reserve required by 17 CFR § 240.15c3-3(e); (ii) In making the quarterly securities



issuing an opinion based on evidence providing reasonable assurance that all material inadequacies have been disclosed, an auditor may issue a report describing a "study" of certain practices and procedures followed by the broker or dealer.^{18/} SEC Proposed Rule 17a-5 would require that auditors perform engagements under Rule 17a-5 in accordance with PCAOB standards instead of the standards or guidance of the AICPA.^{19/} Because the proposed PCAOB standards do not provide for a "study," the auditor would no longer refer to such a "study" in his or her report. Instead, the auditor would express an opinion on the broker's or dealer's assertions based on the examination described in the proposed examination standard.

Both of the proposed attestation standards include requirements related to the auditor's consideration of fraud risks, including the risk of misappropriation of customer assets. Furthermore, both of the proposed attestation standards emphasize coordination between the examination engagement or review engagement and the audit of the broker's or dealer's financial statements and supporting schedules (referred to in this release as "supplemental information"). This emphasis on coordination, when properly executed, can avoid unnecessary redundancy in the work performed. For example, auditors can take into account, when appropriate, evidence obtained while planning and performing the audit of the financial statements and supplemental information in planning and performing the attestation engagement.

As an additional measure, the Board has issued for comment a proposed auditing standard regarding auditing supplemental information accompanying audited financial statements ("proposed auditing standard").^{20/} The proposed auditing standard would apply when the auditor of the financial statements is engaged to audit and report on supplemental information accompanying audited financial statements, including

examinations, counts, verifications and comparisons and the recordation of differences required by 17 CFR § 240.17a-13; (iii) In complying with the requirement for prompt payment for securities of section 4(c) of Regulation T (§ 220.4(c) of chapter II of title 12) of the Board of Governors of the Federal Reserve System; and (iv) In obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by 17 CFR § 240.15c3-3. Such review shall include a determination as to the adequacy of the procedures described in the records required to be maintained pursuant to 17 CFR § 240.15c3-3(d)(4)."

^{18/} See Section II.A. of the SEC Proposing Release.

^{19/} See paragraph (g) of SEC Proposed Rule 17a-5.

^{20/} See PCAOB Release No. 2011-005.



schedules prepared pursuant to Rule 17a-5.^{21/} The proposed auditing standard also includes a requirement for the procedures performed regarding the supplemental information to be planned and performed in conjunction with the audit of the financial statements and, for audits of brokers and dealers, to be coordinated with the attestation engagements related to compliance or exemption reports.^{22/}

III. Overview of the Proposed Attestation Standards

A. Proposed Attestation Standard, Examination Engagements Regarding Compliance Reports of Brokers and Dealers

Consistent with SEC Proposed Rule 17a-5, the proposed examination standard would require auditors to obtain sufficient appropriate evidence to opine on a broker's or dealer's assertions as to whether:

- The broker or dealer was in compliance, in all material respects, with the specified Financial Responsibility Rules as of the fiscal year end;
- The financial information used to assert compliance with the specified Financial Responsibility Rules was derived from the books and records of the broker or dealer; and
- Internal control over compliance with the specified Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness.^{23/}

The proposed examination standard provides procedural requirements for auditors that:

- Establish a risk-based approach for the examination, focusing the auditor on the matters that are most important to the auditor's conclusions regarding the broker's or dealer's assertions;
- Are designed to be scalable based on the broker's or dealer's size and complexity; and

^{21/} See 17 CFR § 240.17a-5(d)(3) and paragraph (d)(2)(ii) of SEC Proposed Rule 17a-5.

^{22/} Ibid.

^{23/} See paragraphs (d)(3)(i)(B) and (g)(2)(i) of SEC Proposed Rule 17a-5.

- Coordinate the examination engagement with the audit of the financial statements and supplemental information.

The proposed examination standard establishes requirements designed specifically for the examination required by SEC Proposed Rule 17a-5.^{24/} In addition, the emphasis on appropriately coordinating the examination engagement with the audit of the financial statements and supplemental information should result in avoiding unnecessary redundancy in the auditor's work.

Also, as discussed previously, the proposed examination standard would substantially change the language in the auditor's report, in connection with the requirements of the amendments to Rule 17a-5.

Appendix 1 of this release presents the proposed examination standard. Appendix 4 of this release discusses the proposed examination standard in more detail. It also discusses the proposed amendments to PCAOB standards related to the proposed attestation standards.

B. Proposed Attestation Standard, Review Engagements Regarding Exemption Reports of Brokers and Dealers

Consistent with SEC Proposed Rule 17a-5, the proposed attestation standard for reviewing a broker's or dealer's assertion in an exemption report ("proposed review standard") would establish requirements that apply when an auditor is engaged to perform a compliance review of the broker's or dealer's assertion in an exemption report.^{25/}

The proposed review standard establishes requirements that are designed specifically for the review required by SEC Proposed Rule 17a-5.^{26/} The proposed review standard would establish requirements for making inquiries and performing other procedures that are commensurate with the auditor's responsibility to obtain moderate assurance^{27/} that the broker or dealer meets the identified conditions for an exemption

^{24/} See paragraph (g)(2)(i) of SEC Proposed Rule 17a-5.

^{25/} See paragraphs (d)(4) and (g)(2)(ii) of SEC Proposed Rule 17a-5.

^{26/} Ibid.

^{27/} Obtaining moderate assurance in a review engagement is consistent with both existing PCAOB standards and the SEC Proposing Release. Paragraphs .55-.56 of AT sec. 101, *Attest Engagements*, states that "[i]n an attest engagement designed to provide a moderate level of assurance (referred to as a *review*), the objective is to



from Exchange Act Rule 15c3-3, *Customer protection – reserves and custody of securities*.^{28/} These procedures include evaluating relevant evidence obtained from the audit of the financial statements and supplemental information and are designed to enable the auditor to scale the review engagement based on the broker's or dealer's size and complexity.

The proposed review standard would establish requirements for the content of the review report. Appendix 2 of this release contains the text of the proposed review standard. Appendix 4 of this release discusses the proposed review standard in more detail.

IV. Effective Date

The Board expects that the proposed attestation standards would be effective for fiscal years ending on or after September 15, 2012, subject to consideration of public comment, SEC rule-making,^{29/} and approval by the SEC. This effective date coincides with the proposed end of the transition period for SEC Proposed Rule 17a-5.^{30/}

V. Other Board Considerations

A. Engagement Quality Review

The Board is proposing certain amendments to Auditing Standard No. 7, *Engagement Quality Review*, that would require an engagement quality review and concurring approval of issuance for examination engagements and review engagements of brokers and dealers.

accumulate sufficient evidence to restrict attestation risk to a moderate level. To accomplish this, the types of procedures performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures). Nevertheless, there will be circumstances in which inquiry and analytical procedures ... cannot be performed... In [this] circumstance, the practitioner should perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided." Section II.B.5. of the SEC Proposing Release states that a review results in "a moderate level of assurance."

^{28/} See 17 CFR § 240.15c3-3.

^{29/} See SEC Proposing Release.

^{30/} See Section II.B.7. of the SEC Proposing Release.



B. Independence

SEC Proposed Rule 17a-5 requires the auditor to be qualified and independent in accordance with the Commission's auditor independence requirements in 17 CFR § 210.2-01, *Qualification of Accountants*.^{31/} The auditor should refer to 17 CFR § 210.2-01 for applicable independence requirements when performing audits and attestation engagements of non-public brokers and dealers. The auditor also should refer to PCAOB Rules 3500T and 3600T, which require registered public accounting firms and their associated persons, in connection with the preparation or issuance of any audit report, to comply with the Board's interim ethics and independence standards to the extent not superseded or amended by the Board. In addition, any person associated with a registered public accounting firm is subject to PCAOB Rules 3501 and 3502, which state that associated persons shall not take or omit to take an action knowing, or recklessly not knowing, that the act or omission would directly and substantially contribute to a violation by that registered public accounting firm of the Act, Board rules, applicable securities laws, SEC rules or professional standards.

The Board has auditor independence requirements in PCAOB Rules 3520 through 3526 that supplement the SEC's independence rules. Rule 3520 requires that a registered public accounting firm and its associated persons be independent throughout the audit and professional engagement period. This concept applies to audits of non-public brokers and dealers to the same extent that it applies to audits of public company audit clients. PCAOB Rules 3521 through 3526, however, contain auditor independence requirements that the Board drafted specifically to pertain to public company audit clients. These requirements generally relate to the provision of tax services for audit clients, auditor communications with audit committees, and audit committee pre-approval of services provided by the auditor. Until the Board completes a separate rulemaking process and appropriate amendments to those rules, if any, are adopted by the Board and approved by the SEC, auditors of non-public brokers and dealers are not subject to the specific provisions of PCAOB Rules 3521 through 3526.

VI. Opportunity for Public Comment

The Board seeks comments on all aspects of the proposals, including the following:

1. Whether the proposed attestation standards are tailored appropriately for examinations and reviews related to compliance and exemption reports of brokers and dealers;

^{31/} See paragraph (f)(1) of SEC Proposed Rule 17a-5.



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2. Whether the proposed attestation standards are appropriately scalable based on the size and complexity of the broker or dealer;
3. Whether the requirements in the proposed attestation standards sufficiently describe the auditor's responsibilities; and
4. Whether specific requirements should be added to either of the proposed attestation standards to further enhance protection of customer assets.

Appendix 4 of this release seeks comments in response to additional questions.

The Board will seek comment on the proposed attestation standards and amendments for a 60-day period. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington DC 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to the PCAOB Rulemaking Docket Matter No. 035 on the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on September 12, 2011.

The Board will consider carefully all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are rules of the Board under the Act.

* * *

On the 12th day of July, in the year 2011, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

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APPENDIX 1 – Proposed Attestation Standard – *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*

APPENDIX 2 – Proposed Attestation Standard – *Review Engagements Regarding Exemption Reports of Brokers and Dealers*

APPENDIX 3 – Proposed Amendments to PCAOB Standards

APPENDIX 4 – Additional Discussion on the Proposed Attestation Standards and Questions for Public Comment



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APPENDIX 1

Proposed Attestation Standard

Examination Engagements Regarding Compliance Reports of Brokers and Dealers

Introduction

1. This standard establishes requirements that apply when an auditor is engaged to perform an examination^{1/} of the assertions made by a broker^{2/} or dealer^{3/} in a compliance report ("compliance report") prepared pursuant to the U.S. Securities and Exchange Commission's ("SEC's" or "Commission's") proposed amendments to Exchange Act Rule 17a-5 ("SEC Proposed Rule 17a-5").^{4/}

2. SEC Proposed Rule 17a-5 requires a broker's or dealer's compliance report to contain the following assertions by the broker or dealer:^{5/}

^{1/} On June 15, 2011, the Securities and Exchange Commission proposed amendments to 17 CFR § 240.17a-5, *Reports to be made by certain brokers and dealers*. Paragraph (g) of SEC Proposed Rule 17a-5 requires that the broker or dealer engage an independent accountant to issue the examination report covered by this standard.

^{2/} Section 110(3) of the Sarbanes-Oxley Act of 2002 (the "Act") defines the term "broker" to mean a broker (as defined in Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act")) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{3/} Section 110(4) of the Act defines the term "dealer" to mean a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{4/} See paragraph (d)(3) of SEC Proposed Rule 17a-5.

^{5/} See paragraph (d)(3)(i)(B) of SEC Proposed Rule 17a-5.



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- a. Whether, as of the fiscal year end, the broker or dealer was in compliance, in all material respects, with Rule 15c3-1, Rule 15c3-3, Rule 17a-13,^{6/} and any rule of the designated examining authority ("DEA") of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer ("account statement rule");

Note: Rule 15c3-1, Rule 15c3-3, Rule 17a-13, and the account statement rule are referred to collectively as "the specified Financial Responsibility Rules."^{7/}

- b. Whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the books and records of the broker or dealer; and
- c. Whether internal control over compliance with the specified Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness.^{8/}

^{6/} See 17 CFR § 240.15c3-1, *Net capital requirements for brokers or dealers*, 17 CFR § 240.15c3-3, *Customer protection – reserves and custody of securities*, and 17 CFR § 240.17a-13, *Quarterly securities counts to be made by certain exchange members, brokers and dealers*, respectively.

^{7/} The SEC's release accompanying SEC Proposed Rule 17a-5 ("SEC Proposing Release") refers to Rule 15c3-1, Rule 15c3-3, Rule 17a-13, and the account statement rule as the "Financial Responsibility Rules."

^{8/} Paragraph (d)(3)(iii) of SEC Proposed Rule 17a-5 defines a material weakness as "a deficiency, or a combination of deficiencies, in internal control over compliance with [the specified Financial Responsibility Rules], such that there is a reasonable possibility that material non-compliance with [the specified Financial Responsibility Rules] will not be prevented or detected on a timely basis. For purposes of this paragraph a deficiency in internal control over compliance exists when the design or operation of a control does not allow the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect non-compliance with [the specified Financial Responsibility Rules] on a timely basis." Section II.B.1. of the SEC Proposing Release states that "[t]here is a reasonable possibility of an event occurring if it is 'probable' or 'reasonably possible'. An event is 'probable' if the future event or events are likely to occur. An event is 'reasonably possible' if the chance of the future event or events occurring is more than remote, but less than likely."



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Objective

3. When performing an examination of the assertions made by a broker or dealer in a compliance report (an "examination engagement"), the auditor's objective is to express an opinion regarding whether the assertions made by the broker or dealer in its compliance report are fairly stated, in all material respects.

4. A broker or dealer is not permitted to conclude that it is in compliance with the specified Financial Responsibility Rules if it identifies one or more instances of material non-compliance.^{9/} Similarly, a broker or dealer is not permitted to conclude that its internal control over compliance with the specified Financial Responsibility Rules was effective if there were one or more instances of material weakness in internal control over compliance.^{10/} Accordingly, to express an opinion on the assertions made by a broker or dealer in a compliance report, the auditor must plan and perform the examination engagement to obtain appropriate evidence that is sufficient^{11/} to obtain reasonable assurance^{12/} about whether (1) one or more instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion and (2) one or more instances of material weakness exist during the period specified in the broker's or dealer's assertion.

Note: Because the broker's or dealer's assertions apply to each specified Financial Responsibility Rule, the auditor's examination should evaluate compliance with each specified Financial Responsibility Rule, and the

^{9/} See paragraph (d)(3)(ii) of SEC Proposed Rule 17a-5. That paragraph also states that "material non-compliance would be a failure by the broker or dealer to comply with the requirements of [the specified Financial Responsibility Rules] in all material respects." Paragraphs 9-11 of this standard establish requirements regarding the auditor's consideration of materiality in planning and performing the examination engagement.

^{10/} See paragraph (d)(3)(iii) of SEC Proposed Rule 17a-5.

^{11/} In this standard, the terms "sufficiency" and "appropriateness" have the same meaning as "sufficiency" and "appropriateness" of audit evidence, as described in Auditing Standard No. 15, *Audit Evidence*.

^{12/} Although not absolute assurance, reasonable assurance is a high level of assurance.



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effectiveness of internal control over compliance with each specified Financial Responsibility Rule individually.

Note: The auditor is not required to express an opinion on the process the broker or dealer used to arrive at the conclusions stated in the broker's or dealer's assertions.

5. The auditor must also plan and perform the examination engagement to obtain appropriate evidence that is sufficient to obtain reasonable assurance about whether the information used to assert compliance with the specified Financial Responsibility Rules was derived, in all material respects, from the books and records of the broker or dealer.^{13/}

Performing the Examination Engagement

General Requirements

6. An auditor who performs an examination engagement must:
- a. Have adequate technical proficiency in attestation engagements,
 - b. Obtain an understanding of the specified Financial Responsibility Rules and other rules and regulations that are relevant to the broker's or dealer's assertions,
 - c. Determine the auditor's compliance with independence and ethics requirements, and
 - d. Exercise due professional care,^{14/} which includes application of professional skepticism, in planning and performing the examination and the preparation of the report.

^{13/} See paragraph 28 of this standard.

^{14/} This standard requires the same due professional care as required by paragraph .40 of AT sec. 101, *Attest Engagements*, which states, in part, that the "[e]xercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report."



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7. The engagement partner is responsible for the examination engagement and performance of the examination procedures. Accordingly, the engagement partner is responsible for proper planning of the examination engagement, proper supervision of the work of engagement team members, and compliance with the requirements of this standard. The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Note: For purposes of this standard, the term "engagement partner" means the member of the engagement team with primary responsibility for the examination engagement.

Note: Proper planning includes establishing an overall strategy for the examination engagement and developing a plan for the engagement, which includes, in particular, identifying risks of material non-compliance and planned responses to those risks. Proper supervision includes supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Relationship Between the Examination Engagement and the Audit of the Financial Statements and Supplemental Information

8. The examination engagement should be coordinated with the audit of the financial statements and supplemental information of the broker or dealer.^{15/} The auditor should take into account relevant evidence from the audit in planning and performing procedures for the examination engagement and in evaluating the results of the procedures performed in the examination. However, the objectives of the audit and the examination engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.

^{15/} Under the definition of supplemental information included in PCAOB Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements* (PCAOB Release 2011-005), supplemental information includes the supporting schedules described in paragraph (d)(2)(ii) and (d)(2)(iii) of SEC Proposed Rule 17a-5, which are required to be filed with the SEC or DEAs by brokers and dealers. Such supporting schedules include a Computation of Net Capital Under Rule 15c3-1, a Computation for Determination of the Reserve Requirements under Exhibit A of Rule 15c3-3, and Information Relating to Possession or Control Requirements Under Rule 15c3-3.



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Note: If the auditor performing the examination engagement does not audit the financial statements and supplemental information of the broker or dealer, then the auditor must obtain knowledge of the evidence obtained and results of procedures performed in the audit of the financial statements and supplemental information that is commensurate with that of the auditor of the financial statements and supplemental information. In addition, the auditor's own work on the examination engagement must be sufficient to support an opinion on the assertions made by the broker or dealer in the compliance report.

Consideration of Materiality in the Examination Engagement

9. To obtain reasonable assurance about whether one or more instances of material non-compliance exist, the auditor should plan and perform examination procedures to detect instances of non-compliance that, individually or in combination, would result in material non-compliance. This includes being alert while planning and performing examination procedures for non-compliance that could be material due to quantitative or qualitative factors. Also, the auditor should take into account relevant quantitative and qualitative factors when evaluating identified non-compliance.

10. In an examination engagement, the auditor should take into account the following matters in his or her consideration of the materiality of non-compliance:

- a. The nature of the specified Financial Responsibility Rules, which may or may not be quantifiable in monetary terms;
- b. The nature and frequency of non-compliance; and
- c. Qualitative considerations.

11. In testing and evaluating the effectiveness of internal control over compliance with the specified Financial Responsibility Rules, the auditor should use the same materiality considerations he or she used for testing and evaluating compliance with the respective specified Financial Responsibility Rules.

Considerations for Brokers and Dealers with Multiple Divisions or Branches

12. When the broker or dealer has multiple divisions or branches, the auditor should determine the extent to which he or she should perform examination procedures at selected divisions or branches to obtain sufficient appropriate evidence to support the conclusions expressed in the auditor's examination report. This includes determining the divisions or branches at which to perform examination procedures, as well as the



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nature, timing, and extent of the procedures to be performed at those individual divisions or branches. In determining the extent of the examination procedures to be performed, the auditor should take into account:

- a. The degree to which the specified Financial Responsibility Rules relate to activities at the division or branch level;
- b. The nature and significance of the related assets, transactions, or activities at the division or branch to the specified Financial Responsibility Rules;
- c. The degree of centralization of records or information processing relevant to the specified Financial Responsibility Rules; and
- d. The degree and effectiveness of management supervision and monitoring of the relevant activities of the division or branch.

Identifying Risks of Material Non-Compliance

13. The auditor should perform procedures that are sufficient to provide a reasonable basis for identifying the risks of material non-compliance, whether intentional or unintentional, associated with each specified Financial Responsibility Rule, and designing further examination procedures.^{16/} To identify and assess risks of material non-compliance, the auditor should:

- a. Evaluate the evidence obtained and the results of procedures performed in the audit of the financial statements and supplemental information;
- b. Evaluate the nature of instances of non-compliance and deficiencies in internal control over compliance with the specified Financial Responsibility Rules identified during previous examination engagements;
- c. Obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the specified Financial Responsibility Rules;

Note: The nature, timing, and extent of procedures that are necessary to obtain an understanding of the broker's or

^{16/} Further examination procedures consist of testing controls over compliance (paragraphs 15-23) and performing compliance tests (paragraphs 24-26).



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dealer's processes, including relevant controls, regarding compliance with the specified Financial Responsibility Rules depend on the size and complexity of the broker or dealer; the auditor's existing knowledge of the broker's or dealer's processes and controls; the degree to which the broker's or dealer's compliance depends on the completeness and accuracy of the broker's or dealer's internally generated data; the nature and extent of changes in systems and operations; and the nature of the broker's or dealer's documentation of its processes and controls.

Note: Obtaining an understanding of the broker's or dealer's processes regarding compliance includes obtaining an understanding of the degree to which the broker's or dealer's compliance depends on the completeness and accuracy of the broker's or dealer's internally generated data.

Note: Obtaining an understanding of the broker's or dealer's processes, including relevant controls, includes evaluating the design of controls that are relevant to the examination and determining whether the controls have been implemented.

- d. Obtain an understanding of instances of non-compliance and deficiencies in controls over compliance identified by management;
- e. Assess risks of material non-compliance associated with related parties,^{17/} including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship;
- f. Obtain an understanding of management's competence regarding the relevant rules and regulations;
- g. Read the Financial and Operational Combined Uniform Single Reports filed by the broker or dealer and obtain an understanding of the reasons for resubmissions, if any;

^{17/} The auditor should look to the FASB Accounting Standards Codification Master Glossary with respect to the term "related parties."



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- h. Read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's assertions;
- i. Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to the broker's or dealer's assertions;
- j. Read correspondence and notifications regarding non-compliance that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA that are relevant to the broker's or dealer's assertions, and, when necessary in the circumstances, make inquiries of the regulatory agencies; and
- k. Obtain an understanding of the nature and frequency of customer complaints that are relevant to compliance with the specified Financial Responsibility Rules.

14. In addition, when identifying and assessing risks of material non-compliance, the auditor should assess the risk of fraud, including the risk of misappropriation of customer assets, relevant to the specified Financial Responsibility Rules.

Testing Controls over Compliance

15. The auditor must test those controls that are important to the auditor's conclusion about whether the broker or dealer maintains effective internal control over compliance for each specified Financial Responsibility Rule. The auditor must obtain evidence that the controls over compliance selected for testing are designed effectively and operated effectively during the entire fiscal year.^{18/}

16. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control.

^{18/} See paragraph (d)(3)(i)(B)(3) of SEC Proposed Rule 17a-5, which requires the broker or dealer to assert on the effectiveness of its internal control over compliance with the specified Financial Responsibility Rules throughout the fiscal year. See also paragraph (d)(3)(i)(C), which requires the broker or dealer to describe each identified instance of material non-compliance and each identified material weakness in internal control over compliance.



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The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

Note: Although the auditor must obtain evidence about the effectiveness of the selected controls for each specified Financial Responsibility Rule, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control.

17. Factors that affect the risk associated with a control include:

- The nature of the specified Financial Responsibility Rule,
- The risk of material non-compliance associated with the specified Financial Responsibility Rule,
- Changes in the broker's or dealer's policies or procedures that might adversely affect control design or operating effectiveness,
- The broker's or dealer's history of instances of non-compliance with the specified Financial Responsibility Rule that the control is intended to prevent or detect,
- The existence and effectiveness of controls that monitor other controls,
- The risk of management override of controls over compliance with the specified Financial Responsibility Rules,
- The nature of the control and the frequency with which it operates,
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls),
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance,
- The extent of use of part-time personnel to perform controls over compliance,



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- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective), and
- The complexity of the control and the significance of the judgments made in connection with its operation.

Testing Design Effectiveness

18. The auditor should test the design effectiveness of the selected controls over compliance with the specified Financial Responsibility Rules by determining whether the broker's or dealer's controls, if they are operating as prescribed by persons possessing the necessary authority and competence to perform the control effectively, can effectively prevent or detect instances of material non-compliance on a timely basis.

Note: If a broker or dealer makes changes to its policies and procedures or key personnel during the fiscal year, the auditor should obtain evidence regarding the design effectiveness of the selected controls before and after the change.

19. Procedures the auditor performs to obtain evidence about design effectiveness include inquiry of appropriate personnel, observation of the broker's or dealer's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

20. The auditor should test the operating effectiveness of the selected controls over compliance with the specified Financial Responsibility Rules by determining whether each control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

Note: The auditor should obtain evidence regarding the operating effectiveness of the selected controls throughout the period.

21. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the broker's or dealer's operations, inspection of relevant documentation, and re-performance of the control.

22. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures.



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Further, for an individual control, different combinations of the nature, timing, and extent of testing may provide sufficient evidence in relation to the risk associated with the control.

Using Evidence Obtained in Past Examination Engagements

23. The auditor should obtain evidence during the current year about the design and operating effectiveness of controls selected for testing. If controls selected for testing in the current year were tested in past examination engagements, and if the auditor plans to use evidence about the effectiveness of those controls that was obtained in prior years, the auditor should take into account the factors discussed in paragraph 17 and the following factors to determine the evidence needed during the current year examination:

- The nature, timing, and extent of procedures performed in previous examination engagements;
- The results of the previous years' testing of the control; and
- Changes in the control or the process in which the control operates since the previous examination engagement.

Performing Compliance Tests

24. The auditor must perform procedures ("compliance tests") that are sufficient to support the auditor's conclusions regarding whether the broker or dealer is in compliance with each specified Financial Responsibility Rule as of the specified date.

Note: The auditor should perform tests of the broker's or dealer's compliance with each of the specified Financial Responsibility Rules as of year end and tests of the broker's or dealer's compliance with Rule 17a-13 and the account statement rule during the fiscal quarter immediately preceding the broker's or dealer's year end.^{19/}

^{19/} Section II.B.1. of the SEC Proposing Release states that "[t]he proposed assertions with respect to compliance with Rules 15c3-1 and 15c3-3 would relate to compliance as of the broker [or] dealer's fiscal year-end. The assertions as to compliance with Rule 17a-13 and the [a]ccount [s]tatement [r]ule also would be made as of the broker [or] dealer's fiscal year-end. However, because these rules impose obligations on a quarterly basis (the broker [or] dealer must conduct the quarterly count



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Note: Procedures performed as part of the audit of the financial statements and supplemental information also might provide evidence regarding the broker's or dealer's compliance with the specified Financial Responsibility Rules. For example, paragraph (g)(1) of SEC Proposed Rule 17a-5 requires the auditor to audit the broker's or dealer's "financial report," which contains certain supplemental information, including supporting schedules that include a Computation of Net Capital Under Rule 15c3-1, a Computation for Determination of the Reserve Requirements under Exhibit A of Rule 15c3-3, and Information Relating to Possession or Control Requirements Under Rule 15c3-3.

25. The auditor should plan and perform compliance tests that are responsive to the risks of material non-compliance, including fraud risks. As the risk of material non-compliance associated with a particular specified Financial Responsibility Rule increases, the evidence that the auditor should obtain from compliance tests also increases. The evidence provided by the auditor's compliance tests depends upon the mix of the nature, timing, and extent of those procedures. Inquiry alone does not provide sufficient appropriate evidence to support the auditor's conclusions about the broker's or dealer's compliance with the specified Financial Responsibility Rules.

26. In connection with performing the compliance tests pursuant to paragraph 24, the auditor must perform procedures to obtain evidence about the existence of customer funds or securities held for customers.^{20/}

Note: Examples of procedures that provide evidence about the existence of customer assets include (1) counting customer securities or observing and testing the broker or dealer's procedures for physical inspection and (2) confirming customer security positions directly with depositories and clearing organizations. Procedures performed in the audit of the financial statements and supplemental information to test the existence of assets

of securities and must send statements to all customers at least once during each quarter, but not necessarily on the last day of the quarter), to be able to make the assertions in the [c]ompliance [r]eport, the broker [or] dealer would need to determine that it had satisfied the requirements over the course of the fiscal quarter immediately preceding the broker [or] dealer's fiscal year-end."

^{20/} Paragraphs (a)(1) and (a)(2) of Rule 15c3-3 define the terms "customer" and "customer securities," respectively.



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held for customers also provide evidence that is relevant to the requirement in this standard.

Effect of Tests of Controls over Compliance on Compliance Tests

27. The auditor should take into account tests of controls over compliance with the specified Financial Responsibility Rules in determining the necessary nature, timing, and extent of compliance tests. For a given specified Financial Responsibility Rule, if the results of the auditor's evaluation of controls over compliance indicates that the controls are effective, less evidence is needed from compliance tests. If the results of the auditor's evaluation of controls over compliance indicate that the controls are ineffective, the auditor should revise the planned compliance tests as necessary to obtain more evidence.

Testing Information Used to Assert Compliance

28. The auditor must perform procedures to determine whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records.

Note: Procedures performed in the audit of the financial statements and supplemental information might provide evidence relevant to determining whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records.

Evaluating the Results of the Examination Procedures

29. In forming an opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects, the auditor should evaluate all evidence obtained, regardless of whether the evidence corroborates or contradicts the broker's or dealer's assertions.

30. The auditor should evaluate:

- a. Instances of non-compliance to determine whether they are material, individually or in combination, as of the specified date;
- b. Instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records to determine whether they are material, individually or in combination; and



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- c. Identified control deficiencies to determine whether the deficiencies, individually or in combination, are material weaknesses.

Note: A material weakness can exist even when no instances of material non-compliance exist.

Note: The auditor cannot assume that an identified instance of non-compliance or an identified control deficiency is an isolated occurrence. The auditor should evaluate the effect of any instance of non-compliance or identified control deficiency on the auditor's assessed risks of material non-compliance.

Note: The auditor also should evaluate the effect on the audit of the financial statements and supplemental information of any material non-compliance, material weaknesses, or instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records.

31. The auditor should evaluate whether he or she has obtained sufficient appropriate evidence to support the conclusions to be presented in the examination report taking into account the risks of material non-compliance, the results of the examination procedures performed and the appropriateness (i.e., the relevance and reliability) of the evidence obtained.

32. If the auditor has not obtained sufficient appropriate evidence about an assertion or has substantial doubt about an assertion, the auditor should perform procedures to obtain further evidence to address the matter. If the auditor is unable to obtain sufficient appropriate evidence about an assertion, the auditor should withdraw from the examination engagement or express a disclaimer of opinion.^{21/}

Subsequent Events

33. For the period from the end of the period specified in the broker's or dealer's assertions to the date of the auditor's examination report (the "subsequent period"), the

^{21/} See Appendix A of this standard, "Examination Report Modifications," which describes the situations in which the auditor should modify his or her examination report and the specific modifications to be made to the auditor's examination report.



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auditor should perform procedures to identify subsequent events relevant to the auditor's conclusions about the assertions made by the broker or dealer in the compliance report. Such procedures should include, but are not limited to:

- a. Reading relevant reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors, and correspondence that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA during the subsequent period that is relevant to the broker's or dealer's assertions; and
- b. Evaluating information obtained through other engagements performed by the auditor for the broker or dealer, including subsequent events procedures performed in the audit of the financial statements and supplemental information.

34. The auditor should evaluate the results of the procedures described in the previous paragraph to determine whether the results corroborate or contradict the broker's or dealer's assertions.

Obtaining a Representation Letter

35. The auditor should obtain written representations from management of the broker or dealer:

- a. Acknowledging management's responsibility for establishing and maintaining a system of internal control to provide the broker or dealer with reasonable assurance that any instances of material non-compliance with the specified Financial Responsibility Rules will be prevented or detected on a timely basis;^{22/}
- b. Stating the broker's or dealer's assertions included in the compliance report;
- c. Stating that management has made available to the auditor all records and other information relevant to the broker's or dealer's assertions, including all known matters contradicting the assertions, and all communications from regulatory agencies, internal auditors, others who perform an equivalent function, compliance functions, and other auditors,

^{22/}

See paragraph (d)(3)(i)(A) of SEC Proposed Rule 17a-5.



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that are relevant to the broker's or dealer's assertions, received through the date of the auditor's report; and

- d. Stating whether there were, subsequent to the period addressed in the broker's or dealer's assertions, any known events or other factors that might significantly affect the broker's or dealer's assertions.

36. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the engagement, as described in Appendix A of this standard.

Communication Requirements

37. The auditor should communicate to management identified instances of non-compliance, identified control deficiencies, and identified instances in which information used to determine compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records.

38. The auditor should communicate to management and the audit committee^{23/} identified instances of material non-compliance, identified instances of material weakness, and identified instances in which information used to determine compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records.

Note: The auditor must also comply with the requirements of paragraph (h) of SEC Proposed Rule 17a-5, which requires the auditor to notify the Commission within one business day of determining that any material non-compliance exists during the course of preparing the reports required by SEC Proposed Rule 17a-5.

Note: See also paragraphs A8 and A10 of this standard.

^{23/} For purposes of this standard, the term "audit committee" refers to a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of a company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company. If a broker or dealer does not have an audit committee or a board of directors of the company, those responsible for the appointment, compensation, and oversight of the work of the auditor.



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Reporting on the Examination Engagement

39. The auditor's examination report must include the following elements, modified as necessary in the circumstances and manner discussed in Appendix A:

- a. A title that includes the word *independent*;
- b. An identification of the compliance report and the broker's or dealer's assertions regarding compliance with the specified Financial Responsibility Rules, whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records, and the effectiveness of internal control over compliance with the specified Financial Responsibility Rules;
- c. A statement that management of the broker or dealer is responsible for establishing and maintaining a system of internal control to provide the broker or dealer with reasonable assurance that any instances of material non-compliance with the specified Financial Responsibility Rules will be prevented or detected on a timely basis;
- d. A statement that the auditor's responsibility is to express an opinion on the broker's or dealer's assertions based on his or her examination;
- e. A statement that the examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);
- f. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the examination engagement to obtain reasonable assurance about whether one or more instances of material non-compliance exist as of the specified date; whether the information used to assert compliance with the specified Financial Responsibility Rules was derived, in all material respects, from the books and records of the broker or dealer; and whether one or more instances of material weakness exist during the specified period;
- g. A statement that an examination engagement includes testing and evaluating the broker's or dealer's compliance with the specified Financial Responsibility Rules, determining whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records, testing and evaluating the



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design and operating effectiveness of internal control over compliance with the specified Financial Responsibility Rules, and performing such other procedures as the auditor considered necessary in the circumstances;

- h. A statement that the auditor believes the examination provides a reasonable basis for his or her opinion;
- i. The auditor's opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects;
- j. The manual signature of the auditor's firm;^{24/}
- k. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's examination report has been issued; and
- l. The date of the examination report.

40. The following example examination report expressing an unqualified opinion on the assertions made by a broker or dealer in a compliance report illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have examined W Broker's assertions, included in the accompanying [title of the compliance report], that (1) W Broker complied, in all material respects, with Rules 15c3-1, 15c3-3, 17a-13 under the Securities Exchange Act of 1934, and Rule [fill-in name/number] of [fill in DEA] that requires account statements to be sent to the customers of W Broker (collectively, "the specified Financial Responsibility Rules") as of [date]; (2) the information used to assert compliance with the specified Financial Responsibility Rules was derived from W Broker's books and records; and (3) internal control over compliance with the specified Financial Responsibility Rules was effective during the year ended [date] such that there were no instances of material weakness. W Broker's management is responsible for establishing and maintaining a system of internal control to

^{24/} Paragraph (i)(1)(ii) of SEC Proposed Rule 17a-5 requires the auditor's report to be manually signed.



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provide W Broker with reasonable assurance that any instances of material non-compliance with the specified Financial Responsibility Rules will be prevented or detected on a timely basis. Our responsibility is to express an opinion on W Broker's assertions based on our examination.

[*Scope paragraph*]

We conducted our examination in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the examination to obtain reasonable assurance about whether one or more instances of material non-compliance exist as of the specified date; whether the information used to assert compliance with the specified Financial Responsibility Rules was derived, in all material respects, from W Broker's books and records; and whether one or more instances of material weakness exist during the specified period. Our examination includes testing and evaluating W Broker's compliance with the specified Financial Responsibility Rules, determining whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from W Broker's books and records, testing and evaluating the design and operating effectiveness of internal control over compliance with the specified Financial Responsibility Rules, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.



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[*Opinion paragraph*]

In our opinion, W Broker's assertions that (1) W Broker complied, in all material respects, with Rules 15c3-1, 15c3-3, 17a-13 under the Securities Exchange Act of 1934, and Rule [fill-in name/number] of [fill in DEA] that requires account statements to be sent to the customers of W Broker as of [date]; (2) the information used to assert compliance with the specified Financial Responsibility Rules was derived from W Broker's books and records; and (3) internal control over compliance with the specified Financial Responsibility Rules was effective during the year ended [date] such that there were no instances of material weakness are fairly stated, in all material respects.

[*Signature*]

[*City and State or Country*]

[*Date*]

Examination Report Date

41. The auditor should date the examination report no earlier than the date on which the auditor obtains sufficient appropriate evidence to support his or her opinion.

Note: Because of the coordination between the examination engagement and the audit of the financial statements and supplemental information, the date of the examination report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.



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APPENDIX A – Examination Report Modifications

A1. The auditor should modify his or her examination report if any of the following conditions exist:

- a. There are one or more instances of material non-compliance as of the date specified in the broker's or dealer's assertion, one or more material weaknesses during the period specified in the broker's or dealer's assertion, or one or more instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the books and records of the broker or dealer (paragraphs A2-A3).
- b. There is a restriction on the scope of the examination engagement (paragraphs A4-A8).
- c. There is other information contained in the compliance report (paragraphs A9-A10).

Material Non-Compliance, Material Weakness, or Instance in which Information Used to Assert Compliance was not Derived, in all Material Respects, from the Broker's or Dealer's Books and Records

A2. If (1) one or more instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion, (2) one or more material weaknesses exist during the period specified in the broker's or dealer's assertion, or (3) one or more instances exist in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the books and records of the broker or dealer, the auditor must express an adverse opinion directly on the subject matter of the respective assertions, rather than on the assertions themselves, unless there is a restriction on the scope of the examination engagement.

Note: The requirement in this paragraph to express an adverse opinion applies regardless of whether the material non-compliance, material weakness, or other matters preventing the unqualified opinion were identified by management or the auditor.

A3. When expressing such an adverse opinion, the auditor's examination report should include, as applicable:



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- a. A statement that one or more instances of material non-compliance have been identified and an identification of the instances of material non-compliance described in the broker's or dealer's compliance report.
- b. A statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in the compliance report.
- c. A statement that one or more instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records have been identified.

Note: If a description of all identified instances of material non-compliance and all identified material weaknesses has not been included in the broker's or dealer's compliance report, the examination report must be modified to describe those instances of material non-compliance or material weaknesses that the auditor has identified but that are not described in the broker's or dealer's compliance report.^{25/}

Scope Limitations

A4. The auditor can express an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects, only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the examination engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion should state that the auditor does not express an opinion on the assertions made by the broker or dealer in the compliance report.

A5. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the examination engagement was not sufficient for the auditor to express an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer, including the procedures that were deemed necessary by the auditor that have been omitted and the reason for their omission. The auditor should

^{25/} Paragraph (d)(3)(i)(C) of SEC Proposed Rule 17a-5 requires the broker's or dealer's compliance report to contain a description of each identified instance of material non-compliance and each identified material weakness.



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not identify the procedures that were performed nor include the statements describing the characteristics of an examination engagement.

A6. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that: (1) one or more instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion, (2) one or more material weaknesses exist during the period specified in the broker's or dealer's assertion, or (3) one or more instances exist in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the books and records of the broker or dealer, the auditor's report also must include the matters described in paragraph A3.

A7. The auditor may issue a report disclaiming an opinion on the assertions made by a broker or dealer in a compliance report as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

Note: In this case, in following the direction in paragraph 41 regarding dating the auditor's examination report, the report date is the date on which the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

A8. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the examination engagement, the auditor should communicate on a timely basis, in writing, to management and the audit committee that the examination engagement cannot be satisfactorily completed.

Other Information in the Compliance Report

A9. If the compliance report contains other information in addition to the statements and assertions required by SEC Proposed Rule 17a-5,^{26/} the auditor should disclaim an opinion on the other information.

A10. If the auditor believes that the other information in the compliance report contains a material misstatement of fact, he or she should discuss the matter with management of the broker or dealer. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify

^{26/} See paragraph (d)(3) of SEC Proposed Rule 17a-5.



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management and the audit committee, in writing, of the auditor's views concerning the information.^{27/}

^{27/} See also AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.



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APPENDIX 2

Proposed Attestation Standard

Review Engagements Regarding Exemption Reports of Brokers and Dealers

Introduction

1. This standard establishes requirements that apply when an auditor is engaged to perform a compliance review^{1/} of the assertion made by a broker^{2/} or dealer^{3/} in an exemption report ("exemption report") prepared pursuant to the U.S. Securities and Exchange Commission's ("SEC's" or "Commission's") proposed amendments to Exchange Act Rule 17a-5 ("SEC Proposed Rule 17a-5").^{4/}
2. SEC Proposed Rule 17a-5 requires a broker's or dealer's exemption report to contain an assertion by the broker or dealer that it is exempt from the provisions of Rule

^{1/} On June 15, 2011, the Securities and Exchange Commission proposed amendments to 17 CFR § 240.17a-5, *Reports to be made by certain brokers and dealers*. Paragraph (g) of SEC Proposed Rule 17a-5 requires that the broker or dealer engage an independent accountant to issue the review report covered by this standard.

^{2/} Section 110(3) of the Sarbanes-Oxley Act of 2002 (the "Act") defines the term "broker" to mean a broker (as defined in Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act")) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{3/} Section 110(4) of the Act defines the term "dealer" to mean a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{4/} See paragraph (d)(4) of SEC Proposed Rule 17a-5.



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15c3-3^{5/} because it meets conditions set forth in paragraph (k) of Rule 15c3-3, and identify the specified conditions.^{6/}

Objective

3. When performing a review of the assertion made by a broker or dealer in an exemption report (a "review engagement"), the auditor's objective is to state a conclusion regarding whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertion for the assertion to be fairly stated, in all material respects.

4. To state such a conclusion, the auditor must plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance^{7/} about whether one or more instances of non-compliance exist with respect to the conditions identified in the broker's or dealer's assertion ("exemption conditions") that, individually or in combination, would cause the broker's or dealer's assertion not to be fairly stated, in all material respects.

Performing the Review Engagement

General Requirements

5. An auditor who performs a review engagement must:
- a. Have adequate technical proficiency in attestation engagements,
 - b. Obtain an understanding of the exemption conditions and other rules and regulations that are relevant to the broker's or dealer's assertion,
 - c. Determine the auditor's compliance with independence and ethics requirements, and

^{5/} See 17 CFR § 240.15c3-3, *Customer protection – reserves and custody of securities*.

^{6/} See paragraph (d)(4) of SEC Proposed Rule 17a-5.

^{7/} Moderate assurance is obtained by performing with due professional care the inquiries and other procedures required by this standard in order to reach a conclusion about whether there is a need to modify the broker's or dealer's assertion about its exemption for the assertion to be fairly stated in all material respects.



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- d. Exercise due professional care,^{8/} which includes application of professional skepticism, in planning and performing the review and the preparation of the report.

6. The engagement partner is responsible for the review engagement and performance of the review procedures. Accordingly, the engagement partner is responsible for proper planning of the review engagement, proper supervision of the work of engagement team members, and compliance with the requirements of this standard. The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Note: For purposes of this standard, the term "engagement partner" means the member of the engagement team with primary responsibility for the review engagement.

Relationship Between the Review Engagement and the Audit of Financial Statements and Supplemental Information

7. The review engagement should be coordinated with the audit of the financial statements and supplemental information of the broker or dealer.^{9/} The auditor should take into account relevant evidence from the audit in planning and performing procedures for the review engagement and in evaluating the results of the procedures performed in the review. However, the objectives of the audit and the review engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.

^{8/} This standard requires the same due professional care as required by paragraph .40 of AT sec. 101, *Attest Engagements*, which states, in part, that: "[e]xercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report."

^{9/} Under the definition of supplemental information included in PCAOB Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements* (PCAOB Release 2011-005), supplemental information includes the supporting schedules described in paragraph (d)(2)(ii) and (d)(2)(iii) of SEC Proposed Rule 17a-5, which are required to be filed with the SEC or designated examining authorities ("DEAs") by brokers and dealers. Such supporting schedules include a Computation of Net Capital Under Rule 15c3-1, a Computation for Determination of the Reserve Requirements under Exhibit A of Rule 15c3-3, and Information Relating to Possession or Control Requirements Under Rule 15c3-3.



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Note: If the auditor performing the review engagement does not audit the financial statements and supplemental information of the broker or dealer, then the auditor must obtain knowledge of the evidence obtained and results of procedures performed in the audit of the financial statements and supplemental information that is commensurate with that of the auditor of the financial statements and supplemental information. In addition, the auditor's own work on the review engagement must be sufficient to support his or her conclusion on the broker's or dealer's assertion.

Review Procedures

8. A review engagement includes the following procedures:
 - a. Reading the exemption report to determine the exemption conditions on which the broker or dealer asserts its exemption,
 - b. Performing inquiries and other review procedures set forth in this standard, and
 - c. Evaluating whether the evidence indicates that there should be modifications to the broker's or dealer's assertion based on the results of the procedures performed.
9. The nature, timing, and extent of the necessary inquiries and other review procedures depend on:
 - a. The following risk factors:
 - (1) The broker's or dealer's history of instances of non-compliance with the exemption conditions;
 - (2) Changes in the broker's or dealer's procedures, controls or the process in which the controls operate since the prior year;
 - (3) Changes in the broker's or dealer's operations that are relevant to compliance with the exemption conditions;
 - (4) Competence of the personnel who are responsible for compliance with the exemption conditions or who perform important controls over compliance, and whether there have been changes in those personnel during the period of the review;



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- (5) The risk of fraud, including the risk of misappropriation of customer assets, relevant to the exemption conditions;
 - (6) Potential non-compliance associated with related parties,^{10/} including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship; and
 - (7) The degree to which the processes that relate to the exemption conditions are performed, monitored, or controlled in a centralized or decentralized environment.
- b. Evidence about the broker's or dealer's compliance with the exemption conditions or about the effectiveness of controls over the exemption conditions obtained from the audit of the financial statements and supplemental information.
10. In performing the review engagement, the auditor should:
- a. Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding:
 - (1) Whether the broker or dealer was in compliance with the exemption conditions for the year under review.
 - (2) Regulatory examinations and correspondence between the SEC or the broker's or dealer's designated examining authority ("DEA") and the broker or dealer that are relevant to compliance with the exemption conditions.

Note: If the broker or dealer has sent or received correspondence with the SEC or the broker's or dealer's DEA that is relevant to compliance with the exemption conditions, the auditor should read such correspondence and, when necessary in the circumstances, make inquiries of the regulatory agencies.

^{10/} The auditor should look to the FASB Accounting Standards Codification Master Glossary with respect to the term "related parties".



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- (3) Subsequent events through the date of the auditor's review report that might have a material effect on the broker's or dealer's assertion that it is exempt from the provisions of Rule 15c3-3.
 - b. Inquire of individuals at the broker or dealer who have relevant knowledge of controls relevant to the broker's or dealer's compliance with the exemption conditions regarding:
 - (1) The controls that are in place to maintain compliance with the exemption conditions, including the nature of the controls and their frequency of operation.

Note: The auditor should take into account procedures performed during the audit of the financial statements and supplemental information in obtaining an understanding of controls or other activities relevant to the broker's or dealer's compliance with the exemption conditions.
 - (2) Whether the individual is aware of any deficiencies in controls over compliance or instances of non-compliance with the exemption conditions and, if so, the nature, frequency, and cause (if known) of the control deficiencies or instances of non-compliance.
 - c. Inquire of individuals who are responsible for monitoring compliance with the exemption conditions or the controls over compliance regarding:
 - (1) The nature and frequency of the monitoring activities.
 - (2) The results of those monitoring activities, including the nature, frequency, and cause (if known) of any instances of non-compliance with the exemption conditions or deficiencies in controls over compliance.
 - (3) The nature and frequency of customer complaints that are relevant to the broker's or dealer's compliance with the exemption conditions.
 - d. Read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's compliance with the exemption conditions.



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- e. Read regulatory filings of the broker or dealer that are relevant to the broker's or dealer's compliance with the exemption conditions.
- f. Evaluate whether the evidence obtained and the results of the procedures performed in the audit of the financial statements and supplemental information corroborate or contradict the broker's or dealer's assertion regarding compliance with the exemption conditions.

Note: Examples of procedures that might provide evidence relevant to the broker's or dealer's compliance with the exemption conditions include testing of transactions related to customer trades, testing of specially designated cash accounts, testing investment inventory or transactions related to the broker's or dealer's trading for its own account, and reading the clearing agreement in connection with testing trade fee or commission revenue or expenses.

- g. Read the broker's or dealer's documentation regarding instances of non-compliance with the exemption conditions identified by the auditor or the broker or dealer.
- h. Perform other procedures as necessary in the circumstances to obtain moderate assurance.

Evaluating the Results of the Review Procedures

11. The auditor should evaluate the identified instances of non-compliance with the exemption conditions to determine whether the instances of non-compliance, individually or in combination, cause the broker's or dealer's assertion not to be fairly stated, in all material respects.^{11/} If the broker's or dealer's assertion is not fairly stated, in all material respects, the auditor should:

- a. Modify the review report, as discussed in paragraph 20; and

^{11/} The SEC's release accompanying SEC Proposed Rule 17a-5 states that "an example of a discovery that would necessitate a material modification would be a discovery that the broker [or] dealer failed to promptly forward any customer securities it received." Paragraph 20 of this standard describes modifying the auditor's standard review report for instances in which the broker's or dealer's assertion is not fairly stated, in all material respects, because of an instance or certain instances of non-compliance with the exemption conditions.



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- b. Evaluate the effect of the matter on the audit of the financial statements and supplemental information.

12. If information coming to the auditor's attention indicates that one or more instances of non-compliance might exist that might cause the broker's or dealer's assertion not to be fairly stated, in all material respects, or if the auditor has substantial doubt about the broker's or dealer's assertion, the auditor should perform additional procedures as necessary to address the matter.

Obtaining a Representation Letter

13. The auditor should obtain written representations from management of the broker or dealer:

- a. Acknowledging management's responsibility for compliance with exemption conditions;
- b. Stating the broker's or dealer's assertion;
- c. Stating that management has made available to the auditor all records and other information relevant to the broker's or dealer's assertion, including all communications from regulatory agencies, internal auditors, others who perform an equivalent function, compliance functions, and other auditors concerning possible non-compliance with the exemption conditions, received through the date of the auditor's review report; and
- d. Stating whether there were, subsequent to the period addressed in the broker's or dealer's assertion, any known events or other factors that might significantly affect the broker's or dealer's compliance with the exemption conditions.

14. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the review engagement as described in paragraph 21 of this standard.

Communication Requirements

15. The auditor should communicate to management identified instances of non-compliance with the exemption conditions.



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16. The auditor should communicate to management and the audit committee^{12/} identified instances of non-compliance that cause the broker's or dealer's assertion about its exemption conditions not to be fairly stated in all material respects.

Reporting on the Review Engagement

17. The auditor's review report must include the following elements, modified as necessary in the circumstances and manner discussed in paragraphs 20-21:

- a. A title that includes the word *independent*;
- b. An identification of the exemption report and the broker's or dealer's assertion;
- c. A statement that management of the broker or dealer is responsible for compliance with the exemption conditions and for its assertion;
- d. A statement that the review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and accordingly, included inquiries and certain other procedures to obtain evidence about the broker's or dealer's compliance with the exemption conditions;
- e. A statement that a review is substantially less in scope than an examination, the objective of which is an expression of opinion on the assertion, and accordingly, no such opinion is expressed;
- f. A statement about whether the auditor is aware of any material modifications that should be made to the assertion for it to be fairly stated, in all material respects;

^{12/} For purposes of this standard, the term "audit committee" refers to a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of a company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company. If a broker or dealer does not have an audit committee or a board of directors of the company, those responsible for the appointment, compensation, and oversight of the work of the auditor.



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- g. The manual signature of the auditor's firm;^{13/}
- h. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's review report has been issued; and
- i. The date of the review report.

18. The following example report illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have reviewed management's assertion, included in the accompanying [*title of the exemption report*], that Z Broker is exempt from the provisions of Rule 15c3-3 under the Securities Exchange Act of 1934 because it meets conditions set forth in paragraph (k) ([*fill in which exemption provision – (1), (2)(i), (2)(ii), or (3)*]) of that rule (the "exemption conditions"). Z Broker's management is responsible for compliance with the exemption conditions and its assertion.

[*Scope paragraph*]

Our review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included inquiries and certain other procedures to obtain evidence about Z Broker's compliance with the exemption conditions. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assertion. Accordingly, we do not express such an opinion.

^{13/} Paragraph (i)(1)(ii) of SEC Proposed Rule 17a-5 requires the auditor's report to be manually signed.



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[*Review results paragraph*]

Based on our review, nothing came to our attention that caused us to believe that management's assertion referred to above is not fairly stated, in all material respects, based on the conditions set forth in paragraph (k)(*fill-in which exemption provision – (1), (2)(i), (2)(ii), or (3)*) of Rule 15c3-3 under the Securities Exchange Act of 1934.

[*Signature*]

[*City and State or Country*]

[*Date*]

Review Report Date

19. The auditor should date the review report no earlier than the date on which the auditor has completed his or her review procedures.

Note: Because of the coordination between the review engagement and the audit of the financial statements and supplemental information, the date of the review report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

Modifications of the Report

20. If the broker's or dealer's assertion is not fairly stated, in all material respects, because of an instance or certain instances of non-compliance with the exemption conditions, the auditor must modify the review report to describe those instances of non-compliance and state that the broker or dealer is not in compliance with the specified exemption conditions.

21. *Scope Limitations.* If the auditor cannot perform the procedures required by this standard or other procedures that the auditor deems necessary in the circumstances, the review is incomplete because of the scope limitation. An incomplete review is not a sufficient basis for stating a conclusion regarding the broker's or dealer's assertion. In those circumstances, the auditor should withdraw from the engagement or should modify the review report to:

- a. Describe the scope limitation and any review procedures deemed necessary by the auditor that have been omitted and the reason for their omission;



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- b. State that the auditor does not express any form of assurance on the broker's or dealer's assertion; and
- c. Disclose identified instances of non-compliance, if any, that, individually or in combination, cause the broker's or dealer's assertion not to be fairly stated, in all material respects.



APPENDIX 3

Proposed Amendments to PCAOB Standards

Auditing Standards

Auditing Standard No. 3, "Audit Documentation"

Auditing Standard No. 3, "Audit Documentation," as amended, is amended as follows:

- a. The following is added at the end of footnote 2 in paragraph 6:

In an engagement conducted pursuant to the attestation standards of the PCAOB, the relevant assertions are the assertions expressed by management or the responsible party regarding the subject matter of the attestation engagement. The documentation requirements in this standard regarding assertions apply to the aspects of the subject matter to which the assertions relate.

- b. The following note is added at the end of paragraph 12:

Note: In an engagement conducted pursuant to the attestation standards of the PCAOB, significant findings or issues include, when applicable: (a) the assessment of, and the responses to, risk requiring special consideration by the auditor; (b) significant matters involving systems, processes, and controls to ensure the appropriateness of the subject matter and management's related assertions; and (c) the evaluation of identified instances of nonconformity with the evaluation criteria (e.g., errors, instances of non-compliance, or control deficiencies).

- c. The following note is added as the second note to paragraph 13:

Note: When conducting an attestation engagement in conjunction with an audit of financial statements in accordance with the standards of the PCAOB, the auditor may include the documentation of significant findings or issues related to the attestation engagement in the



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engagement completion document prepared in connection with the audit of financial statements.

Auditing Standard No. 7, "Engagement Quality Review"

Auditing Standard No. 7, "Engagement Quality Review," is amended as follows:

- a. Paragraph 1 is replaced with:

An engagement quality review and concurring approval of issuance are required for each audit engagement, for each engagement to review interim financial information, and for each attestation engagement performed in conjunction with an audit of financial statements conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB").

- b. Paragraph 18A. is added:

Engagement Quality Review for an Attestation Engagement Performed in Conjunction with an Audit of Financial Statements

In an attestation engagement performed in conjunction with an audit of financial statements, the engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the attestation engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should (1) hold discussions with the engagement partner and other members of the engagement team, (2) read the engagement report and the document containing management's assertions, and (3) review the engagement completion document and other relevant documentation.

Note: For purposes of this standard, an attestation engagement performed pursuant to Proposed Attestation Standard, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Proposed Attestation Standard, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, is an attestation engagement



performed in conjunction with an audit of financial statements.

- c. Paragraph 18B. is added:

In an attestation engagement performed in conjunction with an audit of financial statements, the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency.

- d. The following note is added after paragraph 18B.:

Note: A significant engagement deficiency in an attestation engagement performed in conjunction with an audit of financial statements exists when (1) the engagement team failed to perform attestation procedures necessary in the circumstances of the engagement, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

- e. Paragraph 18C. is added:

In an attestation engagement performed in conjunction with an audit of financial statements, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.

Attestation Standards

AT sec. 101, "Attestation Engagements"

AT sec. 101, "Attestation Engagements," as amended, is amended as follows:

- f. The following is added at the end of paragraph .04:
- g. Engagements in which a practitioner is engaged to perform an examination of the assertions of a broker or dealer in a compliance report that is prepared pursuant to SEC Proposed Rule 17a-5. Such engagements must be conducted pursuant to Proposed



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Attestation Standard, Examination Engagements Regarding Compliance Reports of Brokers and Dealers.

- h. Engagements in which a practitioner is engaged to perform a review engagement on assertions of a broker or dealer in an exemption report that is prepared pursuant to SEC Proposed Rule 17a-5. Such engagements must be conducted pursuant to Proposed Attestation Standard, *Review Engagements Regarding Exemption Reports of Brokers and Dealers.*

AT sec. 601, "Compliance Attestation"

AT sec. 601, "Compliance Attestation," is amended as follows:

- a. Within paragraph .02, subparagraph e. is replaced with:

Apply to examination engagements of brokers and dealers covered by Proposed Attestation Standard, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers.*

- b. Footnote 2 to paragraph .02.e. is deleted.
- c. The last sentence of paragraph .06 is deleted.
- d. Paragraph .07 is replaced with:

When a practitioner is engaged to perform a review engagement on assertions made by a broker or dealer in an exemption report that is prepared pursuant to SEC Proposed Rule 17a-5, the practitioner must conduct the review engagement pursuant to Proposed Attestation Standard, *Review Engagements Regarding Exemption Reports of Brokers and Dealers.*



APPENDIX 4

Additional Discussion of the Proposed Attestation Standards and Questions for Public Comment

This appendix discusses the proposed examination standard in Appendix 1, the proposed review standard in Appendix 2, and the related amendments to PCAOB standards in Appendix 3. In particular, this appendix discusses the basis for the Board's preliminary conclusions regarding certain requirements and contains specific questions for which the Board would like to obtain feedback in addition to those included in the release to the proposed attestation standards.

On June 15, 2011, the Securities and Exchange Commission ("SEC" or "Commission") proposed to amend its Rule 17a-5 regarding the annual reporting by brokers and dealers to, among other things, update the existing requirements of Rule 17a-5 and facilitate the ability of the PCAOB to implement oversight of independent public accountants of brokers and dealers as required by the Dodd-Frank Act.^{1/}

Sections 17(a) and (e) of the Exchange Act and Rule 17a-5 together require a broker or dealer to, among other things, file an annual report with the SEC and the broker's or dealer's designated examining authority ("DEA").^{2/} The SEC's proposed amendments to Rule 17a-5 ("SEC Proposed Rule 17a-5") would require the broker's or dealer's annual report to include a financial report and a compliance report or an exemption report.^{3/} The compliance report generally would be filed by a broker or dealer

^{1/} See 17 CFR § 240.17a-5, *Reports to be made by certain brokers and dealers* and Section I. of SEC Release No. 34-64676 ("SEC Proposing Release").

^{2/} See Section II.A. of the SEC Proposing Release.

^{3/} The financial report required by SEC Proposed Rule 17a-5 would include financial statements and supporting schedules. The audit of the financial statements and supporting schedules would be conducted in accordance with PCAOB standards. In particular, Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*, would apply to the audit of the supporting schedules. The proposed attestation standard in Appendix 1 of this release would apply to an examination of the assertions in the compliance report. The proposed attestation standard in Appendix 2 of this release would apply to a review of the assertion in the exemption report.



that maintains custody of customer funds or securities and would include assertions by the broker or dealer that address:

- (i) Whether it was in compliance, in all material respects, with specified SEC rules related to net capital requirements, customer protection, including reserves and custody of securities, and quarterly security counts,^{4/} as well as the rules of its DEA that require account statements to be sent to customers of the broker or dealer (referred to collectively in this release as "the specified Financial Responsibility Rules") as of the fiscal year end,
- (ii) Whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the books and records of the broker or dealer, and
- (iii) Whether internal control over compliance with the specified Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness.^{5/}

The exemption report would be filed by a broker or dealer that claims exemption from the requirements of the SEC rule related to the safeguarding of customer assets and would identify the specific conditions that are the basis for claiming the exemption (referred to collectively in this release as "the exemption conditions").^{6/}

In addition, the SEC's proposed amendments would require the broker or dealer to include in its annual report an examination report from an independent accountant regarding the assertions in the compliance report or a review report regarding the assertion in the exemption report, as applicable.^{7/} The auditor's examination report or

^{4/} See 17 CFR § 240.15c3-1, *Net capital requirements for brokers or dealers*, 17 CFR § 240.15c3-3, *Customer protection – reserves and custody of securities*, and 17 CFR § 240.17a-13, *Quarterly security counts to be made by certain exchange members, brokers, and dealers*, for the complete text of these SEC rules.

^{5/} See paragraph (d)(3)(i)(B) of SEC Proposed Rule 17a-5. The term "specified Financial Responsibility Rules" as used in this release and the proposed examination standard has the same meaning as the term "Financial Responsibility Rules" used in the SEC Proposing Release.

^{6/} See paragraph (d)(4) of SEC Proposed Rule 17a-5.

^{7/} See paragraph (d)(1)(i)(C) of SEC Proposed Rule 17a-5.



review report would replace the existing requirement in Rule 17a-5 to report on material inadequacies identified in the accounting system, internal accounting controls, procedures of the broker or dealer for safeguarding securities, and certain practices and procedures related to customer protection and securities.^{8/}

The proposed attestation standards would establish requirements for performing and reporting on the examination engagement and the review engagement required by SEC Proposed Rule 17a-5.^{9/}

I. Proposed Attestation Standard, Examination Engagements Regarding Compliance Reports of Brokers and Dealers

The proposed examination standard establishes requirements that apply when an auditor is engaged to perform an examination of the assertions made by a broker or dealer in a compliance report prepared pursuant to SEC Proposed Rule 17a-5.^{10/} SEC Proposed Rule 17a-5 requires a broker's or dealer's compliance report to contain the following assertions by the broker or dealer:^{11/}

- a. Whether, as of the fiscal year end, the broker or dealer was in compliance, in all material respects, with Rule 15c3-1, Rule 15c3-3, Rule 17a-13,^{12/} and any rule of the broker's or dealer's DEA that requires account statements to be sent to the customers of the broker or dealer ("account statement rule");

Note: Rule 15c3-1, Rule 15c3-3, Rule 17a-13, and the account statement rule are referred to collectively as "the specified Financial Responsibility Rules."^{13/}

^{8/} See 17 CFR § 240.17a-5(g).

^{9/} See paragraph (d)(1)(i)(C) of SEC Proposed Rule 17a-5.

^{10/} See paragraph (d)(3) of SEC Proposed Rule 17a-5.

^{11/} See paragraph (d)(3)(i)(B) of SEC Proposed Rule 17a-5.

^{12/} See 17 CFR § 240.15c3-1, 17 CFR § 240.15c3-3, and 17 CFR § 240.17a-13, respectively.

^{13/} The SEC Proposing Release refers to Rule 15c3-1, Rule 15c3-3, Rule 17a-13, and the account statement rule as the "Financial Responsibility Rules."



- b. Whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the books and records of the broker or dealer; and
- c. Whether internal control over compliance with the specified Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness.^{14/}

A. Relationship to Interim Attestation Standards

In general terms, the requirements in the proposed examination standard are consistent with the requirements of AT sec. 101, *Attest Engagements*, and AT sec. 601, *Compliance Attestation*. However, when an auditor performs an engagement pursuant to the proposed examination standard, AT sec. 101 and AT sec. 601 would not apply.

The proposed examination standard focuses specifically on performing an examination of the assertions made by a broker or dealer in a compliance report and allows auditors to perform such engagements without looking to multiple attestation standards. In addition, the emphasis in the proposed examination standard on appropriately coordinating the examination engagement with the audit of the financial statements and supplemental information should avoid unnecessary redundancy in the auditor's work.

^{14/} Paragraph (d)(3)(iii) of SEC Proposed Rule 17a-5 defines a material weakness as "a deficiency, or a combination of deficiencies, in internal control over compliance with [the specified Financial Responsibility Rules], such that there is a reasonable possibility that material non-compliance with [the specified Financial Responsibility Rules] will not be prevented or detected on a timely basis. For purposes of this paragraph a deficiency in internal control over compliance exists when the design or operation of a control does not allow the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect non-compliance with [the specified Financial Responsibility Rules] on a timely basis." Section II.B.1. of the SEC Proposing Release states that "[t]here is a reasonable possibility of an event occurring if it is 'probable' or 'reasonably possible'. An event is 'probable' if the future event or events are likely to occur. An event is 'reasonably possible' if the chance of the future event or events occurring is more than remote, but less than likely."



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B. Objective of the Auditor

When performing an examination of the assertions made by a broker or dealer in a compliance report, the auditor's objective is to express an opinion regarding whether the assertions made by the broker or dealer in its compliance report are fairly stated, in all material respects.

The use of the language "fairly stated, in all material respects," in the objective of the standard and in the examination report is the same language used in AT sec. 101 and AT sec. 601 for other examination engagements. The phrase "in all material respects" is also used in audit reports.^{15/} Because an examination engagement provides users of the auditor's examination report with reasonable and not absolute assurance, similar to AT sec. 101 and AT sec. 601, the proposed examination standard requires the auditor to opine on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects.

Under SEC Proposed Rule 17a-5, a broker or dealer is not permitted to conclude that it is in compliance with the specified Financial Responsibility Rules if it identifies one or more instances of material non-compliance.^{16/} Similarly, the broker or dealer is not permitted to conclude that its internal control over compliance with the specified Financial Responsibility Rules was effective if there were one or more instances of material weakness in internal control over compliance.^{17/} Accordingly, to express an opinion on the assertions made by a broker or dealer in a compliance report, the auditor must plan and perform the examination engagement to obtain appropriate evidence that is sufficient^{18/} to obtain reasonable assurance^{19/} about whether (1) one or more

^{15/} See AU sec. 508, *Reports on Audited Financial Statements*, and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

^{16/} See paragraph (d)(3)(ii) of SEC Proposed Rule 17a-5. Paragraph (d)(3)(ii) of SEC Proposed Rule 17a-5 states that "material non-compliance would be a failure by the broker or dealer to comply with the requirements of [the specified Financial Responsibility Rules] in all material respects."

^{17/} See paragraph (d)(3)(iii) of SEC Proposed Rule 17a-5.

^{18/} In the proposed examination standard, the terms "sufficiency" and "appropriateness" have the same meaning as "sufficiency" and "appropriateness" of audit evidence, as described in Auditing Standard No. 15, *Audit Evidence*.

^{19/} Although not absolute assurance, reasonable assurance is a high level of assurance.



instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion and (2) one or more instances of material weakness exist during the period specified in the broker's or dealer's assertion.

Because the broker's or dealer's assertions apply to each specified Financial Responsibility Rule, the auditor's examination should evaluate compliance with each specified Financial Responsibility Rule, and the effectiveness of internal control over compliance with each specified Financial Responsibility Rule, individually. As each specified Financial Responsibility Rule includes multiple provisions, this involves obtaining evidence about the broker's or dealer's compliance and internal control over compliance with respect to each relevant provision of each specified Financial Responsibility Rule. For example, because Rule 17a-13 includes provisions regarding the performance of quarterly security counts, the recordation of the security count, rules on frequency and timing of performance, and requirements regarding who should supervise the counts, the auditor should obtain evidence about compliance and internal control over compliance with respect to each of these provisions. The nature, timing, and extent of the necessary procedures depend on the risks of material non-compliance and other factors set forth in the proposed examination standard.

Furthermore, because SEC Proposed Rule 17a-5 requires the broker's or dealer's assertion regarding internal control over compliance with the specified Financial Responsibility Rules to cover the entire fiscal year,^{20/} any material weakness identified by the auditor at any point during the fiscal year would prevent the auditor from issuing an unqualified opinion, regardless of whether the identified material weakness continues to exist as of the broker's or dealer's fiscal year end.

SEC Proposed Rule 17a-5 also requires the broker or dealer to assert in its compliance report whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the books and records^{21/} of the broker or dealer.^{22/} Consistent with the concept of reasonable assurance, the proposed examination standard requires the auditor to plan and perform the examination engagement to obtain appropriate evidence that is sufficient to express an opinion about whether the information used to assert compliance with the specified Financial

^{20/} See paragraph (d)(3)(i)(B)(3) of SEC Proposed Rule 17a-5.

^{21/} See, for example, 17 CFR § 240.17a-3, *Records to be made by certain exchange members, brokers and dealers*.

^{22/} See paragraph (d)(3)(i)(B)(2) of SEC Proposed Rule 17a-5.



Responsibility Rules was derived, in all material respects, from the books and records of the broker or dealer.

The proposed examination standard does not require the auditor to express an opinion on the process the broker or dealer used to arrive at the conclusions stated in the broker's or dealer's assertions.

C. Performing the Examination Engagement

1. General Requirements

Under the proposed examination standard, an auditor who performs an examination engagement must:

- *Have adequate technical proficiency in attestation engagements* – This requirement is similar to AT sec. 101.^{23/} An auditor might obtain technical proficiency in attestation engagements through relevant technical training or experience.
- *Obtain an understanding of the specified Financial Responsibility Rules and other rules and regulations that are relevant to the broker's or dealer's assertions* – This requirement is similar to an existing requirement in AT sec. 101, which includes a requirement for the engagement to be performed by an auditor "having adequate knowledge of the subject matter."^{24/}
- *Determine the auditor's compliance with independence and ethics requirements* – SEC Proposed Rule 17a-5 requires the auditor of the broker or dealer to be qualified and independent in accordance with 17 CFR § 210.2-01, *Qualification of Accountants*.^{25/} SEC Proposed Rule 17a-5 also requires the auditor of the broker or dealer to perform the examination engagement in accordance with PCAOB standards.^{26/}

^{23/} See AT sec. 101.19.

^{24/} AT sec. 101.21.

^{25/} See paragraph (f)(1) of SEC Proposed Rule 17a-5.

^{26/} See paragraph (g) of SEC Proposed Rule 17a-5.



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Auditors who perform engagements in accordance with PCAOB standards must comply with applicable PCAOB ethics and independence rules.^{27/}

- *Exercise due professional care,^{28/} which includes application of professional skepticism, in planning and performing the examination and the preparation of the report* – The proposed examination standard requires the same due professional care as required by AT sec. 101, which states that "[d]ue professional care shall be exercised in the planning and performance of the engagement."^{29/} Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of the evidence obtained. In an examination engagement, the auditor's responses to the assessed risks of material non-compliance, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating evidence.

Under the proposed examination standard, the engagement partner^{30/} is responsible for the examination engagement and performance of the examination procedures. Accordingly, the engagement partner is responsible for proper planning of the examination engagement, proper supervision of the work of engagement team members, and compliance with the requirements of this standard.

Proper planning includes establishing an overall strategy for the examination engagement and developing a plan for the engagement, which includes, in particular,

^{27/} See Section V. of the accompanying release, "Other Board Considerations," for further discussion regarding the applicability of PCAOB ethics and independence rules.

^{28/} The proposed attestation standards require the same due professional care as required by AT sec. 101.40, which states, in part, that "[e]xercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report."

^{29/} AT sec. 101.39.

^{30/} For purposes of this standard, the term "engagement partner" means the member of the engagement team with primary responsibility for the examination engagement.



identifying risks of material non-compliance and planned responses to those risks. Similar to an audit, proper supervision includes supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.^{31/} The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Questions:

1. Are the general requirements included in the proposed examination standard sufficiently clear?
 2. Are there additional general requirements that the Board should include for an examination engagement?
2. *Relationship Between the Examination Engagement and the Audit of the Financial Statements and Supplemental Information*

The proposed examination standard recognizes that the examination report covered by the proposed examination standard generally would be issued by the auditor of the financial statements of the broker or dealer.^{32/} Accordingly, the proposed examination standard includes a requirement for the auditor to coordinate the examination engagement with the audit of the financial statements and supplemental information. For example, the proposed examination standard:

- Includes a requirement for the auditor to take into account relevant evidence from the audit of the financial statements and supplemental information in planning and performing procedures for the examination engagement and in evaluating the results of the procedures performed in the examination. In that regard, SEC Proposed Rule 17a-5 requires the auditor to audit certain supplemental information, including supporting schedules that include a Computation of Net Capital Under Rule 15c3-1, a Computation for Determination of the Reserve Requirements under Exhibit A of Rule 15c3-3, and Information Relating to Possession or

^{31/} Auditing Standard No. 10, *Supervision of the Audit Engagement*, establishes requirements regarding supervision of an audit engagement, including supervising the work of engagement team members.

^{32/} See paragraph (g) of SEC Proposed Rule 17a-5.



Control Requirements Under Rule 15c3-3.^{33/} The audit of these supporting schedules should also provide relevant evidence regarding (1) the broker's or dealer's compliance with Rule 15c3-1 and Rule 15c3-3 and (2) whether the information used to assert compliance with Rule 15c3-1 and Rule 15c3-3 was derived from the books and records of the broker or dealer.

- Includes a requirement for the auditor to evaluate the effect on the audit of the financial statements and supplemental information of any material non-compliance, material weaknesses, or instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records.
- Enables the auditor to plan, perform, and evaluate the results of the examination engagement concurrent with the audit of the financial statements because the proposed examination standard is structured similarly to, and contains many of the same concepts included in, auditing standards related to the auditor's assessment of and response to risk.^{34/}

Although the proposed examination standard states that the examination engagement should be coordinated with the audit of the financial statements and supplemental information of the broker or dealer, the objectives of the audit and the examination engagement are not the same, so the proposed examination standard states that the auditor must plan and perform the work to meet the objectives of both engagements.

If the auditor performing the examination engagement does not audit the financial statements and supplemental information of the broker or dealer, the proposed examination standard requires the auditor to obtain knowledge of the evidence obtained and results of procedures performed in the audit of the financial statements and supplemental information that is commensurate with that of the auditor of the financial statements and supplemental information. That level of knowledge is necessary to have a reasonable basis to perform the evaluation of the broker's or dealer's assertions, as required by the proposed examination standard.

^{33/} See paragraph (g)(1) of SEC Proposed Rule 17a-5.

^{34/} See Auditing Standards No. 8-15.



The proposed examination standard also states that the auditor's own work on the examination engagement must be sufficient to support an opinion on the assertions made by the broker or dealer in the compliance report, so that the auditor who performs only the examination engagement does not rely on the work of the auditor of the financial statements and supplemental information instead of performing the procedures required by the proposed examination standard.

Question:

3. In what other ways could the Board promote coordination of the examination engagement with the audit of the financial statements and supplemental information?

3. *Consideration of Materiality in the Examination Engagement*

The proposed examination standard requires the auditor to plan and perform examination procedures to detect instances of non-compliance that, individually or in combination, would result in material non-compliance. This includes being alert while planning and performing examination procedures for non-compliance that could be material due to quantitative or qualitative factors. Also, the auditor should take into account relevant quantitative and qualitative factors when evaluating identified non-compliance.

To describe factors that are relevant when determining whether an instance of non-compliance is material, the release accompanying SEC Proposed Rule 17a-5 ("SEC Proposing Release") draws upon existing concepts included in AT sec. 601 regarding the auditor's consideration of materiality.^{35/} The SEC Proposing Release states that, "any failure by the broker [or] dealer to perform any of the procedures enumerated in the [specified] Financial Responsibility Rules would be an instance of non-compliance; therefore, the broker [or] dealer should evaluate any such failure to determine whether it is material. When determining whether an instance of non-compliance is material ... the broker [or] dealer should consider all relevant factors including but not limited to: (1) the nature of the [specified Financial Responsibility Rules], which may or may not be quantifiable in monetary terms; (2) the nature and frequency of non-compliance identified; and (3) qualitative considerations."^{36/}

^{35/} See Section II.B.1. of the SEC Proposing Release and AT sec. 601.36.

^{36/} See Section II.B.1. of the SEC Proposing Release.



Under the proposed examination standard, the auditor should take into account matters that are consistent with the factors described in the SEC Proposing Release in his or her consideration of the materiality of non-compliance.^{37/} Taking into account the nature of the specified Financial Responsibility Rules, which may or may not be quantifiable in monetary terms, the nature and frequency of non-compliance, and qualitative considerations includes consideration of specific facts and circumstances surrounding any non-compliance. For example, non-compliance, even if relatively small in amount, may be significant to the broker's or dealer's compliance with regulatory thresholds. In addition, intentional non-compliance, even if relatively small in amount, could be material to users of the auditor's examination report for qualitative reasons.^{38/}

Further, the SEC Proposing Release also describes examples of non-compliance that are necessarily instances of material non-compliance.^{39/} The SEC Proposing Release states that, "failing to maintain the required minimum amount of net capital as required under Rule 15c3-1, or failing to maintain the minimum deposit requirement in a special reserve bank account for the exclusive benefit of customers under Rule 15c3-3, would be instances of material non-compliance. These two instances of material non-compliance would not, however, represent all possible instances of material non-compliance with respect to Rules 15c3-1 and 15c3-3.

SEC Proposed Rule 17a-5 defines an instance of material weakness as "a deficiency, or a combination of deficiencies, in internal control over compliance with [the specified Financial Responsibility Rules], such that there is a reasonable possibility that material non-compliance with [the specified Financial Responsibility Rules] will not be prevented or detected on a timely basis. For purposes of this paragraph a deficiency in internal control over compliance exists when the design or operation of a control does not allow the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect non-compliance with [the specified Financial Responsibility Rules] on a timely basis."^{40/}

^{37/} Ibid.

^{38/} Users of the auditor's examination report may include, but are not limited to, the SEC, the Securities Investor Protection Corporation, and the broker's or dealer's DEA.

^{39/} See Section II.B.1. of the SEC Proposing Release.

^{40/} See paragraph (d)(3)(iii) of SEC Proposed Rule 17a-5. Section II.B.1. of the SEC Proposing Release states that "[t]here is a reasonable possibility of an event



Because SEC Proposed Rule 17a-5 links the definition of "an instance of material weakness" to the concept of "material non-compliance,"^{41/} the proposed examination standard includes a requirement for the auditor to use the same materiality considerations used for testing and evaluating compliance with the respective specified Financial Responsibility Rules when testing and evaluating the effectiveness of internal control over compliance.

Similarly, when considering materiality in evaluating whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records, the auditor should take into account the matters set forth in paragraph 10 of the proposed examination standard. An important qualitative consideration is whether an identified instance in which information used to assert compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records results in material non-compliance with the respective specified Financial Responsibility Rules.

4. *Considerations for Brokers and Dealers with Multiple Divisions or Branches*

When a broker or dealer conducts its operations through multiple divisions and branch offices, the proposed examination standard includes a requirement for the auditor to determine the extent to which examination procedures should be performed at selected divisions or branches to obtain sufficient appropriate evidence to support the conclusions expressed in the auditor's examination report. This includes determining the divisions or branches at which to perform examination procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual divisions or branches. Under the proposed examination standard, in determining the extent of the examination procedures to be performed, the auditor should take into account:

- *The degree to which the specified Financial Responsibility Rules relate to activities at the division or branch level* – For example, if a broker or dealer holds securities or executes security trades at the local branch level, then it would be necessary for the auditor to plan or perform procedures pertaining to Rule 17a-13 at the local branch level.

occurring if it is 'probable' or 'reasonably possible'. An event is 'probable' if the future event or events are likely to occur. An event is 'reasonably possible' if the chance of the future event or events occurring is more than remote, but less than likely."

^{41/} See paragraph (d)(3)(iii) of SEC Proposed Rule 17a-5.



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- *The nature and significance of the related assets, transactions, or activities at the division or branch to the specified Financial Responsibility Rules* – For example, if a particular division of a broker or dealer handles large amounts of customer assets and performs the custodian function, including sending customers their periodic account statements, the auditor would need to perform procedures at that division to obtain relevant evidence of compliance with the relevant provisions of Rule 15c3-3, Rule 17a-13, and the account statement rule.
- *The degree of centralization of records or information processing relevant to the specified Financial Responsibility Rules* – For example, if a broker or dealer centralizes the process for computing and monitoring net capital and maintains relevant records at the location at which the computation is performed, most of the relevant evidence for evaluating compliance with Rule 15c3-1 can be obtained by planning and performing examination procedures at the centralized location.
- *The degree and effectiveness of management supervision and monitoring of the relevant activities of the division or branch* – If, for example, in the course of planning and performing the financial statement audit, the auditor identifies weaknesses in management's supervision and monitoring of particular activities at certain divisions, the auditor should take into account the effect of the identified weaknesses when assessing the risk of material non-compliance and adjust the extent of the planned examination procedures at those divisions to properly respond to the heightened risk of material non-compliance.

Questions:

4. Are the matters that the auditor should take into account in determining the extent of the examination procedures to be performed at selected divisions or branches adequate? Are there other matters that the auditor should take into account?
5. When a broker or dealer has multiple divisions or branches, do situations exist in which the auditor that is engaged to perform the examination engagement uses the work of other auditors? If so, should the proposed examination standard establish requirements that govern the use of the work of other auditors?



5. *Identifying Risks of Material Non-Compliance*

Under the proposed examination standard, the auditor should use a risk-based approach in planning and performing procedures for the examination engagement and in evaluating the results of the procedures performed in the examination. The proposed examination standard:

- Requires the auditor to devote more attention to the matters that are most significant to compliance with the specified Financial Responsibility Rules and internal control over compliance with the specified Financial Responsibility Rules,
- Enables the auditor to scale the examination to smaller or less complex brokers and dealers, and
- Enables the auditor to plan, perform, and evaluate the results of the examination engagement concurrent with the audit of the financial statements because the proposed examination standard is structured similarly to, and contains many of the same concepts included in, auditing standards related to the auditor's assessment of and response to risk.^{42/}

Because a proper risk assessment is critical to a risk-based approach, under the proposed examination standard, the auditor should perform procedures that are sufficient to provide a reasonable basis for identifying the risks of material non-compliance, whether intentional or unintentional, associated with each specified Financial Responsibility Rule and designing further examination procedures.^{43/} To identify and assess risks of material non-compliance, under the proposed examination standard, the auditor should:

- *Evaluate the evidence obtained and the results of procedures performed in the audit of the financial statements and supplemental information* – This requirement is consistent with the concept that the examination engagement should be properly coordinated with, and informed by, the audit of the financial statements and supplemental information. For example, if an auditor, in performing procedures for the financial statement

^{42/} See Auditing Standards No. 8-15.

^{43/} Further examination procedures consist of testing controls over compliance and performing compliance tests.



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audit, identifies control deficiencies regarding periodic counts of investment inventory related to the broker's or dealer's trading for its own account, the auditor should take into account the control deficiency when assessing the risk of material non-compliance with Rule 17a-13 and adjust the extent of the planned examination procedures to properly respond to the heightened risk of material non-compliance.

- *Evaluate the nature of instances of non-compliance and deficiencies in internal control over compliance with the specified Financial Responsibility Rules identified during previous examination engagements* – For example, if a broker or dealer does not take steps to address weaknesses in its system of internal control that were identified during a previous examination engagement, the auditor should evaluate the impact on the auditor's assessment of the risks of material non-compliance in the current year.
- *Obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the specified Financial Responsibility Rules* – Obtaining an understanding of the broker's or dealer's processes, including relevant controls, includes evaluating the design of controls that are relevant to the examination and determining whether the controls have been implemented. Obtaining such an understanding is important to identify important points at which a necessary control is missing or not designed effectively. The nature, timing, and extent of procedures that are necessary to obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the specified Financial Responsibility Rules depend on the size and complexity of the broker or dealer; the auditor's existing knowledge of the broker's or dealer's processes and controls; the degree to which the broker's or dealer's compliance depends on the completeness and accuracy of the broker's or dealer's internally generated data; the nature and extent of changes in systems and operations; and the nature of the broker's or dealer's documentation of its processes and controls. For example, the auditor's procedures to obtain an understanding of the broker's or dealer's processes, including relevant controls, would be more extensive if the broker's or dealer's internal control is more complex or if the broker's or dealer's controls have changed significantly.
- *Obtain an understanding of instances of non-compliance and deficiencies in controls over compliance identified by management* – Understanding



instances of non-compliance and deficiencies in controls over compliance identified by management informs the auditor's assessment of the risks of material non-compliance. However, the proposed examination standard does not require the auditor to evaluate the effectiveness of the process used by the broker or dealer to arrive at its conclusions.^{44/}

- *Assess risks of material non-compliance associated with related parties,^{45/} including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship – Relationships and transactions with related parties may heighten the risk of material non-compliance by, for example, providing opportunities to conceal material non-compliance or misappropriate customer assets. In an audit of financial statements, the auditor should perform procedures regarding related parties. These procedures include (1) determining the existence of, and identifying transactions with, related parties,^{46/} (2) examining identified related party transactions,^{47/} (3) conducting a discussion among key engagement team members that includes a discussion of the susceptibility of the financial statements to material misstatement through related party transactions,^{48/} and (4) making inquiry of individuals within the broker or dealer involved in initiating, recording, or processing complex or unusual transactions, including significant related party transactions.^{49/} Evidence obtained from performing these procedures*

^{44/} Section II.B.2. of the SEC Proposing Release states that "[b]ecause the report of the independent public accountant required by proposed paragraph (g) of Rule 17a-5 would require the accountant to perform its own independent examination of the related controls and procedures, the Commission preliminarily does not believe that it is necessary for the independent public accountant to provide an opinion with regard to the process that the broker [or] dealer used to arrive at its conclusions.

^{45/} The auditor should look to the FASB Accounting Standards Codification Master Glossary with respect to the term "related parties."

^{46/} See paragraphs .07 and .08 of AU sec. 334, *Related Parties*.

^{47/} See AU sec. 334.09.

^{48/} See paragraph 52 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

^{49/} See paragraph 57 of Auditing Standard No. 12.



helps inform the auditor's assessment of the risks of material non-compliance associated with related parties.

- *Obtain an understanding of management's competence regarding the relevant rules and regulations* – Under SEC Proposed Rule 17a-5, a broker's or dealer's compliance report should contain a statement that the broker or dealer has established and maintained a system of internal control to provide the broker or dealer with reasonable assurance that any instances of material non-compliance with the specified Financial Responsibility Rules will be prevented or detected on a timely basis.^{50/} A sound understanding of the specified Financial Responsibility Rules increases the likelihood that management's compliance report is prepared in accordance with SEC Proposed Rule 17a-5 and that management's system of internal control is designed and maintained effectively. Evidence obtained during the audit of the financial statements and supplemental information helps inform the auditor's understanding of management's competence regarding the specified Financial Responsibility Rules. For example, in performing the audit of the financial statements and supplemental information, auditors are required to obtain an understanding of the company's control environment.^{51/}
- *Read the Financial and Operational Combined Uniform Single Reports ("FOCUS reports") filed by the broker or dealer and obtain an understanding of the reasons for resubmissions, if any* – Reading the broker's or dealer's FOCUS reports might alert the auditor to instances of material non-compliance during the most recent fiscal year. In addition, if a broker or dealer regularly resubmits FOCUS reports or deems it necessary to make significant changes to previously submitted FOCUS reports, this might be indicative of weaknesses in the broker's or dealer's system of internal control over compliance with the specified Financial Responsibility Rules.
- *Read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the*

^{50/} See paragraph (d)(3)(i)(A) of SEC Proposed Rule 17a-5.

^{51/} See paragraphs 23-25 of Auditing Standard No. 12, for a description of the auditor's responsibilities for obtaining an understanding of a company's control environment in a financial statement audit.



broker's or dealer's assertions – Many brokers and dealers have internal audit and compliance functions. Reviewing and testing internal controls over compliance with SEC rules are often important responsibilities of these functions. In addition, some brokers and dealers engage other auditors to perform work and issue reports that are of relevance to the auditor performing the examination engagement.

Under the Securities Exchange Act of 1934, all brokers and dealers are required to be members of self-regulatory organizations, such as the Financial Industry Regulatory Authority ("FINRA"), which performs routine surveillance and monitoring of its members. In performing such surveillance and monitoring activities, FINRA and other regulators may identify matters relevant to a broker's or dealer's compliance with the specified Financial Responsibility Rules. As such, when identifying and assessing risks of material non-compliance, under the proposed examination standard, the auditor should perform specific procedures related to regulatory examinations and correspondence. In particular, the proposed examination standard includes requirements for the auditor to:

- Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to the broker's or dealer's assertions.
- Read correspondence and notifications regarding non-compliance that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA that are relevant to the broker's or dealer's assertions, and, when necessary in the circumstances, make inquiries of the regulatory agencies.

6. *Consideration of Fraud*

The proposed examination standard has multiple requirements regarding the auditor's consideration of fraud when performing the examination.

The proposed examination standard includes a requirement for the auditor to assess the risk of fraud, including the risk of misappropriation of customer assets, relevant to the specified Financial Responsibility Rules when identifying and assessing the risks of material non-compliance. The relevant fraud risks relating to material non-compliance include the risk of misappropriation of customer assets and intentional



manipulation of the books and records to conceal material misappropriations or material non-compliance.

The requirement to coordinate the examination engagement with the audit of the financial statements and supplemental information is important for the proper assessment of fraud risk in the examination engagement. The auditor's assessment of fraud risk in the examination engagement will be informed to a substantial degree by the procedures performed and the fraud risk assessments in the audit of the financial statements and supplemental information. Many of the fraud risk factors identified in the financial statement audit regarding (1) incentives or pressures to misappropriate assets or commit fraudulent financial reporting and (2) attitudes and rationalizations that justify such fraudulent actions,^{52/} are relevant when identifying and assessing risks of misappropriation of customer assets or intentional manipulation of the books and records to conceal misappropriation of customer assets or material non-compliance. Also, weaknesses in controls regarding safeguarding of assets or stock records can result in opportunities for misappropriation of customer assets or material non-compliance. In addition, the evaluation of misstatements for indications of fraud or matters identified during the audit that might affect the assessment of fraud risks in the audit of the financial statements also might affect the assessment of fraud risks in the examination engagement.^{53/}

The proposed examination standard also includes a requirement for the auditor to obtain an understanding of the nature and frequency of customer complaints that are relevant to compliance with the specified Financial Responsibility Rules, which can provide evidence relevant to the assessment of fraud risks, especially if there is a high incidence of customer complaints, thematic issues in the complaints that indicate the potential for fraudulent misappropriation of customer assets, or specific allegations of fraud by the broker's or dealer's customers.

In addition, the proposed examination standard includes a requirement for the auditor to perform compliance tests that are specifically responsive to fraud risks. In particular, under the proposed examination standard, the auditor must perform

^{52/} See paragraphs 65-66 of Auditing Standard No. 12 and paragraph 85 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

^{53/} See paragraphs 20-23, 28-29 and Appendix C of Auditing Standard No. 14, *Evaluating Audit Results*.



procedures to obtain evidence about the existence of customer funds or securities held for customers.^{54/}

SEC Proposed Rule 17a-5 also requires that auditors directly contact the Commission and the broker's or dealer's DEA within one business day of finding material non-compliance in the course of preparing the auditors reports required by the rule.^{55/}

Questions:

6. Is a risk-based approach to the examination engagement appropriate? What alternative approaches should the Board consider and why?
7. Are the procedures required by the proposed examination standard to identify and assess risks of material non-compliance sufficiently clear? Are there additional procedures that the Board should require?

7. *Testing Controls over Compliance*

SEC Proposed Rule 17a-5 requires the broker's or dealer's compliance report to include an assertion regarding the effectiveness of internal control over compliance with the specified Financial Responsibility Rules during the most recent fiscal year.^{56/} Accordingly, the proposed examination standard requires the auditor to obtain evidence about the design and operating effectiveness of relevant controls over compliance during the entire fiscal year.^{57/}

The proposed examination standard requires the auditor to test those controls that are important to the auditor's conclusion about whether the broker or dealer

^{54/} Paragraphs (a)(1) and (a)(2) of Rule 15c3-3 define the terms "customer" and "customer securities," respectively.

^{55/} See paragraph (h) of SEC Proposed Rule 17a-5.

^{56/} See paragraph (d)(3)(i)(B)(3) of SEC Proposed Rule 17a-5, which requires the broker or dealer to assert on the effectiveness of its internal control over compliance with the specified Financial Responsibility Rules throughout the fiscal year.

^{57/} See paragraph (d)(3)(i)(C) of SEC Proposed Rule 17a-5, which requires the broker or dealer to describe each identified instance of material non-compliance and each material weakness in internal control over compliance.



maintains effective internal control over compliance for each specified Financial Responsibility Rule. As the broker's or dealer's assertion regarding internal control over compliance relates to each specified Financial Responsibility Rule individually, the auditor should obtain evidence about the effectiveness of the selected controls for each specified Financial Responsibility Rule. However, when testing controls over compliance, the auditor's objective is not to support an opinion about the effectiveness of each individual control, rather, the objective is to form an opinion about whether the broker's or dealer's assertion regarding internal control over compliance is fairly stated, in all material respects. This allows the auditor to focus his or her effort on the controls that are important to each of the specified Financial Responsibility Rules and to vary the level of evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

The risk associated with an individual control consists of the risk that a control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with a control increases, the evidence that the auditor should obtain also increases. The proposed examination standard identifies certain factors including, for example, the extent of use of part-time personnel to perform controls over compliance, that affect the risk associated with a control.

The proposed examination standard requires the auditor to test the design and operating effectiveness of the selected controls over compliance. The requirements in the proposed examination standard for testing design and operating effectiveness of controls over compliance are analogous to the requirements for testing controls in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

Under the proposed examination standard, the auditor should obtain evidence each year, but like testing controls in a financial statement audit, the proposed examination standard provides factors for the auditor to consider if the auditor plans to use evidence obtained in prior years in determining the extent of test work in the current year.

As noted above, the auditor is required to obtain evidence about the effectiveness of internal control over compliance during the entire fiscal year. For example, if a broker or dealer makes changes to its policies and procedures or key personnel during the fiscal year, the auditor should obtain evidence regarding the design effectiveness of the selected controls before and after the change.



Questions:

8. Are the requirements in the proposed examination standard for testing controls over compliance sufficiently clear?
9. Are there additional factors that should be considered in assessing the risk associated with a control?

8. *Performing Compliance Tests*

With respect to compliance tests, the auditor's objective is to form a conclusion about whether the broker's or dealer's assertion regarding compliance with each specified Financial Responsibility Rule is fairly stated, in all material respects. To satisfy this objective, the proposed examination standard requires the auditor to perform procedures that are sufficient to support the auditor's conclusions regarding whether the broker or dealer is in compliance with each specified Financial Responsibility Rule as of the specified date. The Board considered two alternatives when developing the requirements for compliance tests: 1) prescribing specific testing procedures for each specified Financial Responsibility Rule and 2) using a more general approach to establishing the requirements. In general, the Board decided to take the latter approach as it requires the auditor to devote more attention to the matters that are most significant to compliance with the specified Financial Responsibility Rules and focuses the auditor's effort on the areas of greater risk. However, in connection with testing compliance with Rule 17a-13 and paragraph (b) of Rule 15c3-3, the proposed examination standard specifically requires the auditor to perform procedures to obtain evidence about the existence of customer funds or securities held for customers.^{58/} Examples of procedures that provide evidence about the existence of customer assets include (1) counting customer securities or observing and testing the broker's or dealer's procedures for physical inspection and (2) confirming customer security positions directly with depositories and clearing organizations. Procedures performed in the audit of the financial statements and supplemental information to test the existence of assets held for customers also provide evidence that is relevant to this requirement in the examination engagement.

The SEC Proposing Release, in discussing the broker's or dealer's assertion regarding compliance with the specified Financial Responsibility Rules at fiscal year end, states that "because [Rule 17a-13 and the account statement rule] impose

^{58/} Paragraphs (a)(1) and (a)(2) of Rule 15c3-3 define the terms "customer" and "customer securities," respectively.



obligations on a quarterly basis (the broker [or] dealer must conduct the quarterly count of securities and must send statements to all customers at least once during each quarter, but not necessarily on the last day of the quarter), to be able to make the assertions in the [c]ompliance [r]eport, the broker [or] dealer would need to determine that it had satisfied the requirements over the course of the fiscal quarter immediately preceding the broker [or] dealer's fiscal year-end."^{59/} Accordingly, under the proposed examination standard, the auditor should perform tests of compliance over each of the specified Financial Responsibility Rules as of year end and, for Rule 17a-13 and the account statement rule, the auditor should perform tests of compliance during the fiscal quarter immediately preceding the broker's or dealer's year end.

Under the proposed examination standard, as the risk of material non-compliance associated with a particular specified Financial Responsibility Rule increases, the evidence that the auditor should obtain from compliance tests also increases. The results of the auditor's tests of controls over compliance also affect the nature, timing, and extent of compliance tests. If the results of the auditor's evaluation of controls over compliance indicate that the controls are ineffective, the auditor should revise the planned compliance tests as necessary to obtain more evidence.

When planning and performing compliance tests, the auditor should take into account the evidence obtained from procedures performed as part of the audit of the financial statements and supplemental information. For example, certain audit procedures performed to test the valuation and classification of the broker's or dealer's investments as of year end may provide relevant evidence regarding the broker's or dealer's compliance with Rule 15c3-1. Further, when testing the broker's or dealer's cash and cash equivalents, certain audit procedures may provide evidence regarding the existence of special reserve bank accounts for the exclusive benefit of customers, as well as evidence about the deposits to, and withdrawals from, those bank accounts. Such evidence may be relevant to the broker's or dealer's compliance with Rule 15c3-3 regarding whether the broker or dealer maintains a special reserve bank account for the exclusive benefit of customers. However, as the objectives of the audit and the examination engagement are not the same, the auditor must plan and perform the work to meet the objectives of both engagements.

^{59/} Section II.B.1. of the SEC Proposing Release.



Question:

10. Are the principles in the proposed examination standard for performing compliance tests sufficiently clear? Should the standard include specific procedures that should always be performed?

9. *Testing Information Used to Assert Compliance*

The proposed examination standard requires the auditor to perform procedures to determine whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records. Proper coordination of these procedures with the audit of the financial statements and supplemental information allows the auditor to avoid unnecessary redundancy in the auditor's work. For example, the PCAOB's Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*, includes a requirement for the auditor to determine that the supplemental information reconciles to the underlying accounting and other records or to the financial statements themselves, as applicable. Such supplemental information includes the supporting schedules that broker or dealers are required to include in their financial reports pursuant to SEC Proposed Rule 17a-5.^{60/}

Although the proposed examination standard does not require the auditor to perform tests of controls that are relevant to whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records, if the auditor plans to rely on controls to reduce the planned extent of other procedures, the auditor must obtain evidence that the controls selected for testing are designed and operating effectively.

10. *Evaluating the Results of the Examination Procedures*

Under the proposed examination standard, in forming an opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects, the auditor should evaluate all evidence obtained regardless of whether the evidence corroborates or contradicts the broker's or dealer's assertions. This includes evaluating evidence obtained from compliance tests, tests of controls, and the audit of the broker's or dealer's financial statements and supplemental information. Under the proposed examination standard, the auditor's evaluation of results includes evaluating: (1) instances of non-compliance to determine whether they are material,

^{60/} See paragraphs (d)(2)(ii) and (d)(2)(iii) of SEC Proposed Rule 17a-5.



individually or in combination, as of the specified date; (2) instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records to determine whether they are material, individually or in combination; and (3) identified control deficiencies to determine whether the deficiencies, individually or in combination, are material weaknesses.

Because SEC Proposed Rule 17a-5 requires the broker or dealer to assert on the effectiveness of internal control over compliance with the specified Financial Responsibility Rules during the entire fiscal year,^{61/} the auditor should evaluate control deficiencies to determine whether the deficiencies, individually or in combination are, or were at some point during the specified period, material weaknesses.

Although the existence of a material weakness in internal control over compliance does not necessarily mean that an instance of material non-compliance exists at the specified date, the auditor nonetheless should take into account the existence of the material weakness in determining the necessary nature, timing, and extent of compliance tests and in evaluating the evidence obtained.

Furthermore, an auditor cannot assume that an identified instance of non-compliance or an identified control deficiency is an isolated occurrence. The auditor should evaluate the effect of any instance of non-compliance or identified control deficiency on the auditor's assessed risks of material non-compliance. This evaluation is important to inform the auditor's conclusions about whether the auditor's risk assessments remain appropriate and whether he or she has obtained sufficient appropriate evidence to support the opinion to be expressed in the auditor's examination report.

Under the proposed examination standard, the auditor should evaluate the effect on the audit of the financial statements and supplemental information of any material non-compliance, material weaknesses, or instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records. This includes determining whether sufficient appropriate audit evidence has been obtained to support the relevant financial statement assertions, including assertions related to the completeness and accuracy of disclosures, taking into account materiality considerations for the audit of the financial statements. For example, if, in performing procedures related to net capital requirements under Rule 15c3-1, the auditor identifies

^{61/} See paragraph (d)(3)(i)(B)(3) of SEC Proposed Rule 17a-5.



that the broker's or dealer's net capital position is misstated because the information used in the calculation was not derived from the broker's or dealer's books and records, the auditor would need to evaluate whether the broker's or dealer's financial statement disclosures and supplemental information are also materially misstated.

The proposed examination standard also includes a requirement for the auditor to evaluate whether he or she has obtained sufficient appropriate evidence to support the conclusions to be presented in the examination report. Factors that are relevant to this evaluation include the following:

- a. The results of procedures performed in the examination engagement and evidence obtained from procedures performed as part of the audit of the financial statements and supplemental information, including whether the evidence obtained supports or contradicts the broker's or dealer's assertions;
- b. The nature and frequency of any non-compliance identified, including the facts and circumstances surrounding such non-compliance, the period covered, and the total number of occurrences, and the likelihood of the non-compliance having a material effect, individually or in combination, considering the possibility of further undetected non-compliance;
- c. The significance of any identified instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records and the likelihood of the instances having a material effect, individually or in combination, considering the possibility of further undetected instances;
- d. The nature and frequency of any identified deficiencies in controls over compliance with the specified Financial Responsibility Rules, including the facts and circumstances surrounding such deficiencies, the period covered, the total number of occurrences, and the likelihood of the control deficiencies resulting in a material weakness, individually or in combination, considering the possibility of further undetected deficiencies;
- e. The risks of material non-compliance associated with each specified Financial Responsibility Rule; and



- f. The appropriateness (i.e., the relevance and reliability) of the evidence obtained.^{62/}

Under the proposed examination standard, if the auditor has not obtained sufficient appropriate evidence about an assertion or has substantial doubt about an assertion, he or she should perform additional procedures to obtain further evidence to address the matter. For example, if, during the audit of the broker's or dealer's financial statements, the auditor identified control deficiencies that existed during the year that may cause the broker or dealer to use incorrect securities hair-cut percentages when computing its net capital under Rule 15c3-1,^{63/} the auditor should (1) determine whether such deficiencies individually or in combination are material weaknesses and (2) revise the planned compliance tests as necessary to obtain more evidence about whether the broker's or dealer's year-end net capital computation complies with the requirements of Rule 15c3-1.

If the auditor is unable to obtain sufficient appropriate evidence about an assertion to provide a reasonable basis for forming a conclusion, the auditor should withdraw from the examination engagement or express a disclaimer of opinion. See Section I.E. of this appendix, "Reporting on a Broker or Dealer Compliance Examination", for further discussion regarding scope limitations.

Question:

11. Are the requirements in the proposed examination standard for evaluating identified instances of non-compliance, instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records, and deficiencies in internal control over compliance, sufficiently clear?

11. *Subsequent Events*

The auditor also has responsibilities regarding events occurring from the end of the period specified in the broker's or dealer's assertions to the date of the auditor's examination report (the "subsequent period"). Under the proposed examination standard the auditor should perform procedures, in addition to those performed as part

^{62/} Paragraphs 5-9 of Auditing Standard No. 15, discuss matters that affect the sufficiency and appropriateness of evidence.

^{63/} See paragraph (c)(2)(vi) of Rule 15c3-1.



of the financial statement audit,^{64/} for the purpose of identifying subsequent events relevant to the auditor's conclusions about the assertions made by the broker or dealer in the compliance report. Rather than repeat the subsequent event procedures included in AU sec. 560, *Subsequent Events*, the proposed examination standard includes requirements relevant to the examination engagement designed to supplement the procedures performed during the audit of the financial statements. Under the proposed examination standard, procedures to identify subsequent events should include, but are not limited to: (a) reading relevant reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors, and correspondence that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA during the subsequent period that is relevant to the broker's or dealer's assertions and (b) evaluating information obtained through other engagements performed by the auditor for the broker or dealer, including subsequent events procedures performed in the audit of the financial statements and supplemental information.

Question:

12. Should the proposed examination standard require additional procedures to identify subsequent events relevant to the auditor's opinion on the assertions made by a broker or dealer in a compliance report?

12. *Representation Letter*

The proposed examination standard includes a requirement for the auditor to obtain written representations from management of the broker or dealer. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the examination engagement. See Section I.E. of this appendix, "Reporting on a Broker or Dealer Compliance Examination," for further discussion regarding scope limitations.

Question:

13. Are the representations the auditor is required to obtain from management necessary for the auditor to express an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects?

^{64/} See AU sec. 560, *Subsequent Events*.



D. Communication Requirements

Under the proposed examination standard, the auditor should communicate to management identified instances of non-compliance, identified control deficiencies, and identified instances in which information used to determine compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records.

Further, the proposed examination standard states that the auditor should communicate to management and the audit committee^{65/} identified instances of material non-compliance, identified instances of material weakness, and identified instances in which information used to determine compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records.

Importantly, in addition to the requirements of this proposed examination standard, the SEC has also proposed to establish additional communication requirements for the auditor regarding notification of material non-compliance. Whereas existing Rule 17a-5 requires the auditor to call any "material inadequacy" to the attention of the broker's or dealer's chief financial officer (who is then obligated to notify the SEC), SEC Proposed Rule 17a-5 requires, among other things, the auditor, upon determining that any material non-compliance exists, to notify the SEC directly within one business day.^{66/}

^{65/} For the purposes of this standard, the term "audit committee" refers to a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of a company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company. If a broker or dealer does not have an audit committee or a board of directors of the company, those responsible for the appointment, compensation, and oversight of the work of the auditor.

^{66/} Paragraph (h) of SEC Proposed Rule 17a-5 states that "[u]pon determining any material non-compliance exists during the course of preparing the independent public accountant's reports, the independent public accountant must notify the Commission within one business day of the determination by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations and provide a



Question:

14. Are there other matters related to the examination that the auditor should communicate to the broker's or dealer's audit committee?

E. Reporting on the Examination Engagement

The proposed examination standard requires the auditor to issue a single report that expresses an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects, when expressing an unqualified opinion. However, the proposed examination standard requires direct reporting on the subject matter if one or more instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion, one or more material weaknesses exist during the period specified in the broker's or dealer's assertion, or one or more instances exist in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the books and records of the broker or dealer. Direct reporting is preferable in these circumstances because it communicates more effectively the nature and results of the examination.

Under the proposed examination standard, the auditor's examination report includes certain elements that are not required by AT sec. 101, but that are important for a reader of the auditor's examination report to understand regarding the auditor's responsibilities. For example, under the proposed examination standard, the auditor's examination report must include:

- A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the examination engagement to obtain reasonable assurance about whether one or more instances of material non-compliance exist as of the specified date; whether the information used to assert compliance with the specified Financial Responsibility Rules was derived, in all material respects, from the books and records of the broker or dealer; and whether one or more instances of material weakness exist during the specified period; and
- A statement that an examination engagement includes testing and evaluating the broker's or dealer's compliance with the specified Financial

copy of such notification in the same manner to the principal office of the designated examining authority for the broker or dealer within one business day of the finding."



Responsibility Rules, determining whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records, testing and evaluating the design and operating effectiveness of internal control over compliance with the specified Financial Responsibility Rules, and performing such other procedures as the auditor considered necessary in the circumstances.

SEC Proposed Rule 17a-5 requires the auditor's examination report to comply with certain technical requirements, make certain representations, and state clearly the auditor's opinion.^{67/} The requirements of the proposed examination standard are aligned with these requirements. For example, the proposed examination standard requires the auditor to manually sign the examination report,^{68/} whereas AT sec. 101 allows either a manual or printed signature of the auditor's firm.^{69/} Furthermore, unlike AT sec. 101, the proposed examination standard includes a requirement for the auditor to include the city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's examination report has been issued.^{70/}

Unlike AT sec. 101, the proposed examination standard does not include provisions that allow the auditor to restrict the use of the review report to specified parties.

The proposed examination standard includes an example of the auditor's examination report expressing an unqualified opinion on the assertions made by a broker or dealer in a compliance report.

Questions:

15. Do the required elements of the auditor's examination report clearly communicate the auditor's responsibilities for the examination engagement?

^{67/} See paragraph (i) of SEC Proposed Rule 17a-5.

^{68/} See paragraph (i)(1)(ii) of SEC Proposed Rule 17a-5.

^{69/} See AT sec. 101.85.

^{70/} See paragraph (i)(1)(iii) of SEC Proposed Rule 17a-5 and AT sec. 101.85.



16. What changes, if any, should be made to the format or content of the report as described in the proposed examination standard? Are there additional auditor representations or other information that should be included in the auditor's report?

1. *Examination Report Date*

Under the proposed examination standard, the auditor should date the examination report no earlier than the date on which the auditor obtains sufficient appropriate evidence to support his or her opinion. Because of the coordination between the examination engagement and the audit of the financial statements and supplemental information, the date of the examination report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

2. *Examination Report Modifications*

The proposed examination standard includes an appendix ("Appendix A") that builds on existing concepts described in AT sec. 101 regarding report modifications and adapts them as appropriate to make the requirements more specific to the examination engagement.

Under the proposed examination standard, if (1) one or more instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion, (2) one or more material weaknesses exist during the period specified in the broker's or dealer's assertion, or (3) one or more instances exist in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the books and records of the broker or dealer, the auditor must express an adverse opinion directly on the subject matter of the respective assertions, rather than on the assertions themselves, unless there is a restriction on the scope of the examination engagement.^{71/} This requirement is different from AT sec. 101 which states that "[r]eservations about the subject matter ... can result in either a qualified or an adverse opinion, depending on the materiality of the departure from the criteria against which the subject matter ... was evaluated."^{72/} Qualification of

^{71/} The requirement to express an adverse opinion applies regardless of whether the material non-compliance, material weakness, or other matters preventing an unqualified opinion were identified by management or the auditor.

^{72/} AT sec. 101.76.



the examination report is not appropriate because any instance of material non-compliance, any material weakness in internal control over compliance, or any instance in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records, is by definition material and, as such, should result in an adverse opinion. Furthermore, this requirement is consistent with SEC Proposed Rule 17a-5 which does not permit the broker or dealer to conclude in its compliance report that it is in compliance with the specified Financial Responsibility Rules if it identifies one or more instances of material non-compliance or that its internal control over compliance with the specified Financial Responsibility Rules is effective if one or more instances of material weakness in internal control over compliance exist.^{73/}

Unlike AT sec. 101, the proposed examination standard describes specific matters that the auditor must include in the examination report when expressing an adverse opinion. For example, when expressing an adverse opinion because one or more material weaknesses exist, the auditor's examination report must include a statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in the compliance report.

The requirement to express an adverse opinion applies only to the subject matter for the respective assertion. It does not require an adverse opinion on the subject matter of all assertions in every instance. For example, if a material weakness was identified, but there were no instances of material non-compliance or instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records, the examination report should include an adverse opinion on internal control over compliance and an unqualified opinion on the other two assertions.

In contrast to AT sec. 101, under the proposed examination standard, further modifications to the examination report are necessary if a description of all identified instances of material non-compliance and all identified material weaknesses have not been included in the broker's or dealer's compliance report. For example, if the broker or dealer concludes in its compliance report that internal controls over compliance are effective when, in fact, one or more material weaknesses in internal control over compliance exist, the proposed examination standard requires the auditor to modify his or her report to describe the material weaknesses that the auditor has identified but that are not described in the broker's or dealer's compliance report.

^{73/} See paragraph (d)(3)(i)(C) of SEC Proposed Rule 17a-5.



Under the proposed examination standard, the auditor can express an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects, only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the examination engagement, the auditor should withdraw from the engagement or disclaim an opinion. This requirement is different from AT sec. 101 which states that "[r]estrictions on the scope of an engagement ... may require a practitioner to qualify the assurance provided, to disclaim any assurance, or to withdraw from the engagement."^{74/} When a scope limitation exists, qualification of the examination report is not appropriate because the auditor does not have a reasonable basis to support the opinion.

Whereas AT sec. 101 provides only an example examination report containing a disclaimer of opinion because of a scope restriction,^{75/} the proposed examination standard includes specific requirements so that users of the report are adequately informed. Under the proposed examination standard, when disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the examination engagement was not sufficient for the auditor to express an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer, including the procedures that were deemed necessary by the auditor that have been omitted and the reason for their omission. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an examination engagement.

Further, under the proposed examination standard, when the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that: (1) one or more instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion, (2) one or more material weaknesses exist during the period specified in the broker's or dealer's assertion, or (3) one or more instances exist in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the books and records of the broker or dealer, the auditor's report also must include the applicable statement required by paragraph A3 of the proposed examination standard. In addition, unlike AT sec. 101, if the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the examination engagement, under the proposed examination standard, the auditor should

^{74/} AT sec. 101.73.

^{75/} See AT sec. 101.114, Appendix A, Example 6.



communicate on a timely basis, in writing, to management and the audit committee that the examination engagement cannot be satisfactorily completed.

Under the proposed examination standard, if the broker's or dealer's compliance report contains other information in addition to the statements and assertions required by SEC Proposed Rule 17a-5,^{76/} the auditor should disclaim an opinion on the other information. For example, if the broker's or dealer's compliance report states that an identified instance of material weakness no longer exists because controls have been implemented that address the instance of material weakness, the auditor should disclaim an opinion on this information. Furthermore, if the auditor believes that additional information in the compliance report contains a material misstatement of fact, the auditor should discuss the matter with management of the broker or dealer. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information.

Questions:

17. What changes, if any, should be made to the format or content of the report modifications described in the proposed examination standard?
18. Should the standard include examples of modified examination reports? If so, what specific examples should be provided?

II. Proposed Attestation Standard, Review Engagements Regarding Exemption Reports of Brokers and Dealers

The proposed review standard establishes requirements that apply when an auditor is engaged to perform a compliance review of the assertion made by a broker or dealer in an exemption report prepared pursuant to SEC Proposed Rule 17a-5.^{77/} SEC Proposed Rule 17a-5 requires a broker's or dealer's exemption report to contain an assertion by the broker or dealer that it is exempt from the provisions of Rule 15c3-3

^{76/} See paragraph (d)(3) of SEC Proposed Rule 17a-5.

^{77/} See paragraph (d)(4) of SEC Proposed Rule 17a-5. Existing Rule 17a-5(g)(2) requires that the independent public accountant engaged by the broker or dealer must "ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the independent public accountant's attention to indicate that the exemption had not been complied with during the period since the independent public accountant's last examination."



because it meets conditions set forth in paragraph (k) of Rule 15c3-3 and to identify the specified conditions.^{78/}

A. Relationship to the Interim Attestation Standards

PCAOB standard, AT sec. 101, *Attest Engagements*, establishes requirements that apply to attestation engagements in general, including review engagements similar to those described in the SEC Proposed Rule 17a-5.^{79/} However, the requirements in AT sec. 101 are not specific to any particular type of review engagement. The proposed review standard establishes requirements that are designed specifically for the review required by SEC Proposed Rule 17a-5.^{80/} Accordingly, auditors should look to the requirements in this standard rather than AT sec. 101 for these engagements. In addition, the emphasis in the proposed review standard on appropriately coordinating the review engagement with the audit of the financial statements and supplemental information should avoid unnecessary redundancy in the auditor's work.

B. Objective of the Auditor

When performing a review of the assertion made by a broker or dealer in an exemption report, the auditor's objective is to state a conclusion regarding whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertion for the assertion to be fairly stated, in all material respects. To state such a conclusion, the auditor must plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance about whether one or more instances of non-compliance exist with respect to the conditions identified in the broker's or dealer's assertion ("exemption conditions") that, individually or in combination, would cause the broker's or dealer's assertion not to be fairly stated, in all material respects.

1. Moderate Assurance

In contrast to an examination engagement in which the auditor obtains reasonable assurance to support his or her opinion on the broker's or dealer's

^{78/} See paragraph (k) of Rule 15c3-3 and paragraph (d)(4) of SEC Proposed Rule 17a-5.

^{79/} AT sec. 601, *Compliance Attestation*, does not apply to review engagements.

^{80/} See paragraph (d)(4) of SEC Proposed Rule 17a-5.



assertions, a review engagement results in obtaining moderate assurance regarding the broker's or dealer's assertion that the broker or dealer meets the identified conditions for an exemption from Rule 15c3-3.^{81/} Review engagements typically involve the performance of inquiries and analytical procedures,^{82/} and the auditor's conclusions typically are expressed in the report in the form of a statement that "[b]ased on the results of the review, nothing came to [the auditor's] attention that caused [the auditor] to believe that management's assertion ... is not fairly stated, in all material respects"^{83/}

In a review engagement covered by the proposed review standard, analytical procedures are not feasible for evaluating compliance with the exemption conditions, as the conditions are based on activities of the broker or dealer rather than on financial statement amounts. Thus, the proposed review standard would establish specific procedural requirements that are commensurate with the responsibility to obtain moderate assurance.^{84/} Subsequent sections of this release discuss those procedures further.

^{81/} Obtaining moderate assurance in a review engagement is consistent with both existing PCAOB standards and the SEC Proposing Release. AT sec. 101.55 describes a review as an attest engagement designed to provide a moderate level of assurance. Section II.B.5. of the SEC Proposing Release states that a "moderate level of assurance [is] contemplated by the required review."

^{82/} AT sec. 101.55 states that "[i]n an attest engagement designed to provide a moderate level of assurance (referred to as a review), the objective is to accumulate sufficient evidence to restrict attestation risk to a moderate level. To accomplish this, the types of procedures performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures)."

^{83/} See AT sec. 101.115, Appendix B, Example 3.

^{84/} This approach is consistent with AT sec 101.55-.56 which states that "... there will be circumstances in which inquiry and analytical procedures ... cannot be performed... In [this] circumstance, the practitioner should perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided."



2. *Non-Compliance Requiring Material Modification*

The proposed review standard refers to non-compliance that would cause the broker's or dealer's assertion not to be fairly stated, in all material respects. The SEC's Proposing Release provides an example of a discovery by the auditor that would require a material modification of the broker's or dealer's assertion in the exemption report.^{85/} That example is a discovery that the broker or dealer failed to promptly forward any customer securities it received.^{86/}

Question:

19. Is the concept of non-compliance requiring material modification clear?

C. **General Requirements**

The proposed review standard requires that an auditor performing a review engagement have technical proficiency in attestation engagements, have an understanding of the exemption conditions and other rules and regulations that are relevant to the broker's or dealer's assertion, determine the auditor's compliance with independence and ethics requirements, exercise due professional care, and properly plan and supervise the review engagement.

Questions:

20. Are the general requirements included in the proposed review standard sufficiently clear?
21. Are there additional general requirements that should be included for a review engagement?

^{85/} See Section II.B.5. of the SEC Proposing Release.

^{86/} See paragraph (k)(2)(ii) of Rule 15c3-3, which provides that an introducing broker or dealer is exempt from the requirements of Rule 15c3-3 if the introducing broker or dealer "promptly transmits all customer funds and securities to the clearing broker or dealer which carries all of the accounts of such customers"



D. Relationship Between the Review Engagement and the Audit of the Financial Statements and Supplemental Information

The proposed review standard recognizes that the auditor of the financial statements of the broker or dealer generally would issue the review report covered by the proposed review standard. Accordingly, the proposed review standard includes a requirement for the auditor to coordinate the review engagement with the audit of the financial statements and supplemental information. However, the objectives of the audit and the review engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.

While recognizing that the objectives of the audit and the review engagement are different, the proposed review standard includes a requirement for the auditor to take into account relevant evidence from the audit in planning and performing procedures for the review engagement and in evaluating the results of the procedures performed in the review.

For example, if the broker or dealer claims exemption under Rule 15c3-3(k)(2)(i), the auditor, among other things, needs to obtain evidence that the broker or dealer has appropriate bank accounts designated as "Special Account for the Exclusive Benefit of Customers of (name of the broker or dealer)" and that all customer transactions are effectuated through such accounts, as required by the rule.^{87/} Audit procedures related to specially designated cash accounts, including confirming the account balance with the clearing broker and testing customer transaction activities, can provide evidence relevant to these exemption conditions.

Furthermore, if the broker or dealer claims exemption under Rule 15c3-3(k)(2)(ii), the auditor, among other things, needs to obtain evidence that the broker or dealer is operating as an introducing broker or dealer and clears all transactions with and for

^{87/} Paragraph (k)(2)(i) of Rule 15c3-3 states that "the provisions of [Rule 15c3-3] shall not be applicable to a broker or dealer ... who carries no margin accounts, promptly transmits all customer funds and delivers all securities received in connection with his activities as a broker or dealer, does not otherwise hold funds or securities for, or owe money or securities to, customers and effectuates all financial transactions between the broker or dealer and his customers through one or more bank accounts, each to be designated as "Special Account for the Exclusive Benefit of Customers of (name of the broker or dealer)"."



customers with clearing brokers and dealers on a fully-disclosed basis.^{88/} Audit procedures, including reading the clearing agreement between the broker or dealer and clearing brokers and dealers when testing trade fee or commission revenues and expenses can provide evidence relevant to these exemption conditions.

Other procedures performed during the audit that are relevant to the broker's or dealer's compliance with the exemption conditions include testing of transactions related to customer trades and testing investment inventory or transactions related to the broker's or dealer's trading for its own account.

Under the proposed review standard, if the broker's or dealer's assertion is not fairly stated, in all material respects, the auditor should evaluate the effect of the matter on the audit of the financial statements and supplemental information.

If the auditor performing the review engagement does not audit the financial statements and supplemental information of the broker or dealer, the proposed review standard requires the auditor to obtain knowledge of the evidence obtained and results of procedures performed in the audit of the financial statements and supplemental information that is commensurate with that of the auditor of the financial statements and supplemental information. That level of knowledge is necessary to have an appropriate basis to perform the evaluation required by the proposed review standard.

The proposed review standard also states that the auditor's own work on the review engagement must be sufficient to support his or her conclusion on the broker's or dealer's assertion, so that the auditor who performs only the review engagement does not rely on the work of the auditor of the financial statements and supplemental information without performing the procedures required by the proposed review standard.

^{88/} Paragraph (k)(2)(ii) of Rule 15c3-3, states that "the provisions of [Rule 15c3-3] shall not be applicable to a broker or dealer ... who, as an introducing broker or dealer, clears all transactions with and for customers on a fully disclosed basis with a clearing broker or dealer, and who promptly transmits all customer funds and securities to the clearing broker or dealer which carries all of the accounts of such customers and maintains and preserves such books and records pertaining thereto pursuant to the requirements of Exchange Act Rules 17a-3 and 17a-4, as are customarily made and kept by a clearing broker or dealer."



Question:

22. Are there any other sources of relevant evidence obtained in the audit of the financial statements and supplemental information that the auditor should take into account when planning and performing the review engagement that should be included in the standard?

E. Review Procedures

The auditor's responsibility when performing a review engagement is to obtain moderate assurance about whether the broker or dealer complied with the exemption conditions cited in the broker's or dealer's assertion. Accordingly, the proposed review standard requires the auditor to plan and perform the review engagement so that the auditor obtains appropriate evidence that is sufficient for moderate assurance.

Under the proposed review standard the auditor should perform procedures including making inquiries of management and relevant personnel of the broker or dealer, reading relevant reports from internal auditors or regulatory correspondence, evaluating evidence from the audit of the financial statements and supplemental information, and performing additional procedures for identified instances of non-compliance.

1. Nature, Timing, and Extent of Procedures

Under the proposed review standard the nature, timing, and extent of the review procedures depend on certain risk factors and evidence about the broker's or dealer's compliance with the exemption conditions or about the effectiveness of controls over the exemption conditions obtained from the audit of the financial statements and supplemental information.

The proposed review standard states that the nature, timing, and extent of the necessary inquiries and other review procedures depend on the following risk factors:

- (1) The broker's or dealer's history of instances of non-compliance with the exemption conditions;
- (2) Changes in the broker's or dealer's procedures, controls, or the process in which the controls operate since the prior year;
- (3) Changes in the broker's or dealer's operations that are relevant to compliance with the exemption conditions;



- (4) Competence of the personnel who are responsible for compliance with the exemption conditions or who perform important controls over compliance, and whether there have been changes in those personnel during the period of the review;
- (5) The risk of fraud, including the risk of misappropriation of customer assets, relevant to the exemption conditions;
- (6) Potential non-compliance associated with related parties,^{89/} including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship; and
- (7) The degree to which the processes that relate to the exemption conditions are performed, monitored, or controlled in a centralized or decentralized environment.

In considering the risk of fraud relevant to the exemption conditions, the auditor also considers if the broker or dealer has misrepresented its activities, e.g., the broker or dealer claims to be operating as a non-carrying broker or dealer, but based on other evidence appears to hold customer funds or securities.

In addition, knowledge of the degree to which the processes that relate to the exemption conditions are performed, monitored, or controlled in a centralized or decentralized environment might help the auditor determine which individuals within the broker or dealer the auditor should make inquiries of and what reports to request when performing review procedures.

Evidence about the broker's or dealer's compliance with the exemption conditions or about the effectiveness of controls over the exemption conditions obtained from the audit of the financial statements and supplemental information also affect the nature, timing, and extent of the necessary inquiries and other review procedures. For example, if the broker or dealer claims exemption under Rule 15c3-3(k)(1), the auditor, among other things, needs to obtain evidence that the broker's or dealer's dealer transactions are limited to those in redeemable securities of investment companies or of interests or participations in an insurance company separate account and places

^{89/} The auditor should look to the FASB Codification Master Glossary with respect to the term "related parties."



limitation on transaction activities outside of the allowable security types.^{90/} Audit procedures regarding the broker's or dealer's investment inventory or investment transactions related to the broker's or dealer's trading for its own account, including confirmation of investment inventory with the custodian and testing investment transactions, can provide evidence relevant to the broker's or dealer's compliance with these exemption conditions.

As another example, if the broker or dealer claims exemption under sections (k)(1) or (k)(2) of Rule 15c3-3, the auditor needs to obtain evidence about whether the

^{90/} Paragraph (k)(1) of Rule 15c3-3, states that "the provisions of [Rule 15c3-3] shall not be applicable to a broker [or] dealer meeting all of the following conditions:

(i) His dealer transactions (as principal for his own account) are limited to the purchase, sale, and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company; except that a broker or dealer transacting business as a sole proprietor may also effect occasional transactions in other securities for his own account with or through another registered broker or dealer;

(ii) His transactions as broker (agent) are limited to: (a) The sale and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company; (b) the solicitation of share accounts for savings and loan associations insured by an instrumentality of the United States; and (c) the sale of securities for the account of a customer to obtain funds for immediate reinvestment in redeemable securities of registered investment companies; and

(iii) He promptly transmits all funds and delivers all securities received in connection with his activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.

(iv) Notwithstanding the foregoing, this section shall not apply to any insurance company which is a registered broker [or] dealer, and which otherwise meets all of the conditions in paragraphs (k)(1) (i), (ii), and (iii) of this section, solely by reason of its participation in transactions that are a part of the business of insurance, including the purchasing, selling, or holding of securities for or on behalf of such company's general and separate accounts."



broker or dealer promptly transmits all funds and delivers all securities received in connection with his activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.^{91/} Audit procedures regarding customer trade and transaction activities can provide evidence relevant to these exemption conditions.

Other procedures performed during the audit that are relevant to the broker's or dealer's compliance with the exemption conditions include testing of specially designated cash accounts and reading clearing agreements between the broker or dealer and clearing brokers and dealers in connection with testing trade fee or commission revenues and expenses.^{92/}

Question:

23. Are the factors that may increase the nature, timing, and extent of the necessary inquiries and other review procedures appropriate?

2. *Review Procedures*

The proposed review standard includes requirements for the auditor to perform inquiries of individuals at the broker or dealer and other procedures to obtain moderate assurance. The proposed review standard does not prescribe specific procedures for each of the various exemption conditions. Instead, the proposed review standard describes in general terms review procedures that should be applied regardless of the exemption claimed by the broker or dealer.

Under the proposed review standard the auditor should make inquiries of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding:

- (1) Whether the broker or dealer was in compliance with the exemption conditions for the year under review,

^{91/} See paragraphs (k)(1)(iii), (k)(2)(i), and (k)(2)(ii) of Rule 15c3-3.

^{92/} Refer to Section II.D., "Relationship between the Review Engagement and the Audit of the Financial Statements and Supplemental Information," of this Appendix for further discussion.



- (2) Regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to compliance with the exemption conditions, and
- (3) Subsequent events through the date of the auditor's review report that might have a material effect on the broker's or dealer's assertion that it is exempt from the provisions of Rule 15c3-3.

In addition, if the broker or dealer has sent or received correspondence with the SEC or the broker's or dealer's DEA that is relevant to compliance with the exemption conditions, the proposed review standard includes a requirement for the auditor to read such correspondence and, when necessary in the circumstances, make inquiries of the regulatory agencies. These procedures provide the auditor with a basis for understanding whether the broker or dealer was in compliance with the exemption conditions.

Under the proposed review standard, the auditor also should make specific inquiries of individuals at the broker or dealer who have relevant knowledge of controls relevant to the broker's or dealer's compliance with the exemption conditions and individuals who are responsible for monitoring compliance with the exemption conditions or the controls over compliance.

Many brokers and dealers have internal auditors, others who perform an equivalent function, and compliance functions. Reviewing and testing internal controls over compliance with SEC rules are often important responsibilities of these functions. In addition, some brokers and dealers may engage other auditors to perform work and issue reports that are relevant to the broker's or dealer's compliance with the exemption conditions. As such, the proposed review standard includes a requirement for the auditor to read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's compliance with the exemption conditions.

SEC rules and rules of the broker's or dealer's DEA may require a broker or dealer, in certain situations, to make certain periodic regulatory filings that might be relevant to the broker's or dealer's compliance with the exemption conditions. The proposed review standard includes a requirement for the auditor to read regulatory filings of the broker or dealer that are relevant to the broker's or dealer's compliance with the exemption conditions.

Under the proposed review standard, the auditor should evaluate whether the evidence obtained and the results of the procedures performed in the audit of the



financial statements and supplemental information corroborate or contradict the broker's or dealer's assertion regarding compliance with the exemption conditions.^{93/}

The proposed review standard also includes a requirement for the auditor to read the broker's or dealer's documentation regarding instances of non-compliance with the exemption conditions that are identified by the auditor or the broker or dealer.

Finally, the auditor should determine whether additional procedures are necessary in the circumstances for the auditor to obtain moderate assurance. These procedures may include additional inquiry procedures or other types of procedures.

Questions:

24. Are there other specific review procedures that the proposed review standard should require? If so, should the procedures be based on the various exemption conditions?
25. Are there alternative procedures that are equally or more effective than the procedures required by the proposed review standard that should replace specific procedures required by the proposed review standard?
26. Regardless of the level of assurance obtained in a review, are there other procedures that the auditor should be required to perform to enhance customer protection?

3. *Evaluating the Results of the Review Procedures*

Under the proposed review standard, the auditor should evaluate the identified instances of non-compliance with the exemption conditions to determine whether the instances of non-compliance, individually or in combination, cause the broker's or dealer's assertion not to be fairly stated, in all material respects. The SEC's Proposing Release states that "an example of a discovery that would necessitate a material modification [to the broker's or dealer's assertion] would be a discovery that the broker [or] dealer failed to promptly forward any customer securities it received."^{94/}

^{93/} Refer to Section D., "Relationship between the Review Engagement and the Audit of the Financial Statements and Supplemental Information" and Section E., "Review Procedures" in this section of the release for further discussion.

^{94/} See Section II.B.5. of the SEC Proposing Release.



The proposed review standard states that if the broker's or dealer's assertion is not fairly stated, in all material respects, the auditor should modify the review report and evaluate the effect of the matter on the audit of the financial statements and supplemental information. This requirement is intended to prompt the auditor, in the event that the broker or dealer does not meet the exemption conditions, to consider the effect on the amounts and disclosures in the financial statements, as well as the auditor's report on the financial statements and supplemental information.

Although the "moderate assurance" required for a review engagement is a lower level of assurance than the "reasonable assurance" required for an examination engagement, due professional care requires an auditor conducting a review to take appropriate actions when becoming aware of indicators of non-compliance or when substantial doubt remains. Under the proposed review standard, if information coming to the auditor's attention indicates that one or more instances of non-compliance might exist that might cause the broker's or dealer's assertion not to be fairly stated, in all material respects, or if the auditor has substantial doubt about the broker's or dealer's assertion, the auditor should perform additional procedures as necessary to address the matter. These additional procedures could include making additional inquiries, reading documents, or performing search and verification procedures, as necessary.^{95/}

Question:

27. Are the requirements in the proposed review standard for evaluating identified instances of non-compliance sufficiently clear?

4. *Obtaining a Representation Letter*

The proposed review standard includes a requirement for the auditor to obtain written representations from management of the broker or dealer. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the review engagement. If a limitation on the scope of the review engagement exists, the auditor should withdraw from the engagement or should modify the review report.^{96/}

^{95/} See AT sec. 101.56.

^{96/} See paragraph 21 of the proposed review standard for auditor requirements when a scope limitation exists.



Question:

28. Are the representations the auditor is required to obtain from management necessary for the auditor to conclude whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertion for it to be fairly stated, in all material respects?

F. Communication Requirements

Under the proposed review standard, the auditor should communicate to management identified instances of non-compliance with the exemption conditions. Further, the auditor should communicate to management and to the audit committee^{97/} identified instances of non-compliance that cause the broker's or dealer's assertion about its exemption conditions not to be fairly stated in all material respects.

Question:

29. Are there other matters related to the review that the auditor should communicate to the audit committee?

G. Reporting on the Review Engagement

AT sec. 101 allows the auditor to either (1) report directly on the subject matter, or (2) report on management's assertion.^{98/} However, the proposed review standard requires the auditor to report on the broker's or dealer's assertion in the exemption report. In providing moderate assurance, reporting on the broker's or dealer's assertion in the exemption report is clearer than reporting on whether the broker or dealer did not

^{97/} For purposes of this standard, the term "audit committee" refers to a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of a company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company. If a broker or dealer does not have an audit committee or a board of directors of the company, those responsible for the appointment, compensation, and oversight of the work of the auditor.

^{98/} See AT sec. 101.63.



meet its exemption conditions specified in the broker-dealer's exemption report.^{99/} Also, this is consistent with SEC Proposed Rule 17a-5 that the auditor's report be based on a review of the exemption report required to be filed by the broker or dealer.^{100/}

Under the proposed review standard, the auditor's review report includes certain elements that are not required by AT sec. 101, but that are important for a reader of the auditor's review report to understand regarding the auditor's responsibilities. For example, under the proposed review standard, the auditor's review report must include a statement that the review was conducted in accordance with the standards of the Public Company Accounting Oversight Board, and accordingly, includes inquiries and certain other procedures to obtain evidence about the broker's or dealer's compliance with the exemption conditions.

SEC Proposed Rule 17a-5 requires the auditor's review report to comply with certain technical requirements, make certain representations, and state clearly the auditor's opinion.^{101/} The requirements of the proposed review standard are aligned with these requirements. For example, the proposed review standard requires the auditor to manually sign the review report,^{102/} whereas AT sec. 101 allows either a manual or printed signature of the auditor's firm.^{103/} Furthermore, unlike AT sec. 101, the proposed review standard includes a requirement for the auditor to include the city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's review report has been issued.^{104/}

Unlike AT sec. 101, the proposed review standard does not include provisions that allow the auditor to restrict the use of the review report to specified parties.

^{99/} It is not expected that an auditor would be engaged to review a broker's or dealer's assertion stating that the broker or dealer failed to meet the specified exemption conditions.

^{100/} See paragraph (g)(2)(ii) of SEC Proposed Rule 17a-5.

^{101/} See paragraph (i) of SEC Proposed Rule 17a-5.

^{102/} See paragraph (i)(1)(ii) of SEC Proposed Rule 17a-5.

^{103/} AT sec. 101.90.

^{104/} See paragraph (i)(1)(iii) of SEC Proposed Rule 17a-5 and AT sec. 101.90.



The proposed review standard includes an example of the auditor's standard review report.

Questions:

30. Do the required elements of the auditor's review report clearly communicate the auditor's responsibilities?
31. What changes, if any, should be made to the format or content of the review report as described in the proposed review standard? Are there additional auditor representations or other information that should be included in the auditor's review report?

1. *Review Report Date*

Under the proposed review standard, the auditor should date the review report no earlier than the date on which the auditor has completed his or her review procedures. Because of the coordination between the review engagement and the audit of the financial statements and supplemental information, the date of the review report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

2. *Modifications of the Report*

If the broker's or dealer's assertion is not fairly stated, in all material respects, because of an instance or certain instances of non-compliance with the exemption conditions, the proposed review standard requires the auditor to modify the review report to describe those instances of non-compliance and state that the broker or dealer is not in compliance with the specified exemption conditions. The auditor is not required to describe all instances of non-compliance; rather, the auditor is required to describe only the instance or instances of non-compliance with the exemption conditions that cause the broker's or dealer's assertion not to be fairly stated, in all material respects.

Under the proposed review standard, if the auditor cannot perform the procedures required by the proposed review standard or other procedures that the auditor deems necessary in the circumstances, the review is incomplete because of the scope limitation. An incomplete review is not a sufficient basis for expressing a conclusion regarding the broker's or dealer's assertion. In the case of a scope limitation, the auditor should withdraw from the engagement or should modify the review report to:



- (a) Describe the scope limitation and any review procedures deemed necessary by the auditor that have been omitted, and the reason for their omission;
- (b) State that the auditor does not express any form of assurance on the broker's or dealer's assertion; and
- (c) Disclose identified instances of non-compliance, if any, that, individually or in combination, cause the broker's or dealer's assertion not to be fairly stated, in all material respects.

Question:

- 32. Do other conditions exist that should be included in the standard that would result in a modification of the report on the review engagement?

H. Effective Date and Other Considerations

1. Effective Date

The Board expects that the proposed attestation standards would be effective for fiscal years ending on or after September 15, 2012, subject to consideration of public comment, SEC rule-making,^{105/} and approval by the SEC. This effective date is intended to coincide with the proposed end of the transition period for SEC Proposed Rule 17a-5, at which time the SEC proposed rule would require the scope of the examination engagement to encompass internal control over compliance with the specified Financial Responsibility Rules for the entire fiscal year rather a point in time as of the date of the compliance report.^{106/} The Board will determine whether adjustments to the effective date are necessary after consideration of comments received and actions taken by the SEC regarding SEC Proposed Rule 17a-5.

^{105/} On June 15, 2011, the Commission proposed to amend its Rule 17a-5 regarding the annual reporting by brokers and dealers to, among other things, update the existing requirements of Rule 17a-5 and facilitate the ability of the PCAOB to implement oversight of independent public accountants of brokers and dealers as required by the Dodd-Frank Act.

^{106/} See Section II.B.7. of the SEC Proposing Release.



Question:

33. Besides alignment with effective dates of the SEC Proposed Rule 17a-5 what other factors, if any, should the Board consider in determining the effective date for adopting final attestation standards?

2. *Agreed-Upon Procedures Engagements*

SEC Proposed Rule 17a-5, carries forward the requirement that the broker or dealer file with the Securities Investor Protection Corporation a supplemental report that includes an accountant's report on applying agreed-upon procedures based on the performance of the procedures outlined in SEC Proposed Rule 17a-5.^{107/}

These proposed attestation standards do not affect the requirements for those agreed-upon procedures engagements. Auditors should continue to look to AT sec. 101, *Attest Engagements*, AT sec. 201, *Agreed-Upon Procedures*, and AT sec. 601, *Compliance Attestation*,^{108/} for the requirements applicable to those engagements.

III. Proposed Amendments

A. Auditing Standard No. 3

Auditing Standard No. 3, *Audit Documentation*, establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to standards of the PCAOB, including the attestation standards of the PCAOB. The Board is proposing certain amendments to Auditing Standard No. 3 to help auditors properly apply the relevant requirements in Auditing Standard No. 3 to attestation engagements, including the attestation engagements covered by the proposed attestation standards. For example, paragraph 6 of Auditing Standard No. 3 includes a requirement for the auditor to document procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions. An amendment is proposed to footnote 2 of paragraph 6 to clarify that, with respect to an engagement conducted pursuant to the attestation standards of the PCAOB, the relevant assertions are the assertions expressed by management or the responsible party regarding the subject matter of the attestation engagement.

^{107/} See paragraph (e)(4)(ii) of SEC Proposed Rule 17a-5.

^{108/} Paragraphs .16-.29 of AT sec. 601.



In addition, paragraph 12 of Auditing Standard No. 3 includes requirements regarding significant findings or issues and provides certain examples of what would be considered as significant findings or issues. An amendment is proposed to include a note regarding additional matters that would be considered as significant findings or issues in an attestation engagement performed pursuant to the standards of PCAOB. Further, paragraph 13 of Auditing Standard No. 3 requires the auditor to identify all significant findings or issues in an engagement completion document. An amendment is proposed to include an additional note to clarify that when conducting an attestation engagement in conjunction with an audit of financial statements in accordance with the standards of the PCAOB, the auditor may include the documentation of significant findings or issues related to the attestation engagement in the engagement completion document prepared in connection with the audit of financial statements.

B. Auditing Standard No. 7

The Board is proposing certain amendments to Auditing Standard No. 7, *Engagement Quality Review*, to require an engagement quality review and concurring approval of issuance for each attestation engagement performed in conjunction with an audit of financial statements conducted pursuant to the standards of the PCAOB. Accordingly, under the proposed amendments, an engagement quality review and concurring approval of issuance are required for examination engagements and review engagements of brokers and dealers.^{109/}

Amendments are proposed to include three new paragraphs regarding the engagement quality reviewer's responsibilities in an attestation engagement performed in conjunction with an audit of financial statements. Under the proposed amendments:

- The engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the attestation engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should (1) hold discussions with the engagement partner and other members of the engagement team, (2) read the engagement report and the document containing management's assertions, and (3) review the engagement completion document and other relevant documentation.

^{109/} Under the proposed amendments, Auditing Standard No. 7 applies even if the firm did not audit the financial statements and supplemental information of the broker or dealer.



- The engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the engagement quality review, he or she is not aware of a significant engagement deficiency. A significant engagement deficiency in an attestation engagement performed in conjunction with an audit of financial statements exists when (1) the engagement team failed to perform attestation procedures necessary in the circumstances of the engagement, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.
- The firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.

Because the proposed amendments apply only to an attestation engagement performed in conjunction with an audit of financial statements, the proposed requirements regarding the engagement quality reviewer's responsibilities in such an engagement are significantly less detailed than the existing requirements of Auditing Standard No. 7 regarding an engagement quality review for an audit. The less detailed requirements reflect the fact that the engagement quality review of the audit generally will involve a review of matters that are also important to the attestation engagement.^{110/}

Questions:

34. Are any other proposed amendments to Auditing Standard No. 3 necessary to clearly describe the auditor's responsibilities regarding documentation when conducting attestation engagements related to brokers and dealers in accordance with the standards of the PCAOB?

^{110/} For example, the Board is proposing an amendment to Auditing Standard No. 3 to state that when conducting an attestation engagement in conjunction with an audit of financial statements in accordance with the standards of the PCAOB, the auditor may include the documentation of significant findings or issues related to the attestation engagement in the engagement completion document prepared in connection with the audit of financial statements.



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35. Are the proposed amendments to Auditing Standard No. 7 clear? Do auditors need more extensive requirements regarding the engagement quality review of these attestation engagements?



Exhibit 2(a)(B)

**Alphabetical List of Comments on the Rules Proposed in
PCAOB Release No. 2011-004**

1	Chris Barnard
2	Center for Audit Quality; Cindy Fornelli, Executive Director
3	Deloitte & Touche LLP
4	Ernst & Young LLP
5	Howard Gluckman, C.P.A.
6	Grant Thornton LLP
7	KPMG LLP
8	McGladrey & Pullen, LLP
9	ParenteBeard LLC, David J. Bolton, CPA, Partner, National Quality Office
10	PricewaterhouseCoopers LLP
11	Texas Society of Certified Public Accountants; Kathryn W. Kapka, CPA, CIA, CGAP, Chair, Professional Standards Committee

Please note that the comments expressed herein are solely my personal views

Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803
United States

Chris Barnard
Actuary

22 July 2011

- **Release No. 2011-004**
- **PCAOB Rulemaking Docket Matter No. 035**
- **Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards**

Dear Sir,

Thank you for giving us the opportunity to comment on your Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards. I generally support these proposals, and their underlying rationale. The proposals will enhance the auditor's review of broker-dealers' internal controls, with particular emphasis on their custody practices. This should therefore act to enhance broker-dealers' safeguarding of investors' assets.

I have already commented on the SEC's proposed rule on Broker-Dealer Reports.¹ My comments thereon are also pertinent to these proposals.² I have some specific comments here, which I will address in answer to your specific questions.

¹ See SEC file no. S7-23-11 Broker-Dealer Reports at: <http://www.sec.gov/rules/proposed/2011/34-64676.pdf>

² See my comment letter at: <http://www.sec.gov/comments/s7-23-11/s72311-4.pdf>

Please note that the comments expressed herein are solely my personal views

Answers to specific questions raised by the PCAOB

1. I agree that the proposed attestation standards are tailored appropriately for examinations and reviews related to compliance and exemption reports of brokers and dealers.
2. The proposed attestation standards are proportionate and appropriately scalable based on the size and complexity of the broker or dealer. For example, paragraphs 12 and 13 of Appendix 1 are particularly helpful in this regard.
3. I support that the requirements in the proposed attestation standards are sufficient and complete to clearly describe the auditor's responsibilities.
4. Paragraph 4 of Appendix 1 states that: "The auditor is not required to express an opinion on the process the broker or dealer used to arrive at the conclusions stated in the broker's or dealer's assertions". Given the increased focus on custody practices and the main objective of safeguarding of investor's assets, I believe that the auditor should provide an opinion on the broker-dealer's process for arriving at assertions. This should provide useful information about the adequacy and robustness of the broker-dealer's process and better manage expectations regarding broker-dealers' ongoing compliance with the Financial Responsibility Rules. I believe that this could help to further promote investor confidence in this arena.

Yours faithfully

C.R.B.

Chris Barnard



September 9, 2011

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Cynthia M. Fornelli

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Re: Request for Public Comment: Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ appreciates the opportunity to provide feedback to the Public Company Accounting Oversight Board's (the "PCAOB") Rulemaking Docket Matter No. 035, "Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards" (the "proposed standards"). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

Additionally, we encourage the PCAOB to review the CAQ's comment letter on the Securities and Exchange Commission's (the "Commission") Broker-Dealer Reports proposal (the "proposed rule"), which covers a majority of the topical areas discussed below.

OVERALL COMMENT

The proposed standards are intended to address the auditor's responsibilities for the examination of the Compliance Report and review of the Exemption Report as proposed within the Commission's proposed rule and include standards that, among other things:

- Establish examination requirements that are risk-based and allow for the independent registered public accounting firms ("auditors" or "audit firms") to obtain reasonable assurance as to whether any material non-compliance or material weakness exists
- Establish review requirements that are commensurate with an auditor's responsibility to obtain moderate assurance that broker-dealers meet the identified conditions for an exemption

In general, the CAQ supports the PCAOB's proposed standards. We believe the proposed standards provide attestation procedures for both examination and review engagements that are consistent with the Commission's proposed rule. However, we recommend that the PCAOB consider the following observations that we believe will enhance the effectiveness of the proposed standards.

SPECIFIC COMMENTS

We have organized these observations around the following topical areas:

- Engagement Quality Reviews
- Examination and Review Reports
- Clarification of "Material Non-Compliance"
- Audit Scalability
- Exemption Report
- Proposed Effective Date
- Internal Control over Compliance with the Financial Responsibility Rules

ENGAGEMENT QUALITY REVIEWS

The proposed standards include certain amendments to PCAOB Auditing Standard No. 7 *Engagement Quality Review* ("AS 7") that would require "an engagement quality review and concurring approval of issuance for examination engagements and review engagements of brokers and dealers."¹ This includes both carrying broker-dealers that file a Compliance Report and non-carrying broker-dealers that are exempt from the Compliance Report requirement and file an Exemption Report. In addition, we note that the application of AS 7 to broker-dealers will also require an Engagement Quality Review ("EQR") as part of the financial statement audit.

¹ Proposed Standards, Section V. A.



- **EQR Procedures for Examination and Review Engagements**

AS 7 includes specific guidance regarding the EQR process for audit engagements² as well as reviews of interim financial information.³ However, AS 7 does not include specific guidance for attestation examination and review engagements of broker-dealers, nor do the proposed standards provide any amendments to AS 7, for inclusion of such guidance. We believe audit firms would benefit from guidance regarding EQR procedures to be performed for examination and review engagements.

- **Non-Carrying Broker-Dealers**

The Exemption Report was established within the Commission's proposed rule to exempt broker-dealers that do not maintain customer funds from the rigors of the Compliance Examination. Broker-dealers that would file an Exemption Report typically tend to be smaller entities. Requiring an EQR for these types of review and audit engagements may present additional costs in excess of any related benefits, particularly as it relates to smaller broker-dealers. Audit firms would be required to perform EQR procedures on both the related audit and review engagements, which will increase the costs of the engagements. We believe the PCAOB should take this into consideration in determining whether the application of AS 7 is necessary for review and audit engagements of non-carrying broker-dealers.

EXAMINATION AND REVIEW REPORTS

- **Explanatory Language**

Broker-dealers' assertions are based principally upon regulatory requirements (e.g., net capital computations pursuant to Rule 15c3-1, reserve requirements pursuant to Rule 15c3-3) that may be subject to legal interpretation. As a result, we believe that the scope paragraph of the examination and review reports should be modified to include a sentence indicating that the auditor's examination or review did not provide for a legal determination of the broker-dealer's compliance with specific requirements, similar to established guidance within the PCAOB's Interim Standards.⁴

Similarly, evaluating a broker-dealer's compliance with certain regulatory requirements (e.g., net capital computations pursuant to Rule 15c3-1, reserve requirements pursuant to Rule 15c3-3) may be based on the interpretation of laws, regulations, or rules established by the Commission and/or Designated Examining Authorities. Therefore, we believe the proposed standards should permit the

² AS 7, paragraphs 9 – 13.

³ AS 7, paragraphs 14 – 18.

⁴ PCAOB Interim Standards Attestation Standard 601 ("AT 601"), paragraph 56.

inclusion of a paragraph within the examination and review reports stating the description and the source of interpretations made by the broker-dealer's management, similar to established guidance within the PCAOB's Interim Standards.⁵

- **Restriction of Use**

Audit firms have previously restricted the use of internal control reports required by the Commission's Rule 17a-5 to the board of directors, management, the Commission, and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934.⁶ However, the proposed standards do not include provisions that allow audit firms to restrict the use of examination and review reports to specified parties.⁷

We believe that a restriction on the use of an auditor's examination or review report may be appropriate in certain situations, given that general users of these reports may not have a sufficient understanding of the subject matter to which they relate, such as, the Financial Responsibility Rules or the exemptive provisions of Rule 15c3-3. As such, we request that the PCAOB consider allowing auditors to restrict the use of examination and review reports, as deemed appropriate by the auditors.

- **Modifications of Standardized Reports**

The proposed standards include examples of standardized examination and review reports, and indicate that these reports should be modified if certain conditions exist.⁸ However, the proposed standards do not include suggested wording or examples of modified reports. We believe that audit firms would benefit from specific examples of report modifications, similar to the standardized reports included within the proposed standards.

CLARIFICATION OF "MATERIAL NON-COMPLIANCE"

The proposed standards require auditors to plan and perform examination procedures to detect instances that individually, or in combination, would result in material non-compliance. The proposed standards also indicate that the auditor should consider "relevant quantitative and qualitative factors"⁹ and "devote more attention to the matters that are most significant to

⁵ AT 601, paragraph 59 provides that the following as an example of such a paragraph, which should directly follow the scope paragraph: "We have been informed that, under [*name of entity*]'s interpretation of [*identify the compliance requirement*], [*explain the source and nature of the relevant interpretation*]."

⁶ AICPA Audit and Accounting Guide: *Brokers and Dealers in Securities*, Appendix C.

⁷ Proposed Standards, Appendix 4, page 32 and page 50.

⁸ Proposed Standards, Appendix A, paragraphs A1 and Appendix 2, paragraphs 20 - 21.

⁹ Proposed Standards, Appendix 4, Section I. C. 3.

compliance with the specified Financial Responsibility Rules”¹⁰ in planning and performing procedures for a compliance examination engagement.

We believe that auditors would benefit from additional guidance related to the determination of material non-compliance, including wherever possible, specific examples regarding the consideration of qualitative and quantitative factors in the context of each of the Financial Responsibility Rules, and matters within each of the Financial Responsibility Rules that the PCAOB considers to be most significant to compliance.

Furthermore, as detailed within our response to the Commission’s proposed rule, we believe that broker-dealers and audit firms would benefit from guidance regarding the impact of material errors and/or misstatements discovered during the audit of the financial statements, on the determination of material non-compliance, as well as guidance related to the interaction between material weaknesses in internal control over financial reporting (“ICFR”) and material non-compliance.

AUDIT SCALABILITY

The proposed standards require that procedures to be performed as part of an examination or review engagement be designed to be “scalable based on the broker’s or dealer’s size and complexity.”¹¹ We believe that auditors would benefit from additional guidance, including wherever possible, specific examples regarding the application of scalability to both compliance examination and exemption review engagements. We believe that without such guidance, the application of the audit scalability concept could vary significantly across the audit profession.

EXEMPTION REPORT

As detailed within our response to the Commission’s proposed rule, the Exemption Report would require broker-dealers to assert that they are exempt from Rule 15c3-3 and identify the provision of the rule that they are relying on to qualify for the exemption. However, the proposed rule did not indicate whether broker-dealers should make these assertions for an annual period (e.g., for the year ending December 31) or an ‘as of date’ (e.g., as of December 31). We believe the PCOAB’s proposed standards should also indicate, consistent with the Commission’s final rule, whether the auditor’s review of the Exemption Report is either for an annual period or an ‘as of date.’

PROPOSED EFFECTIVE DATE

The proposed standards’ effective date for fiscal years ending on or after September 15, 2012 is consistent with the end of the transition period for carrying broker-dealers under the Commission’s

¹⁰ Proposed Standards, Appendix 4, Section I. C. 5.

¹¹ Proposed Standards, Section III. A.

proposed rule, but does not coincide with the proposed rule's effective date of December 15, 2011. We believe the effective date of the proposed standards is reasonable. However, we have expressed to the Commission the following concerns, regarding the effective date of its proposed rule.

The proposed rule's effective date is less than four months after the close of the related comment period (August 26, 2011) and provides little time for broker-dealers to prepare the additional reports and the documentation to support their assertions to facilitate an auditor's examination or review, as applicable.

The proposed rule's effective date also provides little time for auditors to review and evaluate the full body of PCAOB auditing standards (excluding those specifically required for integrated audits) including PCAOB Auditing Standard No. 3 *Audit Documentation Requirements* ("AS 3") and AS 7, among others, in order to identify all required changes to audit procedures, update auditing guidance, and provide any required training.

Additionally, for December 31, 2011 broker-dealer audit engagements, planning and interim procedures may have already begun. Engagement plans designed under GAAS would need to be revised, and related audit procedures would need to be modified in order for these audits to comply with PCAOB auditing standards. These changes may require audit plans (and engagement fees) to be re-approved by Audit Committees and other governing bodies.

Lastly, if the proposed rule's effective date remains unchanged, audit firms would be required to adopt a new set of auditing standards (existing PCAOB standards) during the transition period, and another set after the transition period (proposed PCAOB standards), which could create unnecessary costs for broker-dealers and their auditors.

In our view, and as communicated to the Commission in a separate comment letter on its proposed rule, the timing issues discussed above would be resolved by the Commission postponing the effective date of its proposed rule to align with the effective date of the PCAOB's proposed standards (i.e., September 15, 2012).

INTERNAL CONTROL OVER COMPLIANCE WITH THE FINANCIAL RESPONSIBILITY RULES

Also as detailed within our response to the Commission's proposed rule, we believe that audit firms would benefit from clarification as to the interaction between ICFR and the auditors' attestation on compliance with the Financial Responsibility Rules. Broker-dealers are not required to provide an assertion regarding the effectiveness of ICFR, nor are auditors required to perform procedures related to such an assertion. However, many of the aspects of the Financial Responsibility Rules (specifically Rule 15c3-1 and 15c3-3) are derived from the financial statements. Thus, ICFR testing



performed as part of the financial statement audit may impact the results of the auditors' attestation on compliance with the Financial Responsibility Rules.

Our final observation concerns the period covered in a broker-dealer's assessment of the effectiveness of internal control over compliance with the Financial Responsibility Rules and the related auditor's Examination Report. We recommend that the Board work with the Commission to align the proposed requirements with those that exist for issuer's assertions and auditor reporting for ICFR. As detailed within our response to the Commission's proposed rule, the broker-dealer's assertion related to the effectiveness of internal control over compliance with the Financial Responsibility Rules covers the entire fiscal year (except during the transition period). Any material weaknesses identified during the fiscal year would preclude broker-dealers from asserting to (and the auditor opining on) the effectiveness of internal control over compliance with the Financial Responsibility Rules, even if material weaknesses were remediated during the period. We acknowledge that the period covered by the Commission's proposed rule is consistent with the Investment Adviser Custody Rule, however, we believe that broker-dealers should have the opportunity to remediate material weaknesses identified during the compliance period and thus be able to assert (and auditors opine on) effectiveness of internal control over compliance with the Financial Responsibility Rules at the end of the compliance period. We believe this approach would better align the Commission's proposed rule and the PCAOB's proposed standards with guidance related to an issuer's report on ICFR.

* * * * *

We appreciate the opportunity to comment on the PCAOB's proposed standards and would welcome the opportunity to respond to any questions you may have regarding any of our comments and recommendations.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality



CENTER FOR AUDIT QUALITY

cc:

PCAOB

James R. Doty, Chairman
Daniel L. Goelzer, Board Member
Steven B. Harris, Board Member
Jay D. Hanson, Board Member
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September 12, 2011

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Request for Public Comment on Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards (PCAOB Release No. 2011-004, July 12, 2011, Rulemaking Docket Matter No. 035)

Deloitte & Touche LLP appreciates the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards* (PCAOB Release No. 2011-004 (the "Release"), July 12, 2011, Rulemaking Docket Matter No. 035). The Release includes two proposed attestation standards: *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* (the "Proposed Examination Standard") and *Review Engagements Regarding Exemption Reports of Brokers and Dealers* (the "Proposed Review Standard"), collectively the "Proposed Standards."

The Proposed Standards have been issued as a result of the issuance by the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") of proposed amendments to Rule 17a-5, *Reports to be made by certain brokers and dealers*, under the Securities Exchange Act of 1934 (the "SEC's Proposed Rule" or the "Proposed Rule"). We have previously submitted our comments to the SEC in response to its proposals. Because the Proposed Standards are based in part on the SEC's Proposed Rule, certain of our responses to the Proposed Standards are similar to our comments to the SEC. However, we also encourage the PCAOB to read our comment letter to the SEC on the Proposed Rule.

Our comments and observations on the Proposed Standards address the following principal areas:

- I. Relationship between Proposed Standards and Interim Attestation Standards
- II. Relationship between Proposed Standards and Auditing Standards
- III. Effective Date and Transition Period
- IV. Overall Comments Related to the Proposed Standards

We have also included specific comments by paragraph in Appendix 1.

Within our comments, we have offered potential solutions to address the issues and concerns raised. These potential solutions are offered in an effort to assist the PCAOB in understanding and resolving the issues we have identified. Resolving the issues identified herein will be extremely helpful to auditors as they implement and apply a final standard.

I. *Relationship between Proposed Standards and Interim Attestation Standards*

Appendix 3, *Proposed Amendments to PCAOB Standards* (“Appendix 3”), and Appendix 4, *Additional Discussion of the Proposed Attestation Standards and Questions for Public Comment* (“Appendix 4”), of the Release indicate that neither the interim attestation standard AT section 101 (“AT 101”), *Attest Engagements*, nor AT section 601 (“AT 601”), *Compliance Attestation*, apply when an auditor performs an engagement pursuant to the Proposed Standards. AT 101 and AT 601 contain a significant amount of background and detailed guidance that the auditor needs to be familiar with when performing an attestation engagement. The Proposed Standards are very brief and do not address certain fundamental concepts under which an attestation engagement is performed. For example, they do not include:

- Key definitions, such as “assertion” or “responsible party”
- Concepts such as “suitability of criteria”
- General engagement guidance, such as establishing with the client the terms of the engagement

However, the Proposed Standards appear to be drafted with the expectation that the auditor has an understanding of these fundamental concepts and applies them in the performance of engagements in accordance with the Proposed Standards, even though the concepts have not been embedded within the Proposed Standards. It is also unclear whether the 11 attestation standards (i.e., general standards, standards of fieldwork, and standards of reporting) apply for engagements conducted in accordance with the Proposed Standards. We recommend that the Board use the existing interim attestation standards as a base and then develop supplemental standards for engagements performed related to brokers and dealers. Alternatively, we believe that it is necessary for the Proposed Standards to incorporate some of the fundamental guidance contained in AT 101 and AT 601.

For example, there is no requirement in the Proposed Examination Standard for the auditor to establish an understanding with management regarding the services to be performed on the engagement. While the Proposed Examination Standard appears to advocate that the auditor of the financial statements and supplemental information also perform the examination engagement, the Proposed Examination Standard does not require it. If the auditor of the financial statements does perform the examination engagement, it is possible that the auditor may establish the terms of engagement for the examination engagement at the same time, and in the same document, that the terms for the financial statement audit are established. However, the terms of engagement for the financial statement audit may be established separately or, as mentioned above, an auditor other than the auditor of the financial statements may be engaged to perform the examination engagement, in which case there would be no requirements or guidance related to establishing the terms of engagement for the examination engagement. Accordingly, we believe the Proposed Examination Standard should include a requirement that the auditor establish an understanding with management, regarding the services to be performed. We believe that such an understanding should be in writing and should include obtaining the agreement of management that:

- a. Management is responsible for the assertion
- b. Management acknowledges its responsibility for establishing and maintaining a system of internal control to provide the broker or dealer with reasonable assurance that any instances of material non-compliance with the specified Financial Responsibility Rules (“FRRs”)¹ will be prevented or detected on a timely basis
- c. Management will make available to the auditor all records and other information relevant to the broker’s or dealer’s assertions, including all known matters contradicting the assertions, and all

¹ Paragraph 2a of the Proposed Examination Standard states, “Rule 15c3-1, Rule 15c3-3, Rule 17a-13, and the account statement rule are referred to collectively as “the specified Financial Responsibility Rules.”

communications from regulatory agencies, internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's assertions

In addition, we believe a similar requirement should be added to the Proposed Review Standard for the reasons stated above.

II. *Relationship between Proposed Standards and Auditing Standards*

Appendix 4 to the Release states, “[t]he Proposed Examination Standard focuses specifically on performing an examination of the assertions made by a broker or dealer in a compliance report and allows auditors to perform such engagements without looking to multiple attestation standards.” We agree that it is beneficial to have all relevant requirements and guidance related to examination and review engagements performed in accordance with the Proposed Standards in two individual attestation standards. For that reason, we are concerned that Appendix 3 of the Release contains amendments to the PCAOB’s auditing standards, which make Auditing Standard No. 3, *Audit Documentation*, and Auditing Standard No. 7 (AS No. 7), *Engagement Quality Review*, applicable for engagements conducted in accordance with the Proposed Standards. Instead of looking to multiple attestation standards, the auditor performing the engagements in accordance with the Proposed Standards is now required to look to an entirely separate body of standards that have been designed with a different purpose (i.e., integrated and non-integrated audits of financial statements). AS No. 7 includes specific guidance regarding the engagement quality review process for audit engagements² as well as reviews of interim financial information³.

We believe that it would be more appropriate for the Proposed Standards to include all applicable requirements and guidance for the attestation engagements, including requirements and guidance relating to documentation and engagement quality reviews. We note that the proposed conforming amendments to AS No. 7 include a limited number of proposed paragraphs related to certain attestation engagements, but we believe further guidance related to performing an engagement quality review for attestation engagements is warranted.

III. *Effective Date and Transition Period*

We support the Board’s proposed effective date for fiscal years ending on or after September 15, 2012. We believe the proposed effective date allows sufficient time for auditors to adequately prepare for implementation of the Proposed Standards.

We note that the SEC’s Proposed Rule would be effective for annual reports filed with the SEC for fiscal years ending on or after December 15, 2011. We have commented to the Commission in response to its Proposed Rule that we believe that the effective date for the SEC’s Proposed Rule should be aligned with the proposed effective date of the Proposed Standards to give adequate time to both broker-dealer and auditor to adequately prepare for effective initial implementation.

If the effective dates remain different, the Board will need to provide implementation guidance for the transition period (i.e., for attestation engagements for years ending between December 15, 2011, and September 15, 2012).

² AS 7, paragraphs 9-13

³ AS 7, paragraphs 14 - 18

IV. Overall Comments Related to the Proposed Standards

Our overall comments related to the Proposed Examination Standard and the Proposed Review Standard follow. In terms of both Proposed Standards, the Release indicates that the standards are intended to be “scalable based on the broker’s or dealer’s size and complexity.” However, the Proposed Standards themselves do not provide any guidance or examples of how “scalability” may be implemented when performing engagements in accordance with the Proposed Standards. We recommend that the Board embed such guidance into the Proposed Standards to allow for effective implementation.

Comments related to the Proposed Examination Standard

a. Objective and scope of internal control over compliance with the Financial Responsibility Rules

In our letter to the SEC on its Proposed Rule, we encouraged the Commission to provide additional guidance about the specific control objectives that should be met to achieve effective internal control over compliance with the FRRs. We note that because the auditor is examining management’s assertion about the broker’s or dealer’s compliance with the FRR, the two activities (i.e., management’s assertion and the auditor’s examination) intersect in key ways. The auditor’s engagement to examine the assertions made by management in its Compliance Report will likely utilize the work performed, and the documentation generated, by the broker or dealer in conducting management’s assessment of internal control over compliance. As a result, we believe it is critical that the SEC’s Proposed Rule and the Proposed Examination Standard include consistent, detailed control objectives related to internal control over compliance so that management, in assessing the effectiveness of the broker’s or dealer’s internal control over compliance, is using the same “definition” of internal control over compliance as the auditor when performing an examination of management’s assertion related to the effectiveness of internal control over compliance.

Paragraph 15 of the Proposed Examination Standard indicates that the auditor “must test those controls that are important to the auditor’s conclusion about whether the broker or dealer maintains effective internal control over compliance for each specified Financial Responsibility Rule.” For the reasons stated above, we believe that guidance for the auditor relating to identifying those “controls that are important to the auditor’s conclusion” should be provided, either as an Appendix to the Proposed Examination Standard, or following the requirement in paragraph 15.

b. Relationship between internal control over compliance and (1) internal control over financial reporting and (2) the financial statement audit

- (1) As indicated in our comment letter to the SEC, we believe that additional guidance in the Proposed Rule relating to the relationship between internal control over financial reporting (“ICFR”) and internal control over compliance would be beneficial to both the broker-dealer and the auditor. While the Proposed Rule is clear that the Compliance and Examination reports do not extend to ICFR, we note there may be certain ICFR controls that could overlap with internal control over compliance with the FRRs. Further to our comment above about providing more detailed guidance in both the Proposed Rule and the Proposed Examination Standard related to the control objectives for internal control over compliance, we believe it would be helpful for that detailed guidance to include a discussion of how those control objectives relate to the control objectives for ICFR.
- (2) Paragraph 8 of the Proposed Examination Standard indicates that the auditor should “take into account relevant evidence from the audit in planning and performing procedures for the examination engagement and in evaluating the results of the procedures performed in the examination.” Paragraph 30 of the Proposed Examination Standard indicates that the auditor needs to evaluate the effect on the audit of the financial statements of any material non-compliance or material weaknesses identified in performing the

examination procedures. However, the Proposed Examination Standard does not provide guidance about how control deficiencies or material misstatements identified in the financial statement audit should be evaluated in relation to the effectiveness of internal control over compliance with the FRRs. For example, if a broker-dealer applied the correct “haircut” percentage required by Rule 15c3-1, *Net Capital Requirements for Brokers or Dealers*, to a security whose value is incorrectly stated in the broker’s or dealer’s balance sheet, it is unclear what impact that error should have on the auditor’s conclusion about effectiveness of internal controls over compliance with the FRRs. In other words, in such a situation would the control over the compliance with Rule 15c3-1 still be considered effective, despite the error in the broker’s or dealer’s balance sheet? We believe that auditors would benefit from additional guidance and specific examples in the Proposed Examination Standard demonstrating how the results of the financial statement audit and the results of the examination engagement interact.

c. Definition of the term “material non-compliance” and the evaluating material non-compliance in relation to other findings

The Proposed Rule defines “material non-compliance” as a failure by the broker or dealer to comply with the FRRs in all material respects. In our comment letter to the SEC, we recommended that the Commission include examples of “material non-compliance” for each FRR (currently the Proposed Rule contains examples for Rule 15c3-1 and Rule 15c3-3 only). Similarly, we recommend that the Proposed Examination Standard contain examples of material non-compliance for all FRRs. Paragraph 4 of the Proposed Examination Standard states that “[b]ecause the broker’s or dealer’s assertions apply to each specified Financial Responsibility Rule, the auditor’s examination should evaluate compliance with each specified Financial Responsibility Rule...” As a result, we believe it would be helpful if the Proposed Examination Standard contained examples of material non-compliance to assist auditors in evaluating findings.

Further, we believe that additional guidance specifying the quantitative and qualitative factors to consider when evaluating the materiality of instances of non-compliance would be beneficial to include in the Proposed Examination Standard. For example, in the case where a broker or dealer fails to provide account statements to certain clients during a particular period, would materiality depend on quantitative factors alone, such as the number of statements not provided relative to total statements or the dollar value of accounts for which statements were not provided relative to the total value of all accounts? If not, it would be beneficial to include the qualitative factors that the auditor may consider in such circumstances.

Another example where additional guidance and examples in the Proposed Examination Standard would be helpful is in circumstances where an error is identified, but does not result in a failure to comply with an FRR (e.g., where an error is identified in the calculation of net capital but the broker or dealer still maintains net capital higher than the required level). In such circumstances, it is unclear whether that error would be considered an instance of material non-compliance.

Comments related to the Proposed Review Standard

a. Period covered by exemption report

The SEC’s Proposed Rule would (1) require a broker or dealer claiming an exemption from Rule 15c3-3 to make an assertion that it is exempt from the provisions of Rule 15c3-3 because it meets conditions set forth in paragraph (k) of Rule 15c3-3, (2) require a broker-dealer to identify the specific conditions, and (3) require the accountant to prepare a report based on a review of this assertion. However, we note that both the Proposed Rule and the Proposed Review Standard are silent about whether the broker’s or dealer’s assertion, and therefore the auditor’s review report, is to be made as of a point in time, or for a period of time. In our comment letter to the SEC, we indicated that we believe that management’s assertion, and therefore the auditor’s review of management’s assertion, should be as of the broker’s or

dealer's fiscal year end. We therefore believe that the Proposed Review Standard, including the report example in paragraph 18, should be clarified accordingly.

b. Evaluation of "non-compliance"

The Proposed Review Standard is unclear in terms of the materiality to be used by the auditor in evaluating its findings. For example, paragraph 3 indicates that the objective is to conclude as to whether the "auditor is aware of any material modifications that should be made" to the broker's or dealer's assertion in order for the assertion to be fairly stated in all material respects. Paragraph 4 then indicates that in order to state the conclusion in paragraph 3, the auditor needs to obtain moderate assurance about whether one or more instances of non-compliance individually or in the aggregate cause the broker's or dealer's assertion not to be fairly stated in all material respects. However, no further guidance is given in the Proposed Review Standard related to evaluating the materiality of non-compliance. Taken together, paragraphs 3 and 4 infer that non-compliance with the FRRs may occur and the broker or dealer still may be in a position to reasonably assert their exemption status. It would be beneficial for the Proposed Review Standard to provide examples of non-compliance that would negate management's assertion of exemption from Rule 15c3-3 as well as examples of non-compliance where exemption from Rule 15c3-3 would still be appropriate.

We would welcome an opportunity to further discuss these matters with the Board and the staff. If you have any questions or would like to discuss these matters further, please contact John Fogarty at (203) 761-3227 or Bill Platt at (203) 761- 3755. We thank you for your consideration of these matters.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: James R. Doty, PCAOB Chairman
 Lewis H. Ferguson, PCAOB Member
 Daniel L. Goelzer, PCAOB Member
 Jay D. Hanson, PCAOB Member
 Steven B. Harris, PCAOB Member
 Martin F. Baumann, Chief Auditor and Director of Professional Standards

Mary L. Schapiro, SEC Chairman
 Luis A. Aguilar, SEC Commissioner
 Troy A. Paredes, SEC Commissioner
 Elisse B. Walter, SEC Commissioner
 James L. Kroeker, SEC Chief Accountant
 Brian Croteau, SEC Deputy Chief Accountant

Appendix 1 - Specific Comments by Paragraph

Our comments related to individual paragraphs within the Proposed Standards are included below. Where we have made editorial suggestions, additions are shown as bold underline and deletions as double strike-through.

Proposed Attestation Standard, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*

Paragraphs 5 and 28

Paragraphs 5 and 28 require that the auditor plan and perform procedures to determine whether the information used to assert compliance with the specified FRRs was derived from the broker's or dealer's books and records. However, the Proposed Examination Standard provides no further guidance on the nature or extent of those procedures. We believe that guidance as to the procedures that the auditor might perform in this regard would be helpful.

Paragraph 6

Footnote 14 equates the "due professional care" referred to in paragraph 6 with the same term in paragraph .40 of AT 101. While we do not disagree with the meaning of "due professional care" we believe that referencing AT 101 from the Proposed Examination Standard may be confusing. The Release indicates AT 101 does not apply to engagements conducted in accordance with the Proposed Examination Standard. The footnote, however, seems to infer that the auditor would be looking to AT 101 as part of the examination engagement. As noted in our comments in Section I above, we believe it is appropriate to use the interim attestation standards as a base (in which case, footnote 14 would be unnecessary). If the interim attestation standards are not used as a base, we believe that all of the fundamental concepts from AT 101 related to attestation engagements, such as due professional care, should be embedded in the Proposed Examination Standard itself, rather than through intermittent cross-referencing in footnotes and in the Release.

Paragraph 8

Paragraph 8 imposes on the auditor an obligation that the auditor plan and perform the work to meet the objectives of both the examination engagement and the audit of financial statements. However, the Proposed Examination Standard does not require that the auditor performing the audit of the financial statements and supplemental information also perform the examination engagement. Further, because this is not an integrated audit, within the Proposed Examination Standard, we believe that the auditor's obligation is to plan and perform the work to meet the objectives of the *examination* engagement. We do not believe it is appropriate to have a requirement within the Proposed Examination Standard that the auditor must plan and perform the work to meet the objectives of the financial statement audit. We believe that requirement is sufficiently covered in the Board's existing Auditing Standards.

Accordingly, we believe that the second and third sentences of paragraph 8 should be redrafted as follows:

The auditor should take into account relevant evidence from the audit in planning and performing procedures for the examination engagement and in evaluating the results of the procedures performed in the examination, **bearing in mind that** ~~However,~~ the objectives of the audit and the examination engagement are not the same. **Accordingly, so** the auditor must plan and perform the work to meet the objectives ~~of both engagements~~ **of the examination engagement.**

Paragraph 11

As noted in our Overall Comments Section IV above, we believe additional examples and guidance related to internal control over compliance would be helpful. We suggest that one area for such guidance

and examples would be the addition in paragraph 11 of qualitative factors considered when evaluating the effectiveness of internal control over compliance.

Paragraph 12

In order to be consistent with Auditing Standard No. 9, paragraph 12 as well as AT 601, we recommend adding two additional factors for the auditor to take into account when determining the extent of the examination procedures to be performed at divisions or branches:

- Judgments about materiality of the division or branch
- The similarity of operations over compliance for different divisions or branches

We also recommend the Proposed Examination Standard include guidance with respect to the auditor's use of the internal audit function, similar to the guidance included in AT 601.44 and AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*:

Another factor the practitioner should consider when planning the engagement is whether the entity has an internal audit function and the extent to which internal auditors are involved in monitoring compliance with the specified requirements. A practitioner should consider the guidance in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, when addressing the competence and objectivity of internal auditors, the nature, timing, and extent of work to be performed, and other related matters.

Paragraph 16

We acknowledge that paragraph 16 is the same as paragraph 46 in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements*. However, we believe that paragraph 18, Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, contains language that may convey the intention of the paragraph more clearly, and therefore suggest the following language in place of paragraph 16:

In designing and performing tests of controls for the examination engagement, the evidence necessary to support the auditor's control risk assessment depends on the degree of reliance the auditor plans to place on the effectiveness of a control. The auditor should obtain more persuasive audit evidence from tests of controls the greater the reliance the auditor places on the effectiveness of a control.

Paragraph 17

The factors that affect the risk associated with a control include (in the third-to-last bullet) "the extent of use of part-time personnel to perform controls over compliance." We do not agree that use of part-time personnel in and of itself affects the risk associated with a control (as opposed to the extent of use of temporary personnel, which may be a relevant factor). We believe that the bullet relating to the competence of the personnel who perform the control (i.e., the fourth-to-last bullet) sufficiently covers the concept that the understanding and ability of the individuals performing the control influences the risk associated with the control and as a result, the third-to-last bullet is not necessary and should be removed.

Paragraphs 25 and 27

Paragraphs 25 and 27 both discuss the sufficiency of evidence obtained, as they refer to obtaining "more evidence" in certain situations. This aligns with the first bullet in paragraph 5 of Auditing Standard No. 15, *Audit Evidence*, which discusses sufficiency in the context of risk of misstatement or risk associated with a control. However, paragraphs 25 and 27 do not cover the concept of sufficiency in the context of quality of the evidence obtained, which is covered in the second bullet of paragraph 5 in AS No. 15:

As the quality of the evidence increases, the need for additional corroborating evidence decreases. Obtaining more of the same type of audit evidence, however, cannot compensate for the poor quality of that evidence.

We believe that paragraphs 25 and 27 should also include language embedding the concept of sufficiency with regard to the quality of audit evidence obtained. Otherwise, we are concerned that the auditor will focus on getting more evidence rather than focusing on the persuasiveness of the evidence.

In addition, the first sentence of paragraph 25 discusses the risk of material non-compliance, including fraud risks. We believe it would be helpful to provide guidance and examples of fraud risks related to compliance with the FRRs.

Paragraph 29

Paragraph 29 requires that the auditor evaluate “all evidence obtained...” The Release explains that this evaluation includes evidence obtained from compliance tests, tests of internal control over compliance, and the audit of the broker’s or dealer’s financial statements and supplemental information. We believe the Proposed Examination Standard should include this list from the Release to provide a clearer meaning of “all evidence.”

The Release includes further guidance that we believe would be beneficial to auditors if it were included in the Proposed Examination Standard itself.

- Page A4-26, 4th paragraph states, “This evaluation [of the effect any non-compliance or identified control deficiency on the auditor’s assessed risks of material non-compliance] is important to inform the auditor’s conclusions about whether the auditor’s risk assessments remain appropriate and whether he or she has obtained sufficient appropriate evidence to support the opinion to be expressed in the auditor’s examination report.” We believe it would be helpful to add this language to the second Note of paragraph 30c.
- Page A4-26, 5th paragraph states, “This [evaluation of findings from examination engagement on financial statement audit] includes determining whether sufficient appropriate audit evidence has been obtained to support the relevant financial statement assertions, including assertion related to the completeness and accuracy of disclosures, taking into account materiality considerations for the audit of the financial statements.” We believe it would be beneficial to include this guidance in the third Note to paragraph 30c relating to the coordination between the audit of the financial statements and supplemental information and the examination engagement.
- Page A4-27 includes a list of factors that are relevant to the auditor’s evaluation of whether the auditor has obtained sufficient appropriate audit evidence to support the conclusions to be presented in the examination report. These factors would be helpful to include either in paragraph 30 or in paragraph 31.

Paragraph 35

We believe the list of required written representations in paragraph 35 should also include a representation that management acknowledges its responsibility for the assertions.

Paragraph 39

1. We recommend drafting paragraph 39b. in terms of management’s assertions as they are described in the illustrative report and in paragraph 2 of the Proposed Examination Standard:
 - b. An identification of the compliance report and the broker’s or dealer’s assertions regarding **whether, as of the fiscal year end, the broker or dealer was in** compliance with the specified FRRs, whether the information used to assert compliance with the specified FRRs was derived

from the broker's or dealer's books and records, and **whether internal control over compliance the effectiveness of internal control over compliance with the specified FRRs was effective during the most recent fiscal year such that there were no instances of material weakness.**

2. We believe that the following additional statements should be included in the auditor's examination report to be consistent with current compliance attestation standards and practice.
 - A statement that the assertion is the responsibility of the responsible party (i.e., the broker or dealer).
 - A statement that the examination does not provide a legal determination on the entity's compliance.

3. Currently, audit firms may restrict the use of internal control reports required by the Commission's Rule 17a-5 to specified parties. Paragraph .79 of AT 101 provides reasons for which an auditor may determine the need for a restriction on use of a report including "...the extent to which the procedures performed are known or understood, and the potential for the report to be misunderstood when taken out of the context in which it was intended to be used." Further, paragraph .81 of AT 101 indicates that "nothing in this section precludes a practitioner from restricting the use of any report." We note that Appendix 4 of the Release indicates that the Proposed Standards do not include provisions that allow audit firms to restrict the use of reports issued in accordance with the Proposed Standards. We believe, for the reasons established in paragraph .79 of AT 101, and given the nature of the engagements covered by the Proposed Standards, that guidance should be added to the Proposed Standards clarifying that the auditor may restrict the use of a report if the auditor deems it appropriate to do so.

Appendix A – Examination Report Modifications

Paragraph A2 – Given the difference in reporting when the auditor is issuing an adverse opinion (i.e., when the auditor expresses an unqualified opinion, the auditor expresses an opinion on management's assertions; when the auditor expresses an adverse opinion, the auditor expresses the opinion directly on the subject matter), we believe it would be beneficial for the PCAOB to include an illustrative example of a report where the auditor is expressing an adverse opinion.

Paragraphs A4 and A9 – Similar to our comment on paragraph A2, we believe report examples when the auditor disclaims an opinion on management's assertion or on other information included in the compliance report as described in paragraphs A4 and A9, respectively, would be helpful.

Proposed Attestation Standard, Review Engagements Regarding Exemption Reports of Brokers and Dealers

Paragraphs 5 and 6

Further to our overall comment in Section I above, certain fundamental concepts currently embodied in AT 101 and AT 601 are not included in the Proposed Standards. As a result, the Proposed Review Standard does not encompass certain critical elements related to the performance of the review engagement. For that reason we believe that paragraphs 5 and 6 should include other matters that are "general requirements" when performing a review engagement, such as:

- Responsibility for the assertion
- Establishing the terms of the engagement with management

Paragraphs 10 and 17

Paragraph .55 of AT 101 indicates that the objective of a review engagement "is to accumulate sufficient evidence to restrict attestation risk to a moderate level. To accomplish this, the types of procedures

performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures).” Paragraph 10(a)-(g) of the Proposed Review Standard requires the auditor to inquire, read and evaluate evidence already obtained. We believe that these activities are consistent with AT 101’s description of a review engagement. However, we are concerned that the language in paragraph 10(h), “perform other procedures as necessary in the circumstances to obtain moderate assurance,” is too broad.

This is of particular concern when read in the context of the required elements of the review report. Paragraph 17(d) requires, “a statement that the review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and accordingly, included inquiries *and certain other procedures to obtain evidence* about the broker’s or dealer’s compliance with the exemption conditions” [emphasis added]. We are concerned that users of the report may misinterpret the procedures performed and assume that such procedures are more robust than those procedures required for a moderate level of assurance. We therefore recommend that the words, “and accordingly, included inquiries and certain other procedures to obtain evidence about the broker’s or dealer’s compliance with the exemption conditions” be deleted from the end of paragraph 17(d).

Paragraph 11

Paragraph 11 of the Proposed Standard states, “The auditor should evaluate the identified instances of non-compliance with the exemption conditions to determine whether the instances of non-compliance, *individually or in combination*, cause the broker’s or dealer’s assertion not to be fairly stated, *in all material respects*” [emphasis added]. The SEC’s Proposed Rule provides as an example of a discovery that would necessitate a material modification that the broker or dealer failed to promptly forward any customer securities it received. The introduction of the language “individually or in combination” and “in all material respects” without further guidance as to the application of materiality to non-compliance is confusing. For example, in the example provided in the SEC’s Proposed Rule referred to above, it is unclear what the impact would be on the auditor’s conclusions if the broker or dealer failed to promptly forward *some or a few* of the customer securities it received rather than *all* customer securities. As noted in our overall comments, we believe that guidance related to materiality and evaluation of non-compliance be provided in the Proposed Review Standard to assist in consistent application of the standard.



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Office of the Secretary
Public Company Accounting Oversight Board
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12 September 2011

Re: PCAOB Rulemaking Docket Matter No. 035 – Proposed Standards for attestation engagements related to broker and dealer compliance or exemption reports required by the U.S. Securities and Exchange Commission and related amendments to PCAOB standards

Dear Office of the Secretary:

Ernst & Young LLP is pleased to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) proposed standards for attestation engagements of broker and dealer compliance or exemption reports (Proposed Examination Standard, Proposed Review Standard and, collectively, Proposed Standards) and related commentary (Proposing Release).

We generally support the Proposed Examination Standard and believe it and the proposed amendments respond to the Securities and Exchange Commission's (SEC) proposed amendments to the broker-dealer financial reporting rule under the Securities Exchange Act of 1934 (SEC Proposed Rule 17a-5). We also believe the Proposed Examination Standard provides a good framework for auditors to examine the specific assertions in a broker-dealer's compliance report (Compliance Report) as required by SEC Proposed Rule 17a-5. We do not support requiring a review engagement for a broker-dealer's assertion that it is exempt from Rule 15c3-3 (Exemption Report), as contemplated by the Proposed Review Standard.

We encourage the PCAOB to review our comment letter on SEC Proposed Rule 17a-5, which also discusses many of the matters addressed below.

- ▶ We support the PCAOB's proposed effective date. In our comment letter to the SEC, we recommend that the SEC align the effective date of SEC Proposed Rule 17a-5 with the Proposed Standards to give broker-dealers and their auditors the time to adequately address final SEC rules.
- ▶ We recommend that the PCAOB provide additional guidance on how auditors should evaluate potential instances of material non-compliance, given the heightened reporting and notification requirements for material non-compliance matters contemplated in SEC Proposed Rule 17a-5.
- ▶ We recommend that, rather than require a review engagement of a broker-dealer's assertion that it is exempt from Rule 15c3-3, the PCAOB should require the performance of an agreed-upon procedures engagement or an examination engagement. In either case, the Board would have to develop suitable procedures or suitable criteria.

- ▶ We recommend that the PCAOB provide guidance on specific engagement quality reviewer (EQR) procedures to be performed in the contemplated compliance and exemption examination and review engagements. AS 7 does not presently provide specific guidance for these types of engagements and, as drafted, the Proposed Standards do not outline any amendments to AS 7 in this important area.
- ▶ We believe that the PCAOB would help auditors apply the Proposed Standards more consistently if it clarifies aspects of the Proposed Standards, as outlined below.

We have organized our detailed comments according to the structure of the Proposing Release.

Effective date

In our comment letter to the SEC, we recommend that the SEC eliminate any transition period for carrying broker-dealers and defer the effective date of SEC Proposed Rule 17a-5 to fiscal years ending on or after 15 December 2012 to align with the effective date of the Proposed Standards. We believe this will give broker-dealers and their auditors time to effectively address the final rules including reviewing and evaluating the full body of PCAOB auditing standards (excluding those specifically required for integrated audits) to identify and evaluate all relevant changes to their audit methods for broker-dealers. We believe the Board must work closely with the SEC to make the Proposed Standards and the SEC Proposed Rule 17a-5 effective at the same time.

If the proposed SEC effective dates are adopted, over the course of approximately twelve months the standards by which auditors conduct audits of broker-dealers will change from US GAAS to current PCAOB standards, and finally, to the Proposed Standards. We believe that having a single transition from current US GAAS to the final PCAOB standards in this area will be more efficient for auditors and for the Board's interim broker-dealer audit inspection program.

Independence

The Proposing Release indicates that auditors of non-issuer broker-dealers are not subject to PCAOB Rules 3521 through 3526. We recommend that this point be made explicit in the final standards. For example, what is now paragraph 6c of the Proposed Examination Standard and what is now paragraph 5c of the Proposed Review Standard should include a reference indicating that auditors of non-issuer broker-dealers are not subject to PCAOB Rules 3521 through 3526.

Proposed Attestation Standard, Examination Engagements Regarding Compliance Reports of Brokers and Dealers

Objective

SEC Proposed Rule 17a-5 would require carrying broker-dealers to file a new report asserting compliance with the Financial Responsibility Rules and related internal control and an examination report from their independent registered public accountants that addresses the assertions in the Compliance Report. The Financial Responsibility Rules are identified in SEC Proposed Rule 17a-5 as (1) Rule 15c3-1, (2) Rule 15c3-3, (3) Rule 17a-13 and (4) the Account Statement Rule.

One of the three assertions to be made by a broker-dealer is “whether the broker-dealer was in compliance in all material respects with the Financial Responsibility Rules as of its fiscal year-end.”¹ We note that a broker-dealer may need to interpret requirements of the Financial Responsibility Rules when the rules do not specifically address an aspect of its operations. In other cases, a broker-dealer may rely on informal discussions with the SEC and (or) its designated examining authority (DEA). To better support the assertions made in these circumstances, we recommend in our letter to the SEC that the Commission require broker-dealers to formally document interpretations and obtain evidence of agreements reached with the SEC and (or) its DEA when they have relied on interpretations not cited in the Financial Responsibility Rules. We believe specific PCAOB guidance is needed that outlines the procedures the auditor should perform to determine compliance with this assertion when a broker-dealer has interpreted requirements of the Financial Responsibility Rules or has relied on discussions with the SEC and (or) its DEA.

Another assertion to be made by a broker-dealer is “whether the information used to assert compliance with the Financial Responsibility Rules was derived from the books and records of the broker-dealer.”² In our comment letter to the SEC, we request clarification of the definition of “books and records.” We believe specific PCAOB guidance is needed that outlines the procedures the auditor should perform to determine compliance with this assertion.

General requirements

The Proposed Examination Standard requires the auditor that performs an examination engagement to obtain an understanding of the Financial Responsibility Rules and other rules and regulations relevant to the broker’s or dealer’s assertions.³ Auditors would benefit if the Board were to specify the level of understanding of the Financial Responsibility Rules that auditors are expected to have as well as how such understanding should be documented. Furthermore, open-ended requirements such as “other rules and regulations that are relevant to the broker’s or dealer’s assertions” are too broad to allow auditors to identify suitable criteria and express an opinion on management’s assertion. We recommend that the Board omit the reference to “other rules and regulations that are relevant to the broker’s or dealer’s assertions.”

Clarification of the assessment of material non-compliance

SEC Proposed Rule 17a-5 defines an instance of material non-compliance as a “failure by the broker-dealer to comply with any of the requirements of the Financial Responsibility Rules in all material respects.”⁴

¹ See proposed paragraph (d)(3)(i)(B)(1) of SEC Proposed Rule 17a-5.

² See proposed paragraph (d)(3)(i)(B)(2) of SEC Proposed Rule 17a-5.

³ See proposed paragraph 6b of the Proposed Examination Standard.

⁴ See proposed paragraph (d)(3)(ii) of SEC Proposed Rule 17a-5.

The Proposed Examination Standard notes that to “express an opinion on the assertion made by a broker-dealer in a compliance report, the auditor must plan and perform the examination engagement to obtain reasonable assurance about whether (1) one or more instances of material non-compliance exist as of the date specified in the broker’s or dealer’s assertion and (2) one or more instances of material weakness exist during the period specified in the broker’s or dealer’s assertion.”⁵

The Proposed Examination Standard also states that the auditor “should take into account the following matters in his or her consideration of the materiality of non-compliance: (a) the nature of the specified Financial Responsibility Rules, which may or may not be quantifiable in monetary terms; (b) the nature and frequency of non-compliance; and (c) qualitative considerations.”⁶

We believe the Proposed Examination Standard does not provide sufficient guidance for auditors to assess the factors relevant to determining whether an instance of non-compliance for each of the identified Financial Responsibility Rules is material. Without additional guidance in this important area, we believe it is likely that different auditors may reach different conclusions on whether the same or similar instances of non-compliance are material, which we do not believe furthers the objectives of SEC Proposed Rule 17a-5.

To highlight the areas where additional implementation guidance would be helpful, we ask the following questions in our comment letter to the SEC:

- ▶ Would a different materiality assessment be made for each of the Financial Responsibility Rules, given that the first two (Rules 15c3-1 and 15c3-3) may generally be more quantifiable than the second two (Rule 17a-13 and the Account Statement Rule)?
- ▶ For Rules 15c3-1 and 15c3-3, would an error that was quantitatively significant in the calculation of net capital or the customer reserve formula but did not result in a failure to maintain either the minimum amount of net capital or the adequate amount of segregated cash or qualified securities constitute an instance of material non-compliance?
- ▶ What level of consideration should be given to qualitative factors in evaluating an instance of material non-compliance with Rule 17a-13 and the Account Statement Rule? For example, would the determination of whether the failure to send a single customer statement is a material non-compliance event be based on the total population of customer statements required to be sent (one of five versus one of five thousand)? Furthermore, if one or more customer statements contained errors or omissions of required information, would these errors or omissions be evaluated as instances of material non-compliance based on the materiality of the items to the individual customer statement or to the dollar value of all customer statements?
- ▶ How specifically should an error or misstatement discovered during the audit of a broker-dealer’s financial statements be evaluated to assess whether an instance of material non-compliance has occurred?

⁵ See proposed paragraph 4 of the Proposed Examination Standard.

⁶ See proposed paragraph 10 of the Proposed Examination Standard.

We believe that auditors need clear, well-defined standards to identify instances of material non-compliance. The PCAOB should include examples of instances of material non-compliance with each of the Financial Responsibility Rules in the final standards.

Testing controls over compliance

One factor that the Proposed Examination Standard says affects the risk associated with a control is “the extent of use of part-time personnel to perform controls over compliance.”⁷ We do not believe that the use of part-time personnel in and of itself is a factor that affects the risk associated with a control. In making this assessment, we believe it is more appropriate to evaluate the competence and objectivity of personnel executing the controls, their knowledge of the Financial Responsibility Rules and their authority in the broker-dealer organization. We therefore recommend that that Board omit this risk factor.

We believe clarification is needed relative to the use of audit evidence obtained in past examination engagements. The Proposed Examination Standard indicates that auditors “should obtain evidence during the current year about the design and operating effectiveness of controls selected for testing.”⁸ That same paragraph also discusses using evidence obtained in a prior year. The PCAOB should clarify in this paragraph how evidence obtained in the prior year may affect the nature, timing and extent of the testing performed during the current year examination.

Auditor’s examination report

We recommend revising paragraphs 39 and 40 of the Proposed Examination Standard. A broker-dealer’s assertions are based on regulatory requirements (e.g., net capital computations pursuant to Rule 15c3-1 and reserve requirements pursuant to Rule 15c3-3) that may be subject to legal interpretation. As a result, we suggest adding a sentence to the scope paragraph of the examination and review reports indicating that the auditor’s examination does not provide a legal determination of the broker-dealer’s compliance with specific requirements, similar to established guidance in the PCAOB’s interim attestation standards.⁹

We also believe the Proposed Examination Standard should permit the inclusion of a paragraph in the examination report describing a broker-dealer’s interpretation of the requirements of the Financial Responsibility Rules and the basis for any interpretations, including discussions with the SEC and (or) its DEA, in reaching its compliance assertion. This would be similar to guidance in the PCAOB’s interim attestation standards.¹⁰

We also request that the PCAOB allow auditors to restrict the use of the examination reports. Auditors have previously restricted the use of internal control reports to the board of directors, management, the SEC and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act

⁷ See paragraph 17 of the Proposed Examination Standard.

⁸ See paragraph 23 of the Proposed Examination Standard.

⁹ See PCAOB interim attestation standard AT §601.56.

¹⁰ See PCAOB interim attestation standard AT §601.59.

of 1934. The Proposed Standards do not allow auditors to restrict the use of examination and review reports to specified parties. We believe that a restriction on the use of an auditor's examination report is appropriate, given that general users of these reports may not have sufficient understanding of the subject matter to which they relate, i.e., the Financial Responsibility Rules.

The Proposed Examination Standard states that "because the broker's or dealer's assertions apply to each specified Financial Responsibility Rule, the auditor's examination should evaluate compliance with each specified Financial Responsibility Rule, and the effectiveness of internal control over compliance with each specified Financial Responsibility Rule individually."¹¹ We recommend that the Board clarify what type of modification could be made to the auditor's examination report if the broker-dealer was not compliant with one or more of the Financial Responsibility Rules but was compliant with others. We believe that providing examples of how an examination report should describe these situations would be informative.

Proposed Attestation Standard, Review Engagements Regarding Exemption Reports of Brokers and Dealers

SEC Proposed Rule 17a-5 would require broker-dealers that do not hold customer funds or securities to file a new report asserting their exemption from the requirements of Rule 15c3-3, accompanied by a review report from their independent registered public accountants based on management's assertion regarding such exemption.

Appropriateness of a review engagement

We do not believe a review engagement for a broker-dealer's assertion that it is exempt from the requirements of Rule 15c3-3 is appropriate. Specifically, we do not believe that inquiry and analytical procedures, the standard procedures performed in a review engagement, would provide sufficient evidence of a broker-dealer's assertion that it is exempt from the requirements of Rule 15c3-3.

In making this recommendation, we note that the PCAOB's interim attestation standards (AT section 601, Compliance Attestation) state that an auditor should not accept an engagement to perform a "review" level of service related to an entity's compliance with specified requirements, or an assertion thereon.¹² The Board is proposing to amend paragraph 7 of AT 601 to indicate that when an auditor is engaged to perform a review engagement on assertions made by a broker or dealer in an exemption report that is prepared pursuant to SEC Proposed Rule 17a-5, the auditor is to follow the requirements of the Proposed Review Standard. Notwithstanding the proposed amendment, we continue to believe that the scope of procedures contemplated by a review engagement is not sufficient to permit auditors to conclude, with a moderate level of assurance, that a broker-dealer's assertion that it is exempt from the requirements of Rule 15c3-3 is fairly stated.

¹¹ See Note to proposed paragraph 4 of the Proposed Examination Standard.

¹² See PCAOB interim attestation standard AT §601.07.

We further note the Board's requirement that an auditor that performs the review engagement but does not audit the broker-dealer's financial statements "must obtain knowledge of the evidence obtained and results of procedures performed in the audit of the financial statements and supplemental information that is commensurate with that of the auditor of the financial statements and supplemental information".¹³ We believe that requiring this level of knowledge, which is beyond what would be attained through inquiry and analytical procedures, is further evidence that a review-level engagement does not meet the Board's expectations.

Instead, we recommend requiring an agreed-upon procedures engagement (addressing the results of procedures specified by the SEC) related to a broker-dealer's exemption from the requirements of Rule 15c3-3. We also would support requiring an examination engagement, as contemplated by existing attestation standards, relating to such an assertion, if suitable criteria were developed for such an examination.

Time period for assessment

In our comment letter to the SEC, we request clarification about the time period for the assertion regarding exemption from the requirements of Rule 15c3-3 and indicate that we believe a point-in-time assertion would be sufficient. We believe that the Proposed Review Standard also should indicate whether the auditor's review of the Exemption Report is for an annual period or as of the broker-dealer's fiscal year-end, and we reiterate our belief that a point-in-time assertion would be sufficient.

Other

Our comments provided under the sections entitled *General requirements* and the *Auditor's examination report* under the Proposed Examination Standard also apply to the Proposed Review Standard.

Proposed Amendments to AS 7, Engagement Quality Review (EQR)

The Proposing Release includes amendments to AS 7 that would require "an engagement quality review and concurring approval of issuance for examination engagements and review engagements of broker-dealers."¹⁴ This requirement would apply to both the examination report required for carrying broker-dealers that file a Compliance Report and the review report required for non-carrying broker-dealers that are exempt from the Compliance Report requirement and file an Exemption Report.

AS 7 includes specific guidance on the EQR process for audit engagements and reviews of interim financial information.¹⁵ However, AS 7 does not include specific guidance for examination and review engagements under the attestation standards, nor do the Proposed Standards provide any amendments to AS 7 in this regard. We believe auditors would benefit from guidance on specific EQR procedures to be performed for examination and review engagements under the Proposed Standards.

¹³ See Note to paragraph 7 of the Proposed Review Standard.

¹⁴ See Section V. A. of the Proposing Release

¹⁵ See AS 7, paragraphs 9-18.

Proposed Amendments to AT 101 and AT 601

As indicated in the Proposing Release, the Proposed Standards are designed to tailor the PCAOB's attestation standards to the auditor's responsibilities under SEC Proposed Rule 17a-5. In the Proposed Standards, the Board outlines various requirements relating to supervision, risk assessments and materiality considerations. We believe AT 101 and AT 601 contain relevant and appropriate guidance that should be incorporated into the Proposed Standards. For example, the general standards of fieldwork in AT 101 and the considerations of attestation risk in an examination engagement, subsequent events and the work of an entity's internal audit function in AT 601 are more detailed than those provided in the Proposed Standards. Since the proposed amendments to AT 101 and AT 601 specifically scope out examinations of Compliance Reports and reviews of Exemption Reports,¹⁶ we recommend that the Board expand the guidance in the Proposed Standards to include the relevant sections in AT 101 (e.g., for the general standards of fieldwork including planning and supervision and obtaining sufficient evidence) and AT 601 (e.g., for considerations of attestation risk in an examination engagement, subsequent events and use of internal audit).

Lastly, we note that paragraphs 4.43-.45 of AT 9101 contain guidance for auditors about providing access to or copies of attest documentation to a regulator. We believe this guidance would be helpful to auditors of carrying or clearing broker-dealers subject to the access to audit documentation amendment outlined in SEC Proposed Rule 17a-5. We recommend that the Board add (either directly or via reference) the AT 9101 guidance to the Proposed Standards.

Conclusion

In summary, we generally support the objectives of the Proposed Examination Standard and believe it responds to the auditor requirements in SEC Proposed Rule 17a-5. At the same time, we encourage the PCAOB to clarify the elements of the Proposed Examination Standard discussed above to help facilitate consistent application in practice. We support the PCAOB's proposed effective date for the Proposed Standards and have recommended that the SEC align the effective date of its Proposed Rule 17a-5 with the Proposed Standards to give broker-dealers and their auditors time required to adequately address the final rules. We further encourage the PCAOB to consider requiring an agreed-upon procedures engagement or an examination engagement, rather than a review engagement, relative to a broker-dealer's assertion that it is exempt from Rule 15c3-3.

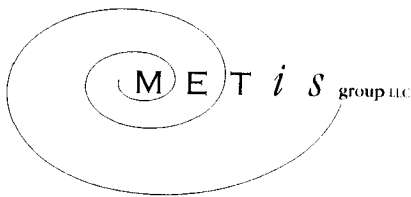
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We would be pleased to discuss our comments with the PCAOB or its staff at your convenience.

Very truly yours,

Ernst & Young LLP

¹⁶ See proposed paragraphs g and h to AT 101 and see proposed paragraph a to AT 601.



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September 2, 2011

VIA ELECTRONIC MAIL

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, NW
Washington, D.C. 20006

Re: PCAOB Rulemaking Docket Matter No. 035 (Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by The U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards)

Dear PCOAB:

I appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) proposed rules, **Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by The U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards**, which pertain to broker dealers. I am an auditor of referring broker dealers that are not public companies that have not previously been subject to PCAOB standards and rules. I believe my experience as a broker dealer auditor, as well as my experience as a bank auditor and committee member of the New York State Society of CPA's Banking and Stock Brokerage Committees allow me to bring a useful perspective. I have also worked on audits of public companies and their subsidiaries during my career.

Please note that all comments are those of the undersigned, Howard Gluckman, C.P.A., and do not represent any opinion of my firm or any other individual members or employees or consultants of my firm, Metis Group Certified Public Accountants LLC, nor of any of the New York State Society of CPA committees of which I am a member or any other committee member.

I support the Board's efforts in proposing these rules and I find them well thought out, well written and clear. I generally do not support additional clarifications, which could

limit the professional judgment necessary to comply with the standards and lead to unnecessarily increase in costs, especially to smaller broker dealers. Current auditing standards together with these proposed standards should suffice for any qualified auditor. I find, however, that some of the wording and a few of the points can cause problems that might lead to additional audit hours and costs to the broker dealer that would not add to the quality of the engagement or its conclusions.

I respectfully request the Board to consider the following suggestions before finalizing the rules.

1. Attestation Standard para. 13, Identifying Risks of Material Non-Compliance

- a. There is mention that the auditor should read all internal audit reports. But I believe the Board should discuss here the use of the broker dealer internal auditor for reliance on internal controls and testing of internal controls, if the broker dealer has an internal auditor. Proper use of internal auditor reports and work papers, and review of those internal auditor work papers can be very effective and often can reduce the amount of testing the external auditor would be required to perform.

Use of internal auditors is discussed in AICPA Standards AU Section 322.12 through 322.27.

2. Attestation Standard, Testing Controls over Compliance

- a. Para. 15: You state that “The auditor must obtain evidence that the controls over compliance selected for testing are designed effectively and operated during the entire fiscal year.” This implies that you would need evidence that the compliance operated every single day of the fiscal year (based upon the word “entire”). But the SEC Proposed Rule 17a-5 reference (paragraph (d)(3)(i)(B)(3)) uses the term “throughout the fiscal year”. This may be a small semantic question, but I believe the Board should use the SEC “throughout” and not the word “entire”. I believe a testing of multiple days could give you comfort for a conclusion throughout the year, but I see the “entire” year meaning every single day. To conclude about every single day, one would have to test every day.
- b. Para. 16: You state “As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.” As risk increases with a control, the evidence becomes more important to the audit. But it does not necessarily increase in number of transactions to be tested or dollar amounts or the type of test. The auditor reaction to increased risk depends upon the circumstances. The word “increases” is unclear and should be changed. I would suggest stating that as the risk associated with the control tested increases, the evidence that the auditor

should obtain becomes more important; the auditor should take appropriate steps so that the quality of the evidence matches the severity of the risk.

- c. Para. 17: As a factor that affects the risk associated with a control you include “the extent of use of part-time personnel to perform controls over compliance.” It may be true in large broker dealers that the use of part-time personnel is a risk factor, because large broker dealers do not generally use part-time personnel so that the use of part-time personnel might be an indication of not considering a procedure important. In a smaller organization it is not so unusual to use part-time personnel, because the amount of work at a high level might not be sufficient to employ a qualified full time employee. The question is the qualification of the individual and the integrity of the individual, and not whether they are full time or part time employees. The bullet before the one about part-time personnel already calls for evaluating the competence of the broker dealer personnel. I recommend the comment be changed to evaluate hiring and training procedures to prevent use of employees who are not qualified to perform their control procedure or have not been properly trained on the procedure’s requirements and importance.
- d. Para. 18: You state that the auditor should obtain evidence regarding design effectiveness of the selected controls before and after a change in policies and procedures or key personnel. A broker dealer may have numerous changes in its policies and procedures, and even in key personnel. To obtain evidence regarding design effectiveness for every such change before and after will require the auditor to literally be reading broker dealer committee meetings daily, especially to anticipate changes and test them before the change. The point here should not be for the auditor to obtain evidence of every such change before and after they occur. Rather the important issue is for the auditor to be cognizant of the fact that many, but not all, changes in key personnel and/or policies and procedures can lead to weaknesses in the effectiveness of controls. Therefore, the standard should require that the auditor determine with the broker dealer management what types of changes could materially affect control effectiveness. Management must monitor the changes, keep records of how they effect the control environment and report actions taken to maintain control effectiveness. The auditor must test and evaluate if proper actions have been taken by management at the right time, and whether the actions taken by management have been done in a manner to ensure continuing satisfactory control. If the auditor is not satisfied with the actions by management and believes any change may or may have affected controls significantly in the negative, then the auditor must test

the design effectiveness relevant to the change to determine if his work or report need to reflect that finding.

- e. Para. 20: The auditor is required to test the operating effectiveness of the selected controls over compliance by determining “whether each control” is operating as designed. To prevent confusion about the word “each” control, which might imply every control must be tested, I would suggest you change the wording to “each control selected for testing”.

3. Attestation Standard, Evaluating the Results of Examination Procedures

- a. Para. 30(c): States the “The auditor should evaluate the effect of any instance of non-compliance or identified control deficiency on the auditor’s assessed risks of material non-compliance.” Although I understand that even very minor instances of non-compliance or control deficiencies may be an indication of a material non-compliance, there are many broker dealer rules that are very minor. Some small instances of non-compliance might only be an indication an isolated case or some matter that could never be material. I believe you should leave it up to the judgment of the auditor as to when and how every instance of non-compliance or control deficiency will be evaluated. You can require that the auditor look at all instances of non-compliance/deficiencies of which he becomes aware, but that any evaluation or other steps be left to auditor’s judgment depending upon the circumstances rather than require every one be evaluated.

4. Attestation Standard, Communication Requirements

- a. Para. 37 requires the auditor to communicate to management identified instances of non-compliance, control deficiencies, and instances of information not derived from the broker dealer’s books and records. My problem is the lack of definition of “identified”. Is the instance “identified” as soon as the auditor becomes aware of its existence, or only if the auditor concludes it is some type of significant deficiency? The general rule in auditing is to inform your client in writing of all violations and deficiencies of which you become aware unless they are “clearly inconsequential”. I would recommend that type of wording with the addition of “unless they are clearly inconsequential” so that broker dealers and their auditors are not wasting time and costs on totally insignificant matters.

5. Proposed Amendments to PCAOB Standard No. 7, Engagement Quality Review

- a. The Board is recommending both an engagement quality review and a concurring approval of issuance for each audit engagement, each

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engagement to review interim financial information, and each attestation engagement. The requirement for engagement quality review and engagement concurring approval is well documented and accepted for SEC filings of financial statements of public companies. The American Institute of Certified Public Accountants (AICPA) has not adopted this requirement for audits and attestation engagements of non-public companies. I have not studied the AICPA decision, but I believe it is based upon the fact that existing generally accepted auditing standards require that the work be properly supervised and reviewed and considered by the CPA before reaching a conclusion and issuing a report. It is up to the judgment of the CPA as to whether there is a need for additional audit work, consulting of a fellow professional in the firm, or seeking outside professional assistance for any review or release approval. In the case of most non-public companies there is simply no need for additional quality review or a concurring approval. The additional time and cost do not justify the risk and additional comfort that may be attained, if any.

Many broker dealers are small and do not have significant accounting or auditing issues that merit both additional quality review and a separate concurring approval. Many merit additional quality review, but not a concurring approval. The added costs for small broker dealers can be significant with little or no additional professional quality.

I strongly recommend the Board consider a capital size, gross income size, or amount of customer liability size as a cut off for requiring either one or both additional quality review and concurring approval. I would suggest, as a framework for discussion, a cutoff in the neighborhood of capital, gross income, and/or customer liability of \$10 million each.

I thank you again for the opportunity to offer my thoughts on the proposal. I would be happy to discuss any of these matters. You can reach me at 212-643-0099 extension 242 or by email at hgluckman@metisgroupllc.com.

Respectfully submitted,



Howard Gluckman, C.P.A.



September 12, 2011

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Re: PCAOB Rulemaking Docket Matter No. 35, *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards*

Dear Board Members and Staff:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) proposed attestation standards, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, and *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, and the related amendments. We respectfully submit our comments and recommendations thereon. Any capitalized terms herein that are undefined have the same meaning assigned to them within these proposals.

As we indicated in our letter, dated August 26, 2011, to the U.S. Securities and Exchange Commission (SEC or Commission) in response to their proposed amendments to the broker-dealer financial reporting rule under the Securities Exchange Act of 1934, we commend the Commission and the PCAOB for concurrently releasing proposed rules and standards that are intended to work together. We believe that this approach not only facilitates a better understanding of what is expected by the SEC and PCAOB, but will also result in more constructive and valuable feedback from respondents. We strongly encourage adopting such an approach for all future joint proposals.

The following provides our specific observations and recommendations pertaining to the Board's proposed standards. We generally support these proposals and applaud the PCAOB as the proposed standards have been clearly aligned with the SEC's proposed rule amendments. Some of our comments are similar to those provided to the SEC related to their proposed rule amendments. We encourage the Board to obtain and review the comments received by the SEC on their proposal prior to finalizing the related examination and review standards.

Compliance examination engagement

The following provides comments that are specific to the proposed attestation standard, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* (proposed examination

standard). Overall, we support the proposed examination standard and, for the most part, believe it is clear and appropriate.

Material non-compliance

In the majority of compliance examination engagements, the evaluation of what constitutes material non-compliance with a specific compliance requirement is both subjective and difficult. We agree with the proposed definition of material non-compliance in the Commission's proposed rule amendments and the Board's proposed examination standard. In order to achieve more consistency in practice regarding application of the definition, we encourage the SEC and PCAOB to collaborate and provide additional interpretive guidance. This would be particularly important for requirements that are more subjective and those that are not quantifiable in monetary terms.

Also, the release includes an extensive discussion about identifying and assessing the risks of material non-compliance, as well as evaluating the sufficiency and appropriateness of evidence. Some of the examples provided, however, seem to impose certain incremental requirements. As we have previously expressed to the Board, we continue to be concerned with establishing requirements outside of the Board's standards, as well as requirements based on illustrative examples. We believe that to achieve consistent application of the Board's standards and rules, including reporting, that is in the best interests of investors, the PCAOB should ensure that the Board's standards clearly define the necessary requirements.

Books and records

With regard to the broker-dealer's assertions addressed by the proposed examination standard, please note that our letter to the SEC indicates that we do not believe it is clear what is expected of the auditor with respect to the broker-dealer's assertion that the information used to assert compliance with the Financial Responsibility Rules was derived from the books and records. We understand that an auditor would likely evaluate the appropriateness of the broker-dealer's books and records during the course of the engagement, including whether the broker-dealer can support its assertion with sufficient documentation (discussed further below). A separate opinion on this specific assertion, however, may entail more detailed procedures as to the source of each piece of information used by the broker-dealer at the time of its assessment. We question whether this is what is actually intended by the auditor's opinion; therefore, we requested that the SEC, in finalizing its proposed rule amendments, provide more context or interpretive guidance to clarify their intention as to management's assertion and the auditor's opinion thereon. In this regard, additional guidance with regard to the procedures necessary to achieve reasonable assurance with respect thereto is necessary in the related proposed examination standard.

Using the work of others

The Board requested comments as to whether the proposed examination standard should establish requirements that govern the use of the work of other auditors. Although it may not be possible to clearly identify, at this point, all of the instances in which the auditor may use the work of other auditors or others, we anticipate that this scenario is possible. Accordingly, we believe that the Board may need to further contemplate whether to maintain an umbrella

standard, similar to AT sec. 101, that addresses matters such as these, regardless of the type of attest engagement being performed. For the time being, we suggest that the Board recognize that this may be possible and utilize the interim inspection program to inform the Board's future standard-setting initiatives in this area.

Written representations

We believe that a written representation letter is necessary and should be required for the examination. There are some matters upon which the examination is premised, and written representations provide essential evidence as to management's assertions and verbal representations. If management is unwilling or unable to provide the requested representations, it is highly likely that additional procedures could not be performed to overcome the substantial doubt about the broker-dealer's assertions.

With respect to the written representations that we believe are necessary, we believe that the following additional representations should be obtained:

- Management's responsibility for compliance with the Financial Responsibility Rules.
- That management has performed an evaluation of compliance.
- That management did not use the auditor's procedures performed during the audit of the financial statements and supplemental information or the examination as part of the basis for management's assertions. (Refer to our specific comments regarding evidence supporting management's assertions below.)
- That management has disclosed to the auditor all known non-compliance.
- That management has disclosed to the auditor any fraud relevant to the assertions.

The proposed examination standard should also include the date through which the written representations should be obtained; typically, the report date.

Reporting

Overall, we agree with the proposed form and content of the examination report. However, we believe that the standard examination report could be expanded by:

- Including a definition of internal control over compliance and a description of its inherent limitations. We believe this will assist users in further understanding the auditor's report.
- Maintaining the extant statement indicating that the examination does not provide a legal determination. We believe that this is a factual statement that is relevant to investors, as legal determinations can only be made by a court of law. As indicated in extant standards, the auditor's report may assist legal counsel or others in making such determinations.

We also note that management's assertion with respect to internal control over compliance is consistent with the SEC's proposed rule amendments. From a user's perspective, however, we

are concerned with the form of opinion that indicates that there were no instances of material weakness, as internal control over compliance and the auditor's examination only provide reasonable assurance to this effect. This would seem to further support the need to define internal control over compliance and to describe its inherent limitations, as noted above.

Further, if there are compliance requirements that do not specifically apply to a particular broker-dealer, we would expect those requirements to be clearly excluded from management's assertion and the auditor's report. For example, this may be the case for broker-dealers that are reporting as a carrying firm because of certain limited past activities. In this circumstance, the scope paragraph of the auditor's report could specifically identify the requirements that are excluded based on management's determination that they are not applicable. We refer the Board to a standard auditor's report issued pursuant to the requirements of Regulation AB.

Report modifications

There are two matters with regard to examination report modifications that we would like the Board to consider and address. The first relates to the form of report when an adverse opinion on one or more management assertions is required. In this circumstance, the auditor should report directly on the subject matter for all assertions, rather than the respective assertion necessitating the adverse opinion. We believe that this form of reporting will result in a more comprehensible report. The second matter relates to misstatements of fact in management's assertion, particularly when management's assertion is improperly presented. In addition to communicating this issue to management and the audit committee, an explanatory paragraph in the auditor's report may be necessary, consistent with the requirements in an audit of internal control over financial reporting. We believe that this should be specifically addressed by the Board's examination standard. Also refer to our comments on report modifications related to the review engagement, particularly with respect to scope limitations and the requirement to describe omitted procedures.

Exemption review engagement

The following provides comments that are specific to the proposed attestation standard, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* (proposed review standard). As we indicated to the SEC, because performing a review, thereby obtaining only a moderate level of assurance of compliance with specified requirements, is a fairly new concept, it is important for the proposed review standard to clearly describe the auditor's responsibilities and for the review report to clearly describe the nature of the review engagement and its inherent limitations.

Non-compliance requiring material modification

The proposed review standard makes reference to material modifications that should be made to the broker-dealer's assertion and non-compliance that would cause the assertion not to be fairly stated, in all material respects. Such references seem to be consistent with the concept of a review engagement. However, we believe that the proposed review standard could be further clarified in the context of material non-compliance. In other words, the overall concept seems appropriate, but the proposed review standard could more clearly indicate that the auditor plans and performs the review in the context of obtaining a moderate level of assurance as to the absence of material non-compliance with the exemption conditions.

Review procedures and evaluating results

The review procedures and the matters affecting their nature, timing, and extent are, for the most part, appropriate for an engagement to obtain a moderate level of assurance. We also generally agree with the requirements to evaluate the results of the review procedures. We do, however, have the following recommendations:

- Clarifying the note in paragraph 10f to explicitly indicate that the examples of procedures are those that may be performed during the audit of the financial statements. Currently, this is more implicit.
- Incorporating the guidance on page A4-43 of the release that relates to the risk of fraud and centralized or decentralized operating environments (the first two full paragraphs). This is helpful guidance, particularly with respect to the Board's intent, that should be included within the standard.
- Explaining the intent of the requirement in paragraph 10h and how it differs from the requirement in paragraph 12. It may help to link paragraph 10h to the consideration of the matters in paragraph 9. That said, however, we question the need for paragraph 10h in consideration of paragraph 12. With respect to the reference to *substantial doubt* in paragraph 12, we believe that a better link to the possibility of *material* non-compliance is warranted.
- Carrying forward the guidance in paragraph .56 of AT sec. 101, *Attest Engagements*, which addresses the performance of other or additional procedures. This guidance seems necessary because AT sec. 101 will not apply to the review engagement. It could also help differentiate between paragraphs 10h and 12, particularly if paragraph 10h is retained.
- Incorporating the guidance on page A4-48 of the release that identifies the procedures (additional inquiries, reading documents, or search and verification procedures) that may be performed in the situations described by paragraph 12.

Written representations

Similar to our comments on the proposed examination standard, we believe that a written representation letter is necessary and should be required for the review. With respect to the written representations that we believe are necessary for the review engagement, we believe that the following additional representations should be obtained:

- Management's responsibility for establishing and maintaining effective internal control over compliance with the exemption conditions.
- That management has performed an evaluation of compliance with the exemption conditions.
- That management did not use the auditor's procedures performed during the audit of the financial statements and supplemental information or the review as part of the basis for

management's assertion. (Refer to our specific comments regarding evidence supporting management's assertions below.)

- That management has disclosed to the auditor all known non-compliance related to the exemption conditions.
- That management has disclosed to the auditor any fraud relevant to the exemption conditions.

The proposed review standard should also include the date through which the written representations should be obtained; typically, the report date.

Reporting

In general, we believe that the proposed form and content of the review report is accurate and supportable. However, the standard review report could be expanded in two regards:

- To address the inherent limitations of a review engagement by including the concept of moderate assurance and summarizing the auditor's objective, as described in paragraphs 3 and 4.
- To indicate that the review does not provide a legal determination. We believe this clarification is important, as discussed above.

Hence, to provide more transparency to users, the scope paragraph of the review report may be revised to read as follows:

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform inquiries and other review procedures to obtain moderate assurance about whether one or more instances of material non-compliance exist with respect to the exemption conditions that would cause management's assertion not to be fairly stated. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on whether management's assertion is fairly stated, in all material respects. Accordingly, we do not express such an opinion. We believe that our review provides a reasonable basis for our conclusion. Our review does not provide a legal determination on the Company's compliance with the provisions for exemption under Rule 15c3-3.

Report modifications

When instances of material non-compliance are identified (that is, the broker-dealer's assertion is not fairly stated, in all material respects, because of an instance(s) of non-compliance), the auditor is required by paragraph 20 to modify the report to describe those instances and to state that the broker-dealer is not in compliance with the specified exemption conditions. Ordinarily, in a review engagement, matters that contradict management's assertion are disclosed and reported on using an *except for* type of conclusion. This form of conclusion differentiates an

audit (or examination) from a review engagement by more clearly indicating that other matters contradicting management's assertion may exist but have not been identified. Thus, we believe that it is necessary for the PCAOB to provide the form of auditor's conclusion that is expected when management's assertion is not fairly stated. We are comfortable with the assumed form of conclusion, provided that there is some indication in the auditor's report, consistent with the notion of moderate assurance, that had the auditor performed additional procedures, other instances of material non-compliance may have been identified and reported.

With respect to scope limitations, we question the appropriateness of the requirement in paragraph 21 for the auditor to describe the omitted procedures and the reason for their omission. To begin with, we believe that the reason for their omission is the description of the scope limitation itself. With respect to the review procedures, their performance or omission is not described in detail today because such discussion is believed to overshadow the disclaimer. We believe that it would be more appropriate to generally describe the effect of the scope limitation on the engagement, without providing a list of omitted procedures that may have been considered necessary. In addition, the proposed review standard should be clear as to the elimination of the scope paragraph when issuing a review report in this circumstance.

Also, we note that the proposed review standard does not address the auditor's responsibility as it relates to report modifications when management's assertion is improperly presented or contains additional information. We believe that these are matters that should be addressed by the Board's standard.

Overall, we understand that some of these situations may be rare. Yet, we believe that it is the Board's responsibility, in the interests of investors, to clearly define and describe the auditor's responsibilities to achieve consistent reporting in practice.

Proposed amendments

We understand and support specific documentation and engagement quality review requirements for attestation engagements performed under PCAOB standards. We are concerned, however, with the Board's approach in adopting such standards. Thus far, the audit and attestation standards have been separate bodies of literature. To promote compliance with PCAOB standards, we believe that the Board should continue to maintain this structure. We also believe that the use of an amendment to adopt such significant changes in the literature may not sufficiently take into account a broader consideration of the affected engagements. For those firms that do not audit broker-dealers, such changes also may go unnoticed.

That said, we do not have significant concerns with the documentation requirements that will be imposed on the examination and review engagements, other than the fact that they may need to be adapted and applied more broadly. Although some firms may apply the same documentation requirements to audit and attestation engagements, all firms will need some time to determine compliance with those requirements for all attestation engagements being performed under PCAOB standards. With regard to the performance of an engagement quality review, we also believe that, although some adaptation may be necessary, the requirements are generally appropriate. A key change, however, relates to the rotation or *cooling off* requirements.

It appears as though the Board's cooling off requirements will apply to non-public broker-dealers. Non-public broker-dealers, however, are not subject to the SEC's independence rules regarding partner rotation. The PCAOB has previously provided the same exemption as it relates to its cooling off requirements that the SEC has afforded to smaller registered firms as it relates to partner rotation. In analogizing to this situation, we question whether a similar exemption with respect to the cooling off period should be afforded to auditors of non-public broker-dealers, since the underlying SEC partner rotation rules do not apply.

Other matters

Evidence supporting management's assertions

Similar to management's responsibility related to an assessment of the effectiveness of internal control over financial reporting, we believe that management is responsible for maintaining evidential matter, including documentation, to provide reasonable support for its broker-dealer related assertions. Such evidence allows the auditor to understand and consider management's work, including determining the ability to perform the examination or review engagement. We suggest that the PCAOB collaborate with the SEC on this matter to more appropriately address management's and the auditor's responsibilities in regards to management's documentation in support of its assertions.

Report restriction

The proposed examination and review reports do not include a paragraph restricting their use to certain specified parties. Based on extant requirements regarding the suitability and availability of criteria, we understand why such a paragraph was not included. However, a general report user may not fully understand the Financial Responsibility Rules or the exemption provisions of Rule 15c3-3. Accordingly, we believe that some form of notification to report users, if not a report restriction, that indicates the intended purpose of the report and the knowledge necessary to use it appropriately may be necessary.

Applicability of PCAOB standards

The Board indicates that auditors of non-public broker-dealers are not subject to the provisions of PCAOB Rules 3521 through 3526, until the Board completes a separate rulemaking process and appropriate amendments. We appreciate the Board's thoughtful consideration of the applicability of these rules. In conjunction with finalizing the proposed examination and review standards, we suggest that the Board issue a more formal amendment to its overarching Rule 3520 to this effect. We believe that this is necessary to clearly indicate the PCAOB standards that apply to the examination and review, as well as the related financial statement audit.

Relationship to interim attestation standards

The release indicates that AT sec. 101 is not specific to any particular type of engagement and that the proposed standards are more specific because they have been designed for the required broker-dealer examination and review engagements. It also notes that the proposed standards allow auditors to perform these engagements without looking to multiple standards, such as AT sec. 101 and AT sec. 601, *Compliance Attestation*.

AT sec. 101 has always been viewed as an umbrella standard for all other attest engagements, and AT sec. 601 has always been viewed as the relevant standard addressing compliance attestation engagements. We can appreciate the use of separate, single standards to address the required broker-dealer examination and review engagements, provided those standard are comprehensive. Nevertheless, we believe that there continues to be some relevant guidance in both AT sec. 101 and 601 that could be encompassed directly within the proposed standards; some matters are discussed herein. We also believe that if the Board is using an all-inclusive approach, the proposed standards should eliminate any references to AT sec. 101 or 601 and incorporate all necessary requirements and guidance therein.

Commodity Futures Trading Commission Rule 1.16

For broker-dealers that are also registered as a Futures Commission Merchant with the Commodity Futures Trading Commission (CFTC), we believe that it will be necessary for the PCAOB to recognize and address the requirements related to CFTC Rule 1.16 for the auditor to report on compliance therewith. We recognize, however, that the SEC and CFTC will likely need to work together to align their respective rules.

We would be pleased to discuss our letter with you. If you have any questions, please contact Karin A. French, National Managing Partner of Professional Standards, at (312) 602-9160.

Sincerely,





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September 9, 2011

Office of the Secretary
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PCAOB Rulemaking Docket Matter No. 035

Proposed Standards for Attestation Engagements Related to Broker Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards

Dear Mr. Secretary:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") Release No. 2011-004, *Proposed Standards for Attestation Engagements Related to Broker Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards* (the "Proposed Standards"). We support the Board's efforts to align its attestation standards more closely with the auditor's responsibilities under Securities and Exchange Commission's (the "SEC" or "Commission") Proposed Rule 17a-5 (the "Proposed Rule") relative to audits of broker-dealers. In general, we support the Board's Proposed Standards. However, we believe that certain elements of the Proposed Standards require further clarification and guidance, and we have summarized our observations and recommendations for your consideration below. Our comments and observations relate to the following areas:

- Audit Scalability
- Material Non-Compliance
- Engagement Quality Reviews
- Examination and Review Reports
- Exemption Report
- Timing and Extent of Certain Compliance Tests
- Inquiries of Regulatory Agencies
- KPMG Comments on Commission's Proposed Rule

We have also commented on the Commission's Proposed Rule in our letter dated August 25, 2011 that covers many of the topical areas discussed below. We encourage the PCAOB to also review that letter in conjunction with our observations herein.



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Audit Scalability

The Proposed Standards require that procedures to be performed as part of an examination or review engagement be designed to be “scalable based on the broker’s or dealer’s size and complexity.”¹ We believe that auditors would benefit from additional guidance in this regard, including where possible, specific examples of the application of scalability to both compliance examination and exemption review engagements. We believe that without such guidance, application of the audit scalability concept could vary greatly across the audit profession and may inhibit the Board’s intent of striking an appropriate balance between increasing investor protection and minimizing audit costs.

Material Non-Compliance

The Proposed Standards require auditors to plan and perform examination procedures to detect instances that, individually or in combination, would result in “material non-compliance”. The Proposed Standards also indicate that the auditor should consider “relevant quantitative and qualitative factors”² and “devote more attention to the matters that are most significant to compliance with the specified Financial Responsibility Rules”³ in planning and performing procedures for a compliance examination engagement.

As the scope of the proposed examination is a compliance attestation engagement, we suggest that the definition of “material non-compliance” as used in AT §601.64-67 of the PCAOB Standards and Related Rules also be used for purposes of the Proposed Standards, *i.e.*, “noncompliance with the applicable requirements that the practitioner believes have a material effect on the entity’s compliance.”⁴ In addition, we believe that the Board should provide guidance with respect to qualitative and quantitative factors that may impact the determination of “materiality” consistent with the objectives of a compliance attestation engagement.⁵

Finally, consistent with our response to the SEC on the Proposed Rule, we suggest that the Board and Commission collaborate to provide further guidance and clarification related to the interaction between (i) material errors discovered during the audit of the financial statements and/or material weaknesses in internal control over financial reporting (“ICFR”) identified, and (ii) the determination of instances of “material non-compliance” and/or material weaknesses in internal control over compliance with the Financial Responsibility Rules.

¹ See PCAOB Release 2011-004, Section III. A.

² See PCAOB Release 2011-004, Appendix 4, Section I.C.3.

³ See PCAOB Release 2011-004, Appendix 4, Section I.C.5.

⁴ See AT §601.64 of the PCAOB Standards and Related Rules.

⁵ See AT §601.36 of the PCAOB Standards and Related Rules.



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Engagement Quality Reviews

The Proposed Standards include certain amendments to PCAOB Auditing Standard No. 7, *Engagement Quality Review* (“AS 7”) that would require “an engagement quality review and concurring approval of issuance for attestation examination engagements and review engagements of broker-dealers.”⁶ This requirement would apply to both carrying broker-dealers that file a Compliance Report and non-carrying broker-dealers that are exempt from the Compliance Report requirement, and file an Exemption Report. In addition, we note that the application of AS 7 to broker-dealers will also require an Engagement Quality Review (“EQR”) as part of the financial statement audit.

Non-Carrying Broker-Dealers

Under the Proposed Rule, broker-dealers that do not maintain customer funds or securities would file an Exemption Report and therefore would not be subject to the compliance examination requirement. Non-carrying broker-dealers are typically smaller entities that pose less risk to investors. As a result, the proposed review standard mandates fewer and less burdensome procedures when compared to the proposed examination standard.

We believe that requiring an EQR under AS 7 for non-carrying broker-dealers may present additional costs in excess of any related benefits. The Board should evaluate whether the application of AS 7 is necessary and cost-justified for the financial statement audit and review of the Exemption Report of non-carrying broker-dealers.

EQR Procedures

AS 7 includes specific guidance regarding the EQR process for audit engagements⁷ as well as reviews of interim financial information.⁸ However, AS 7 does not include guidance for attestation examination or review engagements, nor do the Proposed Standards provide for any amendments to AS 7 to include such guidance. We suggest that the PCAOB evaluate how AS 7 applies to an attestation engagement, and whether any amendments to AS 7 are appropriate.

Examination and Review Reports

Explanatory Language

Broker-dealers’ assertions are principally based upon regulatory requirements (e.g., net capital computations pursuant to Rule 15c3-1 and, reserve requirements pursuant to Rule 15c3-3) that may be subject to legal interpretation. As a result, we believe that the scope paragraph of examination and review reports should be modified to include language indicating that the auditor’s examination or review did not provide for a legal determination of a broker-dealer’s compliance with specific requirements, similar to established guidance within the PCAOB’s Standards and Related Rules.⁹

⁶ See PCAOB Release 2011-004, Section V. A.

⁷ See AS 7, paragraphs 9 – 13.

⁸ See AS 7, paragraphs 14 – 18.

⁹ See AT §601.56 of the PCAOB Standards and Related Rules.



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Similarly, evaluating a broker-dealer's compliance with regulatory requirements may be based upon interpretations of laws, regulations, or rules established by the Commission and/or Designated Examining Authorities ("DEA"). Therefore, we believe the Proposed Standards should permit the inclusion of a paragraph within the examination and review reports stating the description and the source of interpretations made by the broker-dealer's management, similar to established guidance within the PCAOB's Standards and Related Rules.¹⁰

Restriction of Use

Audit firms previously have restricted the use of internal control reports required by Rule 17a-5 to the board of directors, management, the Commission, and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934.¹¹ However, the Proposed Standards do not include provisions that allow auditors to restrict the use of examination and review reports to specified parties.¹²

We believe that a restriction on the use of an auditor's examination or review report is appropriate, given that general users of these reports may not have a sufficient understanding of the subject matter to which they relate, such as the Financial Responsibility Rules or the exemptive provisions of Rule 15c3-3. As such, we request that the PCAOB include a provision allowing auditors to restrict the use of examination and review reports, as deemed appropriate by the auditors.

Modifications of Standardized Reports

The Proposed Standards include examples of standardized examination and review reports, and indicate that these reports should be modified if certain conditions exist.¹³ However, the Proposed Standards do not provide examples of modified reports. We believe audit firms would benefit from specific examples of report modifications, similar to the standard reports included within the Proposed Standards.

Exemption Report

Under the Proposed Rule, the Exemption Report would require broker-dealers to assert that they are exempt from Rule 15c3-3 and identify the provision of that Rule that they are relying on to qualify for the exemption. However, the Proposed Rule does not indicate whether broker-dealers should make these assertions for an annual period (e.g. for the year ending December 31) or an "as of date" (e.g. as of December 31). In our comment letter on the Proposed Rule, we stated that the Commission's final rule should clarify this matter. We believe the PCAOB's Proposed Standards should also indicate, consistent with the Commission's final rule, whether the auditor's review of the Exemption Report is for an annual period or an "as of date."

¹⁰ See AT §601.59 of the PCAOB Standards and Related Rules which provides the following as an example of such a paragraph, which should be placed directly following the scope paragraph: "We have been informed that, under [name of entity]'s interpretation of [identify the compliance requirement], [explain the source and nature of the relevant interpretation]."

¹¹ See AICPA Audit and Accounting Guide: *Brokers and Dealers in Securities*, Appendix C.

¹² See PCAOB Release 2011-004, Appendix 4, page 32 and page 50.

¹³ See PCAOB Release 2011-004, Appendix A, paragraphs A1 and Appendix 2, paragraphs 20 - 21.



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Timing and Extent of Certain Compliance Tests

The Proposed Standards provide examples of certain procedures that auditors are required to perform to obtain evidence about the existence of customer funds or securities.¹⁴ We believe that the Board should provide clarification regarding the extent and timing of these procedures. If the Board believes that these procedures can be performed at an interim date, auditors would benefit from additional guidance, including, where possible, specific examples of roll-forward procedures.

Inquiries of Regulatory Agencies

The Proposed Standards indicate that “if the broker or dealer has sent or received correspondence with the SEC or the broker’s or dealer’s DEA that is relevant to compliance with the exemption conditions, the auditor should read such correspondence and, when necessary in the circumstances, make inquiries of the regulatory agencies.”¹⁵ We suggest that the Board provide guidance related to the interaction between auditors and examiners consistent with the American Institute of Certified Public Accountants *Audit and Accounting Guide for Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies*, Chapter 5 section on “Auditor and Examiner Relationship.”

KPMG Comments on Commission’s Proposed Rule

We have commented on the Commission’s Proposed Rule related to topics on internal control over compliance with the Financial Responsibility Rules and transition timelines and effective dates. We provide these comments due to their interaction with the Board’s Proposed Standards, and to stress the need for further coordination between the Board and the Commission.

Internal Control over Compliance with the Financial Responsibility Rules

Pursuant to the Commission’s Proposed Rule, “a broker-dealer could not assert that its internal control over compliance with the Financial Responsibility Rules during the fiscal year was effective if one or more material weaknesses exist with respect to internal control over compliance.”¹⁶ Consistent with our comment letter to the Commission on the Proposed Rule, we believe that a broker-dealer should be allowed to assert compliance with the Financial Responsibility Rules if it can identify deficiencies, implement effective controls, and test their operating effectiveness prior to year-end, and if the auditor also can adequately test the operating effectiveness of the remediated controls. Such a revision would both allow for the opportunity of remediation and align the Commission’s Proposed Rule and the Board’s Proposed Standards with the requirements in Section 404 of the Sarbanes-Oxley Act of 2002 related to an issuer’s report on ICFR.

¹⁴ See PCAOB Release 2011-004, Appendix A, paragraph 26

¹⁵ See PCAOB Release 2011-004, Appendix 2, paragraph 10 (2).

¹⁶ See SEC Release No. 34-64676, *Broker-Dealer Reports*, Section II, B. 1.



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Transition Timelines and Effective Dates

The Proposed Standards have an effective date for fiscal years ending on or after September 15, 2012, which is consistent with the end of the transition period for carrying broker-dealers under the Proposed Rule, but does not coincide with the Proposed Rule's effective date of fiscal years ending on or after December 15, 2011. We believe the PCAOB's proposed effective date is reasonable. In our comment letter on the Proposed Rule, we had expressed concerns to the Commission about its proposed effective date, a summary of which follows.

With the Commission's effective date approximately four months after the end of the comment period for the Proposed Rule (August 26, 2011), we have concerns about the time available for broker-dealers to prepare the additional reports and documentation needed to support their assertions to facilitate an auditor's examination or review, as applicable. Additionally, this schedule would leave minimal time for auditors to review, assess and comply with the new attestation and reporting requirements.

As detailed in our response to the Proposed Rule, we believe that by the end of the comment period, planning and interim procedures for December 31, 2011 audit engagements may have already begun. A change in the rules and procedures at that point in time would require the revision of already-established audit plans thereby creating both inefficiencies and unnecessary costs.

As communicated in our comment letter on the Proposed Rule, we believe a transition to the Commission's final rule could be accomplished more effectively and efficiently if that final rule were to become effective consistent with the Board's proposed effective date of September 15, 2012.

* * * * *

In closing, we would like to reiterate our support of the Board's efforts to redefine the professional standards applicable to broker-dealer audits. We trust that our comments and observations will assist the Board to that end.

If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Karl E. Ruhry, (212) 872-3133, kruhry@kpmg.com.

Very truly yours,

KPMG LLP



Office of the Secretary
Public Company Accounting Oversight Board
September 9, 2011
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cc:

PCAOB

James R. Doty, Chairman
Lewis H. Ferguson, Member
Daniel L. Goelzer, Member
Jay D. Hanson, Member
Steven B. Harris, Member
Martin F. Baumann, Chief Auditor and Director of
Professional Standards

SEC

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James L. Kroeker, Chief Accountant
Brian T. Croteau, Deputy Chief Accountant
Michael A. Macchiaroli, Associate Director



September 12, 2011

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 35

McGladrey & Pullen, LLP appreciates the opportunity to offer our comments on the PCAOB's *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards*. We generally support the PCAOB's proposed standards for attestation engagements related to broker and dealer compliance and exemption reports. However, we ask the Board to consider the following suggestions related to specific aspects of these proposed standards. In addition, with respect to financial statement audits of broker-dealers, we offer one specific comment on the PCAOB's *Proposed Auditing Standard for Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards*.

PCAOB Rulemaking Docket Matter No. 35

Appendix 1 – Proposed Attestation Standard, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*

Overview

In the overview of the proposed attestation standard on examination engagements regarding compliance reports, the Board states that the proposed examination standard provides procedural requirements for auditors that are designed to be scalable based on the broker's or dealer's size and complexity. It would be helpful if the Board would provide additional guidance, including specific examples, regarding the application of scalability to these examination engagements.

Objective

We re-affirm our August 26, 2011 comment letter to the SEC regarding broker-dealer reports. In that letter we stated that the requirement for a broker-dealer to assert whether its internal control over compliance with the Financial Responsibility Rules was effective during the most recent fiscal year (such that there were no instances of material weaknesses) appears to hold broker-dealers to a higher standard than issuers subject to the Sarbanes-Oxley Act requirements related to internal control over financial reporting. We suggest that a broker-dealer's assertion regarding whether its internal control over compliance with the Financial Responsibility Rules was effective be made only as of the end of the fiscal year consistent with existing practice and PCAOB standards for issuers subject to audits of ICFR.

Consideration of Materiality in the Examination Engagement

Paragraph 9 of the proposed attestation standard for examination engagements regarding compliance reports requires the auditor to plan and perform examination procedures to detect instances of non-compliance that, individually or in combination, would result in material non-compliance. It would be helpful if the PCAOB would provide additional guidance related to the determination of material non-compliance, including where possible, specific examples regarding the consideration of qualitative and quantitative factors in the context of each of the Financial Responsibility Rules, and matters within each of the Financial Responsibility Rules that the PCAOB considers to be most significant to compliance.

Appendix A – Examination Report Modifications

Paragraphs A1 and A2 of Appendix A to the proposed attestation standard on examination engagements discuss situations in which reports should be modified. It would be helpful if the proposed standard included specific examples of report modifications.

Appendix 3 – Proposed Amendments to PCAOB Standards – Auditing Standards**Auditing Standard No. 7, “Engagement Quality Review”**

The Board is proposing certain amendments to Auditing Standard No. 7, *Engagement Quality Review*, which would require an engagement quality review and concurring approval of issuance for examination engagements and review engagements of brokers and dealers. This requirement, by definition, would be applicable to both carrying broker-dealers that file a Compliance Report and non-carrying broker-dealers that are exempt from the Compliance Report requirement and file an Exemption Report. Also, the requirement would be applicable to financial statement audits of broker-dealers.

Broker-dealers that meet the identified SEC conditions for the Exemption Report are typically much smaller entities with relatively simple financial reporting and internal control systems. Accordingly, the audit risks are also less. Requiring an engagement quality review for engagements for these non-carrying broker-dealers seems excessively onerous and would present additional costs that may not be commensurate with the related benefits.

We acknowledge there are several broker-dealers that conduct proprietary trading, yet are still able to submit an Exemption Report. We suggest the engagement quality review requirement only apply to entities that (a) are required to submit Compliance Reports, as defined, with the SEC, or (b) conduct proprietary trading. This would use a more risk-based approach for the engagement quality review requirement and would scale the requirement based on the broker or dealer's size and complexity.

Effective Dates

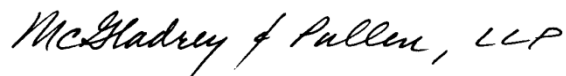
We agree that the proposed attestation standards should be effective for fiscal years ending on or after September 15, 2012, as this will allow sufficient time for brokers and dealers and their auditors to adopt the provisions of the proposed standards.

PCAOB Rulemaking Docket Matter No. 36

Paragraph I.F. of Appendix 3 in the PCAOB's *Proposed Auditing Standard for Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards* states "...if the auditor's report was qualified because of a material departure from GAAP related to a particular account or disclosure, the auditor's report on the supplemental information related to that account also would require qualification." There are several instances where an account or disclosure may be materially misstated or not in compliance with GAAP, yet there may be no effect on the supplemental information. Examples include misstatements to assets that are considered non-allowable for net capital purposes or certain deferred liabilities. Therefore, we suggest that the words "also would require qualification" be changed to "may require qualification."

We would be pleased to respond to any questions the Board or its staff may have about these comments. Please direct any questions to John Hague, National Director of Alternative Investments and Brokerage Groups, at 312-634-3354.

Sincerely,



McGladrey & Pullen, LLP



September 12, 2011

The Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006

Re: Release No. 2011-004: Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards, PCAOB Rulemaking Docket (Matter No. 035)

Ladies and Gentlemen:

This letter represents our response to your request for response on proposed attestation standards and related amendments, dated July 12, 2011.

The proposed standards represent a credible response to isolated, but existing business practices. We agree in principle that the proposed standards represent a practical and effective improvement in applicable auditing standards.

We agree that the existence of material non-compliance, reliance on information outside the books and records to assert compliance, or material weakness in internal control over compliance should result in an adverse opinion on management's assertions. However, the proposal requires direct reporting on the subject matter of management's assertions if those circumstances exist. We believe reporting instead on management's assertions would both clearly communicate existing adverse conditions and emphasize management's responsibility for compliance and the related assertions.

The proposed standard does not clearly describe the procedures necessary to achieve moderate assurance with respect to exemption reports of brokers and dealers. The accounting profession has developed a working knowledge of limited assurance with respect to reviews of private companies' financial statements. The concept of moderate assurance appropriately sets a higher level of assurance for exemption report engagements. However, the standard does not clearly describe the extent of evidence necessary to achieve that level of assurance.

We believe the proposed standards are:

- Tailored appropriately for examinations and reviews related to compliance and exemption reports of brokers and dealers.
- Scalable based on the size and complexity of the broker and dealer.
- With the exceptions described above, sufficiently descriptive of the auditor's responsibilities.
- Generally adequate to enhance protection of customer assets.

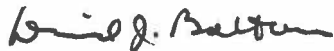
Our specific responses to the questions raised in Appendix 4, Additional Discussion of the Proposed Attestation Standards and Questions for Public are included in the attached schedule.

Please contact me if you have questions with respect to our response.

We appreciate this opportunity to respond to the proposed standard.

Sincerely,

ParenteBeard LLC

A handwritten signature in black ink, appearing to read "David J. Bolton". The signature is fluid and cursive.

David J. Bolton, CPA
Partner, National Quality Office

DJB/mo

Enclosure

**PCAOB Rulemaking Docket (Matter No. 035)
Responses to Questions Raised in Appendix 4**

1. As noted above, the extent of evidence necessary to achieve moderate assurance needs to be clarified. Otherwise the proposed standards are sufficiently clear.
2. No.
3. The practicality of coordination of the examination engagement and the audit of financial statements is adequately described.
4. Yes
5. Yes. A reference to guidance on use of other auditors in the auditing standards would probably be adequate.
6. Yes.
7. Yes.
8. Yes.
9. No.
10. Yes.
11. Yes.
12. No.
13. Yes, absolutely.
14. No.
15. Yes.
16. Separate references in the scope paragraph of the examination report to the PCAOB Standards and the examination process are duplicative. These references should be combined.
17. None.
18. Yes. Reporting examples probably should be included in the standard for adverse reports, with agreement and with non-agreement with management's assertions, and disclaimer of opinion would provide practical guidance.
19. Yes.
20. Yes.
21. No.

22. No.

23. Yes.

24. No.

25. No.

26. As noted above, the standard should include a more precise description of the additional procedures necessary to achieve moderate assurance.

27. Yes.

28. Yes, absolutely.

29. No.

30. Yes

31. None. Report format and content are adequate.

32. No.

33. None.

34. No.

35. Yes.



Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

12 September 2011

RE: PCAOB Rulemaking Docket Matter No. 035, *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards*

Dear Sir:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's (the "Board") *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards* (the "proposed standards").

Overall, we support the proposed standards and believe they will provide a consistent framework for the performance of the work required by the Securities and Exchange Commission's (the "Commission") Broker-Dealer Reports proposal (the "proposed rule"). While supportive, we believe further clarification of the following areas is necessary in finalizing the proposed standards for issuance. In the remainder of our letter, we have organized our observations into the following topical areas:

- The definition and application of material non-compliance
- Interaction of internal control over financial reporting and internal control over compliance
- The proposed effective date
- Use of other auditors

The definition and application of material non-compliance

One of the purposes of the auditors' examination and review procedures outlined by the proposed standards is to detect instances that, individually or in aggregate, would result in material noncompliance with the Financial Responsibility Rules. As discussed in our response to the Commission's proposed rule, we believe that additional guidance is needed in identifying an appropriate framework for evaluating the materiality of such instances, including any quantitative or qualitative measures that may be appropriate, in order to achieve consistent application in the context of each of the Financial Responsibility Rules. In particular, we believe that additional guidance is necessary in the following areas:



- *Elements of the Rule which are not quantitative in nature (e.g., the possession or control requirement under Exchange Act Rule 15c3-3, or the customer statements requirement).* Applying a materiality threshold is more challenging in these areas where "violations" cannot be measured in terms of a relationship to financial statement audit materiality levels. Therefore, a framework involving qualitative considerations must be developed in order to ensure consistent application among broker-dealers, between broker-dealers and their auditors, and among auditing firms.
- *Whether an adjustment that exceeds the financial statement audit materiality levels made to the broker-dealer's regulatory calculations should be considered an instance of material non-compliance, even if no Rule violation resulted from the error.* For example, if a broker-dealer misapplied the guidance related to (i) a calculation under Rule 15c3-1 or (ii) the reserve requirements Rule 15c3-3, resulting in a quantitatively material adjustment to the broker-dealer's net capital or reserve requirement, would these adjustments be considered an instance of material non-compliance even if the broker-dealer's excess net capital or reserve bank account was adequate to cover the revised calculations?

Interaction of internal control over financial reporting and internal control over compliance

As noted in our response to the Commission's proposed rule, broker-dealers will *not* be required to assess the effectiveness of internal control over financial reporting, as issuers are required to do in connection with the requirements of the Sarbanes-Oxley Act of 2002. Instead, the proposed rule would require the Compliance Report to include a statement as to whether the broker-dealer has established and maintained a system of internal control to provide the broker-dealer with reasonable assurance that any instances of material non-compliance with the Financial Responsibility Rules will be prevented or detected on a timely basis. We note that many aspects of the Financial Responsibility Rules (specifically, Rules 15c3-1 and 15c3-3) are derived in part from the financial reporting process. Because of these interactions with the financial reporting process, we believe it would be helpful if the PCAOB could coordinate with the SEC to provide guidance clarifying their expectations with respect to procedures that are considered necessary for the auditor to perform in order to evaluate whether internal control over compliance with the Financial Responsibility Rules is effective.

We also request that the PCAOB coordinate with the SEC to provide further guidance around the evaluation of deficiencies in internal control over compliance when material weaknesses are identified in connection with the financial statement audit pursuant to AU 325, *Communications about Control Deficiencies in an Audit of Financial Statements*; specifically, whether the PCAOB believes that all material weaknesses in internal control over financial reporting identified by the auditor during the financial statement audit should necessarily be considered to be material weaknesses in internal control over compliance with the Financial Responsibility Rules. For example, the auditor may identify a material misstatement in a non-allowable asset during the performance of its financial statement audit and determine that this material misstatement constitutes a material weakness. However, as the asset is not an allowable asset for the purpose of the calculation of net capital under 15c3-1, the resulting adjustment would have no impact on the broker-dealer's net capital or excess net capital under 15c3-1. Would this material weakness in internal control over financial reporting be considered a material weakness in



internal control over compliance with the Financial Responsibility Rules? Conversely, would the SEC and PCAOB expect that all instances of material non-compliance or all material weaknesses in internal control over compliance with the Financial Responsibility Rules be considered by the auditor to be material weaknesses in internal control over financial reporting under AU 325?

The proposed effective date

As noted in our response to the Commission's proposed rule, the effective date of the proposed standards for fiscal years ending on or after September 15, 2012 is inconsistent with the effective date for the Commission's proposed rule for fiscal years ending on or after December 15, 2011. We are concerned that the effective date of the Commission's proposed rule may not be practicable as broker-dealers will need time for effective implementation of the proposed rule, including training, to ensure quality working practices around the identification, evaluation, and remediation of potential instances of non-compliance. In addition, we note that for auditors, engagement planning and interim testing procedures for most December 31, 2011 audit engagements are already underway, and we believe audit firms should be provided additional time to incorporate the changes into their audit methodologies and to complete related training programs prior to the beginning of the year in which the Commission's proposed rule would apply.

We also note that the effective date of the Commission's proposed rule would require the auditor to apply the existing PCAOB standards for audits performed during the transition period, and then adopt the proposed standards for audits performed after the transition period, which would be inefficient and costly for broker-dealers and their auditors. Therefore, we believe that the effective date for the Commission's proposed rule should be delayed to apply to fiscal years ending on or after September 15, 2012, which would align with the effective date of the PCAOB's proposed standards.

Use of other auditors

We note the following question posed by the PCAOB on page A4-15:

"When a broker or dealer has multiple divisions or branches, do situations exist in which the auditor that is engaged to perform the examination engagement uses the work of other auditors? If so, should the proposed examination standard establish requirements that govern the use of the work of other auditors?"

We believe that there will be instances where the auditor may use the work of another auditor; therefore, we believe the proposed standard should include the concept embedded in paragraph 14 of AS 9, *Audit Planning*, that limits this work to selecting locations when using another auditor under AU 543, *Part of Audit Performed by Other Independent Auditors*.



* * * * *

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Brian R. Richson (973-236-5615) or Derrick T. Stiebler (973-236-4904) regarding our submission.

Sincerely,

Brian R. Richson



September 9, 2011

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards

To Whom It May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of Certified Public Accountants in Texas, as well as the public interest. The views expressed herein are written on behalf of the Professional Standards Committee (PSC) of the TSCPA. The PSC has been authorized by the TSCPA Board of Directors to submit comments on matters of interest to the PSC membership. The views expressed in this letter have not been approved by the TSCPA's Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policy of the TSCPA.

In our discussion of the above referenced exposure draft (ED), we considered each of the 35 questions posed by the PCAOB in Appendix 4. Our response to each question is indicated below.

Question 1: Are the general requirements included in the proposed examination standard sufficiently clear?

Yes, the general requirements are clear and understandable.

Question 2: Are there additional general requirements that the Board should include for an examination engagement?

We believe the general requirements are sufficient as stated.

Question 3: In what other way could the Board promote coordination of the examination engagement with the audit of the financial statements and supplemental information?

We believe the best way to promote coordination of the examination engagement with the audit of the financial statements and supplemental information would be to require the auditor of the financial statements to be the one to issue the examination report.

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Question 4: Are the matters that the auditor should take into account in determining the extent of the examination procedures to be performed at selected divisions or branches adequate? Are there other matters that the auditor should take into account?

The matters that the auditor should take into account determining the extent of the examination procedures to be performed at selected divisions or branches are adequate and no other matters appear to be necessary.

Question 5: When a broker or dealer has multiple divisions or branches, do situations exist in which the auditor that is engaged to perform the examination engagement uses the work of other auditors? If so, should the proposed examination standard establish requirements that govern the use of the work of other auditors?

We believe there could be situations in which the auditor engaged to perform the examination may use the work of other auditors. However, in such situations we believe the existing standards related to using the work of other auditors is sufficient and no need exists for establishing additional requirements.

Question 6: Is a risk-based approach to the examination engagement appropriate? What alternative approaches should the Board consider and why?

The risk-based approach appears to be an appropriate approach to use in the examination engagement. However, we can envision the possibility that unique circumstances may call for an alternative approach to the performance of the examination engagement. We believe such situations would be rare and unique. Thus, we suggest that the Board recognize the possibility that such circumstances may arise and allow the auditor to exercise his or her professional judgment in determining the best approach to use in such situations.

Question 7: Are the procedures required by the proposed examination standard to identify and assess risks of material non-compliance sufficiently clear? Are there additional procedures that the Board should require?

The procedures required by the proposed examination standard to identify and assess risks of material non-compliance are sufficiently clear. While there may be the need to apply additional procedures in certain circumstances, we do not believe the Board should expand the list of required procedures. Rather, the Board should acknowledge the possibility that additional procedures may be necessary and should encourage auditors to exercise professional judgment to develop and apply the additional procedures they believe are necessary to assess the risk of material non-compliance.

Question 8: Are the requirements in the proposed examination standard for testing controls over compliance sufficiently clear?

We believe the requirements in the proposed examination standard for testing controls over compliance are sufficiently clear.

Question 9: Are there additional factors that should be considered in assessing the risk associated with a control?

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We believe there is a high probability that individual client situations may arise where additional factors should be considered in assessing the risk associated with a control. However, it would be most difficult, if not impossible, to identify a generic list of such factors. Thus, we suggest that the Board indicate the possibility that unique factors may arise in testing compliance over controls, and when such factors arise, the auditor should give appropriate consideration to these factors in assessing the risk associated with the particular control in question.

Question 10: Are the principles in the proposed examination standard for performing compliance tests sufficiently clear? Should the standard include specific procedures that should always be performed?

We believe the principles in the proposed examination standard for performing compliance tests are sufficiently clear. However, we do not support the development of a list of specific procedures that should always be performed. We strongly encourage allowing auditors to exercise their professional judgment in designing the procedures to be used in performing compliance tests.

Question 11: Are the requirements in the proposed examination standard for evaluating identified instances of non-compliance, instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records, and deficiencies in internal control over compliance, sufficiently clear?

We believe the requirements for all three areas addressed in this question are sufficiently clear.

Question 12: Should the proposed examination standard require additional procedures to identify subsequent events relevant to the auditor's opinion on the assertions made by a broker or dealer in a compliance report?

The requirements in paragraph 33 appear sufficient for their intended purpose. To the extent that additional procedures are applied to identify subsequent events relevant to the auditor's opinion, they should be based on the auditor's judgment. We believe developing a list of generic procedures that may be applicable in some situations is confusing and dysfunctional to the application of the guidance in the resulting standard.

Question 13: Are the representations the auditor is required to obtain from management necessary for the auditor to express an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects?

While we believe there are limitations associated with the competence of management representations, we support the requirement to obtain such representations as a necessary part of the auditor's ability to express an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects.

Question 14: Are there other matters related to the examination that the auditor should communicate to the broker's or dealer's audit committee?

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We believe the requirement to notify the SEC within one day of identifying an event of material non-compliance is somewhat unrealistic. We encourage the Board to consider giving the auditor more time to make the notification. When considering the current literature regarding communications with the SEC, AU 317 requires the auditor to first communicate to those charged with governance. If those parties do not take appropriate remedial action, the Company is subject to a reportable disagreement on Form 8-K. Also, the proposed standard is unclear regarding the form (e.g., Form 8-K) in which the auditor is required to report non-compliance with the Financial Responsibility Rules.

Question 15: Do the required elements of the auditor's examination report clearly communicate the auditor's responsibilities for the examination engagement?

We believe the required elements of the examination report clearly communicate the auditor's responsibilities for the examination engagement.

Question 16: What changes, if any, should be made to the format or content of the report as described in the proposed examination standard? Are there additional auditor representations or other information that should be included in the auditor's report?

The content of the report for the proposed examination standard appears to mirror the audit report presented for companies subject to the requirements under Section 404(b) of the Sarbanes-Oxley Act. The standard audit report as set forth by COSO contains the following limitation paragraph:

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changed conditions, or that the degree of compliance with the policies or procedures may deteriorate.

We recommend the Board consider including a "limitation" paragraph in the standard examination report similar to the paragraph contained in the audit report on internal controls.

Question 17: What changes, if any, should be made to the format or content of the report modifications described in the proposed examination standard?

Regarding modifications of the examination report relating to an adverse opinion in one or more, but not all, assertions, the opinion paragraph should be separated into multiple opinion and explanatory paragraphs. Such an approach would provide users with direct information regarding the broker's or dealer's material non-compliance, material weaknesses in internal control, or material deviation from books and records. This separation will allow users to differentiate between areas of compliance and non-compliance with Financial Responsibility Rules.

Question 18: Should the standard include examples of modified examination reports? If so, what specific examples should be provided?

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Yes, we believe the standard should include examples of modified examination reports. Examples of scope limitations, adverse opinions of one or more assertions, and disclaimers of opinion for one or more assertions should be included. We further recommend examples of explanatory paragraphs for scope limitations and adverse opinions on assertions.

Question 19: Is the concept of non-compliance requiring modifications clear?

We believe the concept of non-compliance is clear.

Question 20: Are the general requirements included in the proposed review standard sufficiently clear?

The general requirements are sufficiently clear.

Question 21: Are there additional general requirements that should be included for a review engagement?

We do not believe that additional general requirements should be included for a review engagement.

Question 22: Are there any other sources of relevant evidence obtained in the audit of the financial statements and supplemental information that the auditor should take into account when planning and performing the review engagement that should be included in the standard?

As written, the standard requires the same level of understanding by the accountant performing the review as that required by the auditor issuing the audit report. Thus, the proposed standard implies that all the information obtained in the audit of the financial statements and supplemental information should already have been taken into account.

Question 23: Are the factors that may increase the nature, timing, and extent of the necessary inquiries and other review procedures appropriate?

We believe these factors are appropriate.

Question 24: Are there other specific review procedures that the proposed review standard should require? If so, should the procedures be based on the various exemption conditions?

We are not aware of any additional specific review procedures that the proposed review standard should require.

Question 25: Are there alternative procedures that are equally or more effective than the procedures required by the proposed review standard that should replace specific procedures required by the proposed review standard?

We have no suggestions for alternative procedures that are equally or more effective than the procedures required by the proposed review standard.

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Question 26: Regardless of the level of assurance obtained in a review, are there other procedures that the auditor should be required to perform to enhance customer protection?

Deciding what procedures would enhance customer protection is a difficult consideration. Customers differ in their desires regarding information and what they believe constitutes comfort and protection in relying on financial statements and an accountant's report. Thus, we believe the procedures indicated in the proposed standard are adequate and the Board should not attempt to expand procedures in an attempt to "enhance customer protection."

Question 27: Are the requirements of the proposed review standard for evaluating identified instances of non-compliance sufficiently clear?

We have no problem with the clarity of the requirements in the proposed review standard.

Question 28: Are the representations the auditor is required to obtain from management necessary for the auditor to conclude whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertion for it to be fairly stated, in all material respects?

We believe the auditor should obtain management representations as a necessary basis for concluding whether there may be any material modifications that should be made to the broker's or dealer's assertions. Whether the required representations constitute an adequate list is impossible to determine. Thus, we would assume that the auditor could request additional representations should he or she consider such additional representations necessary in a particular situation.

Question 29: Are there other matters related to the review that the auditor should communicate to the audit committee?

We have no recommendations for other matters that the auditor should communicate to the audit committee. However, we assume that based on the auditor's judgment, he or she could communicate anything that would be considered necessary to communicate based on the circumstances of the engagement.

Question 30: Do the required elements of the auditor's review report clearly communicate the auditor's responsibilities?

We believe the auditor's responsibilities are clearly communicated by the required elements of the auditor's report.

Question 31: What changes, if any, should be made to the format or content of the review report as described in the proposed review standard? Are there additional auditor representations or other information that should be included in the auditor's review report?

We have no suggestions for any changes to the format or content of the review report as described in the proposed review standard. Also, we have no suggestions for additional auditor representations or other information that should be included in the auditor's review report.

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Question 32: Do other conditions exist that should be included in the standard that would result in a modification of the report on the review engagement?

We do not have suggestions for other considerations that would result in report modifications. However, our lack of specific suggestions does not mean that other conditions that could result in a report modification would never arise. Thus, as we have stated in previous responses, we believe that practitioners should be encouraged to exercise professional judgment in determining whether a condition exists in a particular situation that requires a report modification. When such conditions exist, the practitioner should use his or her judgment in drafting an appropriate modification of the report on the review engagement.

Question 33: Besides alignment with effective dates of the SEC Proposed Rule 17a-5 what other factors, if any, should the Board consider in determining the effective date for adopting final attestation standards?

We suggest that the Board use its discretion in adopting an effective date for attestation standards that allows practitioners a reasonable amount of time to train personnel who will be responsible for implementing the guidance in the proposed standard. Consideration should also be given to the business entities that will be required to also comply with the requirements of the new standard.

Question 34: Are any other proposed amendments to Auditing Standard No. 3 necessary to clearly describe the auditor's responsibilities regarding documentation when conducting attestation engagements related to brokers and dealers in accordance with the standards of the PCAOB?

The proposed amendment sufficiently describes the auditor's responsibilities regarding documentation. No additional amendments appear to be necessary.

Question 35: Are the proposed amendments to Auditing Standard No. 7 clear? Do auditors need more extensive requirements regarding the engagement quality review of these attestation engagements?

We find the proposed amendments to be sufficiently clear and have no suggestions for additional requirements.

We appreciate the opportunity to provide input into the standard-setting process.

Sincerely,



Kathryn W. Kapka, CPA, CIA, CGAP
Chair, Professional Standards Committee
Texas Society of Certified Public Accountants



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STANDARDS FOR ATTESTATION)	
ENGAGEMENTS RELATED TO BROKER AND)	
DEALER COMPLIANCE OR EXEMPTION)	PCAOB Release No. 2013-007
REPORTS REQUIRED BY THE U.S. SECURITIES)	October 10, 2013
AND EXCHANGE COMMISSION)	PCAOB Rulemaking
)	Docket Matter No. 035
AND RELATED AMENDMENTS TO PCAOB)	
STANDARDS)	

Summary: After public comment, the Public Company Accounting Oversight Board ("PCAOB" or the "Board") is adopting two new attestation standards, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, and *Review Engagements Regarding Exemption Reports of Brokers and Dealers*. The Board is also adopting related amendments to certain PCAOB standards. The attestation standards and related amendments will be applicable to all registered firms conducting attestation engagements related to broker and dealer compliance or exemption reports required by the U.S. Securities and Exchange Commission ("SEC" or "Commission").

Board
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I. Introduction

On July 30, 2013, the SEC adopted amendments to Rule 17a-5^{1/} under the Securities Exchange Act of 1934 ("Exchange Act") to strengthen and clarify broker and dealer annual financial reporting requirements and also facilitate the ability of the

^{1/} See Rule 17a-5, 17 C.F.R. § 240.17a-5 ("SEC Rule 17a-5") and SEC Exchange Act Release No. 34-70073, *Broker-Dealer Reports* (July 30, 2013), 78 Federal Register 51910 (August 21, 2013) ("SEC Release"), available at <http://www.sec.gov/rules/final/2013/34-70073.pdf>.



PCAOB to implement the oversight of independent public accountants of brokers^{2/} and dealers^{3/} provided by Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").^{4/}

The Board is adopting two attestation standards, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* (the "examination standard") and *Review Engagements Regarding Exemption Reports of Brokers and Dealers* (the "review standard") (collectively, the "attestation standards"). These attestation standards will apply to examination engagements regarding compliance reports of brokers and dealers ("examination engagements") and review engagements regarding exemption reports of brokers and dealers ("review engagements"), pursuant to requirements contained in SEC Rule 17a-5.^{5/} Pursuant to SEC Rule 17a-5, the audits of brokers and dealers, including the attestation engagements covered by this release, are required to be performed under PCAOB standards.^{6/} Before these amendments to SEC Rule 17a-5, audits of brokers and dealers were required to be performed under generally accepted auditing standards ("GAAS") established by the American Institute of Certified Public Accountants ("AICPA"). The attestation standards will be effective, subject to approval by the SEC, for examination engagements and review engagements for fiscal years ending on or after June 1, 2014. This effective date would coincide with the effective date for the corresponding amendments to SEC Rule 17a-5.

^{2/} According to PCAOB Rule 1001(b)(iii), the term "broker" means a broker (as defined in Section 3(a)(4) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{3/} According to PCAOB Rule 1001(d)(iii), the term "dealer" means a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{4/} Pub. L. No. 111-203, 124 Stat. 1376 (2010).

^{5/} See paragraphs (g)(2)(i) and (ii) of SEC Rule 17a-5.

^{6/} See paragraph (g) of SEC Rule 17a-5.



II. Background

Sections 17(a) and (e) of the Exchange Act and SEC Rule 17a-5 together generally require a broker or dealer to, among other things, file an annual report^{7/} with the SEC and the broker's or dealer's designated examining authority ("DEA").^{8/} SEC Rule 17a-5 requires the annual report to contain, among other things:

- a. A financial report consisting of audited financial statements and supporting schedules;^{9/} and
- b. A compliance report or an exemption report.^{10/}

The requirements for the compliance report and the exemption report are new requirements that are the result of the Commission's amendments to SEC Rule 17a-5. According to the SEC, these reports contain information regarding broker and dealer compliance with key SEC financial responsibility rules^{11/} that enhance the ability of the

^{7/} Paragraph (d) of SEC Rule 17a-5 contains general requirements for annual reports to be filed by SEC-registered brokers and dealers. Paragraphs (d)(1)(iii) and (iv) of SEC Rule 17a-5 provide certain limited exceptions to the requirement to file an annual report.

^{8/} Under SEC Rule 17d-1, 17 C.F.R. § 240.17d-1, a registered broker or dealer that is a member of more than one securities self-regulatory organization may be assigned a "designated examining authority" or "DEA" that is responsible for examining the broker or dealer for compliance with SEC financial responsibility rules. An example of a securities self-regulatory organization that is a designated examining authority is the Financial Industry Regulatory Authority.

^{9/} See paragraph (d)(2) of SEC Rule 17a-5. Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements* (PCAOB Release No. 2013-008) (October 10, 2013), applies to the audit procedures performed and the audit report on supporting schedules.

^{10/} See paragraphs (d)(3) and (4) of SEC Rule 17a-5. The attestation standard in Appendix 1 of this release applies to an examination of certain statements made by the broker or dealer in the compliance report. The attestation standard in Appendix 2 of this release applies to a review of the statements made by the broker or dealer in the exemption report.

^{11/} The SEC Release used the term "financial responsibility rules" to refer to: 17 C.F.R. § 240.15c3-1 ("SEC Rule 15c3-1" or the "net capital rule"); 17 C.F.R. § 240.15c3-3 ("SEC Rule 15c3-3"); 17 C.F.R. § 240.17a-13 ("SEC Rule 17a-13"); and any



SEC to oversee the financial responsibility practices of registered brokers and dealers and, in particular, the safekeeping of customer assets.

Generally, SEC Rule 17a-5 provides that brokers or dealers that did not claim an exemption from SEC Rule 15c3-3 throughout the most recent fiscal year must prepare and file the compliance report. A broker or dealer must prepare and file the exemption report if the broker or dealer did claim that it was exempt from SEC Rule 15c3-3 throughout the most recent fiscal year.

Brokers and dealers also must generally file reports prepared by a PCAOB-registered independent public accountant covering the financial report and the compliance report or exemption report, as applicable.^{12/}

The auditor's examination report or review report would replace the prior requirement in SEC Rule 17a-5 that the auditor report on material inadequacies identified in the broker's or dealer's accounting system, internal accounting controls, procedures of the broker or dealer for safeguarding securities, and certain practices and procedures related to customer protection and securities.

III. Considerations in Adopting the Attestation Standards

The Board is adopting the attestation standards to establish requirements aligned with the auditor's responsibilities under SEC Rule 17a-5.^{13/} Specifically, the attestation standards establish requirements for examining certain statements in a broker's or dealer's compliance report and reviewing a broker's or dealer's statements in an exemption report. The Board is also adopting related amendments to certain PCAOB standards, including amendments regarding documentation and amendments to require engagement quality reviews of the examination and the review engagements.^{14/}

rule of the DEA of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer (an "account statement rule"). See the SEC Release at 8-9. The terms "financial responsibility rules" and "account statement rule" have the same meaning in these standards as they have in the SEC Release.

^{12/} See paragraph (d)(1)(i)(C) of SEC Rule 17a-5.

^{13/} See paragraphs (g) and (h) of SEC Rule 17a-5.

^{14/} In addition, on February 28, 2012, the Board proposed to update certain of its rules to conform to the Dodd-Frank Act amendments to the Sarbanes-Oxley Act of 2002. See *Proposed Amendments to Conform the Board's Rules and Forms to the Dodd-Frank Act and Make Certain Updates and Clarifications*, PCAOB Release No.



The attestation standards for the examination and review engagements, included in appendices 1 and 2 of this release, represent stand-alone standards that are based on existing concepts and principles in the existing attestation standards but are tailored for the specific requirements under SEC Rule 17a-5.^{15/}

In general, both standards set forth a framework of specific procedures that are required for auditors to opine or conclude on a broker's or dealer's statements – referred to in the standards as "assertions"^{16/} – in compliance reports and exemption reports required by SEC Rule 17a-5, respectively.^{17/}

Furthermore, both of the attestation standards emphasize coordination between the examination engagement or review engagement, the audit of the broker's or dealer's financial statements and audit procedures performed on the supporting schedules (referred to in this release as "supplemental information"). This emphasis on coordination, when properly executed, can promote overall audit effectiveness and avoid redundancy in the work performed. For example, auditors can take into account, when appropriate, evidence obtained while planning and performing the audit of the

2012-002 (February 28, 2012). Among other things, these proposed amendments would amend the Board's rules to require that registered firms comply with the Board's interim standards in broker or dealer engagements. See proposed amendments to Rule 1001(a)(v), Rule 1001(a)(vi), Rule 3200T, and Rule 3300T, Rule 3400T, Rule 3500T, and Rule 3600T. The Board expects to act on these proposed amendments in a separate rulemaking in the near future.

^{15/} The requirements in the examination standard are generally consistent with the requirements of AT sec. 101, *Attest Engagements*, and AT sec. 601, *Compliance Attestation*. Similarly, the requirements in the review standard are generally consistent with AT sec. 101. However, when an auditor performs an engagement pursuant to the examination standard or a review pursuant to the review standard, AT sec. 101 and AT sec. 601 would not apply.

^{16/} These standards use the term "assertion" to refer to the broker's or dealer's individual statements that are covered by the examination and review. In the examination standard, the term "assertion" also distinguishes the portion of the statements in the broker's or dealer's compliance report that are covered by the examination.

^{17/} See paragraphs (i)(3)(iii)(A) and (B) of SEC Rule 17a-5 for the specific requirement for an opinion or conclusion to be expressed in the auditor's report.



financial statements and the audit procedures performed on supplemental information in planning and performing the attestation engagement.

This emphasis on coordination is also a key aspect of Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements* (the "auditing standard"),^{18/} which the Board is separately adopting. Auditing Standard No. 17 will apply when the auditor of the financial statements is engaged to perform audit procedures and report on supplemental information accompanying audited financial statements in accordance with PCAOB standards, including supporting schedules prepared pursuant to SEC Rule 17a-5.^{19/} The auditing standard also includes requirements for the procedures on the supplemental information to be planned and performed in conjunction with the audit of the financial statements, and for the audits of brokers and dealers to be coordinated with the attestation engagements related to compliance or exemption reports.^{20/}

In the Board's view, the attestation standards further the public interest and promote investor protection because they are tailored to the corresponding requirements of SEC Rule 17a-5, which are designed to provide safeguards with respect to broker and dealer custody of customer securities and funds. For example, the specific requirements in the examination standard for evaluating Internal Control Over Compliance^{21/} can help auditors to identify deficiencies in a broker's or dealer's internal controls for safeguarding customer securities and funds or maintaining necessary capital or reserves. Similarly, the specific requirements in the review standard should focus auditors on whether the broker or dealer appropriately meets the exemption provisions in paragraph (k) of SEC Rule 15c3-3.

^{18/} See Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*, PCAOB Release No. 2013-008 (October 10, 2013).

^{19/} See paragraph (d)(2) of SEC Rule 17a-5.

^{20/} See the note to paragraph 3.c. of Auditing Standard No. 17.

^{21/} Consistent with SEC Rule 17a-5, the examination standard defines "Internal Control Over Compliance" as "internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with the [financial responsibility rules], will be prevented or detected on a timely basis." See paragraph (d)(3)(ii) of SEC Rule 17a-5.



Also, the SEC Release states that SEC enforcement actions alleging fraudulent conduct by brokers and dealers highlight the need for enhancements to the rules governing broker and dealer custody of customer assets, including increased focus on compliance and internal compliance controls by brokers and dealers and their auditors.^{22/} The attestation standards include requirements related to the auditor's consideration of fraud risks, including the risk of misappropriation of customer assets. The new standard includes requirements for testing controls of the broker or dealer for safeguarding customer assets and funds and for performing procedures to obtain evidence about the existence of customer funds and securities held for customers.

Furthermore, PCAOB inspections staff in their inspections of broker and dealer audits have identified auditing deficiencies in 57 of 60 audits that were conducted under GAAS and the prior SEC Rule 17a-5.^{23/} The attestation standards – tailored for the new audit and reporting requirements under SEC Rule 17a-5 – establish an approach specific to examining compliance reports and reviewing exemption reports that should provide greater clarity as to the procedures that should be used and facilitate consistent compliance for auditors of SEC registered brokers and dealers.

The financial responsibility rules serve an important investor protection function by requiring brokers and dealers to maintain minimum levels of net capital and take steps to safeguard customer securities and cash.^{24/} As described in the SEC Release, the new requirements for engagement of accountants should result in higher levels of compliance with the financial responsibility rules by increasing the focus of carrying brokers and dealers and their independent public accountants on specific statements made in compliance reports and increasing the focus of non-carrying brokers and dealers and their independent public accountants regarding whether the broker or dealer meets applicable exemption provisions.^{25/} Moreover, in the Board's view, the involvement of auditors, under the attestation standards and PCAOB oversight, should enhance the quality of the compliance information provided to the SEC and used in its regulatory oversight, which is important to the protection of investors who entrust their cash and securities with brokers and dealers.

^{22/} See the SEC Release at 206-207.

^{23/} See *Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers*, PCAOB Release No. 2013-006 (August 19, 2013) at 6.

^{24/} See the SEC Release at 255.

^{25/} See the SEC Release at 238.



A. Consideration of Comments Received

In developing the attestation standards, the Board also considered comments received. On July 12, 2011, the Board proposed two attestation standards, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* ("proposed examination standard"), and *Review Engagements Regarding Exemption Reports of Brokers and Dealers* ("proposed review standard") (collectively, the "proposed attestation standards") and related amendments to PCAOB standards. The proposed attestation standards were developed to align the standards of the PCAOB with the SEC's 2011 proposed amendments to SEC Rule 17a-5 ("SEC Proposed Rule 17a-5"),^{26/} which included requirements for brokers and dealers to engage auditors to perform either a compliance examination engagement or review engagement, whichever would be required pursuant to the SEC's proposed amendments.

The Board received eleven comment letters on the proposed attestation standards. Commenters generally were supportive of the Board's efforts to draft attestation standards applicable to brokers and dealers and the Board's efforts to align the attestation standards with the Commission's proposed amendments to SEC Rule 17a-5. Commenters provided observations and comments on certain requirements and other specific aspects of the attestation standards and related amendments to PCAOB standards. Many of the significant comments, which dealt with the meaning of the term "material non-compliance" in the context of the auditor's examination of the broker's or dealer's assertions in the compliance report, are no longer applicable because of subsequent changes made by the SEC in its adoption of final amendments to SEC Rule 17a-5. The Board did, however, revise the attestation standards in response to certain of the comments received. Also, the Board made revisions to the standards in view of the final requirements contained in the SEC's amendments. Such changes are intended to align the Board's attestation standards with the SEC's requirements. Section IV below summarizes the key points and changes made to the attestation standards. Appendix 4 discusses the significant comments received on the proposed attestation standards in greater detail, as well as the revisions to the attestation standards.

^{26/} See SEC Exchange Act Release No. 34-64676, *Broker-Dealer Reports* (June 15, 2011), 76 Federal Register 37572 (June 27, 2011).

IV. Overview of the Attestation Standards

A. *Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers*

The examination standard, which is presented in Appendix 1, establishes requirements for the auditor with respect to the auditor's examination regarding a broker's or dealer's compliance report. Consistent with SEC Rule 17a-5, the examination standard requires auditors to obtain sufficient appropriate evidence to opine on a broker's or dealer's statements in its compliance report as to whether:

- The Internal Control Over Compliance of the broker or dealer was effective during the most recent fiscal year;
- The Internal Control Over Compliance of the broker or dealer was effective as of the end of the most recent fiscal year;
- The broker or dealer was in compliance with the net capital rule and 17 C.F.R. § 240.15c3-3(e) (the "reserve requirements rule") as of the end of the most recent fiscal year; and
- The information the broker or dealer used to state whether it was in compliance with the net capital rule and reserve requirements rule was derived from the books and records of the broker or dealer.^{27/}

The examination standard provides requirements for auditors that:

- Focus the auditor on the matters that are most important to the auditor's conclusions regarding the broker's or dealer's assertions;
- Incorporate consideration of fraud risks, including the risk of misappropriation of customer assets;
- Are designed to be scalable based on the broker's or dealer's size and complexity;

^{27/} See paragraphs (d)(3)(i)(A)(2),(3),(4), and (5), (g)(2)(i), and (i)(3)(iii)(A) of SEC Rule 17a-5. The scope of the auditor's examination does not encompass the statement as to whether the broker or dealer has established and maintained Internal Control Over Compliance required by paragraph (d)(3)(i)(A)(1) of SEC Rule 17a-5.



- Coordinate the examination engagement with the audit of the financial statements and the audit procedures performed on supplemental information; and
- Describe how to report on an examination engagement, in connection with the requirements of SEC Rule 17a-5.

The examination standard retains the requirement that the auditor obtain reasonable assurance to support the auditor's opinion. In particular, the examination standard requires the auditor to obtain reasonable assurance in order to opine on whether the broker's or dealer's assertions are fairly stated, in all material respects. This replaces the requirement to obtain reasonable assurance in prior SEC Rule 17a-5, which stated that "[t]he scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in (a) the accounting system; (b) the internal accounting controls; (c) procedures for safeguarding securities; and (d) the practices and procedures whose review is specified [in SEC Rule 17a-5] would be disclosed."^{28/}

The examination standard reflects changes from the proposed standard to align with SEC Rule 17a-5 and in light of comments received. Significant revisions include the following:

- The auditor's reporting requirements were revised to align with the statements of the broker or dealer pursuant to SEC Rule 17a-5;

^{28/} Prior to the amendments, SEC Rule 17a-5 provided that "[a]dditionally, as specific objectives, the audit shall include reviews of the practices and procedures followed by the client: (i) In making the periodic computations of aggregate indebtedness and net capital under 17 C.F.R. § 240.17a-3(a)(11) and the reserve required by 17 C.F.R. § 240.15c3-3(e); (ii) In making the quarterly securities examinations, counts, verifications and comparisons and the recordation of differences required by 17 C.F.R. § 240.17a-13; (iii) In complying with the requirement for prompt payment for securities of section 4(c) of Regulation T (§ 220.4(c) of chapter II of title 12) of the Board of Governors of the Federal Reserve System; and (iv) In obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by 17 C.F.R. § 240.15c3-3. Such review shall include a determination as to the adequacy of the procedures described in the records required to be maintained pursuant to 17 C.F.R. § 240.15c3-3(d)(4)."

- The requirements for auditor testing of controls over compliance were revised to cover internal controls over compliance both as of the end of the fiscal year and during the fiscal year, as provided by SEC Rule 17a-5; and
- The requirements for auditors to test for compliance were revised in view of the changes to SEC Rule 17a-5 to focus specifically on testing compliance with the net capital rule and reserve requirements rule.

Appendix 4 discusses further the revisions reflected in the examination standard.

B. Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers

The review standard, which is presented in Appendix 2, establishes requirements for the auditor with respect to the auditor's review regarding the broker's or dealer's exemption report. Consistent with SEC Rule 17a-5, the review standard establishes requirements that apply when an auditor is engaged to perform a review of the broker's or dealer's statements in an exemption report.^{29/}

Like the examination standard, the review standard establishes requirements that are designed specifically for the review required by SEC Rule 17a-5.^{30/} The review standard establishes requirements for making inquiries and performing other procedures that are commensurate with the auditor's responsibility to obtain moderate assurance^{31/} regarding whether one or more conditions exist that would cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects. The broker's or dealer's exemption report includes the following assertions:

- A statement that identifies the provisions in paragraph (k) of SEC Rule 15c3-3 (the "exemption provisions") under which the broker or dealer

^{29/} See paragraphs (d)(4) and (g)(2)(ii) of SEC Rule 17a-5.

^{30/} Id.

^{31/} Obtaining moderate assurance in a review engagement is consistent with both existing PCAOB standards and the SEC Release. AT sec. 101.55 describes a review as an attest engagement designed to provide a moderate level of assurance. See the SEC Release at 88, which states that a "moderate level of assurance [is] contemplated by the required review."



claimed an exemption from SEC Rule 15c3-3 (the "identified exemption provisions");

- A statement that the broker or dealer (1) met the identified exemption provisions throughout the most recent fiscal year without exception or (2) met the identified exemption provisions throughout the most recent fiscal year except as described in the exemption report; and
- If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions (an "exception") and that briefly describes the nature of each exception and the approximate date(s) on which the exceptions existed.^{32/}

The auditor's review report regarding a broker's or dealer's exemption report replaces the statement provided by auditors under the prior SEC rules. Before the amendments, SEC Rule 17a-5 provided that the auditor engaged by the broker or dealer must "ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the independent public accountant's attention to indicate that the exemption had not been complied with during the period since the independent public accountant's last examination."

The procedures required by the review standard include evaluating relevant evidence obtained from the audit of the financial statements and the audit procedures performed on supplemental information and are designed to enable the auditor to scale the review engagement based on the broker's or dealer's size and complexity. The review standard also establishes requirements for the content of the review report.

The review standard reflects changes from the proposed standard to align the standard with SEC Rule 17a-5 and in light of comments received. Significant revisions include the following:

- The requirements of the standard were revised to include consideration of disclosure of exceptions to the exemption provisions, as provided by SEC Rule 17a-5; and
- The auditor's reporting requirements were revised to align with the statements of the broker or dealer pursuant to SEC Rule 17a-5.

^{32/} See paragraph (d)(4) of SEC Rule 17a-5.



V. Economic Considerations, including Audits of Emerging Growth Companies

A. Economic Considerations

This release, and the related appendices, provide additional detail regarding the background and need for the new attestation standards; significant comments received; and alternatives considered. As discussed below, the Board also considered the economic consequences of the new standards.^{33/}

As noted above, in developing the attestation standards, the Board's objective was to consider the SEC's amendments to SEC Rule 17a-5 and evaluate whether its standards were appropriate for the SEC's requirements for examinations of compliance reports and reviews of exemption reports.

As part of its process, the Board also considered the SEC's economic analysis related to its amendments to SEC Rule 17a-5. The SEC's analysis considers the economic effects, including the benefits and costs, of the new examinations of compliance reports and reviews of exemption reports that are now required by the SEC to be filed by registered brokers and dealers pursuant to SEC Rule 17a-5 and includes considerations relating to efficiency, competition, and capital formation.^{34/}

The SEC's economic analysis considered the Board's proposed attestation standards. As described in the SEC Release, after considering the views of commenters relating to anticipated costs, including with respect to the Board's proposed attestation standards, the SEC concluded that, while the total costs associated with the new compliance and review requirements would depend on the final PCAOB standards for attestation engagements, "as the PCAOB's proposed standards were tailored to the proposed amendments, nothing in those standards causes the Commission to change its estimates of the costs associated with these requirements, or to question that the

^{33/} The Board did not specifically request comments that attempted to quantify costs related to the attestation standards, but the Board did request comment on the appropriateness of the standards and received comments that pertained to audit effort and related costs that it considered. The discussion in this section reflects the Board's qualitative assessment of the standards.

^{34/} See the SEC Release, which discusses costs and benefits of the requirements for examined compliance reports and reviewed exemption reports at 226-245.



benefits will justify the costs."^{35/} The Board notes that, as adopted, the new attestation standards are aligned with SEC Rule 17a-5, and most of the differences between the proposed standards and the attestation standards in this release result from changes to conform to the SEC's final amendments to SEC Rule 17a-5.

In addition to considering the SEC's requirements and economic analysis, the Board also took into account other related economic considerations as discussed below.

1. *Economic Baseline*

The SEC made the determination to require brokers and dealers to include in their annual reports either a compliance report that is examined by an auditor or an exemption report that is reviewed by an auditor.

Therefore, the SEC Release contains a discussion of the economic baseline in its economic analysis. Aspects of the SEC's discussion of the baseline that are relevant to the attestation standards include:

- Before the SEC's amendments, Rule 17a-5 required that the audit under GAAS include a "review" of the broker's or dealer's accounting system, internal accounting control, and procedures for safeguarding securities.^{36/} The scope of the auditor's work was required to be sufficient to provide reasonable assurance that any material inadequacies^{37/} existing as of the date of the examination would be disclosed.

^{35/} See the SEC Release at 241.

^{36/} See the SEC Release at 70.

^{37/} Prior to the SEC's amendments, paragraph (g)(3) of Rule 17a-5 described a "material inadequacy" in a broker's or dealer's accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures to include "any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to: (i) inhibit a broker-dealer from promptly completing securities transactions or promptly discharging its responsibilities to customers, other broker-dealers or creditors; (ii) result in material financial loss; (iii) result in material misstatements of the broker-dealer's financial statements; or (iv) result in violations of the Commission's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in [(i) through (iii)] above." See the SEC Release at 70, footnote 287.

- Before the SEC's amendments, if the broker or dealer was exempt from the reserve requirements rule, the auditor was required to ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the auditor's attention to indicate that the exemption had not been complied with during the period since the last examination.

Under the SEC's amendments, audits of brokers and dealers are now required to be conducted in accordance with PCAOB standards, the material inadequacy report has been replaced with an examination of the compliance report, and the requirement to ascertain compliance with the exemption conditions has been replaced with a review of the exemption report.

2. *Consideration of Alternatives and Additional Considerations*

In general, the Board sought to evaluate whether its attestation standards were appropriate for performing and reporting on the newly required examinations and reviews. The SEC is a key user of the new reports, which serve to facilitate the SEC's compliance oversight function. Accordingly, the Board's standards for those engagements needed to reflect a compliance focus and needed to be aligned with the requirements in SEC Rule 17a-5.

The Board considered two principal alternatives: (1) issuing guidance on applying existing PCAOB attestation standards to the new examination and review engagements, or (2) developing standards tailored to the requirements of SEC Rule 17a-5. In considering the first alternative, the Board observed that auditors performing examinations of compliance reports would need to look to a patchwork of requirements in existing attestation standards, including AT sec. 101 and AT sec. 601, and apply them to the new examination of the compliance report and review of the exemption report. This could lead to more inconsistencies in compliance with the SEC's rule as compared to a tailored standard that sets forth the necessary procedures for complying with the SEC's rule.

The Board preliminarily determined that a broker and dealer specific approach to examining compliance reports and reviewing exemption reports that is tailored to the SEC's rule would promote consistent audit practices and compliance with the SEC's rule because auditors could more readily determine the procedures necessary to meet the requirements for reasonable assurance in the examination and moderate assurance in the review. The greater clarity also can help facilitate more efficient use of audit resources, which can help mitigate the associated costs. Since the Board's initial proposal, the high level of auditing deficiencies observed by PCAOB inspections of audits of brokers and dealers under pre-existing standards have underscored the



Board's initial concerns about the need for standards that facilitate more consistent compliance with the SEC's rule.^{38/}

In developing the new standards, the Board took into account economic considerations, including taking note of commenters' views on the proposed attestation standards. The Board's approach is intended to focus and streamline the auditor's work in order to promote overall audit effectiveness and avoid duplicative procedures. The Board sought to ease the transition to the new standards and help lessen the effect of associated costs by:

- Building on principles and concepts in existing attestation standards, such as the general requirements in AT sec. 101, and the risk-based principles for testing controls as set forth in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*,
- Focusing the auditor's attention on the most important matters related to the objective of the examination or review, as applicable, including addressing the risk of misappropriation of customer assets;
- Requiring coordination of the attestation standards with the audit of the financial statements and audit procedures on the supplemental information, to enhance the effectiveness of the coordinated work and avoid unnecessary duplication of work;^{39/} and

^{38/} See PCAOB Release 2013-006, which reports that PCAOB inspection staff identified auditing deficiencies in 57 of the 60 audits of brokers and dealers selected for inspection and that deficiencies in compliance with audit requirements for brokers and dealers under the Exchange Act that were among the most frequently noted by PCAOB inspection staff included deficiencies in audit procedures related to net capital and customer reserve supporting schedules, compliance with the conditions of the exemption claimed by the broker or dealer, and the accountant's supplemental report on material inadequacies. See PCAOB Release 2013-006, Executive Summary, at ii.

^{39/} By its terms, SEC Rule 17a-5 requires the financial statement audit and the compliance examination or review to be performed by the same auditor. See paragraph (g) of SEC Rule 17a-5.



- Establishing risk-based approaches for the examination and review that are scalable – that is, the required audit effort is commensurate with the broker's or dealer's size and complexity^{40/} – and that facilitate consistent compliance with SEC Rule 17a-5.

The Board also considered commenters' views. Commenters on the Board's proposed attestation standards generally agreed that the proposed standards were appropriately tailored for the SEC's proposed amendments to Rule 17a-5. Notably, when the attestation standards were proposed, the PCAOB requested comment on whether the standards were appropriately scalable based on the size and complexity of the broker or dealer. Some commenters specifically agreed that the standards are scalable, and no commenters asserted that the standards are not scalable. Additionally, several comments on the proposed standards were no longer relevant because of changes the SEC made when it adopted the amendments.

Some commenters on the proposed standards expressed concerns about costs associated with extending the requirements for engagement quality reviews to encompass the attestation engagements covered by these standards. In light of the importance of the attestation engagements to investor protection and the high level of deficiencies observed by PCAOB inspection staff in areas that would be covered by the attestation engagements, the Board believes that engagement quality reviews can enhance the consistency of compliance with the SEC's rule. An effective engagement quality review can increase the likelihood of identifying significant engagement deficiencies before the examination report or review report is issued. Additionally, the Board took note of the fact that, in a February 2011 AICPA Peer Review Alert, the AICPA designated audits of carrying brokers or dealers as a "must select" for peer review, recognizing the significant public interest in audits of such firms.^{41/}

^{40/} This view is also analogous to the SEC's view for preparation of the compliance report discussed in the SEC Release. In the SEC Release, the SEC observed that the controls necessary for a carrying broker or dealer that engages in limited custodial activities generally should be less complex than the controls necessary for a carrying broker or dealer that engages in more extensive custodial activities, so a carrying broker or dealer with limited custodial activities should have to expend less effort to make the statements in the compliance report regarding Internal Control Over Compliance. See the SEC Release at 229. Similarly, the necessary audit effort related to test controls should be less for brokers and dealers with limited custodial activities.

^{41/} See AICPA Peer Review Alert 11-01 (February 2011).



Regarding the incremental costs of engagement quality reviews, because engagement quality reviews are required for audits of financial statements under PCAOB standards, the requirements for auditors to coordinate their audits of the financial statements and attestation engagements should facilitate the engagement quality review of the attestation engagement and help mitigate incremental costs. Furthermore, the Board anticipates that incremental costs for an engagement quality review of an attest engagement will vary with the nature of the attest engagement. For example, the required effort for an engagement quality review of a review engagement generally would be less than for an examination engagement, and the required effort for an examination of a smaller, less complex broker or dealer generally would be less than for a larger, more complex broker or dealer.

B. Applicability to Audits of Emerging Growth Companies

The Board is adopting the attestation standards pursuant to its authority under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act").^{42/}

Before rules adopted by the Board can take effect, they must be approved by the SEC. Pursuant to Section 107(b)(3) of Sarbanes-Oxley, the SEC shall approve a proposed rule if it finds that the rule is "consistent with the requirements of [the] Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors."

Additionally, Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act")^{43/} amended Sarbanes-Oxley to provide that any additional rules adopted by the PCAOB after April 5, 2012 do not apply to audits of emerging growth companies ("EGCs")^{44/} unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the

^{42/} Pub. L. 107-204, 116 Stat. 745 (2002). Under Section 101 of the Act, the mission of the PCAOB is to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Section 103 of the Act authorizes the Board to adopt auditing standards for use by registered public accounting firms in the preparation and issuance of audit reports "as required by [the] Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors."

^{43/} Pub. L. No. 112-106, 126 Stat. 306 (2012).

^{44/} Section 3(a)(80) of the Exchange Act defines the term "emerging growth company."



protection of investors, and whether the action will promote efficiency, competition, and capital formation".^{45/}

As previously discussed, the attestation standards will apply solely in connection with audits of registered brokers and dealers pursuant to SEC Rule 17a-5. PCAOB staff has discussed the applicability of the JOBS Act to this rulemaking with the SEC staff. The PCAOB is not aware of any EGCs that are also registered brokers or dealers.^{46/} Moreover, the reporting regimes for registered brokers and dealers under SEC Rule 17a-5 are separate and distinct from those for companies subject to reporting requirements pursuant to Section 13 and 15 of the Exchange Act or for a Securities Act registration statement. The Board defers to the SEC on the applicability of the JOBS Act to this rulemaking and stands ready to assist the SEC with any additional analysis that may become necessary.

VI. Effective Date

The attestation standards will be effective, subject to approval by the SEC, for examination engagements and review engagements for fiscal years ending on or after June 1, 2014. This effective date coincides with the effective date for the corresponding amendments to SEC Rule 17a-5.^{47/}

* * *

^{45/} See Section 103(a)(3)(C) of Sarbanes-Oxley (15 U.S.C. §7213(a)(3)), as amended by Section 104 of the JOBS Act, Pub. L. No. 112-106 (2012).

^{46/} PCAOB staff has reviewed the reported industry classifications in the most recent filings of those companies and read SEC filings of self-identified EGCs as necessary to ascertain whether any EGCs were brokers or dealers. For those companies for which audited financial statements were available and based on information included in the most recent audited financial statements filed as of May 15, 2013, PCAOB staff has observed that none of the EGCs is a broker or dealer.

^{47/} See the SEC Release at 2.



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On the 10th day of October, in the year 2013, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

October 10, 2013

APPENDIX 1 – Attestation Standard No. 1 – *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*

APPENDIX 2 – Attestation Standard No. 2 – *Review Engagements Regarding Exemption Reports of Brokers and Dealers*

APPENDIX 3 – Amendments to PCAOB Standards

APPENDIX 4 – Additional Discussion of the Attestation Standards



APPENDIX 1

Attestation Standard No. 1

Examination Engagements Regarding Compliance Reports of Brokers and Dealers

Introduction

1. This standard establishes requirements that apply when an auditor is engaged to perform an examination^{1/} of certain statements made by a broker^{2/} or dealer^{3/} in a compliance report ("compliance report") prepared pursuant to Securities and Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 C.F.R. § 240.17a-5 ("SEC Rule 17a-5") of the U.S. Securities and Exchange Commission ("SEC").^{4/}

2. SEC Rule 17a-5 requires a broker's or dealer's compliance report to include the following statements (hereinafter referred to as "assertions") by the broker or dealer as to whether:^{5/}

^{1/} See paragraphs (d)(1)(i)(C) and (g)(2)(i) of SEC Rule 17a-5, which require that certain brokers or dealers file with the SEC a report prepared by an independent accountant based on an examination of the compliance report, if the broker or dealer is required to file a compliance report with the SEC.

^{2/} According to PCAOB Rule 1001(b)(iii), the term "broker" means a broker (as defined in Section 3(a)(4) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{3/} According to PCAOB Rule 1001(d)(iii), the term "dealer" means a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{4/} See paragraph (g)(2)(i) of SEC Rule 17a-5.

^{5/} The scope of the auditor's examination does not encompass the statement required by paragraph (d)(3)(i)(A)(1) of SEC Rule 17a-5, which is a statement as to



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- a. The **Internal Control Over Compliance**^{6/} of the broker or dealer was effective during the most recent fiscal year;
- b. The Internal Control Over Compliance of the broker or dealer was effective as of the end of the most recent fiscal year;^{7/}
- c. The broker or dealer was in compliance with 17 C.F.R. §§ 240.15c3-1 (the "net capital rule") and 240.15c3-3(e) (the "reserve requirements rule") as of the end of the most recent fiscal year; and
- d. The information the broker or dealer used to state whether it was in compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer.

Objective

3. When performing an examination of the assertions made by a broker or dealer in a compliance report (an "examination engagement"), the auditor's objective is to express an opinion regarding whether the assertions made by the broker or dealer in its compliance report are fairly stated, in all material respects.

4. To express an opinion on the assertions made by a broker or dealer in a compliance report, the auditor must plan and perform the examination engagement to

whether the broker or dealer has established and maintained Internal Control Over Compliance as that term is defined in paragraph (d)(3)(ii) of SEC Rule 17a-5. See paragraphs (d)(3) and (g)(2)(i) of SEC Rule 17a-5.

^{6/} Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear. The definitions of the terms in Appendix A are consistent with paragraphs (d)(3)(ii) and (iii) of SEC Rule 17a-5.

^{7/} See paragraph (d)(3)(iii) of SEC Rule 17a-5, which provides that "a broker or dealer is not permitted to conclude that its Internal Control Over Compliance was effective during the most recent fiscal year if there were one or more material weaknesses in its Internal Control Over Compliance during the most recent fiscal year. The broker or dealer is not permitted to conclude that its Internal Control Over Compliance was effective as of the end of the most recent fiscal year if there were one or more material weaknesses in its Internal Control Over Compliance as of the end of the most recent fiscal year."



obtain appropriate evidence that is sufficient^{8/} to obtain reasonable assurance^{9/} about whether (1) one or more **Material Weaknesses** existed during the most recent fiscal year specified in the broker's or dealer's assertion; (2) one or more Material Weaknesses existed as of the end of the most recent fiscal year specified in the broker's or dealer's assertion; and (3) one or more instances of non-compliance with the net capital rule or the reserve requirements rule existed as of the end of the most recent fiscal year specified in the broker's or dealer's assertion.

Note: Because the broker's or dealer's assertions include assertions regarding Internal Control Over Compliance and its compliance with both the net capital rule and the reserve requirements rule, the auditor's examination should evaluate (a) the effectiveness of Internal Control Over Compliance with each financial responsibility rule^{10/} during, and as of the end of, the most recent fiscal year, and (b) compliance with the net capital rule and with the reserve requirements rule as of the end of the most recent fiscal year.

Note: The auditor is not required to express an opinion on the process the broker or dealer used to arrive at the conclusions stated in the broker's or dealer's assertions.

5. The auditor also must plan and perform the examination engagement to obtain appropriate evidence that is sufficient to obtain reasonable assurance to support the auditor's opinion regarding whether the assertion by the broker or dealer that the information used to assert compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer, is fairly stated, in all material respects.

^{8/} See the description of "sufficiency" and "appropriateness" in Auditing Standard No. 15, *Audit Evidence*.

^{9/} Although not absolute assurance, reasonable assurance is a high level of assurance.

^{10/} The term "financial responsibility rules" refers to: 17 C.F.R. § 240.15c3-1 ("SEC Rule 15c3-1" or the "net capital rule"); 17 C.F.R. § 240.15c3-3 ("SEC Rule 15c3-3"); 17 C.F.R. § 240.17a-13 ("SEC Rule 17a-13"); and any rule of the designated examining authority ("DEA") of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer. The financial responsibility rules are the same as the rules cited in paragraph (d)(3)(ii) of SEC Rule 17a-5.



Performing the Examination Engagement

General Requirements

6. An auditor who performs an examination engagement pursuant to this standard must:
- a. Have adequate technical proficiency in attestation engagements;
 - b. Obtain an understanding of the financial responsibility rules and other rules and regulations that are relevant to the broker's or dealer's assertions;
 - c. Determine the auditor's compliance with independence and ethics requirements; and
 - d. Exercise due professional care, which includes application of professional skepticism, in planning and performing the examination and the preparation of the report.

Note: Due professional care imposes a responsibility on each engagement team member to comply with this standard. The exercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including preparing the report.^{11/}

Note: Auditing Standard No. 3, *Audit Documentation*, establishes the documentation requirements for examination engagements performed pursuant to this standard.

7. The engagement partner is responsible for the examination engagement and performance of the examination procedures. Accordingly, the engagement partner is responsible for proper planning of the examination engagement, proper supervision of the work of engagement team members, and compliance with the requirements of this standard. The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

^{11/} The auditor's responsibility to exercise due professional care is consistent with the description in paragraphs .40-.41 of AT sec. 101, *Attest Engagements*.



Note: For purposes of this standard, the term "engagement partner" means the member of the engagement team with primary responsibility for the examination engagement.

Note: Proper planning includes establishing an overall strategy for the examination engagement and developing a plan for the engagement, which includes, in particular, the nature, timing, and extent of procedures necessary to obtain reasonable assurance. Proper supervision includes supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Relationship Between the Examination Engagement and the Audit of the Financial Statements and the Audit Procedures Performed on Supplemental Information

8. The examination engagement should be coordinated with the audit of the financial statements and the audit procedures performed on supplemental information of the broker or dealer.^{12/} In planning and performing procedures for, and evaluating the results of the procedures performed in, the examination engagement, the auditor should take into account relevant evidence from the audit of the financial statements and the audit procedures performed on the supplemental information. However, the objectives of the financial statement audit and the examination engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.

Planning the Examination Engagement

9. The auditor should plan the examination engagement to perform procedures that are sufficient to provide a reasonable basis for determining whether the broker's or dealer's assertions are fairly stated, in all material respects. In planning the examination engagement, the auditor should:

^{12/} Under the definition of supplemental information included in Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*, supplemental information includes the supporting schedules described in paragraph (d)(2) of SEC Rule 17a-5, which are required to be filed with the SEC, DEA, and the Securities Investor Protection Corporation ("SIPC") by brokers and dealers. Such supporting schedules include a Computation of Net Capital Under SEC Rule 15c3-1, a Computation for Determination of the Reserve Requirements under Exhibit A of SEC Rule 15c3-3, and Information Relating to Possession or Control Requirements Under SEC Rule 15c3-3.



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- a. Evaluate the nature of instances of non-compliance with the financial responsibility rules and **Deficiencies in Internal Control Over Compliance** identified during previous examination engagements;
- b. Obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the financial responsibility rules^{13/};

Note: The nature, timing, and extent of procedures that are necessary to obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the financial responsibility rules depend on the size and complexity of the broker or dealer; the auditor's existing knowledge of the broker's or dealer's processes and controls; the degree to which the broker's or dealer's compliance depends on the completeness and accuracy of the broker's or dealer's internally-generated data; the nature and extent of changes in systems and operations, if any; and the nature of the broker's or dealer's documentation of its processes and controls.

Note: Obtaining an understanding of the broker's or dealer's processes, including relevant controls, includes evaluating the design of controls that are relevant to the examination and determining whether the controls have been implemented.

- c. Obtain an understanding of instances of non-compliance with the financial responsibility rules and Deficiencies in Internal Control Over Compliance identified by management during the most recent fiscal year;
- d. Assess the risks associated with related parties,^{14/} including related parties that are investment advisors or entities with which the broker or dealer has

^{13/} Appendix B of this standard discusses considerations for brokers and dealers with multiple divisions or branches.

^{14/} The auditor should look to the definition in the applicable financial reporting framework with respect to the term "related parties."



- a custodial or clearing relationship, that are relevant to compliance and controls over compliance;
- e. Obtain an understanding of management's competence regarding the relevant rules and regulations;
 - f. Read the Financial and Operational Combined Uniform Single Reports ("FOCUS Reports")^{15/} filed by the broker or dealer and obtain an understanding of the reasons for resubmissions, if any;
 - g. Read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's assertions;
 - h. Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to the broker's or dealer's assertions;
 - i. Read correspondence and notifications regarding non-compliance that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA that are relevant to the broker's or dealer's assertions, and, when necessary in the circumstances, make inquiries of the regulatory agencies; and
 - j. Obtain an understanding of the nature and frequency of customer complaints that are relevant to compliance with the financial responsibility rules.
10. In addition, in planning the examination engagement, the auditor should assess the risk of fraud, including the risk of misappropriation of customer assets, relevant to compliance with the net capital rule and the reserve requirements rule and the effectiveness of the broker's or dealer's Internal Control Over Compliance.

^{15/} The FOCUS Reports are: Form X-17A-5 Schedule I; Form X-17A-5 Part II; Form X-17A-5 Part IIa; Form X-17A-5 Part IIb; and Form X-17A-5 Part III.



Testing Controls over Compliance

11. The auditor must test those controls that are important to the auditor's conclusion about whether the broker or dealer maintained effective Internal Control Over Compliance for each financial responsibility rule during the fiscal year and as of the end of the fiscal year. The auditor must obtain evidence that the controls over compliance selected for testing are designed effectively and operated effectively during the fiscal year and as of the fiscal year end.

12. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a Material Weakness would result. As the risk associated with the control being tested increases, the persuasiveness of the evidence that the auditor should obtain also increases.

Note: Although the auditor must obtain evidence about the effectiveness of the selected controls for each financial responsibility rule, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control.

13. Factors that affect the risk associated with a control include:

- The nature of the financial responsibility rule;
- The risk associated with non-compliance with the financial responsibility rule and the significance of potential non-compliance;
- Changes in the broker's or dealer's policies or procedures or personnel that might adversely affect control design or operating effectiveness;
- The broker's or dealer's history of instances of non-compliance with the financial responsibility rule that the control is intended to prevent or detect;
- The existence and effectiveness of controls that monitor other controls;
- The risk of management override of controls over compliance;
- The nature of the control and the frequency with which it operates;



- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- The extent of use of part-time personnel to perform controls over compliance;
- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and
- The complexity of the control and the significance of the judgments made in connection with its operation.

Testing Design Effectiveness

14. The auditor should test the design effectiveness of the selected controls by determining whether the broker's or dealer's controls, if they are operating as prescribed by persons possessing the necessary authority and competence to perform the control effectively, can effectively prevent or detect instances of non-compliance with the financial responsibility rules on a timely basis.

Note: If a broker or dealer makes changes to its policies and procedures or key personnel during the fiscal year, the auditor should obtain evidence regarding the design effectiveness of the selected controls before and after the change.

15. Procedures the auditor performs to obtain evidence about design effectiveness include inquiry of appropriate personnel, observation of the broker's or dealer's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

16. The auditor should test the operating effectiveness of the selected controls by determining whether each selected control is operating as designed and whether the



person performing the control possesses the necessary authority and competence to perform the control effectively.

Note: The auditor should obtain evidence regarding the operating effectiveness of the selected controls throughout the entire year and as of the end of the fiscal year.

17. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the broker's or dealer's operations, inspection of relevant documentation, and re-performance of the control.

18. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for an individual control, different combinations of the nature, timing, and extent of testing might provide sufficient evidence in relation to the risk associated with the control.

Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

Using Evidence Obtained in Past Examination Engagements

19. The auditor should obtain evidence during the current fiscal year about the design and operating effectiveness of controls selected for testing. If controls selected for testing in the current year were tested in past examination engagements, and if the auditor plans to use evidence about the effectiveness of those controls that was obtained in prior years, the auditor should take into account the factors discussed in paragraph 13 and the following factors to determine the evidence needed during the current fiscal year examination:

- The nature, timing, and extent of procedures performed in previous examination engagements;
- The results of the previous years' testing of the control; and
- Changes in the control or the process in which the control operates since the previous examination engagement.



Using Tests of Controls that are Modified During the Year

20. A broker or dealer might implement changes to controls over compliance to make them more effective or efficient or to address control deficiencies. The auditor should obtain an understanding of the reason for the change and obtain evidence regarding the design and operating effectiveness of the new and superseded controls. The nature, timing, and extent of the testing of new and superseded controls depend on the evidence needed to support the auditor's conclusions about the effectiveness of Internal Control Over Compliance during and as of the end of the fiscal year.

Performing Compliance Tests

21. The auditor must perform procedures ("compliance tests") that are sufficient to support the auditor's conclusions regarding whether the broker or dealer was in compliance with the net capital rule and reserve requirements rule as of the end of its most recent fiscal year. This includes performing the following procedures on the schedules^{16/} the broker or dealer used to determine compliance with the net capital rule and the reserve requirements rule as of its fiscal year end:

- a. Evaluate whether the amounts in the schedules were determined in accordance with the net capital rule or reserve requirements rule, as applicable;
- b. Test the accuracy and completeness of the information in the schedules;
- c. Determine whether the broker or dealer maintained the required level of net capital in accordance with the net capital rule;
- d. Determine whether the broker or dealer maintained a special reserve bank account for the exclusive benefit of customers and deposited funds in at least the required amount in accordance with the reserve requirements rule;
- e. Determine whether the information in the schedules was derived from the books and records of the broker or dealer; and

^{16/} The term "schedules" used in this paragraph refers to the computations of the broker or dealer, in whatever form, that are performed to determine the broker's or dealer's compliance with the net capital rule and the reserve requirements rule.



- f. Determine whether the broker or dealer made the notifications, if any, required by the net capital rule and reserve requirements rule as of the end of the most recent fiscal year.

Note: Procedures performed as part of the audit of the financial statements and audit procedures performed on supplemental information also might provide evidence regarding the broker's or dealer's compliance with the net capital rule and the reserve requirements rule.

22. The auditor should plan and perform compliance tests that are responsive to the risks, including fraud risks, associated with non-compliance with the net capital rule and the reserve requirements rule. As the risk associated with non-compliance with the net capital rule or the reserve requirements rule increases, the persuasiveness of the evidence that the auditor should obtain from compliance tests also increases. The evidence provided by the auditor's compliance tests depends upon the mix of the nature, timing, and extent of those procedures. Inquiry alone does not provide sufficient appropriate evidence to support the auditor's conclusions about the broker's or dealer's compliance with the net capital rule or the reserve requirements rule.

23. In conjunction with performing the compliance tests pursuant to paragraphs 21 and 22, the auditor must perform procedures to obtain evidence about the existence of customer funds or securities held for customers.

Note: Examples of procedures that provide evidence about the existence of customer assets include: (1) counting customer securities or observing and testing the broker's or dealer's procedures for physical inspection and (2) confirming customer security positions directly with depositories and clearing organizations. Procedures performed in the audit of the financial statements and the audit procedures performed on supplemental information to test the existence of assets held for customers also may provide evidence that is relevant to the requirement in this paragraph.

Effect of Tests of Internal Controls on Compliance Tests

24. The auditor should take into account the results of the auditor's tests of controls over compliance with the net capital rule and the reserve requirements rule in determining the necessary nature, timing, and extent of compliance tests. If the test results indicate that the controls are effective, less evidence is needed from compliance tests. If the test results indicate that the controls are ineffective, the auditor should revise the planned compliance tests as necessary to obtain more persuasive evidence regarding compliance.



Evaluating the Results of the Examination Procedures

25. In forming an opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects, the auditor should evaluate all evidence obtained, regardless of whether the evidence corroborates or contradicts the broker's or dealer's assertions.

26. The auditor should evaluate:

- a. Identified instances of non-compliance with the net capital rule and the reserve requirements rule to determine whether any instance of non-compliance existed as of the end of the most recent fiscal year;
- b. Identified instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived from the broker's or dealer's books and records to determine whether they are material, individually or in combination; and
- c. Identified Deficiencies in Internal Control Over Compliance to determine whether the deficiencies, individually or in combination, are Material Weaknesses.

Note: A Material Weakness can exist even when no instances of non-compliance exist. However, instances of non-compliance might indicate the existence of one or more Deficiencies in Internal Control Over Compliance.

Note: The auditor cannot assume that an identified instance of non-compliance or an identified Deficiency in Internal Control Over Compliance is an isolated occurrence. The auditor should evaluate the effect of any instance of non-compliance or identified control deficiency on the auditor's assessment of the risks associated with controls and non-compliance.

Note: The auditor also should evaluate the effect on the audit of the financial statements and audit procedures performed on supplemental information of any non-compliance, Material Weaknesses, or instances in which the information used to assert compliance with the net capital rule or reserve requirements rule was not derived, in all



material respects, from the broker's or dealer's books and records.

27. The auditor should evaluate whether he or she has obtained sufficient appropriate evidence to support the conclusions to be presented in the examination report taking into account the risks associated with controls and non-compliance, the results of the examination procedures performed, and the appropriateness (i.e., the relevance and reliability) of the evidence obtained.

28. If the auditor has not obtained sufficient appropriate evidence about an assertion or has substantial doubt about an assertion, the auditor should perform procedures to obtain further evidence to address the matter.

29. If the auditor is unable to obtain sufficient appropriate evidence about an assertion, the auditor should express a disclaimer of opinion.^{17/}

Subsequent Events

30. For the period from the end of the period specified in the broker's or dealer's assertions to the date of the auditor's examination report (the "subsequent period"), the auditor should perform procedures to identify subsequent events relevant to the auditor's conclusions about the assertions made by the broker or dealer in the compliance report. Such procedures should include, but are not limited to:

- a. Reading relevant reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors, and correspondence that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA during the subsequent period that is relevant to the broker's or dealer's assertions; and
- b. Evaluating information obtained through other engagements performed by the auditor for the broker or dealer, including subsequent events procedures performed in the audit of the financial statements and the audit procedures performed on supplemental information.

^{17/} See Appendix C of this standard, "*Examination Report Modifications*," which describes the situations in which the auditor should modify his or her examination report and the specific modifications to be made to the auditor's examination report. The requirement in paragraph 29 does not preclude the auditor from withdrawing from the examination engagement.



31. The auditor should evaluate the results of the procedures described in the previous paragraph to determine whether the results corroborate or contradict the broker's or dealer's assertions.

Obtaining a Representation Letter

32. The auditor should obtain written representations from management of the broker or dealer:

- a. Acknowledging management's responsibility for establishing and maintaining a system of internal control with the objective of providing the broker or dealer with reasonable assurance that any instances of non-compliance with the financial responsibility rules will be prevented or detected on a timely basis;
- b. Stating the broker's or dealer's assertions included in the compliance report are the responsibility of management;
- c. Stating that management has made available to the auditor all records and other information relevant to the broker's or dealer's assertions, including all known matters contradicting the assertions, and all communications from regulatory agencies, internal auditors, others who perform an equivalent function, compliance functions, and other auditors, that are relevant to the broker's or dealer's assertions, received through the date of the auditor's report; and
- d. Stating whether there were, subsequent to the period addressed in the broker's or dealer's assertions, any known events or other factors that might significantly affect the broker's or dealer's assertions.

33. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the engagement, as described in Appendix C of this standard.

Communication Requirements

34. The auditor should communicate to management all identified Deficiencies in Internal Control Over Compliance.



35. The auditor should communicate to management and the audit committee^{18/} identified instances of non-compliance with the financial responsibility rules, identified Material Weaknesses, and identified instances in which information used to determine compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records.

Note: The auditor also must comply with the requirements of paragraph (h) of SEC Rule 17a-5, which contains notification requirements that apply to auditors of brokers and dealers.

Reporting on the Examination Engagement

36. The auditor's examination report must include the following elements, modified as necessary in the circumstances and manner discussed in Appendix C:

- a. A title that includes the word *independent*;
- b. An identification of the compliance report and the broker's or dealer's assertions regarding the effectiveness of Internal Control Over Compliance during the fiscal year and as of the fiscal year end, compliance with the net capital rule and the reserve requirements rule as of the fiscal year end, and whether the information used to assert compliance with those rules was derived from the broker's or dealer's books and records;
- c. A statement that management of the broker or dealer is responsible for establishing and maintaining a system of internal control that has the objective of providing the broker or dealer with reasonable assurance that any instances of non-compliance with the financial responsibility rules will be prevented or detected on a timely basis;
- d. A statement that the auditor's responsibility is to express an opinion on the broker's or dealer's assertions based on his or her examination;
- e. A statement that the examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

^{18/} For purposes of this standard, the term "audit committee" has the same definition as that in Auditing Standard No. 16, *Communications with Audit Committees*.



- f. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the examination engagement to obtain reasonable assurance about whether the broker's or dealer's Internal Control Over Compliance was effective during and as of the end of the most recent fiscal year, whether the broker or dealer complied with the net capital rule and the reserve requirements rule as of the end of the most recent fiscal year, and whether the information used to assert compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer;
- g. A statement that an examination engagement includes evaluating the design and operating effectiveness of Internal Control Over Compliance; testing and evaluating the broker's or dealer's compliance with the net capital rule and the reserve requirements rule; determining whether the information used to assert compliance with the net capital rule and reserve requirements rule was derived from the broker's or dealer's books and records; and performing such other procedures as the auditor considered necessary in the circumstances;
- h. A statement that the auditor believes the examination provides a reasonable basis for his or her opinion;^{19/}
- i. The auditor's opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects;
- j. The manual signature of the auditor's firm;
- k. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's examination report has been issued; and
- l. The date of the examination report.

37. The following example examination report expressing an unqualified opinion on the assertions made by a broker or dealer in a compliance report illustrates the report elements described in this section.

^{19/} When management has made an interpretation of the financial responsibility rules and the auditor has determined that it is necessary to emphasize this interpretation in the auditor's report, the auditor may include a paragraph stating the description and the source of the interpretation made directly following the scope paragraph.



Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have examined W Broker's statements, included in the accompanying [title of the compliance report], that (1) W Broker's internal control over compliance was effective during the most recent fiscal year ended [date]; (2) W Broker's internal control over compliance was effective as of [date]; (3) W Broker was in compliance with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e) as of [date]; and (4) the information used to state that W Broker was in compliance with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e) was derived from W Broker's books and records. W Broker's management is responsible for establishing and maintaining a system of internal control over compliance that has the objective of providing W Broker with reasonable assurance that non-compliance with 17 C.F.R. § 240.15c3-1, 17 C.F.R. § 240.15c3-3, 17 C.F.R. § 240.17a-13, or Rule [fill in name/number] of [fill in DEA] that requires account statements to be sent to the customers of W Broker will be prevented or detected on a timely basis. Our responsibility is to express an opinion on W Broker's statements based on our examination.

[*Scope paragraph*]

We conducted our examination in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the examination to obtain reasonable assurance about whether W Broker's internal control over compliance was effective as of and during the most recent fiscal year ended [date]; W Broker complied with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e) as of [date]; and the information used to assert compliance with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e) as of [date] was derived from W Broker's books and records. Our examination includes testing and evaluating the design and operating effectiveness of internal control over compliance, testing and evaluating W Broker's compliance with 17 C.F.R. §§ 240.15c3-1 and 240.15c3-3(e), determining whether the information used to assert compliance with 240.15c3-1 and 240.15c3-3(e) was derived from W Broker's books and records, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.



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[*Opinion paragraph*]

In our opinion, W Broker's statements referred to above are fairly stated, in all material respects.

[*Signature*]

[*City and State or Country*]

[*Date*]

Examination Report Date

38. The auditor should date the examination report no earlier than the date on which the auditor obtains sufficient appropriate evidence to support his or her opinion.

Note: Because of the coordination between the examination engagement, the audit of the financial statements and the audit procedures performed on supplemental information, the date of the examination report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.



APPENDIX A – Definitions

A1. For purposes of this standard, the terms listed below are defined as follows:

A2. **Deficiency in Internal Control Over Compliance** – A Deficiency in Internal Control Over Compliance exists when the design or operation of a control does not allow the management or employees of the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect on a timely basis non-compliance with 17 C.F.R. § 240.15c3-1, § 240.15c3-3, § 240.17a-13 or 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.^{1/}

A3. **Internal Control Over Compliance** – Internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with 17 C.F.R. § 240.15c3-1, § 240.15c3-3, § 240.17a-13, or 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, will be prevented or detected on a timely basis.^{2/}

A4. **Material Weakness** – A Material Weakness is a deficiency, or a combination of deficiencies, in Internal Control Over Compliance such that there is a reasonable possibility that non-compliance with 17 C.F.R. §240.15c3-1 or 17 C.F.R. § 240.15c3-3(e) will not be prevented or detected on a timely basis or that non-compliance to a material extent with 17 C.F.R. §240.15c3-3, except for paragraph (e), 17 C.F.R. § 240.17a-13, or 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 will not be prevented or detected on a timely basis.^{3/}

^{1/} The definition of "Deficiencies in Internal Control Over Compliance" is consistent with the same term in paragraph (d)(3)(iii) of SEC Rule 17a-5.

^{2/} The definition of "Internal Control Over Compliance" is consistent with the same term in paragraph (d)(3)(ii) of SEC Rule 17a-5.

^{3/} The definition of a "Material Weakness" is consistent with the same term in paragraph (d)(3)(iii) of SEC Rule 17a-5.



APPENDIX B – Considerations for Brokers and Dealers with Multiple Divisions or Branches

B1. When the broker or dealer has multiple divisions or branches, the auditor should determine the extent to which he or she should perform examination procedures at selected divisions or branches to obtain sufficient appropriate evidence to support the conclusions expressed in the auditor's examination report. This includes determining the divisions or branches at which to perform examination procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual divisions or branches. In determining the extent of the examination procedures to be performed, the auditor should take into account:

- a. The degree to which the financial responsibility rules relate to activities at the division or branch level;
- b. The nature and significance of the related assets, transactions, or activities at the division or branch to the financial responsibility rules;
- c. The degree of centralization of records or information processing relevant to the financial responsibility rules; and
- d. The degree and effectiveness of management supervision and monitoring of the relevant activities of the division or branch.



APPENDIX C – Examination Report Modifications

C1. The auditor should modify his or her examination report if any of the following conditions exist:

- a. There is non-compliance with the net capital rule or the reserve requirements rule as of the end of the most recent fiscal year, one or more Material Weaknesses in Internal Control Over Compliance during or as of the end of the most recent fiscal year, or the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer (paragraphs C2-C3).
- b. There is a restriction on the scope of the examination engagement (paragraphs C4-C8).
- c. There is information other than the assertions and descriptions required under paragraph (d)(3)(i) of SEC Rule 17a-5 contained in the compliance report (paragraphs C9-C10).

Non-Compliance, Material Weakness, or Instance in which Information Used to Assert Compliance was not Derived from the Broker's or Dealer's Books and Records

C2. If (1) one or more instances of non-compliance with the net capital rule or the reserve requirements rule exist as of the end of the fiscal year; (2) one or more Material Weaknesses in Internal Control Over Compliance exist during or as of the end of the fiscal year; or (3) the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer, the auditor must express an adverse opinion directly on the subject matter of the respective assertions, rather than on the assertions themselves, unless there is a restriction on the scope of the examination engagement.

Note: The requirement in this paragraph to express an adverse opinion applies regardless of whether the non-compliance, Material Weakness, or other matters preventing the unqualified opinion were identified by management or by the auditor.

C3. When expressing such an adverse opinion, the auditor's examination report should include, as applicable:



- a. A statement that non-compliance with the net capital rule or the reserve requirements rule has been identified and an identification of each instance of non-compliance described in the broker's or dealer's compliance report as of the end of the most recent fiscal year.
- b. A statement that one or more Material Weaknesses in Internal Control Over Compliance have been identified during the fiscal year and an identification of each Material Weakness described in the compliance report.
- c. A statement that one or more Material Weaknesses in Internal Control Over Compliance have been identified as of the end of the fiscal year and an identification of each Material Weakness described in the compliance report.
- d. A statement that one or more instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records have been identified.

Note: If a description of all identified instances of non-compliance with the net capital rule or the reserve requirements rule and all identified Material Weaknesses has not been included in the broker's or dealer's compliance report, the examination report must be modified to describe those instances of non-compliance or Material Weaknesses that the auditor has identified but that are not described in the broker's or dealer's compliance report.^{1/}

Scope Limitations

C4. The auditor can express an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects, only if the auditor has been able to apply the procedures necessary in the circumstances. If there

^{1/} Paragraphs (d)(3)(i)(B) and (C) of SEC Rule 17a-5 require the broker's or dealer's compliance report to contain a description of each material weakness in Internal Control Over Compliance during the most recent fiscal year and any instance of non-compliance with the net capital rule or the reserve requirements rule as of the end of the most recent fiscal year.



are restrictions on the scope of the examination engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion should state that the auditor does not express an opinion on the assertions made by the broker or dealer in the compliance report.

C5. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the examination engagement was not sufficient for the auditor to express an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer, including the procedures that were deemed necessary by the auditor that have been omitted and the reason for their omission. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an examination engagement.

C6. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that: (1) one or more instances of non-compliance with the net capital rule or the reserve requirements rule existed as of the end of the fiscal year; (2) one or more Material Weaknesses in Internal Control Over Compliance existed during or as of the end of the most recent fiscal year; or (3) the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer, the auditor's report also must include the matters described in paragraph C3, as applicable.

C7. The auditor may issue a report disclaiming an opinion on the assertions made by a broker or dealer in a compliance report as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work before issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

Note: In this case, in following the direction in paragraph 38 of this standard regarding dating the auditor's examination report, the report date is the date on which the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

C8. If the auditor concludes that he or she cannot express an opinion because of a limitation on the scope of the examination engagement, the auditor should communicate on a timely basis, in writing, to management and the audit committee that the examination engagement cannot be satisfactorily completed.



Other Information in the Compliance Report

C9. If the compliance report contains other information besides the statements and descriptions required by SEC Rule 17a-5,^{2/} the auditor should disclaim an opinion on the other information.

C10. If the auditor believes that the other information in the compliance report contains a material misstatement of fact, he or she should discuss the matter with management of the broker or dealer. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee of the auditor's views concerning the information.^{3/}

^{2/} See paragraph (d)(3)(i) of SEC Rule 17a-5.

^{3/} See also AU sec. 317, *Illegal Acts by Clients*, which describes the auditor's responsibilities in a financial statement audit regarding illegal acts.



APPENDIX 2

Attestation Standard No. 2

Review Engagements Regarding Exemption Reports of Brokers and Dealers

Introduction

1. This standard establishes requirements that apply when an auditor is engaged to perform a review^{1/} of the statements made by a broker^{2/} or dealer^{3/} in an exemption report ("exemption report") prepared pursuant to Securities and Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 C.F.R. § 240.17a-5 ("SEC Rule 17a-5") of the U.S. Securities and Exchange Commission ("SEC").^{4/}

2. SEC Rule 17a-5 requires a broker's or dealer's exemption report to contain the following statements by the broker or dealer:

- a. A statement that identifies the provisions in paragraph (k) of SEC Rule 15c3-3^{5/} (the "exemption provisions") under which the broker or dealer

^{1/} See paragraphs (d)(1)(i)(C) and (g)(2)(ii) of SEC Rule 17a-5, which require that certain brokers or dealers file with the SEC a report prepared by an independent accountant based on a review of the statements in the exemption report, if the broker or dealer is required to file an exemption report with the SEC.

^{2/} According to PCAOB Rule 1001(b)(iii), the term "broker" means a broker (as defined in Section 3(a)(4) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{3/} According to PCAOB Rule 1001(d)(iii), the term "dealer" means a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{4/} See paragraph (g)(2)(ii) of SEC Rule 17a-5.

^{5/} See 17 C.F.R. § 240.15c3-3 ("SEC Rule 15c3-3").



claimed an exemption from SEC Rule 15c3-3 (the "identified exemption provisions");

- b. A statement that the broker or dealer (1) met the identified exemption provisions throughout the most recent fiscal year without exception or (2) met the identified exemption provisions throughout the most recent fiscal year except as described in the exemption report; and
- c. If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions (an "exception") and that briefly describes the nature of each exception and the approximate date(s) on which the exception existed.^{6/}

Objective

3. When performing a review of the statements (hereinafter referred to as "assertions") made by a broker or dealer in an exemption report (a "review engagement"), the auditor's objective is to state whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertions for the assertions to be fairly stated, in all material respects.

4. The auditor must plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance^{7/} about whether one or more conditions exist that would cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects. Such conditions include:

- a. The broker's or dealer's assertion that identifies the provisions in paragraph (k) of SEC Rule 15c3-3 under which the broker or dealer claimed an exemption for SEC Rule 15c3-3 is inaccurate;

^{6/} See paragraph (d)(4) of SEC Rule 17a-5.

^{7/} Moderate assurance is obtained by performing with due professional care the inquiries and other procedures required by this standard in order to reach a conclusion about whether there is a need to modify the broker's or dealer's assertions regarding the exemption provisions for the assertions to be fairly stated, in all material respects. Further, this standard is consistent with the concept of moderate assurance as described in paragraph .55 of AT sec. 101, *Attest Engagements*.



- b. The broker or dealer asserts that it met the identified exemption provisions in paragraph (k) of SEC Rule 15c3-3 without exception when the auditor is aware of exceptions in meeting the exemption provisions; or
- c. The broker's or dealer's assertion that identifies and describes each exception during the most recent fiscal year in meeting the identified exemption provisions in paragraph (k) of SEC Rule 15c3-3 is inaccurate or incomplete.

Performing the Review Engagement

General Requirements

- 5. An auditor who performs a review engagement must:
 - a. Have adequate technical proficiency in attestation engagements;
 - b. Obtain an understanding of the exemption conditions and other rules and regulations that are relevant to the broker's or dealer's assertions;
 - c. Determine the auditor's compliance with independence and ethics requirements; and
 - d. Exercise due professional care, which includes application of professional skepticism, in planning and performing the review and preparation of the report.

Note: Due professional care imposes a responsibility on each engagement team member to comply with this standard. The exercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including preparing the report.^{8/}

Note: Auditing Standard No. 3, *Audit Documentation*, establishes the documentation requirements for review engagements performed pursuant to this standard.

- 6. The engagement partner is responsible for the review engagement and performance of the review procedures. Accordingly, the engagement partner is

^{8/} The auditor's responsibility to exercise due professional care is consistent with the description in paragraphs .40-.41 of AT sec. 101.



responsible for proper planning of the review engagement, proper supervision of the work of engagement team members, and compliance with the requirements of this standard. The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Note: For purposes of this standard, the term "engagement partner" means the member of the engagement team with primary responsibility for the review engagement.

Note: Proper planning includes determining the nature, timing, and extent of procedures necessary to obtain moderate assurance. Proper supervision includes supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

Relationship Between the Review Engagement and the Audit of Financial Statements and the Audit Procedures Performed on Supplemental Information

7. The review engagement should be coordinated with the audit of the financial statements and the audit procedures performed on supplemental information of the broker or dealer.^{9/} In planning and performing procedures for, and evaluating the results of the procedures performed in, the review engagement, the auditor should take into account relevant evidence from the audit of the financial statements and the procedures performed on the supplemental information. However, the objectives of the financial statement audit and the review engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.

Review Procedures

8. A review engagement includes the following procedures:

^{9/} Under the definition of supplemental information included in Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*, supplemental information includes the supporting schedules described in paragraph (d)(2) of SEC Rule 17a-5, which are required to be filed by brokers and dealers with the SEC and the broker's and dealer's designated examining authority ("DEA") and the Securities Investor Protection Corporation ("SIPC"). Such supporting schedules consist of, as applicable, a Computation of Net Capital Under Rule 15c3-1, a Computation for Determination of the Reserve Requirements under Exhibit A of SEC Rule 15c3-3, and Information Relating to Possession or Control Requirements Under SEC Rule 15c3-3.



- a. Reading the exemption report to determine the exemption provisions under which the broker or dealer asserts its exemption and the identified exceptions to the exemption provisions;
 - b. Performing inquiries and other review procedures set forth in this standard; and
 - c. Evaluating whether the evidence indicates that there should be modifications to the broker's or dealer's assertions based on the results of the procedures performed.
9. The nature, timing, and extent of the necessary inquiries and other review procedures depend on:
- a. The following risk factors:
 - (1) The broker's or dealer's history of instances of non-compliance with the exemption provisions;
 - (2) Changes in the broker's or dealer's procedures, controls, or the environment in which the controls operate since the prior year;
 - (3) Changes in the broker's or dealer's operations that are relevant to compliance with the exemption provisions;
 - (4) Competence of the personnel who are responsible for compliance with the exemption provisions or who perform important controls over compliance, and whether there have been changes in those personnel during the period of the review;
 - (5) The risk of fraud, including the risk of misappropriation of customer assets, relevant to the exemption provisions;
 - (6) Potential non-compliance associated with related parties,^{10/} including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship;

^{10/} The auditor should look to the definition in the applicable financial reporting framework with respect to the term "related parties."



- (7) The degree to which the broker's or dealer's processes that relate to the exemption provisions are performed, monitored, or controlled in a centralized or decentralized environment; and
 - b. Evidence about the broker's or dealer's compliance with the exemption provisions or about the effectiveness of controls over compliance with the exemption provisions obtained from the audit of the financial statements and the audit procedures performed on supplemental information.
- 10. The auditor should perform procedures to identify exceptions to the exemption provisions, including the following:
 - a. If the broker or dealer identified exceptions to the exemption provisions during the year under review, the auditor should read the broker's or dealer's documentation regarding the exceptions to the exemption provisions and compare it to the information included in the exemption report.
 - b. Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding:
 - (1) Whether the broker or dealer was in compliance with the exemption provisions throughout the year under review or whether exceptions have been identified.
 - (2) Regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to compliance with the exemption provisions.

Note: If the broker or dealer has sent or received correspondence with the SEC or the broker's or dealer's DEA that is relevant to compliance with the exemption provisions, the auditor should read such correspondence and, when necessary in the circumstances, make inquiries of the regulatory agencies.
 - (3) Subsequent events through the date of the auditor's review report that might have a material effect on the broker's or dealer's assertions.



- c. Inquire of individuals at the broker or dealer who have relevant knowledge of controls relevant to the broker's or dealer's compliance with the exemption provisions regarding:
- (1) The controls that are in place to maintain compliance with the exemption provisions, including the nature of the controls and their frequency of operation.

Note: The auditor should take into account procedures performed during 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's or dealer's compliance with the exemption provisions.
 - (2) Whether the individual is aware of:
 - i. Any exceptions to the exemption provisions and, if so, the nature, frequency, timing, and cause (if known) of the exceptions to the exemption provisions, during the year under review.
 - ii. Any deficiencies in controls over compliance with the exemption provisions and, if so, the nature, frequency, and cause (if known) of the control deficiencies during the year under review.
- d. Inquire of individuals who are responsible for monitoring compliance with the exemption provisions or the controls over compliance regarding:
- (1) The nature and frequency of the monitoring activities.
 - (2) The results of those monitoring activities, including the nature, frequency, timing, and cause (if known) of any exceptions to the exemption provisions or deficiencies in controls over compliance.
 - (3) The nature and frequency of customer complaints that are relevant to the broker's or dealer's compliance with the exemption provisions.



- e. Read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's compliance with the exemption provisions.
- f. Read regulatory filings of the broker or dealer that are relevant to the broker's or dealer's compliance with the exemption provisions.
- g. 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's or dealer's assertions regarding compliance with the exemption provisions.

Note: Examples of procedures performed during the audit of the financial statements that might provide evidence relevant to the broker's or dealer's compliance with the exemption provisions include: (i) testing related to customer trades; (ii) testing of specially designated cash accounts; (iii) testing investment inventory or transactions related to the broker's or dealer's trading for its own account; and (iv) reading the clearing agreement in connection with testing trade fee or commission revenue or expenses.

- h. Perform other procedures as necessary in the circumstances to obtain moderate assurance regarding whether a material modification should be made to the broker's or dealer's assertions for the assertions to be fairly stated, in all material respects.

Evaluating the Results of the Review Procedures

11. The auditor should evaluate whether information has come to the auditor's attention that causes the auditor to believe that one or more of the broker's or dealer's assertions are not fairly stated, in all material respects.^{11/} If a broker's or dealer's assertion is not fairly stated, in all material respects, the auditor should:

- a. Modify the review report, as discussed in paragraph 19 of this standard; and

^{11/} See paragraph 4 of this standard, which provides examples of conditions that would cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects.



- b. Evaluate the effect of the matter on the audit of the financial statements and the audit procedures performed on supplemental information.

12. If information coming to the auditor's attention indicates that one or more exceptions to the exemption provisions occurred during the year under review or might exist at year-end, other than exceptions disclosed in the exemption report, that might cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects, or if the auditor has substantial doubt about one or more of the broker's or dealer's assertions, the auditor should perform additional procedures as necessary to address the matter.

Obtaining a Representation Letter

13. The auditor should obtain written representations from management of the broker or dealer:

- a. Acknowledging management's responsibility for compliance with the identified exemption provisions throughout the fiscal year;
- b. Stating the broker's or dealer's assertions and that they are the responsibility of management;
- c. Stating that management has made available to the auditor all records and other information relevant to the broker's or dealer's assertions, including all communications from regulatory agencies, internal auditors, others who perform an equivalent function, compliance functions, and other auditors concerning possible exceptions to the exemption provisions, received through the date of the auditor's review report; and
- d. Stating whether there were, subsequent to the period addressed in the broker's or dealer's assertions, any known events or other factors that might significantly affect the broker's or dealer's compliance with the identified exemption provisions.

14. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the review engagement as described in paragraph 20 of this standard.



Communication Requirements

15. The auditor should communicate to management and to the audit committee^{12/} any exceptions to the exemption provisions identified by the auditor and information that causes the broker's or dealer's assertions about the exemption provisions not to be fairly stated, in all material respects.

Note: The auditor must also comply with the requirements of paragraph (h) of SEC Rule 17a-5, which contains notification requirements that apply to auditors of brokers and dealers.

Reporting on the Review Engagement

16. The auditor's review report must include the following elements, modified as necessary in the circumstances and manner discussed in paragraphs 19-20:

1. A title that includes the word *independent*;
2. An identification of the exemption report and the broker's or dealer's assertions;
3. A statement that management of the broker or dealer is responsible for compliance with the identified exemption provisions throughout the fiscal year and for its assertions;
4. A statement that the review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included inquiries and other required procedures to obtain evidence about the broker's or dealer's compliance with the exemption provisions;
5. A statement that a review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assertions, and accordingly, no such opinion is expressed;
6. A statement about whether the auditor is aware of any material modifications that should be made to the assertions for them to be fairly stated, in all material respects;

^{12/} For purposes of this standard, the term "audit committee" has the same definition as that in Auditing Standard No. 16, *Communications with Audit Committees*.



7. The manual signature of the auditor's firm;
 8. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's review report has been issued; and
 9. The date of the review report.
17. The following example report illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[Introductory paragraph – no exceptions to the exemption provisions included in the broker's or dealer's assertion]

We have reviewed management's statements, included in the accompanying *[title of the exemption report]*, in which (1) Z Broker identified the following provisions of 17 C.F.R. § 15c3-3(k) under which Z Broker claimed an exemption from 17 C.F.R. § 240.15c3-3: (*[fill in which exemption provision – (1), (2)(i), (2)(ii), or (3)]*) (the "exemption provisions") and (2) Z Broker stated that Z Broker met the identified exemption provisions throughout the most recent fiscal year without exception. Z Broker's management is responsible for compliance with the exemption provisions and its statements.

[Introductory paragraph – exceptions to the exemption provisions included in the broker's or dealer's assertion]

We have reviewed management's statements, included in the accompanying *[title of the exemption report]*, in which (1) Z Broker identified the following provisions of 17 C.F.R. § 15c3-3(k) under which Z Broker claimed an exemption from 17 C.F.R. § 240.15c3-3: (*[fill in which exemption provision – (1), (2)(i), (2)(ii), or (3)]*) (the "exemption provisions") and (2) Z Broker stated that Z Broker met the identified exemption provisions throughout the most recent fiscal year except as described in its exemption report. Z Broker's management is responsible for compliance with the exemption provisions and its statements.

[Scope paragraph]

Our review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included inquiries and other required procedures to obtain evidence about



Z Broker's compliance with the exemption provisions. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's statements. Accordingly, we do not express such an opinion.

[*Review results paragraph*]

Based on our review, we are not aware of any material modifications that should be made to management's statements referred to above for them to be fairly stated, in all material respects, based on the provisions set forth in paragraph (k)([*fill-in which exemption provision – (1), (2)(i), (2)(ii), or (3)*]) of Rule 15c3-3 under the Securities Exchange Act of 1934.

[*Signature*]

[*City and State or Country*]

[*Date*]

Review Report Date

18. The auditor should date the review report no earlier than the date on which the auditor has completed his or her review procedures.

Note: Because of the coordination between the review engagement and the audit of the financial statements and the audit procedures performed on supplemental information, the date of the review report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

Modifications of the Report

19. If one or more of the broker's or dealer's assertions are not fairly stated, in all material respects, the auditor must modify the review report to describe the reasons the assertions are not fairly stated, in all material respects. If a broker's or dealer's assertion is not fairly stated, in all material respects, because of one or more omitted exceptions, the auditor's review report should disclose each omitted exception.

20. *Scope Limitations.* If the auditor cannot perform the procedures required by this standard or other procedures that the auditor deems necessary in the circumstances, the review is incomplete because of the scope limitation. An incomplete review is not a sufficient basis for stating a conclusion regarding the broker's or dealer's assertions. In



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those circumstances, the auditor should withdraw from the engagement or should modify the review report to:

- a. Describe the scope limitation and any review procedures deemed necessary by the auditor that have been omitted and the reason for their omission;
- b. State that the auditor does not express any form of assurance on the broker's or dealer's assertions; and, if applicable,
- c. Describe any circumstances that cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects.



APPENDIX 3

Amendments to PCAOB Standards

Auditing Standards

Auditing Standard No. 3, "Audit Documentation"

Auditing Standard No. 3, "Audit Documentation," as amended, is amended as follows:

- a. The following is added at the end of footnote 2 in paragraph 6:

In an engagement conducted pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the relevant assertions are the assertions expressed by management or the responsible party regarding the subject matter of the attestation engagement. The documentation requirements in this standard regarding assertions apply to the aspects of the subject matter to which the assertions relate.

- b. The following note is added at the end of paragraph 12:

Note: In an engagement conducted pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, significant findings or issues include, when applicable: (a) the assessment of, and the responses to, risks requiring special consideration by the auditor; (b) significant matters involving systems, processes, and controls to ensure the appropriateness of the subject matter and management's related assertions; and (c) the evaluation of identified instances of nonconformity with the evaluation criteria (e.g., errors, instances of non-compliance, or control deficiencies).



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- c. The following note is added as the second note to paragraph 13:

Note: When conducting an attestation engagement pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the auditor may include the documentation of significant findings or issues related to the attestation engagement in the engagement completion document prepared in connection with the audit of the financial statements.

Auditing Standard No. 7, "Engagement Quality Review"

Auditing Standard No. 7, "Engagement Quality Review," is amended as follows:

- a. Paragraph 1 is replaced with:

An engagement quality review and concurring approval of issuance are required for the following engagements conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB"): (a) an audit engagement; (b) a review interim financial information; and (c) an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*.

- b. Paragraph 18A. is added:

Engagement Quality Review for an Attestation Engagement Performed Pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*

In an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the engagement quality reviewer should evaluate the



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significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the attestation engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should, taking into account the procedures performed in the engagement quality review of the financial statement audit, (1) hold discussions with the engagement partner and other members of the engagement team, (2) read the engagement report and the document containing management's assertions, and (3) review the engagement completion document and other relevant documentation.

- c. Paragraph 18B. is added:

In an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency.

- d. The following note is added after paragraph 18B.:

Note: A *significant engagement deficiency* in an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, exists when (1) the engagement team failed to perform attestation procedures necessary in the circumstances of the engagement, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.



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- e. Paragraph 18C. is added:

In an attestation engagement performed pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.

Auditing Standard No. 16, "Communications with Audit Committees"

Auditing Standard No. 16, "Communications with Audit Committees," is amended as follows:

- a. The following bullets are inserted after the third bullet in Appendix B:
- Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, paragraphs 34 and 35.
 - Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, paragraph 15.

Attestation Standards

AT sec. 101, "Attestation Engagements"

AT sec. 101, "Attestation Engagements," as amended, is amended as follows:

- a. The following is added at the end of paragraph .04:
- g. Engagements in which a practitioner is engaged to perform an examination of certain statements of a broker or dealer in a compliance report that is prepared pursuant to SEC Rule 17a-5. Such engagements must be conducted pursuant to Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*.
- h. Engagements in which a practitioner is engaged to perform a review of statements of a broker or dealer in an exemption report



that is prepared pursuant to SEC Rule 17a-5. Such engagements must be conducted pursuant to Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*.

AT sec. 601, "Compliance Attestation"

AT sec. 601, "Compliance Attestation," is amended as follows:

a. Within paragraph .02, subparagraph e. is replaced with:

Apply to examination engagements of brokers and dealers covered by Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*.

b. Footnote 2 to paragraph .02.e. is deleted.

c. The last sentence of paragraph .06 is deleted.

d. Paragraph .07 is replaced with:

When a practitioner is engaged to perform a review of statements made by a broker or dealer in an exemption report that is prepared pursuant to SEC Rule 17a-5, the practitioner must conduct the review engagement pursuant to Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*.



APPENDIX 4

Additional Discussion of the Attestation Standards

This appendix provides background information and additional detail regarding the attestation standards, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* (the "examination standard"), which is presented in Appendix 1, and *Review Engagements Regarding Exemption Reports of Brokers and Dealers* (the "review standard"), which is presented in Appendix 2 (collectively, the "attestation standards"). Additionally, this appendix discusses related amendments made to PCAOB standards, which are presented in Appendix 3.

Briefly, the attestation standards apply to examination engagements regarding compliance reports of brokers and dealers ("examination engagements") and review engagements regarding exemption reports of brokers^{1/} and dealers^{2/} ("review engagements") pursuant to U.S. Securities and Exchange Commission ("SEC" or "Commission") requirements contained in Rule 17 C.F.R. § 240.17a-5, *Reports to be made by certain brokers and dealers* ("SEC Rule 17a-5").^{3/}

In particular, this appendix discusses significant comments received and revisions made by the Board to the attestation standards and the related amendments in response to comments and to align the attestation standards with SEC Rule 17a-5.

^{1/} According to PCAOB Rule 1001(b)(iii), the term "broker" means a broker (as defined in Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act")) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{2/} According to PCAOB Rule 1001(d)(iii), the term "dealer" means a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

^{3/} See paragraphs (f)(1), (g)(2)(i) and (ii) of SEC Rule 17a-5. See also SEC Exchange Act Release No. 34-70073, *Broker-Dealer Reports* (July 30, 2013), 78 Federal Register 51910 (August 21, 2013) ("SEC Release"), for a complete description of the amendments to SEC Rule 17a-5.



I. Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers and Dealers

As discussed more fully below, the examination standard has been designed specifically for an auditor's examination of certain statements made by a broker or dealer in a compliance report required by SEC Rule 17a-5. As a result of amendments to SEC Rule 17a-5, certain brokers and dealers (e.g., those that maintain custody of customer funds) must file a compliance report with the Commission making statements regarding compliance with and controls over certain financial responsibility rules.^{4/} Specifically, SEC Rule 17a-5 also requires the broker or dealer to engage an independent public accountant registered with the PCAOB to examine, and independently report on, certain statements made by the broker or dealer in the compliance report.^{5/}

According to the Commission, the amendments to SEC Rule 17a-5 strengthen audit requirements for brokers and dealers as well as provide additional safeguards with respect to brokers' and dealers' custody of customers' assets.^{6/} Previously, audits of brokers and dealers were subject to generally accepted auditing standards ("GAAS") established by the American Institute of Certified Public Accountants ("AICPA"). The examination standard the Board is adopting has been designed to align with the requirements of SEC Rule 17a-5. The examination standard includes specific procedures for auditors performing examinations of certain statements required in a compliance report prepared by brokers and dealers as required under SEC Rule 17a-5. In the Board's view, this approach is consistent with the objectives of SEC oversight and is warranted in view of the importance of brokers' and dealers' compliance with the financial responsibility rules and to the protection of investors. In developing the standard, the Board has emphasized coordination with the financial statement audit and audit procedures performed on supplemental information. This approach should

^{4/} The examination standard and the SEC Release use the term "financial responsibility rules" to refer to 17 C.F.R. § 240.15c3-1 ("SEC Rule 15c3-1" or the "net capital rule"); 17 C.F.R. § 240.15c3-3 ("SEC Rule 15c3-3"); and 17 C.F.R. § 240.17a-13 ("SEC Rule 17a-13"); and any rule of the designated examining authority ("DEA") of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer (an "account statement rule"). See the SEC Release at 8-9.

^{5/} See paragraph (g)(2)(i) of SEC Rule 17a-5.

^{6/} See generally the SEC Release at 206-209.



enhance overall audit effectiveness and also help avoid unnecessary duplication of work.

The following discussion provides background regarding the attestation standards, including significant comments received on the proposed standards and changes made to the standards.

A. SEC Rule 17a-5 and Related Changes

SEC Rule 17a-5 requires a broker's or dealer's compliance report to include the following statements by the broker or dealer as to whether:^{7/}

- a. The Internal Control Over Compliance of the broker or dealer was effective during the most recent fiscal year;
- b. The Internal Control Over Compliance of the broker or dealer was effective as of the end of the most recent fiscal year;
- c. The broker or dealer was in compliance with the net capital rule and 17 C.F.R. § 240.15c3-3(e) (the "reserve requirements rule") as of the end of the most recent fiscal year; and
- d. The information the broker or dealer used to state whether it was in compliance with the net capital rule and the reserve requirements rule was derived from the books and records of the broker or dealer.

As noted above, SEC Rule 17a-5 also requires the broker or dealer to engage an independent public accountant registered with the PCAOB to examine, and independently report on, certain statements made by a broker or dealer in the compliance report. Neither the SEC Rule nor the examination standard require the auditor to opine on the broker's or dealer's process for arriving at the conclusions in the statements made in the compliance report.^{8/} Thus, the auditor need not opine on the

^{7/} See paragraph (d)(3)(i)(A) of SEC Rule 17a-5. SEC Rule 17a-5 also requires the compliance report to contain a statement as to whether the broker or dealer has established and maintained Internal Control Over Compliance. However, the auditor is not required by SEC Rule 17a-5 to examine and report on that statement.

^{8/} See the SEC Release at 38 and the second note to paragraph 5 of the examination standard.



evaluation procedures that a broker or dealer may have performed in order make the statements in the compliance report.

As amended by the Commission, SEC Rule 17a-5 includes modifications from the SEC's proposed amendments,^{9/} including changes that are reflected in the examination standard. Amendments made to SEC Rule 17a-5 included narrowing the scope of the compliance assertion;^{10/} eliminating the concepts of "material non-compliance" and "compliance in all material respects;" and requiring the auditor to opine on Internal Control Over Compliance as of the end of the fiscal year, as well as during the fiscal year.^{11/}

The Commission's narrowing of the scope of the compliance assertion and changes to the evaluation of Internal Control Over Compliance affected the scope of the examination procedures required to be performed by the auditor and the auditor's report, and therefore resulted in conforming changes to the final examination standard. These and other modifications to the examination standard are discussed further below.

1. *Changes to the Examination Standard to Align with SEC Rule 17a-5*

The proposed examination standard was designed specifically for the examination of the compliance report required by the proposed amendments to SEC Rule 17a-5. As noted earlier, the examination standard reflects conforming changes based on the Commission's revision of its amendments to SEC Rule 17a-5 in the following areas: narrowing the scope of the compliance assertion; eliminating the

^{9/} See SEC Exchange Act Release No. 34-64676, *Broker-Dealer Reports* (June 15, 2011), 76 Federal Register 37572 (June 27, 2011) ("SEC Proposing Release").

^{10/} These standards use the term "assertion" to refer to the broker's or dealer's statements that are covered by the examination and review. In the examination standard, the term "assertion" also distinguishes the portion of the statements in the broker's or dealer's compliance report that are covered by the examination.

^{11/} See paragraph (d)(3)(ii) of SEC Rule 17a-5, which states that the term "Internal Control Over Compliance" means internal controls that have the objective of providing the broker or dealer with reasonable assurance that non-compliance with §§ 240.15c3-1, 240.15c3-3, 240.17a-13, or 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 will be prevented or detected on a timely basis.



concepts of "material non-compliance" and "compliance in all material respects;" and requiring the auditor to opine on Internal Control Over Compliance as of the end of the fiscal year, as well as during the fiscal year.

2. *Changes to the Scope of the Compliance Assertion*

The SEC's Adopting Release states:

[T]he final rule [SEC Rule 17a-5] requires a statement as to whether the broker-dealer was in compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3 as of the end of the most recent fiscal year and, if applicable, a description of any instances of non-compliance with these rules as of the fiscal year end. This is a modification from the proposed assertion that the broker-dealer is in compliance with the financial responsibility rules in all material respects and proposed description of any material non-compliance with the financial responsibility rules. Thus, the final rule reflects two changes from the proposal: (1) elimination of the concepts of "material non-compliance" and "compliance in all material respects" for the purposes of reporting in the compliance report; and (2) a narrowing of these statements and requirements from compliance with all of the financial responsibility rules to compliance with Rule 15c3-1 and paragraph (e) of Rule 15c3-3.^{12/}

The narrowing of the scope of the broker's or dealer's assertion to include only compliance with the net capital rule and reserve requirements rule resulted in several changes to the performance and reporting requirements in the examination standard. As the final rule limits the broker's or dealer's assertion regarding compliance to SEC Rule 15c3-1 and paragraph (e) of SEC Rule 15c3-3, the examination standard requires tests of compliance tailored to compliance with the net capital rule and the reserve requirements rule.

Because the broker's or dealer's assertion relates to compliance with the net capital rule rather than compliance "in all material respects," the concept of material non-compliance has been removed from the provisions of the examination standard regarding testing compliance. Also, the auditor cannot opine that a broker's or dealer's assertion that it is in compliance with the net capital rule and reserve requirements rule is fairly stated, in all material respects, if one or more instances of non-compliance with either the net capital rule or reserve requirements rule exist as of the end of the most recent fiscal year.

^{12/} See the SEC Release at 32.



The specific performance and reporting requirements are discussed in more detail later in this release.

3. *Materiality Considerations*

As discussed previously, the SEC's elimination of the concepts of "material non-compliance" and "compliance in all material respects" from the provisions of SEC Rule 17a-5 related to asserting compliance has been carried over to the examination standard, which no longer refers to "material non-compliance" or the "risk of material non-compliance." However, most of the procedures set forth in the proposal for assessing the risks of material non-compliance have been retained in paragraph 9 of the examination standard as planning procedures because they remain relevant for determining the necessary nature, timing, and extent of procedures to be performed in the examination.

Also, consistent with SEC Rule 17a-5, the examination standard retains the concept of a Material Weakness in Internal Control Over Compliance, and the requirements regarding performing procedures to determine whether Material Weaknesses exist in Internal Control Over Compliance.

The concept of materiality also remains relevant when evaluating whether the information the broker or dealer used to assert compliance with the net capital rule and reserve requirements rule is derived from the broker's or dealer's books and records, is fairly stated, in all material respects. The concept of materiality as applied to this assertion is discussed further in the section on evaluating results later in this release.

The Board received a number of comments on the proposed examination standard that are no longer applicable given the narrowing of the scope of the compliance assertion. These comments included requests for additional guidance related to the determination of material non-compliance and requests for specific examples regarding the consideration of qualitative and quantitative factors in the context of each of the rules included in the compliance assertion, as well as matters within each of those rules that the PCAOB considers to be most significant to compliance.

4. *Evaluating Internal Control Over Compliance During the Fiscal Year and as of the End of the Fiscal Year*

The SEC Release states that SEC Rule 17a-5 requires that the compliance report contain, among other things, statements as to whether (1) the broker or dealer has established and maintained Internal Control Over Compliance, (2) the Internal Control Over Compliance of the broker or dealer was effective during the most recent



fiscal year, and (3) the Internal Control Over Compliance of the broker or dealer was effective as of the end of the most recent fiscal year.^{13/}

To align with SEC Rule 17a-5, the examination standard requires the auditor to express an opinion regarding whether the specified assertions made by the broker or dealer in its compliance report are fairly stated, in all material respects, including whether the broker's or dealer's Internal Control Over Compliance was effective during *and* as of the end of the most recent fiscal year. This change from the proposed SEC Rule 17a-5 resulted in conforming changes to the examination standard relating to the requirements for testing controls and the scope of the examination report. For example, the examination standard addresses the effect of changes in controls on the auditor's testing.

Further, Appendix A to the examination standard defines certain terms used in the examination standard, including "Internal Control Over Compliance," "Deficiency in Internal Control Over Compliance," and "Material Weakness." The definitions of these terms in the examination standard are consistent with the definitions of these terms in SEC Rule 17a-5.

B. Performing the Examination Engagement (paragraphs 6 – 33 of Appendix 1)

1. General Requirements (paragraphs 6 – 7 of Appendix 1)

The examination standard retains the general requirements as proposed. These requirements are consistent with AT sec. 101, *Attest Engagements*. Briefly, paragraph 6 of the examination standard sets forth general requirements for an auditor performing an engagement pursuant to the examination standard. Paragraph 6 requires that an auditor: have adequate technical proficiency in attestation engagements; obtain an understanding of the financial responsibility rules and other rules and regulations that are relevant to the broker's or dealer's assertions; determine the auditor's compliance with independence and ethics requirements;^{14/} and exercise due professional care.

Some commenters stated that the general requirements in the examination engagement were sufficiently clear as proposed. One commenter recommended that

^{13/} See the SEC Release at 29-30.

^{14/} Determining the auditor's compliance with independence and ethics requirements includes determining that the auditor complied with relevant requirements of the PCAOB and the SEC. Paragraph (f)(1) of SEC Rule 17a-5 requires the auditor to be independent in accordance with 17 C.F.R. § 210.2-01.



the examination standard specify the level of understanding of the financial responsibility rules that auditors are expected to have. The commenter also recommended deleting the reference to "other rules and regulations that are relevant to the broker's or dealer's assertions," asserting that the requirement is too broad to allow auditors to identify suitable criteria and express an opinion on management's assertion. Additionally, that commenter recommended that the examination standard specify how the auditor's understanding of the financial responsibility rules should be documented.

The requirement for the auditor to obtain an understanding of the financial responsibility rules is similar to an existing requirement in AT sec. 101, which includes a requirement for the engagement to be performed by an auditor "having adequate knowledge of the subject matter."^{15/} In addition, understanding the requirements in other rules and regulations is important to enable the auditor to form conclusions on the broker's or dealer's assertions, as well as aiding the auditor's own compliance with the requirements in the examination standard and SEC Rule 17a-5. For example, paragraph (h) of SEC Rule 17a-5 requires a broker or dealer to provide notification to the Commission and other securities regulators when the auditor notifies the broker or dealer that the auditor has determined that the broker or dealer is not in compliance with SEC Rule 15c3-1 as required by SEC Rule 17a-11, *Notification Provisions for Brokers and Dealers*. In addition to the financial responsibility rules, it is of course important that the auditor understands the requirements of SEC Rule 17a-5, including the notification requirements when an instance of non-compliance is identified. As such, the requirement was retained substantially as proposed.

With respect to documentation, the attestation engagements are subject to the requirements of Auditing Standard No. 3, *Audit Documentation*, which applies to engagements conducted pursuant to the standards of the PCAOB. Auditing Standard No. 3 states that as audit documentation is the written record that provides the support for the representations in the auditor's report, it should demonstrate that the engagement complied with the standards of the PCAOB.^{16/} Further, as there are potentially a variety of ways for the auditor to document their understanding of the financial responsibility rules and other rules and regulations, the examination standard does not prescribe any specific manner to do so. A note has been added to paragraph 6 of the examination standard to remind auditors of their responsibility to comply with Auditing Standard No. 3.

^{15/} See AT sec. 101.21.

^{16/} See paragraph 4 of Auditing Standard No. 3.



The proposed examination standard included a footnote which stated that "due professional care" referred to in that paragraph was the same term in paragraph .40 of AT sec. 101. One commenter stated that while the commenter did not disagree with the meaning of "due professional care," referencing AT sec. 101 from the examination standard may be confusing, especially as AT sec. 101 would not be applicable to engagements in which the examination standard is applicable. In the examination standard, a note has been added to state that due professional care imposes a responsibility on each engagement team member to comply with the examination standard and that the exercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report. A footnote to that note states that the auditor's responsibility to exercise due professional care is consistent with the description in paragraphs .40-.41 of AT sec. 101.

The Board did not receive other significant comments on the general requirements of the proposed examination standard. As such, the general requirements are being adopted substantially as proposed.

2. *Relationship Between the Examination Engagement and the Audit of the Financial Statements and Audit Procedures Performed on Supplemental Information (paragraph 8 of Appendix 1)*

By its terms, SEC Rule 17a-5 requires the financial statement audit and the compliance examination to be performed by the same auditor.^{17/} Accordingly, the examination standard includes a requirement for the auditor to coordinate the examination engagement with the audit of the financial statements and the audit procedures performed on supplemental information. The emphasis on appropriately coordinating the examination engagement with the audit of the financial statements and the audit procedures performed on supplemental information should promote overall audit effectiveness and avoid redundancy in the auditor's work.

For example, the examination standard includes a requirement for the auditor to take into account evidence from the audit of the financial statements in planning and performing procedures for the examination engagement and in evaluating the results of the procedures performed in the examination. This enables the auditor to plan, perform, and evaluate the results of the examination engagement concurrent with the audit of the financial statements because the examination standard is structured similarly to, and

^{17/} See paragraph (g) of SEC Rule 17a-5.



contains many of the same concepts included in, auditing standards related to the auditor's assessment of and response to risk.^{18/}

The proposing release requested comments on other ways the Board could promote coordination of the examination engagement with the audit of the financial statements and the audit procedures performed on supplemental information. Commenters generally stated that requirements regarding the coordination of the examination engagement with the audit of the financial statements were appropriate.

One commenter stated that the Board should require the auditor of the financial statements to perform the examination engagement and issue the examination report. As noted previously, SEC Rule 17a-5 includes this requirement.^{19/} Thus, the attestation standards do not include specific requirements for performing the examination or review if the auditor did not audit the financial statements.

Another commenter stated that it is inappropriate to require that the auditor plan and perform the work to meet the objectives of both the examination engagement and the financial statement audit, and that the auditor's obligation under the examination standard is to meet the objectives of the examination engagement. The language in the standard was retained as proposed. The auditor should plan and perform the work to meet the objectives of both the examination engagement as well as the financial statement audit. Existing auditing standards require the auditor to properly plan and perform the financial statement audit.^{20/} Since the objectives are not identical, the auditor must plan and perform the work to achieve the objectives of both engagements. Further, the examination standard does require the auditor to take into account the evidence obtained and the results of procedures performed during the audit of the financial statements and the audit procedures performed on the supplemental information in planning and performing procedures for the examination engagement and in evaluating the results of the procedures performed in the examination engagement.

3. *Consideration of Fraud (paragraph 10 of Appendix 1)*

The auditor's consideration of fraud is an important part of the examination engagement. Fraud risks particularly relevant to a broker's or dealer's non-compliance with the financial responsibility rules include the risk of misappropriation of customer

^{18/} See generally, Auditing Standards Nos. 8-15.

^{19/} See paragraph (g) of SEC Rule 17a-5.

^{20/} See Auditing Standard No. 9, *Audit Planning*.



funds or securities held for customers and intentional manipulation of the books and records to conceal material misappropriations or other non-compliance. The SEC Release notes that the amendments to SEC Rule 17a-5, which include requiring the examination and review engagements, are designed to provide additional safeguards with respect to broker and dealer custody of customer securities and funds.^{21/}

Paragraph 10 of the examination standard includes a requirement for the auditor to assess the risk of fraud, and specifically refers to the risk of misappropriation of customer assets, which is relevant to compliance with the net capital rule and the reserve requirements rule, as well as the broker's or dealer's Internal Control Over Compliance.

The requirement to coordinate the examination engagement with the audit of the financial statements and audit procedures performed on supplemental information is also important for the proper assessment of fraud risk in the examination engagement. The auditor's assessment of fraud risk in the examination engagement will be informed to a substantial degree by the procedures performed and the fraud risk assessments in the audit of the financial statements and audit procedures performed on supplemental information. Many of the fraud risk factors identified in the financial statement audit regarding (1) incentives or pressures to misappropriate assets or commit fraudulent financial reporting, and (2) attitudes and rationalizations that justify such fraudulent actions,^{22/} are relevant when identifying and assessing risks of misappropriation of customer assets or intentional manipulation of the books and records to conceal misappropriation of customer assets or non-compliance with the financial responsibility rules. Also, weaknesses in controls regarding safeguarding of assets or stock records can result in opportunities for misappropriation of customer assets or non-compliance. In addition, the evaluation of misstatements for indications of fraud or matters identified during the audit that might affect the assessment of fraud risks in the audit of the financial statements also might affect the assessment of fraud risks in the examination engagement.^{23/}

^{21/} See the SEC Release at 206.

^{22/} See paragraphs 65-66 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, and paragraph 85 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

^{23/} See paragraphs 19-22, 28-29 and Appendix C of Auditing Standard No. 14, *Evaluating Audit Results*.



Paragraph 9.d. of the examination standard includes a requirement for the auditor to assess the risks associated with related parties, including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship, that are relevant to compliance and controls over compliance. Given the nature of the transactions with related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship, they are particularly relevant to the auditor's consideration of the risks associated with related parties in the examination engagement and in considering both the broker's or dealer's assertions related to Internal Control Over Compliance, as well as to the broker's or dealer's assertion related to compliance with the net capital rule and the reserve requirements rule.

Likewise, paragraph 9.j. of the examination standard includes a requirement for the auditor to obtain an understanding of the nature and frequency of customer complaints that are relevant to compliance with the financial responsibility rules, which can provide evidence relevant to the assessment of fraud risks, especially if there is a high incidence of customer complaints, thematic issues in the complaints that indicate the potential for misappropriation of customer assets, or specific allegations of fraud or misfeasance by the broker's or dealer's customers.

Other paragraphs in the examination standard address the auditor's responsibilities for responding to fraud risks. For example, paragraph 22 of the examination standard retains an important requirement from the proposed examination standard for the auditor to perform compliance tests that are responsive to risks, including fraud risks. Also, paragraph 23 of the examination standard retains from the proposal the requirement for the auditor to perform procedures to obtain evidence about the existence of customer funds or securities held for customers. This is an important responsibility in an audit of a broker or dealer that has access to customer assets. It affects compliance with the net capital rule and the reserve requirements rule, and it has the potential to result in contingent liability to the broker or dealer that requires recognition or disclosure in the financial statements.

Because the examination standard requires the auditor to perform tests that are responsive to fraud risks, the nature, timing, and extent of procedures to obtain evidence about the existence of assets held for customers should be commensurate with the risk of misappropriation of customer assets. Determining the necessary procedures involves considering relevant risk factors, including, but not limited to, the amount of cash and securities held for customers and the results of testing and evaluation of the relevant controls. Examples of procedures that provide evidence about the existence of customer assets include (1) counting customer securities or observing and testing the broker's or dealer's procedures for physical inspection and (2)



confirming customer security positions directly with depositories and clearing organizations. Procedures performed in the audit of the financial statements and the audit procedures performed on supplemental information to test the existence of assets held for customers also provide relevant evidence in the examination engagement.

The Board requested comment regarding whether specific requirements should be added to either of the proposed attestation standards to further enhance protection of customer assets. One commenter stated that generally the attestation standards are adequate to enhance protection of customer assets. Another commenter stated that the principles in the examination standard for performing compliance tests are sufficiently clear.

One commenter recommended that the Board clarify the extent and timing of procedures included as examples in paragraph 26 of the proposed examination standard regarding procedures that provide evidence about the existence of customer assets. The examination standard requires the auditor to perform procedures to obtain evidence of customer funds or securities held for customers, but the standard does not prescribe specific procedures for the auditor to perform to obtain such evidence. The procedures included in the note to paragraph 23 of the examination standard are examples of procedures that the auditor might perform to obtain such evidence. The necessary extent and timing of those procedures depends on, among other things, the complexity of the operations of the broker's or dealer's business, the nature of carrying and clearing arrangements, and the design and effectiveness of controls related to the existence assertion. As such, the examination standard has not been changed to reflect this comment.

4. Testing Controls over Compliance (paragraphs 11 – 20 of Appendix 1)

SEC Rule 17a-5 requires the broker's or dealer's compliance report to include an assertion regarding the effectiveness of Internal Control Over Compliance during the most recent fiscal year and as of the end of the fiscal year.^{24/} Accordingly, the examination standard requires the auditor to obtain evidence about the design and operating effectiveness of relevant controls over compliance throughout the fiscal year and as of the end of the fiscal year.

^{24/} See paragraphs (d)(3)(i)(A)(2) and (3) of SEC Rule 17a-5, which requires the broker or dealer to assert on the effectiveness of its Internal Control Over Compliance with the financial responsibility rules throughout the fiscal year and as of the end of the most recent fiscal year.



The examination standard requires the auditor to test those controls that are important to the auditor's conclusion about whether the broker or dealer maintained effective Internal Control Over Compliance for each financial responsibility rule during the fiscal year and as of the end of the fiscal year. The examination standard also requires the auditor to obtain evidence that the controls over compliance selected for testing are designed effectively and operated effectively during the fiscal year and as of the fiscal year end.^{25/}

As the broker's or dealer's assertion regarding Internal Control Over Compliance relates to each financial responsibility rule individually, the auditor should obtain evidence about the effectiveness of the selected controls for each financial responsibility rule. However, when testing controls over compliance, the auditor's objective is not to support an opinion about the effectiveness of each individual control, rather, the objective is to form an opinion about whether the broker's or dealer's assertions regarding Internal Control Over Compliance are fairly stated, in all material respects. This allows the auditor to focus his or her effort on the controls that are important to each of the financial responsibility rules and to vary the level of evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

One commenter recommended that the examination standard include guidance regarding the identification of controls important to the auditor's conclusion about whether the broker or dealer maintained effective internal controls over compliance for each financial responsibility rule. As the financial responsibility rules outline the requirements necessary to be in compliance, the auditor can identify the controls for testing by understanding the controls the broker or dealer has implemented to assure compliance with the respective requirements.

Additionally, the examination standard identifies certain factors that affect the risk associated with a control. One factor included in paragraph 13 is the broker's or dealer's history of instances of non-compliance with the financial responsibilities rules that the control is intended to prevent or detect. A recent history of non-compliance generally indicates higher risk associated with the control. Factors that affect the risk associated

^{25/} See paragraphs (d)(3)(i)(A)(2) and (3) of SEC Rule 17a-5, which requires the broker or dealer to assert on the effectiveness of its Internal Control Over Compliance throughout the fiscal year and as of the broker's or dealer's fiscal year end. See also paragraphs (d)(3)(i)(B) and (C) of SEC Rule 17a-5, which require the broker or dealer to describe each material weakness in Internal Control Over Compliance and any instance of non-compliance with the net capital rule or reserve requirements rule.



with a control include, but are not limited to, those described in paragraph 13 of the examination standard.

Another factor included in paragraph 13 includes the extent of use of part-time personnel. Some commenters stated that they did not agree that the use of part-time personnel is a factor that affects the risk associated with a control. Those commenters stated that this risk factor is incorporated in another risk factor regarding the competence of the personnel who perform the control or monitor its performance. One commenter stated that, in their opinion, it would be more appropriate to evaluate the competence and objectivity of personnel executing the controls and their knowledge of the financial responsibility rules.

In considering these comments, the Board took into account the SEC's June 2007 compliance alert,^{26/} which noted that SEC examinations found that many part-time financial and operational principals did not actually supervise or create and maintain various books and records. In light of risks illustrated in the SEC compliance alert, the use of part-time personnel has been retained in the examination standard as a risk factor for the auditor to consider when testing internal controls over compliance. The auditor's understanding of the role and responsibilities of the part-time personnel is important to evaluating the associated risks.

Paragraphs 14-18 of the examination standard provide requirements for the auditor to test the design and operating effectiveness of the selected controls over compliance. These requirements for testing design and operating effectiveness of controls over compliance are analogous to the requirements for testing controls in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

Under the examination standard, the auditor should obtain evidence about the effectiveness of controls each year. Similar to testing controls in a financial statement audit, the examination standard provides factors for the auditor to take into account if the auditor plans to use evidence obtained in prior years in determining the extent of testing in the current year.

One commenter recommended that paragraph 16 of the proposed examination standard, which stated "[a]s the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases," be replaced with paragraph

^{26/} See Compliance Alert, June 2007, available at <http://www.sec.gov/about/offices/ocie/complialert.htm>.



18 of Auditing Standard No. 13, which states that [t]he auditor should obtain more persuasive audit evidence...." The suggested revision is consistent with the intent of the requirement, so it has been included in paragraph 12 of the examination standard. This change will focus the auditor on the persuasiveness of audit evidence, rather than quantity, and avoid unnecessary differences between the examination standard and the auditing standards. Similar changes are reflected in paragraphs 22 and 24 of the examination standard.

Paragraphs 19 and 20 of the examination standard describe the auditor's use of evidence obtained in past examination engagements and using tests of controls that are modified during the year. One commenter suggested that as changes to controls occur throughout the period, the examination standard should require the auditor to determine with management what types of changes could materially affect control effectiveness. That commenter stated that the auditor should then test and evaluate management's documentation of the changes to controls and perform procedures to test the broker's or dealer's implementation of that change. SEC Rule 17a-5 requires that the broker or dealer assert that its controls were effective during the most recent fiscal year. As stated in the examination standard, to evaluate controls over compliance throughout the period, the auditor should obtain evidence regarding the design effectiveness of the selected controls before and after the change. Further, the examination standard also requires that, if a broker or dealer makes changes to its policies and procedures or key personnel during the fiscal year, the auditor should obtain an understanding of the reason for the change and obtain evidence regarding the design and operating effectiveness of the superseded and new controls before and after the change.

One commenter stated that the phrase within paragraph 20 of the proposed examination standard which stated, "whether each control is operating as designed" might be confusing and recommended revising the paragraph to state "each control selected for testing." The suggested revision is consistent with the intent of the requirement, so it has been included in paragraph 16 of the examination standard.

5. Performing Compliance Tests (paragraphs 21 – 24 of Appendix 1)

Paragraphs 21-24 set forth requirements for performing tests of compliance with the net capital rule and reserve requirements rule.

With respect to compliance tests, the auditor's objective is to form a conclusion about whether the broker's or dealer's assertion regarding compliance with the net capital rule and the reserve requirements rule is fairly stated, in all material respects. To satisfy this objective, the examination standard requires the auditor to perform procedures that are sufficient to support the auditor's conclusions regarding whether the



broker or dealer was in compliance with the net capital rule and reserve requirements rule as of the end of its most recent fiscal year.

The examination standard requires the auditor to perform specific procedures on the schedules the broker or dealer used to determine compliance with the net capital rule and the reserve requirements rule as of the end of its fiscal year, including:

- a. Evaluating whether the amounts in the schedule were determined in accordance with the net capital rule or reserve requirements rule, as applicable;
- b. Testing the accuracy and completeness of the information in the schedule;
- c. Determining whether the broker or dealer maintained the required level of net capital in accordance with the net capital rule;
- d. Determining whether the broker or dealer maintained a special reserve bank account for the exclusive benefit of customers and deposited funds in at least the required amount in accordance with the reserve requirements rule;
- e. Determining whether the information in the schedule was derived from the books and records of the broker or dealer; and
- f. Determining whether the broker or dealer made the notifications, if any, required by the net capital rule and reserve requirements rule as of the end of the most recent fiscal year.

Paragraph 21.e. of the examination standard requires the auditor to perform procedures to determine whether the information used to assert compliance with the net capital rule and the reserve requirements rule was derived from the broker's or dealer's books and records. Proper coordination of these procedures with the audit of the financial statements and audit procedures performed on supplemental information should allow the auditor to avoid redundancy in the auditor's work and increase the effectiveness of the procedures performed. For example, Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*, includes a requirement for the auditor to determine that the supplemental information reconciles to the underlying accounting and other records or to the financial statements themselves, as applicable. Such supplemental information includes the supporting



schedules that brokers or dealers are required to include in their financial reports pursuant to SEC Rule 17a-5.^{27/}

To test compliance pursuant to paragraph 21, the auditor will need to design his or her procedures to test the provisions of the net capital rule and reserve requirements rule that have a bearing on the broker's or dealer's compliance with that rule. For example, the current requirements in the net capital rule generally include:

- a. The requirement to maintain minimum net capital and tentative net capital, as applicable, at all times.^{28/}
- b. The requirement for certain brokers or dealers not to let a specified amount of certain accounts it carries exceed a specified threshold for more than five business days.^{29/}
- c. The requirement for brokers or dealers carrying accounts of listed options specialists not to let the amount of certain deductions required under Appendix A of the net capital rule to exceed a specified threshold for more than three business days.^{30/}
- d. The notification requirement relating to paragraph (c)(2)(x)(C) of the net capital rule.^{31/}
- e. The requirement for brokers or dealers carrying accounts of listed options specialists to liquidate accounts when a liquidating deficit exists which includes a notice requirement.^{32/}
- f. The requirement that the total of outstanding principal amounts of satisfactory subordination agreements cannot exceed 70% of the broker's

^{27/} See paragraph (d)(2) of SEC Rule 17a-5.

^{28/} See paragraph (a) of 17 C.F.R. § 240.15c3-1.

^{29/} See paragraph (a)(6)(v) of 17 C.F.R. § 240.15c3-1.

^{30/} See paragraph (c)(2)(x)(C) of 17 C.F.R. § 240.15c3-1.

^{31/} See paragraph (c)(2)(x)(C)(1) of 17 C.F.R. § 240.15c3-1.

^{32/} See paragraph (c)(2)(x)(D) of 17 C.F.R. § 240.15c3-1.



- or dealer's debt-equity total for a period in excess of 90 days.^{33/}
- g. The notification requirements relating to withdrawals of equity capital.^{34/}
 - h. The limitations on withdrawal of equity capital.^{35/}
 - i. The requirements regarding temporary restrictions on net capital withdrawals.^{36/}

Other provisions of the rule also may apply depending on the particular activities or elections of the broker or dealer. Auditors should look to the requirements of the individual rules in order to test compliance.^{37/}

The requirements for testing compliance with the net capital rule and the reserve requirements rule should facilitate the coordination of the examination engagement and the audit procedures performed on supplemental information. The compliance procedures, if properly planned and performed, should provide substantial evidence to satisfy the requirements of Auditing Standard No. 17.

As discussed earlier, in view of the amendments to SEC Rule 17a-5 adopted by the Commission, the examination standard was revised to more closely align the auditor's performance requirements with the scope of the compliance assertion in SEC Rule 17a-5. It is appropriate to include specific procedures the auditor should perform on the schedules the broker or dealer used to determine compliance with the net capital rule and the reserve requirements rule as of the end of its fiscal year.

In addition to those procedures that the auditor would perform on the broker's or dealer's schedules when planning and performing compliance tests, the auditor should take into account the evidence obtained from procedures performed as part of the audit

^{33/} See paragraph (d) of 17 C.F.R. § 240.15c3-1.

^{34/} See paragraph (e)(1) of 17 C.F.R. § 240.15c3-1.

^{35/} See paragraph (e)(2) of 17 C.F.R. § 240.15c3-1.

^{36/} See paragraph (e)(3) of 17 C.F.R. § 240.15c3-1.

^{37/} See paragraph 6.b. of the examination standard, which requires the auditor to obtain an understanding of the financial responsibility rules and other rules and regulations that are relevant to the broker's or dealer's assertions.



of the financial statements and the audit procedures performed on supplemental information. For example, certain audit procedures performed to test the valuation and classification of the broker's or dealer's investments as of the end of the fiscal year may provide relevant evidence regarding the broker's or dealer's compliance with the net capital rule. Further, when testing the broker's or dealer's cash and cash equivalents, certain audit procedures may provide evidence regarding the existence of special reserve bank accounts for the exclusive benefit of customers, as well as evidence about the deposits to, and withdrawals from, those bank accounts. Such evidence may be relevant to the broker's or dealer's compliance with the reserve requirements rule. However, as the objectives of the audit and the examination engagement are not the same, the auditor must plan and perform the work to meet the objectives of both engagements.

6. *Evaluating the Results of the Examination Procedures (paragraphs 25 – 29 of Appendix 1)*

Paragraph 25 of the examination standard states that in forming an opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects, the auditor should evaluate all evidence obtained, regardless of whether the evidence corroborates or contradicts the broker's or dealer's assertions. Paragraph 26 of the examination standard provides that the auditor should evaluate: (1) identified instances of non-compliance^{38/} with the net capital rule and reserve requirements rule, to determine whether any instances of non-compliance existed as of the end of the most recent fiscal year; (2) identified instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived from the broker's or dealer's books and records to determine whether they are material, individually or in combination; and (3) identified Deficiencies in Internal Control Over Compliance to determine whether the deficiencies, individually or in combination, are Material Weaknesses. Identified instances of non-compliance might be an indication of a Deficiency in Internal Control Over Compliance.

^{38/} In evaluating the results of compliance testing, an error in a broker's or dealer's computation used to determine compliance with a provision of the net capital rule or reserve requirements rule is not an instance of non-compliance if, after giving consideration to the effect of the error, the broker or dealer still met the requirements of that provision, e.g., maintained at least the required minimum level or net capital or at least the minimum level on deposit in the special reserve account. However, such an instance might be an indication of a Deficiency in Internal Control Over Compliance that requires evaluation pursuant to this standard.



The auditor's evaluation of the materiality of instances in which the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived from the broker's or dealer's books and records is based on relevant quantitative and qualitative factors, including, in particular, the importance of the information not derived from the books and records to the broker's or dealer's compliance with the corresponding requirement in the net capital rule or the reserve requirements rule. For example, when a broker or dealer asserts that the information used to state whether it was in compliance with the net capital rule was derived from its books and records, and the auditor identifies an amount not derived from a broker's or dealer's books and records, the broker or dealer may still be able to support its assertion that it maintained the required net capital using information that was derived from the books and records of the broker or dealer. However, such an instance might be an indication of a Deficiency in Internal Control Over Compliance.

Paragraph 28 of the examination standard applies when the auditor has not obtained sufficient appropriate evidence about an assertion or has substantial doubt about an assertion. Pursuant to paragraph 28, the auditor in those situations is required to perform additional procedures to address the matter. Performing the examination with due professional care requires an auditor conducting an examination to take appropriate actions when becoming aware of non-compliance or Material Weaknesses not included in the broker's or dealer's assertions or when substantial doubt remains. This requirement is similar to the requirement in paragraph 35 of Auditing Standard No. 14, which states that if the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter.

7. Obtaining a Representation Letter (paragraphs 32 – 33 of Appendix 1)

The examination standard includes a requirement for the auditor to obtain written representations from management of the broker or dealer. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the examination engagement. See Section I.D. of this appendix, "Reporting on the Examination Engagement," for further discussion regarding scope limitations.

Overall, commenters were supportive of the requirement for the auditor to obtain representations from management and stated that obtaining representations from management is a necessary part of the auditor's ability to support the auditor's opinion. One commenter recommended that the auditor obtain a written representation from the broker or dealer that acknowledges the broker's or dealer's responsibility for the



assertions in the compliance report. This recommendation has been incorporated into paragraph 32.b. of the examination standard.

Commenters suggested additional representations that the auditor should obtain from management during an examination engagement, including representations regarding management's responsibility for compliance with the financial responsibility rules, that management has performed an evaluation of compliance, that management did not use the auditor's procedures performed during the audit of the financial statements or procedures performed on supplemental information as part of the basis for management's assertions and that management has disclosed to the auditor all known instances of non-compliance and fraud. While many of these additional representations might be appropriate based on the facts and circumstances of the examination engagement, the examination standard was not modified to include them as they are either duplicative of management's assertions or not necessary to meet the requirements of the standard. However, the examination standard does not preclude the auditor from obtaining additional representations from management in situations in which the auditor believes additional representations are appropriate.

C. Communication Requirements (paragraphs 34 – 35 of Appendix 1)

The examination standard requires the auditor to communicate certain matters to management and the audit committee. These requirements reflect changes from the proposed communication requirements to conform to SEC Rule 17a-5. In addition, rather than defining the term "audit committee," the examination standard states that the term "audit committee" has the same definition as that in Auditing Standard No. 16, *Communication with Audit Committees*.

One commenter stated that communication requirements in the proposed examination standard are sufficient. Another commenter requested that the Board clarify the meaning of "identified" as used in paragraph 36 of the proposed examination standard. That commenter questioned whether an "identified" instance of non-compliance referred to the moment the auditor becomes aware of the its existence or only after the auditor concludes it represented a significant deficiency. The language in the standard was retained as proposed. In the context of the examination standard, the term "identified instance of non-compliance" is meant to clarify that the communication requirement applies to instances of non-compliance identified by the auditor.^{39/} A note

^{39/} See also the discussion of the notification requirements in the SEC Release at 101-107.



has been included to paragraph 35 of the examination standard reminding auditors of their obligation to comply with the requirements of paragraph (h) of SEC Rule 17a-5.

D. Reporting on the Examination Engagement (paragraphs 36 – 38 of Appendix 1)

The examination standard requires the auditor to issue a single report that expresses an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects, when expressing an unqualified opinion. Paragraph 36 of the standard includes basic report elements, while paragraph 37 includes an illustrative report.

The reporting requirements in the examination standard have been revised to align with the compliance report that is required by SEC Rule 17a-5. This includes reporting on the broker's or dealer's assertions regarding the effectiveness of Internal Control Over Compliance during and as of the end of the most recent fiscal year, compliance with the net capital rule and the reserve requirements rule, and whether the information used to assert compliance with those rules was derived from the broker's or dealer's books and records.

1. Legal Determinations, Discussion of Inherent Limitation of the Examination, Discussion of Interpretations of Rules and Regulations, and Restrictions on the Use of the Examination Report

One commenter stated that the report clearly communicates the auditor's responsibilities. Other commenters suggested that the examination standard should address additional reporting matters, such as including a caveat about legal determinations, discussion of inherent limitations of the examination, discussion of interpretations of rules and regulations, and restrictions on the use of the examination report.

Legal Determinations

Some commenters stated that the auditor's examination report should be modified to include language indicating that the auditor's examination does not provide for a legal determination of a broker's or dealers compliance with financial responsibility rules. When the auditor is engaged to perform an examination, it is necessary for the auditor to read and make judgments regarding the application of the regulatory requirements, as applicable to the engagement. The auditor's report issued pursuant to the examination standard does not provide a legal determination, nor does it purport to provide a legal determination, of a broker's or dealer's compliance with the net capital



rule or the reserve requirements rule. However, such a report may be useful to legal counsel or others in making such determinations. In the context of an examination, the auditor expresses an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects. Accordingly, the Board did not add the suggested language to the examination standard.

Inherent Limitations of the Examination

Some commenters stated that the examination report should be revised to include language discussing the inherent limitations of the examination, similar to language contained in other PCAOB auditing standards. Those commenters recommended including a statement similar to the statement contained in the audit report on internal control over financial reporting, which states that because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements.^{40/}

The examination standard does not prescribe reporting language regarding the inherent limitations of the examination. Such language might be confusing to users who interpret such a statement as a limitation on the opinion expressed in the auditor's examination report, rather than the nature of internal controls over compliance. Also, an inherent limitation statement about internal control over financial reporting, which is management's responsibility and the subject of the audit, is different from a limitation statement about the auditor's examination itself.

Interpretations of Rules and Regulations

Several commenters stated that evaluating a broker's or dealer's compliance with regulatory requirements may be based upon interpretations of regulations or rules established by the Commission and/or DEAs. Commenters recommended that the examination standard permit the inclusion of a statement within the examination report stating the description and the source of interpretations made by the brokers and dealer's management. After considering these comments, a footnote has been added to paragraph 36.h. of the examination standard. The statement in the footnote is consistent with the existing requirements of paragraph .59 of AT sec. 601, *Compliance Attestation*, which allows the auditor to include a paragraph stating the description and the source of interpretations made by the entity's management immediately after the

^{40/} Paragraph 85.j. of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.



scope paragraph of the auditor's report. The following is an example of such a paragraph:

We have been informed that, under X Broker's interpretation of [identify the compliance requirement, e.g. SEC Rule 15c3-1], [explain the source and nature of the relevant interpretation].

One commenter recommended that the auditor's examination report should include a statement that the assertions are the responsibility of the broker or dealer. The examination standard does not include this language because the first sentence in the auditor's examination report clarifies that the assertions are the responsibility of the broker or dealer.

Restriction of Use of the Examination Report

The proposed examination standard did not include provisions for restricting the use of the examination report to specified parties. Some commenters stated that audit firms previously have often restricted the use of reports required by SEC Rule 17a-5 to the board of directors, management, the Commission, and other regulatory agencies that rely on SEC Rule 17a-5. Some commenters stated that a restriction on the use of an auditor's examination or review report is appropriate, given that general users of these reports may not have a sufficient understanding of the subject matter to which they relate, such as the financial responsibility rules.

SEC Rule 17a-5 specifies the required reports, assertions, and the compliance requirements related to these engagements. The reports pursuant to this rule are generally filed only with the Commission, the broker's or dealer's DEA, and the Securities Investor Protection Corporation ("SIPC"). Accordingly, these criteria are suitable and available for purposes of these engagements.

As the reporting criteria have been established by the Commission and those reporting criteria are publicly available, including language restricting the auditor's examination report in the examination standard is unnecessary. As such, no additional language is included in the examination standard.

2. *Examination Report Date (Paragraph 38 of Appendix 1)*

Under paragraph 38 of the examination standard, the auditor should date the examination report no earlier than the date on which the auditor obtains sufficient appropriate evidence to support his or her opinion. Because of the coordination between the examination engagement, the audit of the financial statements and the audit procedures performed on supplemental information, the date of the examination



report should not be earlier than the date of the auditor's report on the financial statements and supplemental information. The Board did not receive comments on the proposed dating of the report. As such, these requirements are adopted as proposed.

3. *Examination Report Modifications (Appendix C of Appendix 1)*

The examination standard includes an appendix ("Appendix C") that builds on existing concepts described in AT sec. 101 regarding report modifications and adapts them as appropriate to the requirements of the examination engagement.

Under the examination standard, if one or more instances of non-compliance with the net capital rule or the reserve requirements rule exist as of the end of the most recent fiscal year, one or more Material Weaknesses in Internal Control Over Compliance exist during or as of the end of the most recent fiscal year, or the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer, the auditor must express an adverse opinion directly on the subject matter of the respective assertions, rather than on the assertions themselves, unless there is a restriction on the scope of the examination engagement.^{41/} For example, if the broker or dealer is not in compliance with the net capital rule, the auditor's report would include an adverse opinion on compliance and would identify the instance of non-compliance regardless of whether it was described in the broker's or dealer's compliance report.

This requirement is different from AT sec. 101, which states that "[r]eservations about the subject matter ... can result in either a qualified or an adverse opinion, depending on the materiality of the departure from the criteria against which the subject matter ... was evaluated."^{42/} Qualified opinions are not appropriate because any instance of non-compliance as of the end of the fiscal year, any Material Weakness in Internal Control Over Compliance during or as of the end of the fiscal year, or any instance in which the information used to assert compliance with the net capital rule and the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records, is by definition material and, as such, must result in an adverse opinion.

^{41/} The requirement to express an adverse opinion applies regardless of whether the instance of non-compliance, material weakness, or other matters preventing an unqualified opinion were identified by management or the auditor.

^{42/} See AT sec. 101.76.



The examination standard describes specific matters that the auditor should include in the examination report when expressing an adverse opinion. For example, when expressing an adverse opinion because one or more Material Weaknesses exist, the auditor's examination report must include a statement that one or more Material Weaknesses have been identified and an identification of the description of the Material Weaknesses in the compliance report.

The requirement to express an adverse opinion applies only to the subject matter for the respective assertion. It does not require an adverse opinion on the subject matter of all assertions in every instance. For example, if a Material Weakness was identified during the year but not at year end, and there were no instances of non-compliance or instances in which the information used to assert compliance with the net capital rule and the reserve requirements rule was not derived, in all material respects, from the broker's or dealer's books and records, the examination report should include an adverse opinion on Internal Control Over Compliance during the year and an unqualified opinion on the other three assertions.

Several commenters recommended that the examination standard include examples of modified examination reports. Appendix C to the examination standard describes examination report modifications. Additional report examples may be considered, if guidance is issued in the future.

Further, paragraph C6 of the examination standard states that, when the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to make certain conclusions, the auditor's report also must include the matters described in paragraph C3 of the examination standard. Those conclusions include that: (1) one or more instances of non-compliance with the net capital rule or the reserve requirements rule existed as of the end of the fiscal year, (2) one or more Material Weaknesses existed during or as of the end of the most recent fiscal year, or (3) the information used to assert compliance with the net capital rule or the reserve requirements rule was not derived, in all material respects, from the books and records of the broker or dealer.

The examination standard states that the auditor may issue a report disclaiming an opinion on the assertions made by a broker or dealer in a compliance report as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work before issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.



In addition, unlike AT sec. 101, if the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the examination engagement, under the examination standard, the auditor should communicate on a timely basis, in writing, to management and the audit committee that the examination engagement cannot be satisfactorily completed.

Some commenters stated that when the auditor expresses an adverse opinion, the auditor should report directly on the subject matter for all assertions, rather than the respective assertion necessitating the adverse opinion. As discussed, the examination standard aligns with the requirements of SEC Rule 17a-5, which requires the auditor to report on the respective management assertion.

Under the examination standard, if the broker's or dealer's compliance report contains other information in addition to the statements and descriptions, if applicable, required by SEC Rule 17a-5,^{43/} the auditor should disclaim an opinion on the other information. For example, if the broker's or dealer's compliance report states that an identified Material Weakness no longer exists because controls have been implemented after the end of the fiscal year that address the Material Weakness, the auditor should disclaim an opinion on this information.

One commenter recommended that the examination standard address instances when there is a misstatement of fact in management's assertion, particularly when management's assertion is improperly presented. SEC Rule 17a-5 establishes the assertions brokers and dealers are required to make regarding compliance with the financial responsibility rules. The auditor's responsibility is to express an opinion on management's assertions. SEC Rule 17a-5 specifically describes the content of the statements to be made by the broker or dealer.^{44/} Further, a misstatement of fact by the broker or dealer in its assertion would likely result in an adverse opinion on one or more of the broker's or dealer's assertions. As the examination standard provides requirements relating to adverse opinions, no further changes were made based on this comment. Furthermore, as stated in the proposing release, if the auditor believes that additional information in the compliance report contains a material misstatement of fact, the auditor should discuss the matter with management of the broker or dealer. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee of the auditor's views concerning the information.

^{43/} See paragraphs (d)(3) and (g)(2) of SEC Rule 17a-5.

^{44/} See paragraph (d)(3) of SEC Rule 17a-5.



E. Appendix B. Considerations for Brokers and Dealers with Multiple Divisions or Branches

When a broker or dealer conducts its operations through multiple divisions and branch offices, the examination standard includes, in Appendix B, a requirement for the auditor to determine the extent to which examination procedures should be performed at selected divisions or branches to obtain sufficient appropriate evidence to support the conclusions expressed in the auditor's examination report. This includes determining the divisions or branches at which to perform examination procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual divisions or branches. The same requirements were included in the body of the proposed examination standard.

One commenter recommended certain additional factors that should be taken into account when determining the extent of the examination procedures to be performed at divisions or branches, including judgments about materiality of the division or branch and the similarity of operations over compliance for different divisions or branches. These factors were considered during the development of the examination standard. The requirement in the examination standard for the auditor to take into account the degree to which the financial responsibility rules relate to activities at the division or branch level is broader than judgments based solely on the materiality of a specific division. Adding another factor regarding materiality within paragraph 13 of the examination standard might limit an auditor's consideration of the procedures to be performed to only quantitative factors rather than risks related to non-compliance. As such, this factor has not been included in the examination standard.

One commenter recommended including the similarity of operations over compliance for different divisions or branches as a factor within the examination standard. Similar to the discussion in the preceding paragraph, the requirement in the examination standard for the auditor to take into account the degree to which the financial responsibility rules relate to activities at the division or branch level includes considerations regarding the similarity of operations over compliance for different divisions or branches. Including this factor within paragraph 13 of the examination standard might limit the auditor's consideration of the procedures to be performed to identified differences between different divisions or branches, rather than assessing the risk that different divisions or branches with similar operations over compliance might have instances of non-compliance.



F. Other Comments

1. Use of the Work of Other Auditors

Some commenters stated that situations could exist in which the auditor that is engaged to perform an examination engagement might use the work of other auditors. Those commenters stated that the examination standard should include a reference to AU sec. 543, *Part of Audit Performed by Other Independent Auditors*. Other commenters stated that references to the Board's auditing standards were inappropriate within the attestation standards. By its terms, AU sec. 543 applies when one auditor uses the work and reports of another auditor of the financial statements of a component. As this situation does not apply to a compliance examination engagement, the standard does not refer to AU sec. 543. Nonetheless, auditors can use the work of other auditors if such work is performed under their supervision.

2. Interaction with an Audit of Internal Control Over Financial Reporting

Some commenters stated that additional guidance relating to the relationship between internal control over financial reporting and Internal Control Over Compliance would be beneficial. Those commenters stated that while SEC Proposed Rule 17a-5 is clear that the attestation reports do not extend to internal control over financial reporting, there may be certain controls over financial reporting that could overlap with Internal Control Over Compliance with the financial responsibility rules.

Several commenters stated that the Board should coordinate with the SEC to provide further guidance regarding the relationship between the evaluation of Deficiencies in Internal Control Over Compliance and the evaluation of Material Weaknesses and significant deficiencies in internal control over financial reporting. The SEC Release contains relevant discussion regarding the interaction between Internal Control Over Compliance and internal control over financial reporting.^{45/}

^{45/} See the SEC Release at 38, which notes, among other things, that internal control over financial reporting is focused on the reliability of financial reporting and preparation of financial statements in accordance with generally accepted accounting principles, whereas the compliance report should focus on oversight of net capital, custody arrangements, and protection of customer assets, and, therefore should be focused on compliance with the financial responsibility rules.



II. Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers and Dealers

As previously described, the review standard has been designed specifically for an auditor's review of statements made by a broker or dealer in an exemption report required by the Commission's amendments to SEC Rule 17a-5.

Briefly, certain brokers and dealers claim exemption from the Commission's requirements contained in SEC Rule 15c3-3, the SEC rule relating to the custody of customer funds, pursuant to exemption provisions contained in paragraph (k) of SEC Rule 15c3-3 (the "exemption provisions"). In the exemption report, the broker or dealer identifies (i) the exemption provision of paragraph (k) of SEC Rule 15c3-3 under which the broker or dealer claimed exemption from the SEC's custody requirements (the "identified exemption provisions"), and (ii) states that the broker or dealer met the exemption provisions throughout the most recent fiscal year without exception or, if applicable, states that exceptions to the identified exemption provisions were identified, including a description of any such exceptions and the approximate date on which the exception existed. SEC Rule 17a-5 requires the broker or dealer to engage an independent public accountant registered with the PCAOB to review, and independently report on, the statements in the broker's or dealer's exemption report.

Because brokers and dealers claiming an exemption from SEC Rule 15c3-3 requirements under paragraph (k) of that rule might have access to customer funds, a review engagement focusing on the identification of exceptions to the exemption provisions claimed by brokers and dealers is important to the protection of investors. Notably, a recent PCAOB report on the progress of its interim inspection program of broker and dealer audits noted that in a significant number of audits of brokers and dealers that claimed an exemption from SEC Rule 15c3-3, auditors did not perform sufficient procedures to ascertain that the broker or dealer complied with the conditions of the exemption.^{46/} The review standard includes specific procedures for auditors performing compliance reviews of a broker's or dealer's assertions in an exemption report with an emphasis on coordination with the auditor's work on the financial statement audit and the audit procedures performed relating to supplemental information. This approach should enhance overall audit effectiveness and also help avoid unnecessary duplication of work.

^{46/} See *Second Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers*, PCAOB Release No. 2013-006 (August 19, 2013), at 9.



The following discussion provides background regarding the review standard, including significant comments received on the proposed review standard and changes made to the standard.

A. Overview of SEC Rule 17a-5 and Related Changes

As amended by the Commission, SEC Rule 17a-5 includes modifications from the SEC's proposed amendments, including a number of changes that focus the auditor more directly on the exemption provisions claimed by the broker or dealer and the identification of any exceptions. These modifications resulted in corresponding changes to the review standard. Principally, the changes involve:

- The introduction of certain terms, including "exemption provisions," and "exceptions;"
- Changes to the broker's or dealer's assertions, as set forth in SEC Rule 17a-5, to include more detailed information regarding the exemption provision claimed asserted by the broker or dealer and any exceptions identified; and
- Changes to the auditor's reporting requirements, and the example report, including requirements for auditors to modify their reports in situations in which the broker or dealer fails to disclose an exception in the exemption report.

As noted above, the review standard was designed specifically to implement the auditor's requirements in SEC Rule 17a-5. The review standard establishes requirements that apply when an auditor is engaged to perform an exemption review of the statements made by a broker or dealer in an exemption report prepared pursuant to SEC Rule 17a-5.

Paragraph 2 states that SEC Rule 17a-5 requires a broker's or dealer's exemption report to contain the following statements^{47/} by the broker or dealer:

- a. A statement that identifies the exemption provisions under which the broker or dealer claimed an exemption from SEC Rule 15c3-3;
- b. A statement that the broker or dealer (1) met the identified exemption provisions throughout the most recent fiscal year without exception or (2)

^{47/} See paragraph (d)(4) of SEC Rule 17a-5.



met the identified exemption provisions throughout the most recent fiscal year except as described in the exemption report; and

- c. If applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified exemption provisions (an "exception") and that briefly describes the nature of each exception and the approximate dates on which the exception existed.

The changes reflected in SEC Rule 17a-5 to include exceptions to the exemption provisions in the exemption report did not result in significant changes to the procedural requirements in the proposed review standard. The review standard, similar to the proposed review standard, requires the auditor to state a conclusion regarding whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertions for the assertions to be fairly stated, in all material respects.^{48/} To state such a conclusion, the auditor must plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance about whether one or more conditions exist that would cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects.

1. *Moderate Assurance*

The requirement that the auditor obtain moderate assurance^{49/} to support his or her opinion has not been changed from the Board's proposal. The approach taken in the review standard is in contrast to the examination standard, in which the auditor obtains reasonable assurance to support his or her opinion on the broker's or dealer's

^{48/} The review standard largely carries forward the requirement from prior SEC Rule 17a-5 that the independent public accountant engaged by the broker or dealer "must ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the independent public accountant's attention to indicate that the exemption had not been complied with during the period since the last examination." See the SEC Release at 72.

^{49/} Obtaining moderate assurance in a review engagement is consistent with both existing PCAOB standards and the SEC Release. AT sec. 101.55 describes a review as an attest engagement designed to provide a moderate level of assurance. See the SEC Release at 88, which states that a "moderate level of assurance [is] contemplated by the required review."



assertions. In the review engagement contemplated by the review standard, the auditor must obtain moderate assurance regarding the broker's or dealer's assertions.

Review engagements typically involve the performance of inquiries and analytical procedures,^{50/} and the auditor's conclusions typically are expressed in the report in the form of negative assurance.^{51/}

The proposing release noted that, in a review engagement covered by the proposed review standard, analytical procedures are not feasible for evaluating compliance with the exemption conditions, as the conditions are based on activities of the broker or dealer rather than on financial statement amounts. Thus, the review standard establishes specific procedural requirements that are commensurate with the responsibility to obtain moderate assurance. This approach is consistent with AT sec 101.55-.56 which states that "... there will be circumstances in which inquiry and analytical procedures ... cannot be performed... In [this] circumstance, the practitioner should perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided."

Commenters generally stated that the requirements in the review standard were appropriate for obtaining moderate assurance. Further, some commenters stated that the term "moderate assurance" as used in the review standard is consistent with how the term "moderate assurance" is presently used in practice and with how auditors are currently performing engagements to obtain moderate assurance.

One commenter stated that the review standard could clarify that the auditor plans and performs the review engagement in the context of obtaining a moderate level of assurance. In considering this comment, the Board noted that the objective of the review standard states "...the auditor must plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance...." As such, additional clarification is not necessary.

^{50/} AT sec. 101.55 states that "[i]n an attest engagement designed to provide a moderate level of assurance (referred to as a review), the objective is to accumulate sufficient evidence to restrict attestation risk to a moderate level. To accomplish this, the types of procedures performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures)."

^{51/} See AT sec. 101.68.



One commenter stated that an "agreed-upon procedures" engagement would be more appropriate than a review engagement for a broker's or dealer's assertion that it is exempt from SEC Rule 15c3-3. SEC Rule 17a-5 requires a broker or dealer that claimed exemption from the requirements of SEC Rule 15c3-3 to file a report from their independent public accountants that includes the results of a review of the broker's or dealer's assertions. As adopted, the review standard establishes requirements that are designed specifically to provide auditors with a standard for performing the review required by SEC Rule 17a-5.

B. Performing the Review Engagement (Paragraphs 5 – 14 of Appendix 2)

1. General Requirements (paragraphs 5 – 6 of Appendix 2)

Paragraphs 5 and 6 of the review standard set forth general requirements for an auditor performing the review standard. The Board did not receive significant comments on the general requirements of the proposed review standard. As such, the general requirements are being adopted largely as proposed.

Paragraph 5 of the review standard requires that an auditor performing a review engagement have adequate technical proficiency in attestation engagements, obtain an understanding of the exemption conditions and other rules and regulations that are relevant to the broker's or dealer's assertion, determine the auditor's compliance with independence and ethics requirements,^{52/} and exercise due professional care.

The proposed review standard included a footnote which stated that "due professional care" referred to in that paragraph was the same term in paragraph .40 of AT sec. 101. One commenter stated that while they did not disagree with the meaning of "due professional care," they believe that referencing AT sec. 101 from the review standard may be confusing, especially as AT sec. 101 would not be applicable to engagements in which the review standard is applicable. In response, a note has been added to state that due professional care imposes a responsibility on each engagement team member to comply with the review standard and that the exercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report. A footnote to that note states that the auditor's responsibility to

^{52/} Determining the auditor's compliance with independence and ethics requirements includes determining whether the auditor complied with relevant requirements of the PCAOB and the SEC. Paragraph (f)(1) of SEC Rule 17a-5 requires the auditor to be independent in accordance with 17 C.F.R. § 210.2-01.



exercise due professional care is consistent with the description in paragraphs .40-.41 of AT sec. 101.

With respect to documentation, the review engagement is subject to the requirements of Auditing Standard No. 3, which applies to engagements conducted pursuant to the standards of the PCAOB. Auditing Standard No. 3 states that as audit documentation is the written record that provides the support for the representations in the auditor's report, it should demonstrate that the engagement complied with the standards of the PCAOB.^{53/} A note has been added to paragraph 5 of the review standard to remind auditors of their responsibility to comply with Auditing Standard No. 3.

2. *Review Procedures (Paragraphs 8-10 of Appendix 2)*

The review standard requires the auditor to perform procedures consistent with a review engagement; however, the procedures have been tailored for the exemption report required by SEC Rule 17a-5.

Nature, Timing, and Extent of Procedures (Paragraph 9 of Appendix 2)

Under the proposed review standard, the nature, timing, and extent of the review procedures were dependent on certain risk factors and evidence about the broker's or dealer's compliance with the exemption conditions or about the effectiveness of controls over the exemption conditions obtained from the audit of the financial statements and the audit procedures performed on supplemental information. For example, one risk factor is potential non-compliance associated with related parties. Risks associated with related parties that are investment advisors or with which the broker or dealer has a custodial or clearing relationship may be especially relevant to the exemption provisions.

Evidence about the broker's or dealer's compliance with the exemption provisions or about the effectiveness of controls over the exemption provisions obtained from the audit of the financial statements and the audit procedures performed on supplemental information also affect the nature, timing, and extent of the necessary inquiries and other review procedures. For example, if the broker or dealer claims an exemption under Rule 15c3-3(k)(1), the auditor, among other things, needs to obtain evidence that the broker's or dealer's transactions are limited to those in redeemable securities of investment companies or of interests or participations in an insurance

^{53/} See paragraph 4 of Auditing Standard No. 3.



company separate account.^{54/} Audit procedures regarding the broker's or dealer's investment inventory or investment transactions related to the broker's or dealer's trading for its own account, including confirmation of investment inventory with the custodian and testing investment transactions, can provide evidence relevant to the broker's or dealer's compliance with these exemption conditions.

As another example, if the broker or dealer claims exemption under section (k)(1) of Rule 15c3-3, the auditor needs to obtain evidence about whether the broker or dealer

^{54/} Paragraph (k)(1) of SEC Rule 15c3-3, states that "the provisions of [Rule 15c3-3] shall not be applicable to a broker or dealer meeting all of the following conditions:

(i) His dealer transactions (as principal for his own account) are limited to the purchase, sale, and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company; except that a broker or dealer transacting business as a sole proprietor may also effect occasional transactions in other securities for his own account with or through another registered broker or dealer;

(ii) His transactions as broker (agent) are limited to: (a) The sale and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company; (b) the solicitation of share accounts for savings and loan associations insured by an instrumentality of the United States; and (c) the sale of securities for the account of a customer to obtain funds for immediate reinvestment in redeemable securities of registered investment companies; and

(iii) He promptly transmits all funds and delivers all securities received in connection with his activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.

(iv) Notwithstanding the foregoing, this section shall not apply to any insurance company which is a registered broker [or] dealer, and which otherwise meets all of the conditions in paragraphs (k)(1) (i), (ii), and (iii) of this section, solely by reason of its participation in transactions that are a part of the business of insurance, including the purchasing, selling, or holding of securities for or on behalf of such company's general and separate accounts."



promptly transmits all funds and delivers all securities received in connection with his activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.^{55/} Audit procedures regarding customer trade and transaction activities can provide evidence relevant to these exemption provisions.

Other procedures performed during the audit that are relevant to the broker's or dealer's compliance with the exemption provisions include testing of specially designated cash accounts and reading clearing agreements between the broker or dealer and clearing brokers and dealers in connection with testing trade fee or commission revenues and expenses.^{56/}

One commenter recommended incorporating the discussion in the proposing release relating to the risk of fraud into the review standard to provide further guidance. The proposing release stated that in considering the risk of fraud relevant to the exemption conditions, the auditor also considers whether the broker or dealer has misrepresented its activities, for example, the broker or dealer claims to be operating as a non-carrying broker or dealer but, based on other evidence appears to hold customer funds or securities. The Board considered this comment and determined, as it has done in other projects, to include performance requirements in the standard and to provide additional discussion and examples in an appendix to the release. Therefore, the release discussion regarding the risk of fraud has not been incorporated into the review standard. The request for guidance regarding the risk of fraud may be taken into account if additional guidance is issued.

The Board did not receive extensive comment on these requirements. Two commenters stated that the factors are appropriate. In general, these requirements are being adopted substantially as proposed.

Review Procedures (Paragraph 10 of Appendix 2)

Paragraph 10 of the review standard sets forth the required procedures for the review engagement. Specifically, the procedures required by the standard are consistent with a review engagement, including making inquiries of management and relevant personnel of the broker or dealer; reading relevant reports from internal

^{55/} See paragraph (k)(1)(iii) of SEC Rule 15c3-3.

^{56/} Refer to Section I.B.2., "Relationship Between the Examination Engagement and the Audit of the Financial Statements and Audit Procedures Performed on Supplemental Information," of this Appendix for further discussion.



auditors or regulatory correspondence; evaluating evidence from the audit of the financial statements and the audit procedures performed on supplemental information; and performing additional procedures for identified exceptions.

While the review standard requires the auditor to perform procedures consistent with a review engagement, the procedures in the standard have been modified in a number of ways to reflect changes made to SEC Rule 17a-5, including to reflect terms used in SEC Rule 17a-5. The following discussion highlights some of the key aspects of, comments on, and changes made to, the required review procedures.

Commenters generally supported the requirements as proposed. However, one commenter stated the proposed review standard does not clearly describe the procedures or the extent of evidence necessary to obtain moderate assurance. Another commenter stated that the language in paragraph 10.h. of the proposed review standard, "perform other procedures as necessary in the circumstances to obtain moderate assurance," is an overly broad requirement.

As previously discussed, obtaining moderate assurance in a review engagement is consistent with both existing PCAOB standards and the SEC Release. AT sec. 101.55 describes a review as an attest engagement designed to provide a moderate level of assurance. The SEC Release states that a "moderate level of assurance [is] contemplated by the required review."^{57/} The procedures required by the review standard have been designed to assist the auditor in obtaining moderate assurance in a review engagement. These procedures largely focus on making inquiries and reading information relevant to the broker's or dealer's assertions. In the Board's view, such procedures are consistent with AT sec. 101.56, given that analytical procedures would not provide relevant evidence in light of the broker's or dealer's assertions required by SEC Rule 17a-5. For example, paragraph 10.g. of the review standard states that in performing the review engagement, 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 information in the broker's or dealer's assertions. Further, paragraph 10.h. of the review standard has been revised to state that in performing the review engagement, the auditor should perform other procedures as necessary in the circumstances to obtain moderate assurance regarding whether a material modification should be made to the broker's or dealer's assertions for the assertions to be fairly stated, in all material respects.

^{57/} See the SEC Release at 88.



One commenter stated that, while the review procedures and the matters affecting their nature, timing, and extent are, for the most part, appropriate for an engagement to obtain a moderate level of assurance, they did have certain specific recommendations, including clarifying the note in paragraph 10.g. of the review standard to explicitly indicate that the examples of procedures are those that may be performed during the audit of the financial statements. The Board considered this comment and agrees that such a revision would clarify that the note is referring to examples of procedures performed during the audit of the financial statements that might provide relevant evidence to the review engagement. As such, the note to paragraph 10.g. of the review standard has been revised.

In addition, if the broker or dealer has sent to or received correspondence from the SEC or the broker's or dealer's DEA that is relevant to compliance with the exemption conditions, the review standard includes a requirement for the auditor to read such correspondence and, when necessary in the circumstances, make inquiries of the regulatory agencies. These procedures can provide the auditor with relevant information about a broker's or dealer's compliance with the exemption provisions. Under the circumstances when a need arises to make inquiries of the regulatory agencies, the Board acknowledges that auditors may need authorization from the broker or dealer before contacting the regulatory authority.

One commenter suggested that the Board provide guidance related to the interaction between auditors and a company's regulatory examiners consistent with the *AICPA Audit and Accounting Guide for Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies*. The guidance in that publication is specific to the interaction between the auditor and federal bank examiners, and might differ from the DEAs of the broker or dealer. As such, additional requirements in this area have not been included in the review standard.

3. *Evaluating the Results of the Review Procedures (paragraphs 11 – 12 of Appendix 2)*

Under paragraph 11 of the review standard, the auditor should evaluate whether information has come to the auditor's attention that cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects. For example, a broker's or dealer's failure to disclose an exception in the exemption report would cause the assertion not to be fairly stated, in all material respects, which would require modification of the review report. This paragraph has been modified to align with the amendments to SEC Rule 17a-5.



Additionally, the proposed standard required the auditor to perform additional procedures if information came to the auditor's attention that indicated that one or more instances of non-compliance might exist that might cause the broker's or dealer's assertion not to be fairly stated or if the auditor had substantial doubt about the assertion. The review standard has been revised to align with the requirements in SEC Rule 17a-5.

One commenter requested clarification of the relationship between paragraphs 10.h. and 12 of the review standard. Those two requirements address different situations, as discussed below.

As previously noted, paragraph 10.h. of the review standard requires auditors to perform other procedures as necessary in the circumstances to obtain moderate assurance. This applies when the auditor determines the nature, timing, and extent of review procedures to be performed, such as in planning the review.

Paragraph 12 of the review standard applies when information comes to the auditor's attention during the engagement indicating that the broker's or dealer's assertions might not be fairly stated or if the auditor has substantial doubt about the assertion. Pursuant to paragraph 12, the auditor in those situations is required to perform additional procedures to address the matter. Performing the review with due professional care requires an auditor conducting a review to take appropriate actions when becoming aware of exceptions to the exemption provisions not included in the broker's or dealer's assertion or when substantial doubt remains. The phrase "substantial doubt" has the same meaning as the phrase "substantial doubt" in paragraph 35 of Auditing Standard No. 14, which states that if the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter. In the context of a review engagement, these additional procedures could include, but are not limited to, making additional inquiries, reading documents, or performing search and verification procedures, as necessary.^{58/}

One commenter recommended incorporating the examples in the preceding paragraph, e.g., making additional inquiries, reading documents, or performing search and verification procedures, as necessary, and the discussion in AT sec. 101.56, into the review standard. That discussion and the examples have not been included in the review standard as they are provided to illustrate the nature of procedures that might be

^{58/} See, e.g., AT sec. 101.56.



appropriate in such circumstances. Including these as examples in the review standard might limit auditors' consideration of additional procedures to only these procedures, when other procedures, not discussed in this release, might be appropriate.

4. *Obtaining a Representation Letter (paragraphs 13 – 14 of Appendix 2)*

The review standard includes a requirement for the auditor to obtain written representations from management of the broker or dealer that relate to the review engagement. The purpose of such representations is to provide the auditor with necessary information for, and context regarding, the engagement. The auditor should not rely inappropriately on management's representations.

The review standard also provides that the failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the review engagement. If a limitation on the scope of the review engagement exists, the auditor should withdraw from the engagement or should modify the review report.^{59/} Additionally, the review standard also includes a list of written representations that the auditor should obtain from management.

Commenters stated that obtaining representations from management is a necessary part of the auditor's ability to express an opinion. One commenter recommended that the list of required written representations include a representation from management that acknowledges its responsibility for the assertions in the exemption report. The suggested additional representation has been included in the review standard.

Further, in the review standard, several of the representations were updated to align with the language in SEC Rule 17a-5.

C. Communication Requirements (paragraph 15 of Appendix 2)

The review standard requires the auditor to communicate to management and to the audit committee any exceptions to the exemption provisions identified by the auditor or information that causes the broker's or dealer's assertions about its exemption provisions not to be fairly stated, in all material respects. In addition, rather than defining the term audit committee, the review standard states that the term "audit committee" has the same definition as that in Auditing Standard No. 16.

^{59/} See paragraph 20 of the review standard for auditor requirements when a scope limitation exists.



The Board did not receive significant comments on the communication requirements included in the proposed review standard. However, the communication requirements in the standard have been modified to align closely with SEC Rule 17a-5. Additionally, a note has been added to paragraph 15 of the review standard reminding auditors of their obligation to comply with the requirements of paragraph (h) of SEC Rule 17a-5.^{60/}

D. Reporting on the Review Engagement (paragraphs 16 – 18 of Appendix 2)

The review standard includes requirements for the auditor's review report to include certain elements that are important for a reader of the review report to understand regarding the auditor's responsibilities. This includes a statement that the review was conducted in accordance with the standards of the PCAOB and, accordingly, includes inquiries and other required procedures to obtain evidence about the broker's or dealer's compliance with the exemption provisions. These are largely the same elements as in the proposed standard.

The review standard includes an example of the auditor's standard review report when the broker or dealer asserted that it met the identified exemption provisions throughout the most recent fiscal year without exception and an example of the auditor's standard review report when the broker or dealer includes exceptions to the exemption provisions in the exemption report. A change was made to the review results paragraph in the example review report to align the reporting language more closely to the corresponding reporting element, which was not modified from the proposed review standard.

Some commenters stated concerns similar to those for the examination report regarding the use of the review report as a legal determination, interpretation of rules and regulations, restrictions on use of the review report, and limitations of an engagement to obtain moderate assurance. When the auditor is engaged to perform a review engagement, it is necessary for the auditor to read and make judgments regarding the application of regulatory requirements, as applicable to the engagement. The review report issued pursuant to the review standard does not provide a legal determination, nor does it purport to provide a legal determination, of a broker's or dealer's compliance exemption provision. However, such a report may be useful to legal counsel or others in making such determinations.

^{60/} See also the discussion of the notification requirements in the SEC Release at 101-107.



E. Modifications of the Report (paragraphs 19 – 20 of Appendix 2)

The review standard requires that if one or more of the broker's or dealer's assertions are not fairly stated, in all material respects, the auditor must modify the review report to describe the reasons why the assertions are not fairly stated, in all material respects. If the broker's or dealer's assertion is not fairly stated because of one or more omitted exceptions, the auditor's review report should disclose each omitted exception.

Paragraph 20 of the review standard sets forth circumstances involving scope limitations. Under the review standard, if the auditor cannot perform the procedures required by the review standard or other procedures that the auditor deems necessary in the circumstances, the review is incomplete because of the scope limitation. An incomplete review is not a sufficient basis for stating a conclusion regarding the broker's or dealer's assertions. In the case of a scope limitation, the auditor should withdraw from the engagement or should modify the review report to:

- a. Describe the scope limitation and any review procedures deemed necessary by the auditor that have been omitted and the reason for their omission;
- b. State that the auditor does not express any form of assurance on the broker's or dealer's assertions; and, if applicable,
- c. Describe the circumstances which cause one or more of the broker's or dealer's assertions not to be fairly stated, in all material respects.

One commenter stated that auditors should use judgment in drafting an appropriate modification to the review report. Other commenters stated that the attestation standards should contain examples of report modifications. The standard sets forth the necessary reporting elements for modified reports. Additional report examples may be considered if guidance is issued in the future.

One commenter questioned the appropriateness of the requirement in paragraph 20 of the proposed review standard for the auditor to describe the omitted procedures and the reason for their omission. The commenter stated that as the reason for the omission of the review procedures is required in the description of the scope limitation itself, describing the omitted review procedures might overshadow the scope limitation. The commenter recommended that it would be more appropriate to generally describe the effect of the scope limitation on the engagement, without providing a list of omitted procedures that may have been considered necessary. Including in the review report a



description of the scope limitation, the omitted procedures, and the reason for their omission are important elements of a modified review report given the nature of the procedures and the specificity of the exemption provisions. The discussion of the omitted procedures generally would provide the reader with additional information beyond the description of the scope limitation. As such, this recommendation has not been incorporated into the review standard.

The same commenter also recommended that the review standard address the auditor's responsibility as it relates to report modifications when management's assertion is improperly presented or contains additional information. That commenter suggested that, in such circumstances, an explanatory paragraph should be included in the auditor's report. Paragraph 19 of the review standard requires the auditor to modify the review report to describe the reasons the assertions are not fairly stated, in all material respects, if one or more of the broker's or dealer's assertions are not fairly stated. This would include circumstances in which management's assertion is improperly presented, and other PCAOB standards address additional information.^{61/}

III. Amendments

A. **Auditing Standard No. 3**

The Board is adopting certain amendments to Auditing Standard No. 3, *Audit Documentation*, to clarify that its requirements apply to examination engagements and review engagements. Auditing Standard No. 3 establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to standards of the PCAOB, including the attestation standards of the PCAOB. The Board is amending Auditing Standard No. 3 to help auditors properly apply the relevant requirements in Auditing Standard No. 3 to attestation engagements, including the attestation engagements covered by the attestation standards. For example, paragraph 6 of Auditing Standard No. 3 includes a requirement for the auditor to document procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions. An amendment to footnote 2 of paragraph 6 clarifies that, with respect to an engagement conducted pursuant to the attestation standards of the PCAOB, the relevant assertions are the assertions expressed by management or the responsible party regarding the subject matter of the attestation engagement.

^{61/} See, e.g., AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.



In addition, paragraph 12 of Auditing Standard No. 3 includes requirements regarding significant findings or issues and provides certain examples of significant findings or issues. Further, paragraph 13 of Auditing Standard No. 3 requires the auditor to identify all significant findings or issues in an engagement completion document.

The Board did not receive comments requiring revision to the amendments to Auditing Standard No. 3. As such, the amendments are adopted largely as proposed.

B. Auditing Standard No. 7

The Board is adopting certain amendments to Auditing Standard No. 7, *Engagement Quality Review*, to extend the requirements for an engagement quality review and concurring approval of issuance for the examination engagements and review engagements of brokers and dealers covered by these attestation standards. The proposal also included amendments that set forth certain procedures to be applied in an engagement quality review of the examination and review under these attestation standards.

Commenters expressed a range of views. Some commenters generally supported the engagement quality review requirement for these attestation engagements as well as the required procedures. One commenter did not support requiring an engagement quality review for either an examination engagement or a review. Other commenters did not support engagement quality reviews for review engagements. Some commenters stated that additional guidance is necessary to implement the proposed amendments.

Other commenters stated that as the audit and attestation standards have been separate bodies of literature, audit and attest standards should be kept separate. Those comments stated that to promote compliance with PCAOB standards, they believe that the Board should continue to maintain this structure. They also believe that the use of an amendment to adopt such significant changes in the literature may not sufficiently take into account a broader consideration of the affected engagements. For those firms that do not audit brokers or dealers, such changes also may go unnoticed.

The Board considered the comments received regarding the amendments to Auditing Standard No. 7 and is adopting the amendments as proposed for both a compliance examination and a compliance review.

Given the importance of the attestation engagements to investor protection and the high level of deficiencies observed by PCAOB inspection staff in areas that would



be covered by the attestation engagements,^{62/} the Board believes that engagement quality reviews can enhance the consistency of compliance with the SEC's rule. An effective engagement quality review can increase the likelihood of identifying significant engagement deficiencies before the examination or review report is issued. Additionally, the Board took note of the fact that, in a February 2011 AICPA Peer Review Alert, the AICPA designated audits of carrying brokers or dealers as a "must select" for peer review, recognizing the significant public interest in audits of such firms.^{63/}

Also, the emphasis in the attestation engagements regarding the coordination of the attestation engagement with the financial statement audit should reduce the audit effort required to complete the engagement quality review. To emphasize the coordination of the attestation engagement with the financial statement audit in performing an engagement quality review, the proposed amendment to paragraph 18A of Auditing Standard No. 7 was modified to reflect that to evaluate significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the attestation engagement and in preparing the engagement report, the engagement quality review should take into account the procedures performed in the engagement quality review of the financial statement audit. The knowledge that the engagement quality reviewer gains from the engagement quality review of the audit and the specific steps in paragraph 18A should enable the engagement quality reviewer to identify whether there are any significant engagement deficiencies, or any indications of potential significant engagement deficiencies that warrant further investigation.

^{62/} See PCAOB Release 2013-006, which reports that PCAOB inspection staff identified auditing deficiencies in 57 of the 60 audits of brokers and dealers selected for inspection and that deficiencies in compliance with audit requirements for brokers and dealers under the Exchange Act that were among the most frequently noted by PCAOB inspection staff included deficiencies in audit procedures related to net capital and customer reserve supporting schedules, compliance with the conditions of the exemption claimed by the broker or dealer, and the accountant's supplemental report on material inadequacies. See PCAOB Release 2013-006, Executive Summary, at ii.

^{63/} See AICPA Peer Review Alert 11-01 (February 2011).



IV. Other Areas of Comment

The Board requested comment from interested parties on all aspects of the proposal. Several commenters included additional recommendations that have not yet been discussed. Those suggestions are discussed below.

A. Scalability of the Attestation Standards

The Board requested comment regarding whether the proposed attestation standards are tailored appropriately for examinations and reviews related to compliance and exemption reports of brokers and dealers. Commenters who responded to the question generally agreed that the proposed attestation standards are tailored appropriately for examinations and reviews related to compliance and exemption reports of brokers and dealers. One commenter stated that they generally support the proposals and noted that the proposed standards had been clearly aligned with the SEC's proposed rule amendments.

The Board also requested comment regarding whether the proposed attestation standards were appropriately scalable based on the size and complexity of the broker or dealer. Some commenters stated that the standards are proportionate and appropriately scalable based on the size and complexity of the broker or dealer, noting that paragraphs 11 and 12 of Appendix 1 are particularly helpful. Some commenters recommended that the Board provide additional guidance, including specific examples, regarding the application of scalability to these examination engagements. Other commenters expressed concern that without such guidance, application of the audit scalability concept could vary greatly across the audit profession. The requests for guidance may be taken into account if additional staff guidance is issued.

B. Commodity Futures Trading Commission Rules

One commenter stated that for brokers and dealers that are also registered as a Futures Commission Merchant with the Commodity Futures Trading Commission ("CFTC"), it will be necessary for the PCAOB to recognize and address the requirements related to CFTC Rule 1.16 for the auditor to report on compliance therewith. The Commission stated in the SEC Release that its staff "is in discussions with the CFTC staff concerning ways to align the reporting and audit requirements for dually-registered broker-dealers/Futures Commissions Merchants with the goal of coordinating these requirements."^{64/}

^{64/} See the SEC Release at 8.



C. Independence

Several commenters recommended that the discussion in the proposing release stating that auditors of non-issuer brokers and dealers are not subject to PCAOB Rules 3521 through Rule 3526 be included in the attestation standards. On February 28, 2012, the Board proposed amendments to require that registered firms that audit brokers and dealers comply with certain of the Board's professional practice standards including the Board's Rules relating to independence.^{65/} The Board will consider relevant comments applicable to the Board's independence rules in connection with adopting final amendments.

D. Period of the Examination and Review

Some commenters stated that brokers and dealers should be allowed to assert compliance with the financial responsibility rules if it can identify deficiencies, implement effective controls, and test their operating effectiveness prior to year-end, and if the auditor also can adequately test the operating effectiveness of the remediated controls. SEC Rule 17a-5 requires the broker or dealer to assert that Internal Control Over Compliance was effective during the most recent fiscal year and as of the end of the most recent fiscal year. While this would require a broker or dealer to identify in its report Material Weaknesses in internal control that occurred during the most recent fiscal year, if those Material Weaknesses are remediated, it would allow the broker or dealer to assert that Internal Control Over Compliance was effective as of the end of the most recent fiscal year.

Some commenters requested clarification about the time period for the assertion regarding exemption from the requirements of SEC Rule 15c3-3 and indicate that they believe a point-in-time assertion would be sufficient. SEC Rule 17a-5 requires the broker or dealer to assert that it met, or met with exception, the identified exemption provisions in paragraph (k) of SEC Rule 15c3-3 throughout the most recent fiscal year end. The review standard has been updated to reflect this time period.

^{65/} See Proposed Amendments to Conform PCAOB Rules and Forms to the Dodd-Frank Act and Make Certain Updates and Clarifications, PCAOB Release No. 2012-002 (February 28, 2012).



E. Providing Additional Guidance and Including Examples from the Proposing Release in the Examination Standard

Several commenters recommended incorporating the additional discussion and examples included in Appendix 4 of the proposing release into the standard. The examples are not included in the attestation standards. Those examples were illustrative and did not impose requirements or define engagement requirements. Additional report examples may be considered, if guidance is issued in the future.

V. Other Considerations

A. Agreed-Upon Procedures Engagements

SEC Rule 17a-5 largely carries forward the requirement that the broker or dealer file with SIPC a supplemental report that includes an accountant's report on applying agreed-upon procedures based on the performance of the procedures outlined in SEC Rule 17a-5.^{66/}

These attestation standards do not affect the requirements for those agreed-upon procedures engagements. Auditors should continue to look to AT sec. 101, AT sec. 201, *Agreed-Upon Procedures*, and AT sec. 601,^{67/} for the requirements applicable to those engagements.

B. Relationship to the Interim Attestation Standards

In general terms, the requirements in the examination standard are consistent with the requirements of AT sec. 101 and AT sec. 601. However, when an auditor performs an engagement pursuant to the examination standard, AT sec. 101 and AT sec. 601 would not apply. For this reason, the examination standard includes, for example, a section on general requirements that are consistent with those in AT sec. 101.

The examination standard focuses specifically on performing an examination of the statements made by a broker or dealer in a compliance report and allows auditors to perform such engagements without looking to multiple attestation standards. In addition, the emphasis in the examination standard on appropriately coordinating the

^{66/} See paragraph (e)(4)(ii) of SEC Rule 17a-5.

^{67/} See paragraphs .16-.29 of AT sec. 601.



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examination engagement with the audit of the financial statements and supplemental information should avoid unnecessary redundancy in the auditor's work.

VI. Effective Date

The attestation standards will be effective, subject to approval by the SEC, for examination engagements and review engagements of fiscal years ending on or after June 1, 2014. This effective date coincides with the effective date for the corresponding amendments to SEC Rule 17a-5.^{68/}

^{68/} See the SEC Release at 2.