PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers

PCAOB Release No. 2021-002
August 19, 2021

CONTENTS

OVERVIEW

The Public Company Accounting Oversight Board (PCAOB) has registration, inspection, standard-setting, and disciplinary authority over the auditors of brokers and dealers registered with the U.S. Securities and Exchange Commission (SEC).[1] Overseeing the audits of SEC-registered broker-dealers is a key component of the PCAOB's mission to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports.

This *Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers* ("Annual Report") provides (1) information about our 2020 inspections approach, (2) a summary of our 2020 inspections observations, and (3) "good practices," which include brief scenarios and possible procedures that may be effective to address those scenarios. The information in this Annual Report is provided under the requirements of PCAOB Rule 4020T, which addresses reporting under the interim inspection program.

Changes in the Presentation of this Report

To streamline this Annual Report, we have made changes to how we present information.

Information about the selection of firms and engagements for inspections that was included as an appendix to our **previous annual reports** is now included in the "2020 Inspections Approach" and "Information About Selected Firms and Engagements" sections below.

As a supplement to this Annual Report, we have compiled additional information on inspection results and selected firms and engagements under the interim inspection program. This additional information, which was included as an appendix to our previous annual reports, is now posted as a separate document on our **website**.

Under Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5, broker-dealers registered with the SEC are generally required to file annually: a financial report and either a compliance report (if the broker-dealer did not claim it was exempt from Exchange Act Rule 15c3-3, *Customer Protection – Reserves and Custody of Securities* ("Customer Protection Rule")) or an exemption report (if the broker-dealer did claim it was exempt from the Customer Protection Rule), as well as reports of an independent public accountant covering the financial report and the compliance report or exemption report, as applicable. The accountant must be engaged to prepare a report based on an examination of the financial report in accordance with PCAOB auditing standards ("audit engagement") and a report based on an examination of certain statements in the compliance report ("examination engagement") or a report based on a review of the exemption report ("review engagement"). The PCAOB has issued attestation standards covering the compliance report (AT No. 1) and the exemption report (AT No. 2).

Overarching observations from our 2020 inspections of firms that audit broker-dealers include the following:

- The number of firms that had one or more audit and/or attestation engagements with deficiencies showed a 14% drop from 2019 but remained high as a percentage of firms inspected (78%).

[1] The use of the term "broker-dealer" in this report refers to entities that are registered with the SEC as both a broker and a dealer and to entities that are registered as only one or the other.

- The number of audit engagements with deficiencies declined 15% from 2019 levels but remained high as a percentage of engagements reviewed (61%) primarily due to deficiencies in auditing revenue.
- The percentage of examination engagements with deficiencies declined slightly to 67% of engagements reviewed from 69% in 2019 but remained high primarily due to deficiencies in testing internal control over compliance (ICOC).[2] Examination engagements address assertions made by broker-dealers in compliance reports.
- The percentage of review engagements with deficiencies declined to 23% of engagements reviewed from 51% in 2019. Review engagements address assertions made by broker-dealers in exemption reports.
- Generally, the results of inspections of firms that audited more than 100 broker-dealers resulted in lower percentages of audit engagements with deficiencies, compared to the results for firms that audited 100 or fewer broker-dealers. For firms that audited more than 100 broker-dealers, the percentage of audit engagements with deficiencies declined to 38% in 2020 from 41% in 2019. For all other firms, the percentage of audit engagements with deficiencies declined to 71% in 2020 from 84% in 2019.

Additional information about inspection results based on firm characteristics is included in the supplement to this Annual Report.

By highlighting deficiencies and good practices, this Annual Report helps to advance our strategic goal of driving improvement in the quality of audit services through a combination of prevention, detection, deterrence, and remediation. In addition to being helpful to audit firms, it may also be useful for other stakeholders, including management and the audit committee (or equivalent body) of broker-dealers, as they engage with audit firms regarding audit quality and broker-dealer financial reporting.

[2] Internal Control Over Compliance is defined in paragraph (d)(3)(ii) of Exchange Act Rule 17a-5 as internal controls that have the objective of providing the broker-dealer with reasonable assurance that non-compliance with Exchange Act Rule 15c3-1, *Net Capital Requirements for Brokers or Dealers* ("Net Capital Rule"); the Customer Protection Rule; Exchange Act Rule 17a-13, *Quarterly Security Counts to be Made by Certain Exchange Members, Brokers and Dealers* ("Quarterly Security Counts Rule"); or any rule of the designated examining authority of the broker-dealer that requires account statements to be sent to the customers of the broker-dealer (an "Account Statement Rule") will be prevented or detected on a timely basis.

Inspections By the Numbers	2020	2019	2018
Total Firms Inspected	**65**	**66**	**67**
Firms Whose Audits and/or Attestation Engagements Showed Deficiencies	51	59	64
Firms Whose Audits and Attestation Engagements Did Not Show Deficiencies	14	7	3
Total Audits	**105**	**106**	**105**
Audits with Deficiencies	64	75	80
- Audits with Audit Deficiencies and Attestation Deficiencies	27	53	55
- Audits with Audit Deficiencies but without Attestation Deficiencies	37	22	25
Audits without Deficiencies	41	31	25
Total Examination Engagements	**21**	**29**	**24**
Examination Engagements with Deficiencies	14	20	18
Examination Engagements without Deficiencies	7	9	6
Total Review Engagements	**83**	**74**	**79**
Review Engagements with Deficiencies	19	38	43
Review Engagements without Deficiencies	64	36	36

2020 INSPECTIONS APPROACH

Under the interim inspection program, the PCAOB assessed firms' compliance with applicable laws, rules, and professional standards when performing audit and attestation engagements for broker-dealers. We also evaluated elements of firms' quality control systems.

For our 2020 inspections, we selected PCAOB-registered firms that performed audits of SEC-registered broker-dealers with financial statement periods that ended during the period from April 1, 2019, through March 31, 2020. The following table provides additional information about that population of firms.

Number of Broker-Dealer Audits Per Firm	Number of Firms	Number of Broker-Dealer Audits
1	109	109
2 to 20	212	1,190
21 to 50	25	779
51 to 100	10	681
More than 100	4	550
Total	**360**	**3,309**

In selecting firms to inspect, we made risk-based selections that considered characteristics of the firms, which included:

- The number of broker-dealer audits performed;
- Whether the firm conducted examination engagements;
- Whether the firm also issued audit reports for issuers;
- Previous inspection results;
- The history of the firm or firm personnel in auditing broker-dealers; and
- The existence of disciplinary actions against the firm or its partners by the SEC, PCAOB, or other regulatory authorities.

The mix of firms inspected under the interim inspection program is different each year, and our 2020 selections included some firms inspected for the first time.

In selecting engagements for review, we made (1) risk-based selections that considered various characteristics of the broker-dealers, and (2) random selections that provided an element of unpredictability. The broker-dealer characteristics included:

- Whether the broker-dealer filed a compliance report with the SEC pursuant to Exchange Act Rule 17a-5;
- Whether the broker-dealer was a subsidiary of an issuer and its significance to the issuer's consolidated financial statements;

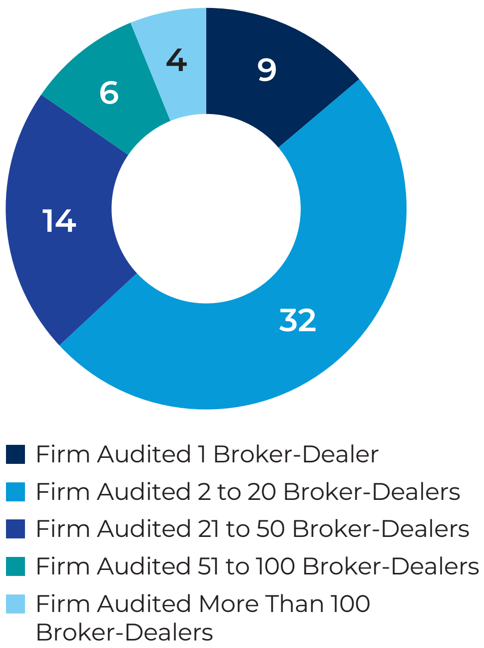
- Financial metrics;
- Changes in auditors and certain circumstances related to the changes; and
- Existence of disciplinary actions against the broker-dealer by the SEC, the Financial Industry Regulatory Authority (FINRA), or other regulatory authorities.

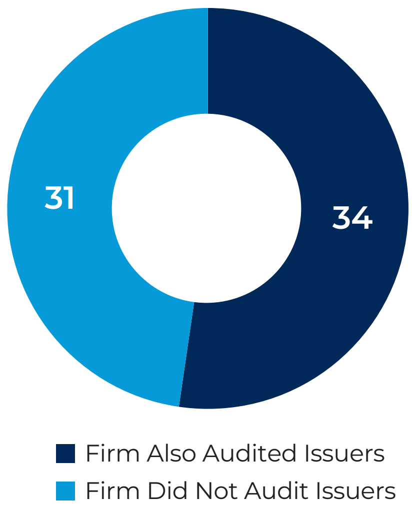
We did not review every aspect of the selected engagements. Rather, we generally focused on areas we believed to be of greater complexity and significance or with a heightened risk of material misstatement to the broker-dealer's financial statements. We also generally focused on assertions made in broker-dealer compliance reports or exemption reports with heightened risk of not being fairly stated in all material respects. We selected nontraditional focus areas on some audits to provide an added element of unpredictability.

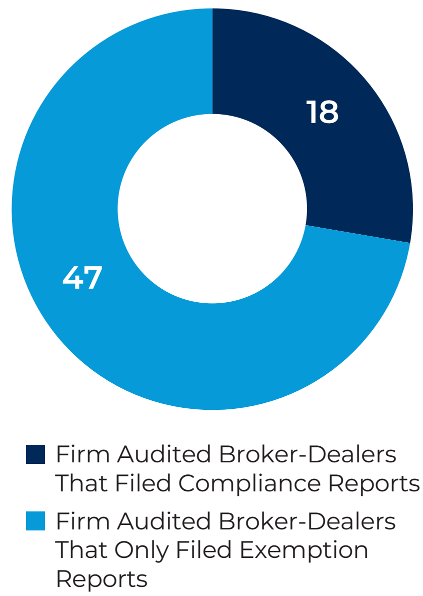
INFORMATION ABOUT SELECTED FIRMS AND ENGAGEMENTS

Firms

We selected 65 firms for inspection in 2020.[3] The following charts depict the number of broker-dealer audits performed by those 65 firms (as determined at the time of the inspection), whether or not the firms also audited issuers, and whether the firms audited broker-dealers that filed compliance reports or audited broker-dealers that only filed exemption reports.







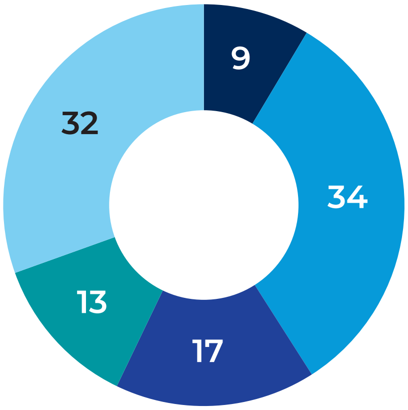
At the time of the 2020 inspections, of the 34 firms that audited issuers in addition to broker-dealers, four audited more than 100 issuers and 30 audited 100 or fewer issuers.

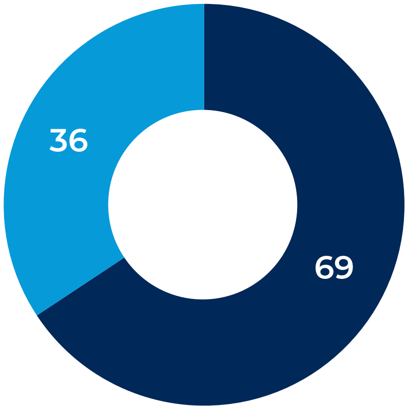
Engagements

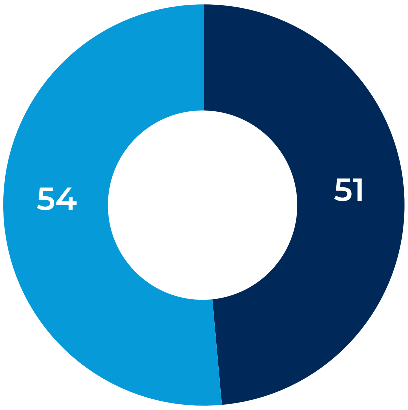
We selected 105 financial statement audits for review during our 2020 inspections. Of those, 102 audits were of broker-dealers with financial statement periods that ended during April 1, 2019, through March 31, 2020, including eight with financial statement periods that ended March 31, 2020. These audits were selected from the population of 3,309 broker-dealer audits described above. The remaining three audits were of broker-dealers with financial statement periods that ended June 30, 2020. These audits, and the eight above, provided the opportunity to obtain insight into how COVID-19 may have affected the performance of procedures in broker-dealer audits.

[3] The results of the 2019 inspection of one firm and review of one audit conducted by that firm that occurred in January 2020 were included in the Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers issued August 20, 2020. See PCAOB Release No. 2020-001.

The following charts provide information about the distribution of the 105 audits among the selected firms, using the same criteria as the corresponding firm charts on page 8.







- Firm Audited 1 Broker-Dealer
- Firm Audited 2 to 20 Broker-Dealers
- Firm Audited 21 to 50 Broker-Dealers
- Firm Audited 51 to 100 Broker-Dealers
- Firm Audited More Than 100 Broker-Dealers

- Firm Also Audited Issuers
- Firm Did Not Audit Issuers

- Firm Audited Broker-Dealers That Filed Compliance Reports
- Firm Audited Broker-Dealers That Only Filed Exemption Reports

The following table presents information about the minimum net capital requirements and actual net capital reported for the 105 broker-dealers whose audits were selected for review, stratified by whether the broker-dealer did or did not claim an exemption from the Customer Protection Rule.

Broker-Dealers	Number of Audits Reviewed	Range of Minimum Net Capital Requirements (Thousands)	Range of Actual Net Capital Reported at Fiscal Year End (Thousands)
Did Not Claim Exemption	22	\$250 - \$1,300,000	\$750 - \$6,100,000
Claimed Exemption	83	\$5 - \$2,500	\$5 - \$350,000
Total	**105**	**\$5 - \$1,300,000**	**\$5 - \$6,100,000**

We also reviewed 104 attestation engagements related to the 105 audits. For one audit, our firm inspection did not cover the related review engagement.

In addition to the selection of three audits of broker-dealers with financial statement periods that ended June 30, 2020, eight other broker-dealers whose engagements were selected for review had financial statement periods that ended March 31, 2020, after the onset of COVID-19. The following table presents deficiencies in audit and attestation procedures, and other instances of non-compliance with PCAOB standards by type of engagement ("other deficiencies"), stratified based on the financial statement period of the broker-dealers. Other deficiencies include deficiencies that do not directly relate to the sufficiency or appropriateness of evidence firms obtained to support their audit opinions or attestation reports, as well as deficiencies related to engagement quality reviews.

Broker-Dealers Financial Statement Periods Ended	Number of Audits Reviewed	Percentage of Audits Reviewed with Audit and Other Deficiencies	Percentage of Areas Reviewed with Audit and Other Deficiencies	Examination Engagements Covered	Percentage of Examinations Covered with Attestation and Other Deficiencies	Review Engagements Covered	Percentage of Reviews Covered with Attestation and Other Deficiencies
April 1, 2019, through December 31, 2019	94	60%	17%	18	67%	75	23%
March 31, 2020, through June 30, 2020	11	73%	24%	3	67%	8	25%
Total	**105**	**61%**	**18%**	**21**	**67%**	**83**	**23%**

The results from our review of engagements for broker-dealers with financial statement periods that ended in 2020 reflected slightly higher percentages of deficiencies in audits and audit areas compared to broker-dealers with financial statement periods that ended in the last nine months of 2019. The percentages of examination and review engagements with deficiencies were comparable. The results from our review of these engagements are included in the results described in the Inspections Observations section of this Annual Report.

Of the 105 audit engagements that we reviewed, 90 were risk-based selections, and 15 were random selections. The following table shows the percentage of audits, areas, and attestation engagements with deficiencies for the engagements selected at random and those selected based on risk characteristics.

	Number of Audits Reviewed	Percentage of Audits Reviewed with Audit and Other Deficiencies	Percentage of Areas Reviewed with Audit and Other Deficiencies	Percentage of Examinations Covered with Attestation and Other Deficiencies	Percentage of Reviews Covered with Attestation and Other Deficiencies
Risk-Based Selections	90	66%	20%	63%	24%
Random Selections	15	33%	8%	100%	15%
Total	**105**	**61%**	**18%**	**67%**	**23%**

We noted that the percentage of audits, areas, and review engagements with deficiencies was lower for random selections when compared to the risk-based selections. For broker-dealers selected randomly, there were 13 related review engagements and two related examination engagements, which were covered during the inspection of the firm.

INSPECTIONS OBSERVATIONS

Inspections of selected firms under the interim inspection program included review of portions of selected engagements and evaluation of elements of the firms' quality control systems. Inspection staff communicated the following, as applicable, to each inspected firm:

- Deficiencies in the firm's audits of broker-dealer financial statements and supporting schedules, and its examination and review attestation engagements;
- Other instances of non-compliance with PCAOB standards;
- Deficiencies related to the firm's quality control system; and
- Independence findings.

Throughout this section, we generally present observations within each area, in order, based on frequency of occurrence.

The deficiencies we identified do not necessarily mean that the broker-dealer's financial statements, supporting schedules, or compliance or exemption reports are not fairly presented or stated, in all material respects. It is often not possible for us to reach a conclusion on those points based on our inspection because we have only the information in the broker-dealer's filings and the information the auditor retained. We do not have access to the broker-dealer's management, or direct access to its underlying books and records, and other information.

Our selections of firms for inspection and engagements for review do not constitute representative samples of the populations of firms that audit broker-dealers or broker-dealer engagements. Additionally, our inspection findings are specific to the particular portions of the engagements reviewed. They are not an assessment of all work performed by the firms selected for inspection or of all of the procedures performed for the engagements reviewed. Further, the populations of firms and broker-dealers are not homogeneous. Therefore, the observations in this Annual Report are not necessarily representative of the population of all firms that perform broker-dealer audits or of all broker-dealer audit and attestation engagements.

Good Practices

Throughout this Annual Report, we highlight good practices that may be effective to address various scenarios. These good practices are provided as examples and do not modify or establish auditing or attestation standards.

We encourage auditors to consider how these examples may apply to their broker-dealer engagements and to implement changes to engagement procedures proactively where necessary to comply with PCAOB standards.

Importantly, the good practices we highlight are dependent upon the specific attendant facts and circumstances.

Deficiencies in Attestation and Audit Engagements

This section of our report discusses deficiencies we identified related to attestation and audit engagements when firms did not perform — or did not sufficiently perform — certain required procedures, or otherwise comply with the applicable standards. Attestation engagements include examinations of statements made by broker-dealers in compliance reports and reviews of statements made by broker-dealers in exemption reports.

Deficiencies in Examination Engagements

In an examination engagement, the auditor must plan and perform an examination of statements made by the broker-dealer in its compliance report in accordance with AT No. 1.

	2020			2019	2018
	Number of Applicable Engagements Reviewed	Number of Engagements Reviewed with Deficiencies	Percentage	Percentage	Percentage
Examination Engagements	21	14	67%	69%	75%

Planning for the Examination Engagement

As part of planning for the examination engagement, firms did not:

- Obtain a sufficient understanding of broker-dealer processes, including relevant controls, regarding compliance with one or more financial responsibility rules;[4] (AT No. 1.09) and
- Assess the risk of fraud, including the risk of misappropriation of customer assets, relevant to compliance with the Reserve Requirements Rule and the effectiveness of the broker-dealer's ICOC. A firm did not assess these risks associated with the broker-dealer's receipt of customer checks payable to the broker-dealer or its registered representatives. (AT No. 1.10)

Testing Controls over Compliance

Deficiencies in testing ICOC continue to drive high deficiency rates in examination engagements. Many of the deficiencies relate to AT No. 1 requirements for auditors to obtain sufficient, appropriate evidence about the operating effectiveness of controls important to the auditor's conclusion regarding the effectiveness of ICOC ("important controls").

[4] The term "financial responsibility rules" refers to the same rules cited in Exchange Act Rule 17a-5 paragraph (d)(3)(ii) and AT No. 1. Specifically, the Net Capital Rule, Customer Protection Rule, Quarterly Security Counts Rule, and Account Statement Rule. Paragraph (e) of the Customer Protection Rule is referred to as the "Reserve Requirements Rule."

Deficiency Focus

Testing Controls over Compliance

The majority of examination engagement deficiencies relate to testing of important controls over compliance with broker-dealer financial responsibility rules. Each examination engagement with a deficiency had at least one deficiency based on the requirements for auditors to obtain evidence that important controls are designed effectively and operated effectively during the broker-dealer's fiscal year and as of the fiscal year end. (AT No. 1.11, .14, and .16) Deficiencies overall are comparable to the prior year and remain at high levels.

Where did firms fall short in testing ICOC?

Generally, firms did not test ICOC for one or more financial responsibility rules, or did not test, or sufficiently test, important controls. The important controls included information technology and automated application controls, controls over the accuracy and completeness of information produced by the broker-dealer upon which the design and operating effectiveness of ICOC depended, and management review controls. Specific deficiencies related to four aspects of the financial responsibility rules are as follows:

1. For the Reserve Requirements Rule, firms did not test, or sufficiently test, controls over determination of credit and debit balances reported within the customer reserve computation pursuant to Exhibit A of the Customer Protection Rule.
2. For the possession or control requirements of the Customer Protection Rule, firms did not test, or sufficiently test, controls over consideration of customers' related accounts when determining excess margin and segregation requirements. Firms also did not sufficiently test controls over identification and resolution of deficits requiring action within the required timeframe; and maintenance of accounts free of any right, charge, security interest, lien, or claim, including acknowledgement letters for mutual fund custody accounts.
3. For the Account Statement Rule, firms did not test, or sufficiently test, controls over the production and delivery of complete and accurate account statements, either electronically or by mail, to all customers.
4. For the Quarterly Security Counts Rule, firms did not test, or sufficiently test, controls over accounting for all securities subject to the broker-dealer's control or direction, but not in its physical possession, including a firm that did not sufficiently test the assignment of broker-dealer personnel to make or supervise quarterly security counts.

Good Practices: Possession or Control

Scenario: The auditor considered management's daily deficit review control an important control for addressing the possession or control requirements of the Customer Protection Rule. The auditor determined that the control owner used a deficit report that detailed deficits by security to perform the review.

Good Practices:

- The auditor inquired of the control owner regarding the nature of the review, information used during the review, types of deficits identified and associated timeframes for resolution, and actions taken to resolve possession or control deficits of customer securities.
- The auditor tested controls over the accuracy and completeness of information in the deficit report, including controls over segregation instructions and control locations, and relevant information technology controls over the system that generated the deficit report.
- The auditor selected a sample of deficit reports from throughout the year and inspected evidence of management's review. The auditor also obtained evidence that management took action to resolve the deficits within the timeframes required by the Customer Protection Rule.

Good Practices: Quarterly Security Counts

Scenario: The auditor considered management's periodic review of security position reconciliations between the broker-dealer's stock record and its security custodians, an important control for addressing the requirements of the Quarterly Security Counts Rule to account for securities subject to its control or direction but not in its physical possession. The auditor determined that the control owner used a reconciliation report that detailed position variances between the broker-dealer and its custodians to perform the review.

Good Practices:

- The auditor inquired of the control owner regarding the nature of the review, information used during the review, and procedures to resolve differences. The auditor assessed whether the control owner had other responsibilities for securities recordkeeping that might be incompatible with the review responsibilities.
- The auditor tested controls over the accuracy and completeness of information in the reconciliation report, including the position information on the stock record and custodian statements.
- The auditor selected a sample of reconciliations from throughout the year and inspected evidence of management's review.

Note: The auditor also tested controls over compliance with the securities verification requirements of the Quarterly Security Counts Rule.

Performing Compliance Tests

Firms did not perform, or sufficiently perform, tests of compliance with the Reserve Requirements Rule as of the end of the broker-dealer's fiscal year, including: (AT No. 1.21 and .23)

- Testing the accuracy and completeness of the information used to prepare the customer reserve computation;
- Evaluating whether the credit balances reported within the customer reserve computation were determined in accordance with the Reserve Requirements Rule, including amounts related to customer checks received by the broker-dealer and securities in transfer;
- Determining whether the broker-dealer maintained a special reserve bank account for the exclusive benefit of its customers in accordance with the Reserve Requirements Rule because it did not determine whether the broker-dealer obtained a written bank notification letter; and
- Performing procedures to obtain evidence about the existence of customer funds.

Evaluating Results of the Examination Procedures

A firm did not sufficiently evaluate an identified deficiency to determine whether a material weakness in ICOC existed. (AT No. 1.26)

Obtaining a Representation Letter

A firm did not obtain written representations from management of the broker-dealer. (AT No. 1.32)

Reporting on the Examination Engagement

A firm included a statement in its examination report that referred to an assertion by the broker-dealer that its ICOC was effective as of its fiscal year-end; however, the broker-dealer did not include that required assertion in its compliance report. (AT No. 1.36)

Deficiencies in Review Engagements

In a review engagement, the auditor must plan and perform the review of the statements (assertions) made by the broker-dealer in its exemption report in accordance with AT No. 2.

	2020			2019	2018
	Number of Applicable Engagements Reviewed	Number of Engagements Reviewed with Deficiencies	Percentage	Percentage	Percentage
Review Engagements	83	19	23%	51%	54%

The number of review engagements with deficiencies declined from the prior year. In particular, we observed fewer instances of firms that did not evaluate or properly address assertions in broker-dealer exemption reports that appeared to be incomplete or inconsistent with exemption reporting requirements.

If a broker-dealer's assertion that identifies the provisions in paragraph (k) of the Customer Protection Rule under which the broker-dealer claimed an exemption is inaccurate, that assertion is not fairly stated, in all material respects. The requirements of AT No. 2 apply to the evaluation of the accuracy of assertions regarding exemptions claimed, or other assertions made by broker-dealers supporting their filing of exemption reports under Exchange Act Rule 17a-5.

Deficiencies related to documentation of review engagements are described on page 24.

Performing the Review Engagement

Firms did not evaluate evidence obtained in the audit of the financial statements that contradicted the broker-dealer's assertions regarding compliance with the exemption provision claimed. Such evidence included, for broker-dealers that claimed exemption under paragraph (k)(2)(ii) of the Customer Protection Rule, information from broker-dealer books and records and financial statements that described customer securities businesses that were conducted outside of arrangements with clearing brokers. (AT No. 2.10)

Firms did not make required inquiries, including inquiries about controls in place to maintain compliance with the exemption provisions, and those involving the nature, frequency, and results of related monitoring activities. (AT No. 2.10)

Good Practices: Performing the Review Engagement

Scenario: A broker-dealer stated in its exemption report that it complied with the exemption provisions of paragraph (k)(2)(ii) of the Customer Protection Rule. The broker-dealer also stated in its exemption report that it engaged in other business activities that were limited to proprietary trading and receiving transaction-based compensation for identifying potential merger and acquisition opportunities for clients.

Good Practices:

- The auditor, in planning and performing the audit of the broker-dealer's financial statements, obtained an understanding of the broker-dealer's business activities, including the nature of its arrangements with clearing brokers.
- The auditor took into account this understanding when assessing whether the broker-dealer conducted other business activities that should have caused the broker-dealer to either claim an additional exemption or provide disclosures related to its additional business activities in its exemption report.

Obtaining a Representation Letter

Firms did not obtain written representations from management of the broker-dealer. (AT No. 2.13)

Reporting on the Review Engagement

Firms included a statement in their review reports that referred to an assertion by the broker-dealer that it met the identified exemption provisions throughout the most recent fiscal year without exception; however, the broker-dealers did not include that required assertion in their exemption reports. (AT No. 2.16)

Deficiencies in Auditing Financial Statements

We did not assess all of the procedures performed for the audit engagements selected for review. We reviewed portions of those engagements. The areas of the audit engagements reviewed varied between audit engagements, and the frequency with which we reviewed areas varied between years. The following table provides accumulated results for areas reviewed across all selected audit engagements.

	2020			2019	2018
	Number of Applicable Engagements Reviewed	Number of Engagements Reviewed with Deficiencies	Percentage	Percentage	Percentage
Revenue	95	45	47%	53%	60%
Evaluating Audit Results[5]	105	27	26%	37%	27%
Identifying and Assessing Risks of Material Misstatement	105	6	6%	15%	23%
Related Party Relationships and Transactions	20	5	25%	27%	55%
Receivables and Payables	18	4	22%	27%	21%
Consideration of an Entity's Ability to Continue as a Going Concern	10	3	30%	67%	40%
Consideration of Materiality in Planning and Performing an Audit	105	2	2%	4%	3%
Leases	5	2	40%	N/A	N/A
Fair Value Measurements	23	1	4%	0%	14%

[5] Deficiencies related to this area primarily involve the auditor's responsibilities for evaluation of financial statement presentation, including disclosures, under AS 2810, *Evaluating Audit Results*. We changed the name of this area from Financial Statement Presentation and Disclosure used in prior annual reports.

Revenue

Deficiencies in auditing revenue continue to drive high deficiency rates in audit engagements. Many of the deficiencies relate to requirements for auditors to perform audit procedures to address assessed risks of material misstatement for all relevant assertions of each significant account and disclosure, plan appropriate audit samples, and obtain audit evidence that is sufficient and appropriate.

Deficiency Focus

Revenue – Responding to Risks of Material Misstatement

The majority of the deficiencies in the revenue area related to responding to the risks of material misstatement for each relevant assertion of revenue (and related receivable) accounts (AS 2301.08). While the percentage of engagements with deficiencies in this area decreased in each of the last two years, deficiencies overall remain at high levels.

In most cases, firms either identified a fraud risk related to revenue or did not rebut the presumption of revenue recognition as a fraud risk. Accordingly, these firms should have addressed the risk of material misstatement through appropriate substantive procedures that included tests of details.

Where did firms fall short in responding to risks associated with revenue?

Deficiencies in this area included instances of firms that did not perform any procedures for one or more significant revenue accounts, or did not perform procedures to address the assessed risks of material misstatement for one or more relevant assertions for revenue (and related receivables). More specifically, the following are deficiencies related to auditing common sources of broker-dealer revenue:

1. For commissions, firms did not sufficiently test whether the commission recorded by the broker-dealer was accurate based on the terms of the securities trade (including price and quantity) and the applicable commission or commission rate.
2. For trading gains and losses, firms did not sufficiently test data from the broker-dealer's proprietary trades, including acquisition cost and sales proceeds.
3. For investment banking fees, firms did not sufficiently test whether the investment banking transactions had occurred, and whether the recorded revenue was consistent with final transaction terms and the agreement between the broker-dealer and its customer.
4. For investment and other advisory fees, firms did not sufficiently test the accuracy of related balances (for example, assets under management), and whether fee rates were consistent with the terms of the broker-dealer's contract with its customer.
5. For success fees, firms did not sufficiently test final deal terms (including transaction values), applicable rates, and whether the related merger or acquisition successfully closed.

When testing a sample, firms did not plan and design an appropriate sample and did not select sample items in such a way that the sample could be expected to be representative of the population. (AS 2315.16, .23, .23A, and .24)

Firms used information produced by the broker-dealer as audit evidence but did not test, or sufficiently test, the accuracy and completeness of that information, whether by testing controls, testing the information, or a combination of both. (AS 1105.10)

When using substantive analytical procedures, firms did not establish that there were plausible and predictable relationships in the data, evaluate the reliability of the data from which their expectations were developed, develop expectations that were sufficiently precise to identify misstatements, or determine the amount of difference from expectations that could be accepted without further explanation. (AS 2305.13, .14, .16, .17, and .20)

Firms did not perform, or sufficiently perform, tests of controls to support control risk assessments at less than the maximum and the related modifications to the nature, timing, and extent of substantive procedures. As a result, firms did not obtain sufficient evidence to address the assessed risks of material misstatement. (AS 2301.16, .18, and .37)

A firm did not perform sufficient procedures to test necessary user organization controls identified in the service auditor's report to support a control risk assessment at less than the maximum and the related modification to the nature, timing, and extent of substantive procedures. (AS 2601.14)

Good Practices: Revenue

Scenario: A broker-dealer earned commissions on customer trades it introduced to a clearing broker. The auditor identified a fraud risk related to improper revenue recognition for commissions. The auditor did not test the operating effectiveness of controls over commissions and accordingly assessed control risk at maximum and planned to perform substantive procedures including tests of details.

Good Practices:

- The auditor evaluated the design of the broker-dealer's controls to ensure that revenue was recognized on a trade date basis and in amounts that were consistent with the terms of the broker-dealer's agreements with its customers, and whether those controls had been implemented.
- The auditor obtained a detail of customer trades and related commissions for the year and tested its completeness by comparing total commissions per the detail to total commissions per the broker-dealer's general ledger.
- The auditor selected a sample of customer trades and tested the accuracy of the security price and quantity associated with the customer trade for each selection. The auditor also compared the commission or commission rate charged to the customer to the commission or commission rate applicable at the time of the trade per the terms of the broker-dealer's agreement with its customer.

Evaluating Audit Results

Firms did not sufficiently evaluate the presentation of financial statements, including disclosures. Deficiencies included instances involving: (AS 2810.30 and .31)

- Incomplete qualitative and quantitative disclosures of information regarding revenue from contracts with customers under FASB ASC Topic 606, *Revenue from Contracts with Customers*;
- Revenue recognition policies that were not in conformity with FASB ASC Topic 606;
- Incomplete qualitative and quantitative disclosures of information regarding leases under FASB ASC Topic 842, *Leases*;
- Lease recognition and measurement that were not in conformity with FASB ASC Topic 842;
- Incomplete disclosures for assets measured at fair value on a recurring basis using significant unobservable inputs under FASB ASC Topic 820, *Fair Value Measurement*;
- Presentation of cash flows that were not in conformity with FASB ASC Topic 230, *Statement of Cash Flows*; and
- Incomplete non-cash disclosures under FASB ASC Topic 230.

A firm did not take into account audit evidence that appeared to contradict the broker-dealer's assertions regarding the occurrence and allocation of revenues. (AS 2810.03)

Deficiencies related to the evaluation and disclosure of related parties are described below.

Identifying and Assessing Risks of Material Misstatement

Insufficient risk assessment procedures contributed to deficiencies in areas of the financial statement audit described in this report.

As part of their risk assessment procedures, firms did not:

- Evaluate the design of broker-dealer controls intended to address fraud risks, and determine whether those controls had been implemented; (AS 2110.72)
- Obtain a sufficient understanding of the broker-dealer's internal control over financial reporting, including information systems and business processes and control activities, to identify and assess the risks of material misstatement and design further audit procedures; (AS 2110.18 and .28)
- Identify and assess the risks of material misstatement at the financial statement level and assertion level; (AS 2110.59) and
- Sufficiently evaluate qualitative and quantitative risk factors related to financial statement line items and disclosures and determine the likely sources of potential misstatements. (AS 2110.59, .60, and .61)

Related Party Relationships and Transactions

Firms did not address the identified and assessed risks of material misstatement because firms performed insufficient audit procedures over expenses allocated between the broker-dealers and their parents or affiliates, including not evaluating whether the allocated expenses were consistent with the terms of the formal agreements between the related entities. (AS 2301.08; AS 2410.11 and .12)

A firm did not sufficiently evaluate whether the financial statements contained information essential for fair presentation in conformity with FASB ASC Topic 850, *Related Party Disclosures*, regarding relationships and transactions between the broker-dealer and an entity whose managing partners were registered representatives of the broker-dealer. (AS 2410.17; AS 2810.30 and .31)

Receivables and Payables

A firm did not perform sufficient audit procedures to test payables to customers because it did not test whether the broker-dealer appropriately calculated fee offsets for customer accounts. (AS 2301.08)

A firm did not consider the materiality of payables to customers when determining its items for substantive testing, and as a result did not obtain sufficient evidence to address the assessed risks of material misstatement. (AS 2301.08 and .42)

Deficiencies related to receivables associated with revenue are described on page 18.

Consideration of an Entity's Ability to Continue as a Going Concern

Firms did not perform sufficient audit procedures to obtain evidential matter about the intent and ability of other parties to provide financial support to the broker-dealers, which were significant elements of managements' plans to overcome the adverse effects of the conditions and events that indicated substantial doubt. (AS 2415.07 and .08)

A firm did not evaluate conditions at the broker-dealer that included recurring operating losses, negative cash flows from operating activities, an accumulated deficit, and declining net capital levels that, when considered in the aggregate, indicated there could be substantial doubt about the broker-dealer's ability to continue as a going concern for a reasonable period of time. (AS 2415.03)

Consideration of Materiality in Planning and Performing an Audit

Firms did not establish and apply materiality in planning and performing the audit in accordance with AS 2105.

Leases

Firms did not sufficiently test the right-of-use assets and related lease liabilities, including procedures to test present value calculations. (AS 2301.08)

Fair Value Measurements

A firm did not perform audit procedures to test the valuation of an asset requiring fair value measurement. (AS 2502.15)

Deficiencies in Auditing Supplemental Information Accompanying Audited Financial Statements

	2020			2019	2018
	Number of Applicable Audits Reviewed	Number of Audits Reviewed with Deficiencies	Percentage	Percentage	Percentage
Net Capital Rule	49	15	31%	31%	29%
Customer Protection Rule	23	9	39%	42%	36%

Performing Audit Procedures on Supplemental Information

Firms did not perform, or sufficiently perform, procedures to evaluate whether the following aspects of net capital computations were determined in compliance with the Net Capital Rule: (AS 2701.04)

- Allowable assets and assets not readily convertible into cash, including commissions receivable and receivables from affiliates;
- Minimum net capital requirement for market makers;
- Haircuts applied to securities owned; and
- Marketability of restricted securities.

Good Practices: Supplemental Net Capital Information

Scenario: A broker-dealer reported a commission receivable from the sale of mutual funds and a related commission payable to its sales representatives in its Statement of Financial Condition. The broker-dealer classified the receivable as an allowable asset in its net capital computation.

Good Practices:

- The auditor performed procedures to test the relevant assertions of the receivable and payable as part of the financial statement audit.
- To determine whether the classification of the receivable as allowable was in accordance with the Net Capital Rule, the auditor reviewed the language in written contracts between the broker-dealer and its sales representatives regarding payment of the commission to the sales representatives, and assessed whether that language met the requirements of the Net Capital Rule.

Firms did not perform, or sufficiently perform, procedures to evaluate whether credit balances in customer reserve computations were determined in compliance with the Reserve Requirements Rule, or to test the completeness and accuracy of information presented, including the following aspects: (AS 2701.04)

- Deposits and customer checks received by the broker-dealer;
- Market values of securities in transfer; and
- Refundable fees.

Firms did not perform, or sufficiently perform, procedures to evaluate whether information about possession or control requirements, including its form and content, were determined in compliance with the Customer Protection Rule. These included instances where broker-dealers omitted required information about possession or control from the supplemental information accompanying the financial statements. Firms also did not perform, or sufficiently perform, procedures to test the completeness and accuracy of information presented, including the following aspects: (AS 2701.04)

- Determining securities deficits; and
- Determining whether mutual fund custody accounts were good control locations.

Obtaining a Representation Letter

Firms did not obtain written representations from management of the broker-dealer. (AS 2701.05)

Other Instances of Non-Compliance with PCAOB Standards

This section of our report discusses certain deficiencies we identified that relate to other instances of non-compliance with PCAOB standards. These deficiencies do not relate directly to the sufficiency or appropriateness of evidence firms obtained to support their audit opinions or attestation opinions or conclusions.

Deficiencies in Auditors' Reports on the Financial Statements and Supporting Schedules

	2020			2019	2018
	Number of Applicable Audits Reviewed	Number of Audits Reviewed with Deficiencies	Percentage	Percentage	Percentage
Auditors' Reports on the Financial Statements and Supporting Schedules	105	7	7%	14%	18%

Certain auditors' reports on broker-dealer financial statements and supporting schedules were not presented in accordance with PCAOB standards. The auditors' reports omitted or did not properly present one or more of the required elements listed below:

- A required element from the auditor's report on supplemental information; (AS 2701.10)
- A required element from the opinion on the financial statement section of the auditor's report; (AS 3101.08)
- A required element from the basis for opinion section of the auditor's report; (AS 3101.09)
- Tenure for the firm; (AS 3101.10) and
- A required addressee. (AS 3101.07)

Deficiencies in Auditor Communications

	2020			2019	2018
	Number of Applicable Audits Reviewed	Number of Audits Reviewed with Deficiencies	Percentage	Percentage	Percentage
Auditor Communications	105	2	2%	5%	12%

A firm did not inquire of the audit committee (or equivalent body) about whether it was aware of matters relevant to the audit and did not communicate the audit strategy and results of the audit to the audit committee (or equivalent body). (AS 1301.08 through .20)

A firm did not communicate, prior to the issuance of the auditor's report on the financial statements, an identified significant deficiency in writing to management and the audit committee (or equivalent body). (AS 1305.04)

Deficiencies in Engagement Documentation

	2020			2019	2018
	Number of Applicable Engagements Reviewed	Number of Engagements Reviewed with Deficiencies	Percentage	Percentage	Percentage
Audit Documentation	105	2	2%	25%	25%
Review Documentation	83	1	1%	11%	16%

Firms did not assemble a complete and final set of audit and review documentation ("engagement file") by the documentation completion date and properly document additions to the engagement file after the report release date. (AS 1215.15 and .16)

Deficiencies related to proper completion of an engagement completion document decreased in 2020.

Deficiencies in Quality Control Systems

Our inspections indicate that 43 (out of 65 inspected) firms' quality control systems did not appear to provide reasonable assurance that firm personnel had complied with applicable professional standards in the areas of engagement performance and/or personnel management.

Deficiencies Regarding Firms' Quality Control Systems Related to Engagement Performance

	Number of Firms with Quality Control Deficiencies		
	2020	2019	2018
Engagement Performance	43	52	54

We noted the following deficiencies:

- Policies and procedures did not provide reasonable assurance that engagement partners reviewed and supervised audit and attestation engagements with due professional care in accordance with AS 1201, which contributed to not identifying deficiencies in those engagements. (QC 20.03 and .17)
- Engagement quality reviews were not performed for some audit and attestation engagements. (QC 20.03 and .17)
- Policies and procedures did not exist to address the engagement quality review requirements of AS 1220. (QC 20.03 and .17)
- Policies and procedures did not provide reasonable assurance that engagement quality reviews for audit and attestation engagements were performed with due professional care in accordance with AS 1220. This contributed to engagement quality reviewers not identifying certain errors in, or certain required disclosures omitted from, broker-dealer financial statements, documents containing broker-dealer management assertions, and engagement reports. It also contributed to engagement quality reviewers not identifying deficiencies in audit responses in areas of significant risks, including fraud risks. All of these were required to be reviewed by the engagement quality reviewer. (QC 20.03 and .17)

The deficiencies presented above include deficiencies in engagement quality reviews for audit and attestation engagements. The following table provides information about engagement quality review deficiencies by engagement type:

	2020			2019	2018
	Number of Applicable Engagements Reviewed	Number of Engagements Reviewed with Deficiencies	Percentage	Percentage	Percentage
Audit Engagements	66	45	68%	68%	65%
Review Engagements	19	14	74%	71%	43%
Examination Engagements	14	2	14%	10%	26%

Other Deficiencies Regarding Firms' Quality Control Systems

	Number of Firms with Quality Control Deficiencies		
	2020	2019	2018
Personnel Management	1	1	0
Monitoring	0	2	1
Independence, Integrity, and Objectivity	0	2	0

Policies and procedures did not provide reasonable assurance that engagement personnel assigned to broker-dealer engagements complied with a firm's education requirements. (QC 20.03 and .13)

Auditor Independence Findings

	2020			2019	2018
	Number of Applicable Audits Reviewed	Number of Audits Reviewed with Findings	Percentage	Percentage	Percentage
Auditor Independence	23	2	9%	17%	5%

Firms assisted in the preparation of broker-dealer financial statements and supplemental information, which appeared to impair their independence. Assistance by the auditor with the preparation of financial statements and supplemental information being audited is not a permissible service as prescribed by Rule 2-01(c)(4)(i) of SEC Regulation S-X.

PCAOB STANDARDS ASSOCIATED WITH INSPECTIONS OBSERVATIONS

AT No. 1	Examination Engagements Regarding Compliance Reports of Brokers and Dealers
AT No. 2	Review Engagements Regarding Exemption Reports of Brokers and Dealers
AS 1105	Audit Evidence
AS 1201	Supervision of the Audit Engagement
AS 1215	Audit Documentation
AS 1220	Engagement Quality Review
AS 1301	Communications with Audit Committees
AS 1305	Communications About Control Deficiencies in an Audit of Financial Statements
AS 2105	Consideration of Materiality in Planning and Performing an Audit
AS 2110	Identifying and Assessing Risks of Material Misstatement
AS 2301	The Auditor's Responses to the Risks of Material Misstatement
AS 2305	Substantive Analytical Procedures
AS 2315	Audit Sampling
AS 2410	Related Parties
AS 2415	Consideration of an Entity's Ability to Continue as a Going Concern
AS 2502	Auditing Fair Value Measurements and Disclosures
AS 2601	Consideration of an Entity's Use of a Service Organization
AS 2701	Auditing Supplemental Information Accompanying Audited Financial Statements
AS 2810	Evaluating Audit Results
AS 3101	The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion
QC 20	System of Quality Control for a CPA Firm's Accounting and Auditing Practice

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