Webinar: PCAOB Inspections of Small Firm Broker-Dealer Auditors

January 15, 2015

Introductory Remarks

Mary Sjoquist, Director

Office of Outreach and Small Business Liaison

PCAOB
Public Company Accounting Oversight Board

Caveat

The views we express today are our own and do not necessarily reflect the views of the Board, individual Board members, or other members of the Board's staff.

Broker-Dealer Inspections: Interim Inspection Process and Inspection Findings

Bob Maday and Kate Ostasiewski
Division of Registration and Inspections

January 15, 2015

Agenda

- Summary of Interim Inspection Program
- Inspections Observations
- 2014 Inspections
- 2015 Inspection Plan
- Next Steps for Auditors
- Questions

Interim Inspection Program – Objectives

- Assess compliance with applicable Board and Commission rules and professional standards
- Help inform the Board's eventual determinations about the scope and elements of a permanent inspection program
  - Whether and how to differentiate among classes of brokers and dealers
  - Whether to exempt any category of registered public accounting firms
  - Establishment of minimum inspection frequency schedules
- Assist in the development of the approach to inspections under a permanent inspection program

PCAOB
Public Company Accounting Oversight Board

Interim Inspection Process

- Communication and scheduling
- Inspection of audit work
- Information gathering
- Communication of findings/observations

PCAOB
Public Company Accounting Oversight Board

Interim Inspection Process - *continued*

- Firm response to findings and responsibilities
- Reporting
- Communication with the SEC and other regulators
- Enforcement

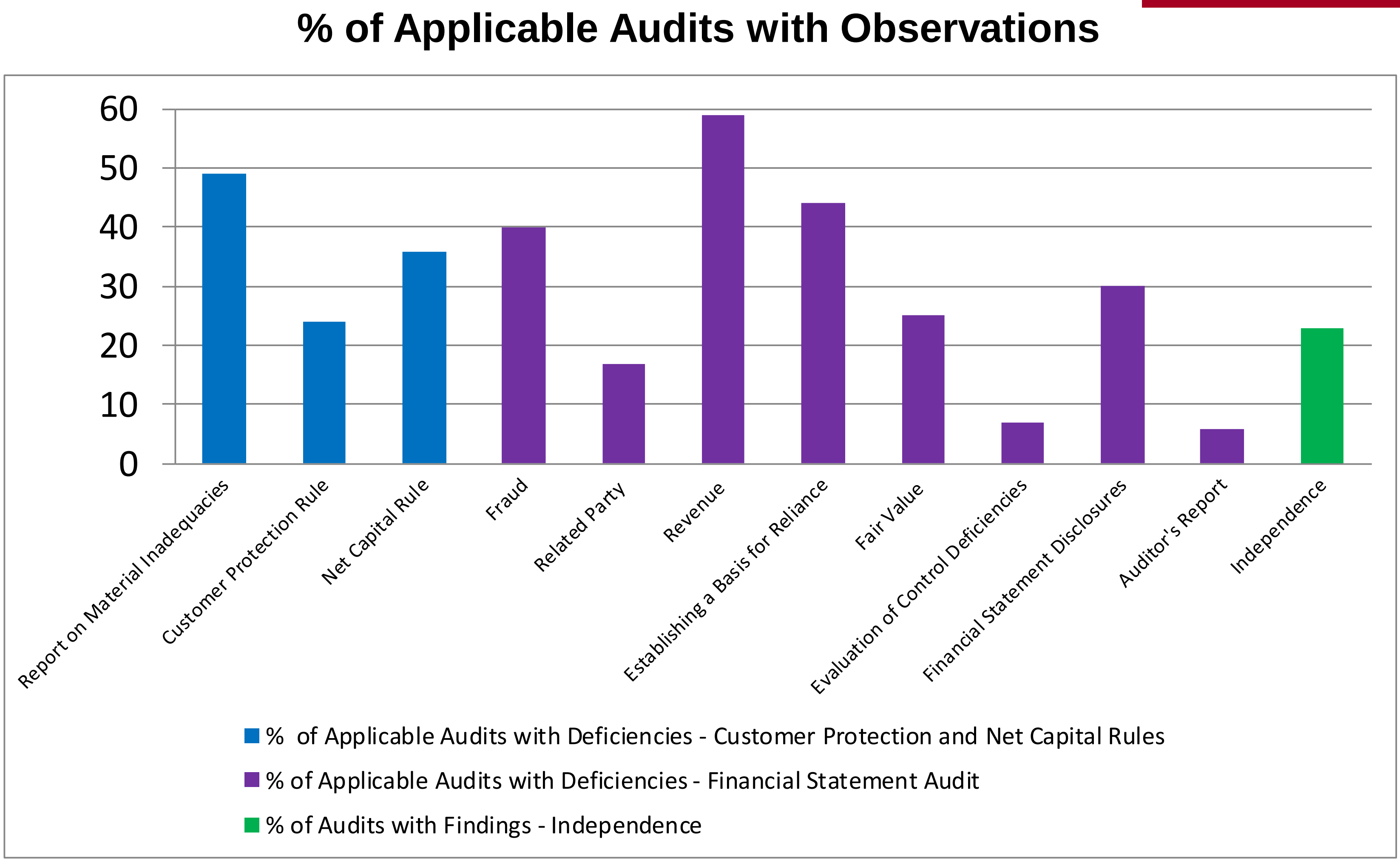
Interim Inspection Program - Reporting

- Inspections - First Progress Report
  - Inspected 10 Firms and portions of 23 audits
- Inspections - Second Progress Report
  - Inspected 43 Firms and portions of 60 audits
- Inspections – Third Progress Report
  - Inspected 60 firms and portions of 90 audits

Interim Inspection Program - Disclaimer

The information presented in the following slides is not necessarily indicative of the population of firms or of audits of brokers and dealers because the selection of firms and of audits of brokers and dealers for inspection is not necessarily representative of these populations.

Inspections Observations by Audit Area - 2013



Compliance with Independence Requirements

20 out of 60 Firms failed to satisfy independence requirements by:

- Preparation of, or assistance in the preparation of financial statements or supporting schedules
- Preparation of journal entries or source data underlying the financial statements

Compliance with Independence Requirements - *continued*

- Auditors of brokers and dealers registered with the SEC are subject to SEC independence requirements in (b) and (c) of Rule 2-01 of Regulation S-X.
- Effective for fiscal years ended on or after June 1, 2014 certain PCAOB independence rules apply to auditors of broker and dealers.

Compliance with Independence Requirements - *continued*

On December 8, 2014, PCAOB announced settled disciplinary orders against seven audit firms for independence violations when auditing brokers and dealers.

- Prepared the financial statements or portions of the financial statements being audited
- Censure and significant remedial measures
- $2,500 civil money penalty

PCAOB
Public Company Accounting Oversight Board

Compliance with Independence Requirements - *continued*

On December 8, 2014, the Securities and Exchange Commission sanctioned eight firms for violating auditor independence rules.

- Prepared the financial statements of their audit clients
- Censure and cease and desist from committing or causing any violations of Exchange Act Section 17(a) and Rule 17a-5
- Collectively, $140,000 in penalties and required remedial undertakings

PCAOB
Public Company Accounting Oversight Board

Net Capital Requirements

- Minimum net capital requirements
  - Nature of the broker's or dealer's operation
  - Aggregated indebtedness calculation
- Allowable assets
  - Receivables offset by related payables
  - Appropriate PAIB agreement
  - Aged receivables
- Haircuts
  - Haircut percentages, including use of external party haircut reports

Example 1 - Facts

Broker Dealer A:

- Reported minimum dollar net capital requirement of $5,000 and calculated minimum net capital required of $53,000 (6-2/3% of aggregated indebtedness)
- Reported net capital of $705,000 and excess net capital of $653,000
- Reported Securities Owned, marketable, at fair value of $894,000
- Net capital as calculated included a deduction for haircuts on securities of $97,000

PCAOB
Public Company Accounting Oversight Board

Example 1 – Audit Procedures

<u>To Test Haircuts</u>

- Obtained a schedule of haircuts used in the net capital calculation
- Tested the completeness and accuracy of the haircut schedule:
  - Reconciled the total for securities in the haircut schedule to the total securities account balance in the general ledger
  - Verified that securities valuations used for financial statement valuation were the same as those used in the calculation of haircuts
  - Recalculated haircuts taken on Broker Dealer A’s proprietary portfolio using the percentages and positions included in the haircut schedule
  - Verified the mathematical of the haircut schedule

Example 1 – Polling Question #1

- Are the procedures for haircuts as designed, sufficient to test the classification of non-allowable assets included in the net capital calculation?
  A. Yes
  B. No. The auditor did not test Broker Dealer A's classification of the proprietary positions and did not verify that haircut percentages applied were in accordance to Rule 15c3-1(c)(2)(vi)(A) through (M).
  C. No. The auditor did not agree the total for securities in the haircut schedule to the securities account balance in the general ledger.

Example 1 – Polling Question #1

- Are the procedures for haircuts as designed, sufficient to test the classification of non-allowable assets included in the net capital calculation?

  A. Yes

  B. No. The auditor did not test Broker Dealer A's classification of the proprietary positions and did not verify that haircut percentages applied were in accordance to Rule 15c3-1(c)(2)(vi)(A) through (M).

  C. No. The auditor did not agree the total for securities in the haircut schedule to the securities account balance in the general ledger.

PCAOB
Public Company Accounting Oversight Board

Customer Protection Rule

- Exempt BDs
  - Compliance with Exemption

- Non-Exempt BDs
  - Customer credits or debits
  - Special Reserve Bank Account
  - Possession or control requirements

Polling Question #2

- Does your firm audit brokers or dealers that are not exempt from Exchange Act Rule 15c3-3?
  - A. Yes
  - B. No

Net Capital Requirements and Customer Protection Rule – New Guidance

Effective for fiscal years ending on or after June 1, 2014:

- Auditing Standard No. 17 – *Auditing Supplemental Information Accompanying Audited Financial Statements*
- 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*

Polling Question #3

- What was the auditing area for which the inspection staff identified the highest percentage of deficiencies during the 2013 inspections?
  A. Revenue
  B. Related Parties
  C. Establish a Basis for Reliance on Records and Reports

PCAOB
Public Company Accounting Oversight Board

Polling Question #3

- What was the auditing area for which the inspection staff identified the highest percentage of deficiencies during the 2013 inspections?
  A. **Revenue**
  B. Related Parties
  C. Establish a Basis for Reliance on Records and Reports

PCAOB
Public Company Accounting Oversight Board

Financial Statement Audit

Revenue

- Extent of Testing:
  - Did not test material classes of revenue transactions
  - Insufficient sampling procedures
- Substantive analytical procedures
  - Suitability, reliability, precision
- Other procedures
  - Cutoff, revenue recognition policies, significant contract terms

PCAOB
Public Company Accounting Oversight Board

Example 2 - Facts

<u>Broker Dealer B</u>:

- Reported total annual investment advisory ("IA") fee revenue of $600,000. This amount exceeded auditor materiality
- Primary customer for IA services was the parent of Broker Dealer B. For the audit period, 70% of IA fee revenue from the Parent, down 20% from prior year
- IA fee revenue determined based on the assets under management ("AUM") and rates from advisory agreements applied to AUM
- Monthly accrual recorded for IA fee revenue earned, later adjusted when cash received

PCAOB
Public Company Accounting Oversight Board

Example 2 – Audit Procedures

- Obtained an understanding of revenue business cycle and related controls
- Performed substantive analytical procedures:
  - Used total prior-year IA fee revenue as the expectation for current-year IA fee revenue
  - Compared prior-year revenue amounts to current-year revenue amounts as recorded in the general ledger
  - Investigated any differences that exceeded 50% of planning materiality

Example 2 – Polling Question #4

- Did the analytical procedures, as performed, meet the requirements for a substantive analytic, including the precision of the expectation, which was the prior-year IA fee revenue, in accordance with PCAOB Standards?

  A. Yes

  B. No. A plausible relationship for comparability between prior-year IA fee revenue and current year was not established, particularly given the known decrease in revenue from the Parent in the current year.

  C. No. A plausible relationship for comparability between prior-year IA fee revenue and current year was not established, particularly given the known decrease in revenue from the Parent in the current year. Also, investigation of variances only in excess of 50% of planning materiality may not detect potential material misstatements.

Example 2 – Polling Question #4

- Did the analytical procedures, as performed meet the requirements for a substantive analytic, including the precision of the expectation which was the prior-year IA fee revenue, in accordance with PCAOB Standards?

  A. Yes

  B. No. A plausible relationship for comparability between prior-year IA fee revenue and current year was not established, particularly given the known decrease in revenue from the Parent in the current year.

  C. **No. A plausible relationship for comparability between prior-year IA fee revenue and current year was not established, particularly given the known decrease in revenue from the Parent in the current year. Also, investigation of variances only in excess of 50% of planning materiality may not detect potential material misstatements.**

PCAOB
Public Company Accounting Oversight Board

Break

(5 minutes)

Financial Statement Audit - *continued*

Fraud

- Identify and assess risks of material misstatement due to fraud
- Perform sufficient journal entry testing in response to the risk of management override
- Responses to fraud risk related to revenue recognition

Example 3 - Facts

<u>Broker Dealer C</u>

- Reported total annual investment banking revenue of $800,000, which was material for the audit
- Entered into contracts with customers to find investors for securities offerings. Each contract provided for an upfront fee, paid at contract signing, and a success fee, paid upon transaction close
- Recorded upfront fees as deferred revenue and recognized success fees upon successful closing of the related transactions
- Auditor identified <u>fraud risk</u> (occurrence, allocation) related to the opportunity to manipulate the timing of revenue recognition

PCAOB
Public Company Accounting Oversight Board

Example 3 – Audit Procedures

- Evaluated Broker Dealer C's revenue recognition policy
- Obtained and tested the completeness and accuracy of Broker Dealer C's listing of all investment banking transactions. Selected all deals closed during the audit period above materiality, and a sample under materiality and:
  - Inspected deal documents, including contracts, and agreed relevant terms to the prospectus
  - Recalculated revenues recorded, including deferred revenue, and traced terms used in the determination of revenue to the deal documents
  - Traced revenues in Broker Dealer C's general ledger to closing statements of investment banking deals and to Broker Dealer C's bank statements
- Reviewed terms per deal documents for those contracts without transactions that closed during the year, to assess revenue recognition, including the timing of recognition of deferred revenue
- Reviewed all material investment banking revenue recorded during the last month of the year and the following month

PCAOB
Public Company Accounting Oversight Board

Example 3 – Polling Question #5

- Did the procedures performed by the auditor adequately respond to the identified fraud risk related to the opportunity to manipulate the timing of investment banking revenue recognition?
  A. Yes
  B. No

PCAOB
Public Company Accounting Oversight Board

Example 3 – Polling Question #5

- Did procedures performed by the auditor adequately respond to the identified fraud risk related to the opportunity to manipulate the timing of investment banking revenue recognition?

  A. **Yes**

  B. No

Example 4 - Facts

<u>Broker Dealer D</u>

- Agent for customers transacting in equity securities and provider of investment banking services
- Owned by one individual, eight employees, only one individual had accounting duties
- General ledger system is QuickBooks application
- Total of 450 journal entries in the general ledger for the audit period
- Manual journal entries were posted each day and at each month end
- Nature of the journal entry not apparent from the description in the general ledger

Example 4 – Audit Procedures

- Obtained an understanding of Broker Dealer D's internal control over financial reporting
- Inquired of individual with accounting duties as to whether there were significant adjusting journal entries recorded at the end of the year
- Obtained the QuickBooks general ledger report of journal entries for the entire year under audit and retained copy of the report in the work papers
- Scanned the general ledger report to identify journal entries that appeared unusual
- Retained a copy of the general ledger report in the work papers

Example 4 – Polling Question #6

- Has the auditor performed sufficient procedures to examine journal entries and other adjustments for evidence of possible material misstatement due to fraud?
  A. No
  B. Yes. The auditor obtained an understanding of internal controls, verified that there were no significant adjusting journal entries and reviewed all journal entries for the year.

PCAOB
Public Company Accounting Oversight Board

Example 4 – Polling Question #6

- Has the auditor performed sufficient procedures to examine journal entries and other adjustments for evidence of possible material misstatement due to fraud?
  - A. **No**
  - B. Yes. The auditor obtained an understanding of internal controls, verified that there were no significant adjusting journal entries and reviewed all journal entries for the year.

Financial Statement Audit - *continued*

Related Parties

- Existence and identification of related party relationships and or transactions
- Examining identified related party transactions

Example 5 – Facts

<u>Broker Dealer E</u>

- Wholly owned subsidiary of a financial services company ("Parent")
- Occupancy expenses incurred and paid were reimbursed to Parent under provisions of expense sharing agreement
- Notes to the financial statement included:

  "Broker Dealer E reimburses the Parent for a portion of the occupancy expenses incurred and paid by the Parent under an expense sharing agreement. Under this agreement, Broker Dealer E reimbursed the Parent approximately $205,000 for occupancy expenses incurred during the fiscal year."

Example 5 – Audit Procedures

- Obtained an understanding of the expense cycle and related controls
- Identified general ledger accounts in which related party transactions may be reported
- Inquired of management as to whether there were any changes to the expense sharing agreement (obtained in prior year and maintained in audit permanent file)
- Traced the amount of occupancy expenses from the notes to the financial statements to the general ledger

Example 5 – Polling Question #7

- Audit procedures related to the occupancy expenses were <u>not sufficient</u> because:
  - A. The auditor did not test controls over the payment of the occupancy expenses.
  - B. The auditor did not test the nature and amount of the occupancy expenses that were allocated to Broker Dealer E, as its procedures were limited to tracing amounts to the general ledger.
  - C. The auditor did not obtain and review the expense sharing agreement.

Example 5 – Polling Question #7

- Audit procedures related to the occupancy expenses were <u>not sufficient</u> because:
  - A. The auditor did not test controls over the payment of the occupancy expenses.
  - **B. The auditor did not test the nature and amount of the occupancy expenses that were allocated to Broker Dealer E, as its procedures were limited to tracing amounts to the general ledger.**
  - C. The auditor did not obtain and review the expense sharing agreement.

PCAOB
Public Company Accounting Oversight Board

Financial Statement Audit - *continued*

Establish a Basis for Reliance on Records and Reports

- Auditing information produced by service organizations
- Testing records and reports produced by brokers and dealers

Example 6 – Facts

<u>Broker Dealer F</u>

- Reported total annual commission revenue of $300,000, which was material for the audit
- Used a clearing broker to clear securities transactions on a fully disclosed basis
- Recorded monthly commission revenue with related clearing fees and charges using amounts obtained from monthly statements received from its clearing broker
- Each month the clearing firm wired commission revenue, net of clearing fees and charges, to Broker Dealer F's operating bank account

Example 6 – Audit Procedures

- Obtained a service organization report for the clearing firm that covered the period under audit and noted an unqualified opinion
- Obtained copies of monthly clearing statements from Broker Dealer F for each month during the audit period and traced net commission revenue to; 1) Broker Dealer F's general ledger, and 2) Broker Dealer F's monthly bank statements
- Obtained the year-end clearing statement directly from the clearing firm
- Evaluated Broker Dealer F's trade date vs. settlement date analysis and agreed with Broker Dealer F's conclusion that difference was immaterial

PCAOB
Public Company Accounting Oversight Board

Example 6 – Polling Question #8

- Has the auditor performed sufficient procedures to rely on the statements from the clearing firm?
  - A. Yes, because the auditor obtained a service organization report for the clearing firm, it covered the period of the audit, and the opinion was unqualified.
  - B. Yes, because in addition to obtaining the statements from Broker Dealer F, the auditor independently obtained the year-end clearing statement from the clearing firm.
  - C. Yes, given both A and B.
  - D. No

Example 6 – Polling Question #8

- Has the auditor performed sufficient procedures to rely on the statements from the clearing firm?
  - A. Yes, because the auditor obtained a service organization report for the clearing firm, it covered the period of the audit and the opinion was unqualified.
  - B. Yes, because in addition to obtaining the statements from Broker Dealer F, the auditor independently obtained the year-end clearing statement from the clearing firm.
  - C. Yes, given both A and B.
  - **D. No**

PCAOB
Public Company Accounting Oversight Board

Financial Statement Audit - *continued*

Financial Statement Disclosures

- Omitted disclosures
- Incomplete or inaccurate disclosures
- Fair value disclosures

Financial Statement Audit *– continued*

Effective for fiscal years ending on or after June 1, 2014

	Audit Procedure	PCAOB Standard(s)
Revenue	• *Identifying and Assessing Risk* • *Responding to Risk of Material Misstatement* • *Substantive Analytical Procedures*	• **AS 12** • **AS 13** • **AU 329**
Fraud	• *Identifying and Assessing Risk* • *Responding to Fraud Risk* • *Addressing Risk of Management Override*	• **AS 12** • **AS 13** • **AU 316**
Related Parties	• *Identifying RP Relationships/Transactions* • *Evaluating RP Accounting and Disclosure*	• **AU 334**
Basis for Reliance	• *Evaluating Sufficiency of Audit Evidence* • *Use of Service Organizations*	• **AS 15** • **AU 324**
Evaluation of Deficiencies	• *Responding to Risk of Material Misstatement* • *Evaluating Audit Results* • *Communications about Control Deficiencies*	• **AS 13** • **AS 14** • **AU 325**
FS Disclosures	• *Evaluating FS Presentation, Including Disclosures and Communicating Results*	• **AS 14** • **AS 16**

PCAOB
Public Company Accounting Oversight Board

Polling Question #9

- How many registered firms and how many broker or dealer audits have been inspected by the PCAOB since the inception of the interim inspection program through the end of 2013?
  A. 60 firms and 90 audits
  B. 90 firms and 100 audits
  C. 101 firms and 173 audits

Polling Question #9

- How many registered firms and how many broker or dealer audits have been inspected by the PCAOB since the inception of the interim inspection program through the end of 2013?
  A. 60 firms and 90 audits
  B. 90 firms and 100 audits
  C. 101 firms and 173 audits

PCAOB
Public Company Accounting Oversight Board

Summary of Inspection Observations

Since inception of Interim Inspection Program:

- Audit deficiencies identified in 150 of 173 audits
- Independence findings identified in 45 of 173 audits
- Lower percentage of audits inspected with deficiencies when comparing 2013 to inspections through 2012 for each area inspected

Summary of Inspection Observations - *continued*

Observations Stratified by Characteristics:

- Firm Characteristics
  - Number of broker or dealer audits per firm
  - Firms that audited issuers compared to firms that did not
- Broker Dealer Characteristics
  - Reported Actual Net Capital, Revenue and Assets
  - Special Reserve Bank Account

2014 Inspections

- 66 firms and portions of 113 audits
- Continued coverage of cross-sections of firms and brokers and dealers, will include some firms previously inspected
- Included seven current audits by seven firms previously inspected
- Observations similar to past inspections, including independence findings

2014 Inspections - PCAOB Standards

- Inspected five firms covering one audit at each
- Observations:
  - Audit opinion
  - Examination Report
  - Review Report
  - Engagement Quality Review
  - Engagement Completion Document
  - Similar to Deficiencies Previously Reported

2015 Inspection Plan

- Audits of brokers and dealers, which are required to be performed in accordance with PCAOB standards
- Examination and Review Engagements, also to be performed in accordance with PCAOB standards
- Continue to increase inspection coverage and address previous inspection findings

Next Steps for Auditors

- Re-examine audit approaches
- Consider whether audit deficiencies and independence findings might be present in audits currently performed and take appropriate action to prevent or correct
- Take appropriate action when audit deficiencies are discovered after the date of the audit report
- Consider how to prevent similar or other deficiencies by anticipating and addressing risks that might arise in audits of brokers and or dealers

Next Steps for Auditors - *continued*

- Stress the need to conduct audits with due professional care
- Review the following with respect to independence:
  - Agreements for services performed for broker and dealer audit clients
  - Guidance and training provided to professionals
  - Quality control procedures
- Review firm guidance, training and policies around supervision and reviews to ensure areas with reported audit deficiencies are given appropriate attention and focus

PCAOB

Public Company Accounting Oversight Board

Questions?