

# Consideration of a Broker's or Dealer's Use of a Service Organization, pursuant to AS 2601

December 13, 2016

# Introductory Remarks

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Mary Sjoquist, Director

Office of Outreach and Small Business Liaison

# Caveat

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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.

# Learning Objectives

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The PCAOB Webcast for Auditors of Broker-Dealers on the Consideration of a Broker's or Dealer's Use of Service Organization is intended to assist auditors in further understanding the factors an auditor should consider when auditing the financial statements of a broker or dealer that uses a service organization to process certain transactions.

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# Consideration of a Broker's or Dealer's Use of a Service Organization, pursuant to AS 2601

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December 13, 2016

# Agenda

- ❑ Inspections Results
- ❑ AS 2601 and Audits of Brokers and Dealers and Attestation Engagements
- ❑ Effect of the Service Organization on the Broker's or Dealer's Internal Control
- ❑ Using a Service Auditor's Report
- ❑ Actions for Auditors
- ❑ Questions

# Inspections Results



# 2015 Inspections Results – Polling Question #1

In the Annual Report on the Interim Inspection Program related to Audits of Brokers and Dealers, issued in August 2016, what area had the highest percentage of audits with deficiencies?

- A. Fair value measurements
- B. Net capital computation
- C. Revenue
- D. Related party transactions

# 2015 Inspections Results

- ❑ Deficiencies related to auditing revenue when using information produced by service organizations
- ❑ Insufficient audit evidence obtained regarding the accuracy and completeness of this information
- ❑ Reliance on controls at the service organization

# 2015 Inspections Results (continued)

- ❑ Used as audit evidence statements and other information the broker or dealer obtained from its service organization
- ❑ Did not obtain and evaluate a service auditor's report or perform procedures related to the accuracy and completeness of the information used in performing audit procedures

# 2015 Inspections Results (continued)

- ❑ Obtained a service auditor's report
- ❑ Insufficient evaluation of service auditor's report
- ❑ Did not consider whether the service auditor's report provided evidence about the design and operating effectiveness of controls relevant to the information being used

# **AS 2601 and Audits of Brokers and Dealers and Attestation Engagements**

# AS 2601 - Background

- ❑ Reorganization of standards effective as of December 31, 2016
- ❑ Prior to reorganization –  
AU Section 324 – *Service Organizations*
- ❑ Generally accepted auditing standard adopted as PCAOB Interim Auditing Standard in April 2003
- ❑ AU Section 324 - effective in 1993

# AS 2601 and the Audit Process

- ❑ Audit of the Financial Statements
  - ❑ Planning the Audit
  - ❑ Responding to the Risks of Material Misstatement
  - ❑ Communications about Control Deficiencies
- ❑ Audit Procedures Performed on Supporting Schedules

# Definitions in AS 2601, Paragraph 2

- ❑ User organization - the entity that has engaged a service organization and whose financial statements are being audited
- ❑ User auditor - the auditor who reports on the financial statements of the user organization
- ❑ Service organization - the entity (or segment of an entity) that provides services to a user organization that are part of the user organization's information system
- ❑ Service auditor - the auditor who reports on controls of a service organization that may be relevant to a user organization's internal control as it relates to an audit of financial statements



# AGI – Background – Example for Discussion

- ❑ Adviser Group, Inc. (AGI) is an introducing broker-dealer that also trades for its own proprietary account
- ❑ Clearing House (CH) provides clearing services to AGI for both customer and proprietary trades
- ❑ Trades are entered by AGI representatives or traders into manual trade blotters and into CH's front end trade system
- ❑ Revenue from commissions and proprietary transactions is recorded in AGI's general ledger (GL) by AGI accounting staff using monthly clearing statements and inventory reports received from CH

# AGI – Background – Polling Question #2

Which is a factor an auditor would consider under AS 2601 to identify that a service organization's services affect and are part of an entity's information system?

- A. The classes of transactions in the entity's operations that are significant to the entity's financial statements
- B. The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures
- C. The related accounting records, whether electronic or manual, supporting information, and specific accounts in the entity's financial statements involved in initiating, recording, processing and reporting the entity's transactions
- D. Any one of the above or more

# Applicability of AS 2601

- ❑ AS 2601 applies to audits of brokers and dealers, which obtain services from an organization and those services are part of the brokers' and dealers' information systems (Paragraph 3)
- ❑ Specific considerations for whether a service organization's services are part of a broker's or dealer's information system
- ❑ "A service organization's services are part of a entity's information system if..."

# Use of a Service Organization – Do the services affect:

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The classes of transactions in the entity's operations that are significant to the entity's financial statements

# Use of a Service Organization – Do the services affect (continued):

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The procedures, both automated and manual, by which the entity's transactions are initiated, recorded, processed, and reported from their occurrence to their inclusion in the financial statements

# Use of a Service Organization – Do the services affect (continued):

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The related accounting records, whether electronic or manual, supporting information, and specific accounts in the entity's financial statement involved in initiating, recording, processing and reporting the entity's transactions

# Use of a Service Organization – Do the services affect (continued):

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How the entity's information system captures other events and conditions that are significant to the financial statements

# Use of a Service Organization – Do the services affect (continued):

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The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures



# Applicability of AS 2601 (continued) – Polling Question #3

What is an example of a service provided by a service organization?

- A. Bank trust departments that invest and service assets for employee benefit plans or for others
- B. Data processing organizations that provide packaged software applications and technology environments
- C. Mortgage bankers that service mortgages for others
- D. Any of the above

# Applicability of AS 2601 (continued) – Paragraph 3

“The provisions of this guidance are not intended to apply to situations in which the services provided are limited to executing client organization transactions that are specifically authorized by the client, such as the processing of checking account transactions by a bank or **the execution of securities transactions by a broker**”

# **Effect of the Service Organization on the Broker's or Dealer's Internal Control**

# PCAOB Audit Standards

- ❑ Audits of the financial statements of brokers and dealers are required to be performed under PCAOB Audit Standards
- ❑ Includes the following:
  - ❑ AS 2110, *Identifying and Assessing Risks of Material Misstatement*
    - ❑ **Referenced in paragraph .07 of AS 2601**
  - ❑ AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*
    - ❑ **Referenced in paragraph .16 of AS 2601**

# AGI – Background (continued)

1. Trades are entered by AGI representatives or traders into manual trade blotters, and CH's front end trade system
2. Revenue from commissions and proprietary transactions is recorded in AGI's GL by AGI accounting staff using monthly clearing statements and inventory reports received from CH
3. AGI accounting staff reconcile monthly each trade blotter to CH statements and inventory reports
4. AGI's CFO reviews GL reconciliations prepared by AGI accounting staff related to revenue and approves any adjusting entries

# AGI – Background (continued)– Polling Question #4

Which is a factor the auditor may need to consider under AS 2601 in determining whether to obtain an understanding of the internal control environment at CH?

- A. The nature of the transactions processed by CH for AGI only
- B. The materiality of the transactions processed by CH for AGI only
- C. Whether AGI has a service organization report available
- D. Both the nature and materiality of the transactions processed by CH for AGI

# Effect of the Service Organization on the Broker's or Dealer's Internal Control

Paragraph 7 of AS 2601 states that the auditor's understanding of internal control sufficient to plan the audit may encompass controls placed in operation by the service organizations whose services are part of the entity's information system

# Effect of the Service Organization – Polling Question #5

What information could the auditor obtain under AS 2601 to understand the nature of the services provided by a service organization to a user organization?

- A. Contract between the user organization and the service organization
- B. Reports by service auditors, internal auditors, or regulatory authorities
- C. User manuals, system overviews and technical manuals
- D. Any one of the above or more



# Auditor's Use of the Understanding of Internal Control

- ❑ Identify types of potential misstatements
- ❑ Consider risk factors that affect the risk of misstatement
- ❑ Assess control risk for account balance assertions and classes of transactions
- ❑ Design tests of controls (when applicable)
- ❑ Design substantive tests

# AGI – Background (continued) – Risk Assessment

- ❑ Auditor gained an understanding of internal control at AGI and CH
- ❑ Auditor completed risk assessment
- ❑ The auditor's risk assessment for commission revenue is as follows:

Account & Assertions	Inherent Risk	Control Risk	RoMM	Significant/ Fraud Risk?
Commission Revenue (E/O, V/A, C)	Low	High	Low	No

# AGI – Background (continued) – Commission Revenue Audit Procedures

1. Obtained the CH clearing statements for all 12 months from AGI
2. Traced commission revenue amounts reported on each clearing statement to amounts recorded to general ledger for each month
3. Traced net amount reported in each clearing statement to cash received each month per AGI's bank statement
4. Independently obtained 12/31 year end clearing statement directly from CH and compared it to the one obtained from AGI for 12/31 without exception

# Commission Revenue Audit Procedures

- ❑ Testing Information Produced by Service Organization –
  - ❑ The auditor may use a service auditor's report to establish reliability on the accuracy and completeness of information produced by the service organization
  - ❑ The auditor may identify and test controls at the user organization sufficient to ensure accuracy and completeness of the information from the service organization
  - ❑ The auditor may test the accuracy and completeness of information from the service organization directly

# AGI – Background (continued) – Risk Assessment

- The auditor's risk assessment for proprietary trading (PT) revenue is as follow:

Account & Assertions	Inherent Risk	Control Risk	RoMM	Significant / Fraud Risk?
PT Revenue (E/O, V/A, C)	Low	High	Low	No

# AGI – Background (continued) – PT Revenue Audit Procedures

1. Tested the CH monthly trade blotters and trading reports by tracing a sample of trades between these documents
2. Recalculated the realized gain or loss included in the CH trading report of total purchases and sales
3. Traced the net PT gain or loss from a sample of monthly CH statements to AGI's general ledger
4. Vouched net cash settlements to AGI's trading account at CH
5. Recalculated the total unrealized PT gain or loss using the current year-end and prior year-end fair values
6. Reconciled the total PT gain or loss per the financial statements to the general ledger

# PT Revenue Audit Procedures

- ❑ Testing Information Produced by Service Organization –
  - ❑ The auditor may use a service auditor's report to establish reliability on the accuracy and completeness of information produced by the service organization
  - ❑ The auditor may identify and test controls at the user organization sufficient to ensure accuracy and completeness of the information from the service organization
  - ❑ The auditor may test the accuracy and completeness of information from the service organization directly

# Assessing Control Risk – Polling Question #6

Does AS 2601 require the auditor to obtain a service auditor's report in order to assess control risk below the maximum (controls reliance)?

Yes

No



# 5 Minute Break

# Using a Service Auditor's Report

# AGI – Background (continued) – Risk Assessment

- ❑ At year-end, AGI holds securities positions and a large inventory balance
- ❑ The auditor's risk assessment for securities inventory is as follows:

Account & Assertions	Inherent Risk	Control Risk	RoMM	Significant / Fraud Risk?
Securities Inventory (E/O, V/A, C, P&D)	Moderate	<b><u>Low</u></b>	Moderate	Yes

# AGI – Background (continued) – Securities Inventory Valuation

- ❑ Inventory includes exchange-traded equity securities, corporate bonds and mortgage-backed securities (Level 1 and 2 securities, respectively)
- ❑ AGI uses reporting provided by CH to determine fair value and periodically checks these prices to Bloomberg
- ❑ CH uses another un-related organization, Pricing Services, Inc. (PSI), to obtain its securities pricing
- ❑ CH provides to AGI an annual “Service Organization Control Report on Controls Placed in Operation and Tests of Operating Effectiveness (SOC 1)”

# Service Organization's Use of a Sub-Service Organization

- ❑ A service organization may use third party service providers (“sub-service organization”) in providing services to a user organization
- ❑ Paragraph 6 of AS 2601
  - ❑ Consider the effect of the use of the sub-service organization by the service organization on the user organization’s internal controls
  - ❑ Consider the nature and materiality of the services provided
  - ❑ Degree of interaction between the entities’ activities
- ❑ Consider what additional procedures the auditor may perform based on this understanding

# CH SOC 1 Report – Excerpt of Examination Opinion

## Excerpt of Scope Paragraph –

“The description indicates that certain control objectives specified in the control objectives can only be achieved only if complementary user entity controls contemplated in the design of Clearing House’s controls are suitably designed and operating effectively, along with related controls at the service organization. We have not evaluated the suitability of design and operating effectiveness of such controls.”

“Clearing House uses third party sub-service providers for market data and pricing of securities. The accompany description includes only those control objectives and related controls of Clearing House, and excludes the control objectives and related controls of the third-party subservice provider. Our examination did not extend to controls of the sub-service providers.”

# AGI – Background (continued) – Securities Inventory Audit Procedures

1. Obtained a confirmation from CH of all AGI securities held in custody at year end
2. Compared individual positions confirmed to an inventory listing provided by AGI
3. Obtained and evaluated the CH SOC 1 Report
4. Traced the securities owned account balance from the general ledger to the year-end inventory pricing report produced by CH for AGI
5. Traced total equity, corporate bond and mortgage-backed securities fair values to the financial statement footnotes

# AGI – Background (continued) - Evaluation of CH SOC 1 Report

- ❑ Service auditor's professional reputation was considered satisfactory based on inquiries made
- ❑ CH SOC 1 Report included tests of design and operating effectiveness related to securities pricing
- ❑ Service auditor's opinion indicated that controls were suitably designed and operating effectively
- ❑ Service auditor's opinion was for the period of October 1, XX to September 30, XX and therefore covered the first nine months for the year under audit
- ❑ A letter was obtained from CH for the remainder of the audit period, from October 1, XX to December 31, XX



# Securities Inventory Audit Procedures – Polling Question #7

Which of the following factors may the auditor consider when using a service auditor's report on controls placed in operation and tests of operating effectiveness in relation to the auditor's planned procedures?

- A. The specific tests of controls and results in the CH SOC 1 report are relevant to the assertions that are significant to AGI's financial statements
- B. The professional reputation of the service auditor
- C. Time period covered by the CH SOC 1 report in relation to AGI's financial statement period
- D. One or more of the above

# Considerations in Using a Service Auditor's Report

- ❑ Whether the report is satisfactory for the user auditor's purpose by make inquiries concerning the service auditor's professional reputation
- ❑ Whether the report is sufficient to meet the user auditor's objectives
- ❑ The extent of the evidence provided by the report about the effectiveness of controls intended to prevent or detect material misstatements in the particular assertions
- ❑ Whether the nature, timing and extent of tests of relevant controls and results provide appropriate evidence about the effectiveness of controls

# CH SOC 1 Report – Tests of Design and Operating Effectiveness

- ❑ Controls provide reasonable assurance that security market pricing data is obtained from authorized pricing sources

Description of Controls	Tests of Controls
1.1 Pricing group reviews, investigates, and signs off on price fluctuation reports which identify price variances according to established criteria	Inquired of management who noted that the process and controls to review the price fluctuation occurs on a daily basis. Examined a sample of reports for management's sign-off.
1.2 Each night, an automated pricing review is performed to ensure that the pricing from automatic pricing feeds were processed. Pricing logs are signed off for each nightly feed to ensure the feeds were accurate and complete, and exceptions are investigated	Inquired of management who noted that the process and controls for monitoring the automated pricing feed occurs on a nightly basis.  Examined a sample of pricing logs for management's sign-off.

- ❑ No exceptions noted

# CH SOC 1 Report – Excerpt of Examination Opinion

“In our opinion, in all material respects, based on the criteria described in Clearing House’s assertion, (1) the description fairly presents Clearing House’s clearing firm services that was designed and implemented throughout the period October 1, XX to September 30, XX, (2) the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively throughout the period October 1, XX to September 30, XX, and **user entities applied the complementary user entity controls contemplated in the design of Clearing House’s controls throughout the period, and (3) the controls tested, which together with the complementary user entity controls referred to in the scope paragraph of this report, if operating effectively**, were those necessary to provide reasonable assurance that the control objectives stated in the description in the service organization report were achieved, operated effectively throughout the period October 1, XX to September 30, XX.”

# CH SOC 1 Report – Complementary User Entity Controls

Control Objective	Complementary User Entity Consideration
<p>Controls provide reasonable assurance that security market pricing data is obtained from authorized pricing sources</p>	<p>Physical and logical access to Clearing House’s systems via terminals at user organizations should be established, monitored and maintained by the user organization</p>
	<p>User organization reviews securities inventory reports (including stale and unpriced securities) provided by Clearing House for appropriateness</p>
	<p>Transmission of all trading activities to Clearing House from the user organization is accurate and complete</p>

# Complementary User Entity Controls – Polling Question #8

Under what scenarios might an auditor consider testing complementary user entity controls at the broker or dealer that are identified in a service organization report?

- A. When the auditor assesses control risk at the maximum and performs procedures directly over information produced by a service organization
- B. When the auditor assesses control risk below the maximum and obtains evidential matter to support its assessed control risk from a service auditor's report on controls placed in operation and tests of operating effectiveness
- C. When the auditor assesses control risk below the maximum and performs procedures directly over information produced by a service organization
- D. None of the above

## Excerpt from Letter Obtained from CH

“We have reviewed the internal control environment at Clearing House and **we are please to advise you that to the best of our knowledge** as of January 8, XX, no material changes has been made to the design of the internal controls referenced in Section IV of the Clearing House SOC1 Report, which would materially affect our internal control environment”

# Actions for Auditors



# Actions for Auditors

- ❑ Understand the use of service organizations
- ❑ Apply the guidance in AS 2601
  - ❑ Determine the significance of the controls at the service organization relative to those at the broker or dealer and the associated degree of interaction
  - ❑ Consider the relevance of the service organization when assessing risk of material misstatement and planned audit response
  - ❑ Evaluate the service auditor's report and consider the extent of evidence it provides
- ❑ Contact us at [info@pcaobus.org](mailto:info@pcaobus.org)  
Standards Inquiry: 202-591-4395

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# Questions?