

# Forum for Auditors of Broker-Dealers

June 3, 2015

Chicago, IL

# Caveat

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One of the benefits of today's session is that you will hear firsthand from one of the PCAOB Board members and numerous PCAOB staff. You should keep in mind, though, that when we share our views they are those of the speaker alone, and do not necessarily reflect the views of the Board, its members or staff.

# Welcome

Mary Sjoquist

Director, Office of Outreach and  
Small Business Liaison

# PCAOB Highlights

James R. Doty, Chairman

# Compliance & Industry Trends

Office of Research & Analysis  
Tim Gustafson



# *PCAOB Forum for Auditors of Broker-Dealers*

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***Khalid Shah***  
***Associate Chief Accountant***

***Office of the Chief Accountant***  
***U.S. Securities and Exchange Commission***

***June 3, 2015***



# *Disclaimer*

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# *Agenda*

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- ❖ **Implementation of July 30, 2013 Amendments to the SEC's Broker-Dealer Annual Reporting Requirements (Release No. 34-70073)**
  - **Overview of the Annual Reporting Requirements**
- ❖ **Applicability of Auditor Independence Rules to Broker-Dealer Audits**
- ❖ **Office of Compliance Inspections and Examinations - Broker-Dealer Inspections**





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*Overview of the Annual  
Reporting Requirements*

# *Overview of the Annual Reporting Requirements*

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## ❖ Reporting

- Annual Reports under Rule 17a-5(d) generally include:
  - Financial Report (audited financial statements and certain supporting schedules);
  - Compliance Report or Exemption Report; and
  - Independent public accountant reports.
- Independent public accountant reports must be in accordance with the standards of the PCAOB
- Material Inadequacy report no longer relevant for compliance with Rule 17a-5 (replaced by Compliance Report or Exemption Report for SEC registered broker-dealers)

# *Overview of the Annual Reporting Requirements*

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## ❖ Reporting

- Compliance Report and Exemption Report must cover the requirements in Rule 17a-5(d)(3) for the Compliance Report and Rule 17a-5(d)(4) for the Exemption Report
- Same person that signs the oath or affirmation to sign the Compliance or Exemption Report

## ❖ Reporting by non-carrying broker-dealers that are not claiming exemption under Rule 15c3-3(k)

- Frequently Asked Questions (FAQ 6) by Division of Trading & Markets on April 4, 2014
- Relief from filing a Compliance Report
- Exemption Report (if applicable) – needs to be sufficiently descriptive of why the broker-dealer has no obligations under Rule 15c3-3

# *Overview of the Annual Reporting Requirements*

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- ❖ **Notification Requirements under paragraph (h) of Rule 17a-5 of non-compliance or material weakness:**
  - **The auditor must immediately notify the broker-dealer of the nature of the non-compliance or material weakness**
  - **The broker-dealer must file a notification with the Commission and the regulatory authority that examines the broker-dealer if the auditor's notice relates to an instance of non-compliance that would trigger notification, and provide a copy of the notification to the auditor**
  - **If the auditor does not receive a copy of the notification within one business day, or if the auditor does not agree with the statements in the notification, the auditor must notify the SEC and the designated examining authority within one business day**

# *Overview of the Annual Reporting Requirements*

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- ❖ **Compliance Report to include statements as to whether:**
  - **The broker-dealer has established and maintained Internal Control over Compliance;**
  - **Internal Control over Compliance was effective during the most recent fiscal year;**
  - **Internal Control over Compliance was effective as of the end of the most recent fiscal year;**
  - **The broker-dealer was in compliance with Rule 15c3-1 and Rule 15c3-3(e) as of its fiscal year-end;**
  - **The information used to state whether it was in compliance was derived from the books and records of the broker-dealer.**

# *Overview of the Annual Reporting Requirements*

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- ❖ **If applicable, a carrying broker-dealer would be required to include:**
  - **A description of each material weakness in Internal Control Over Compliance during the most recent fiscal year**
  - **A description of each instance of non-compliance with Rules 15c3-1 or 15c3-3(e) as of the end of the most recent fiscal year**

# *Overview of the Annual Reporting Requirements*

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- ❖ ***Non-carrying* broker-dealer required to state the following in its Exemption Report:**
  - The provisions in Rule 15c3-3(k) under which the broker-dealer claimed an exemption from Rule 15c3-3
  - Either:
    - The broker-dealer met the identified exemption provisions in Rule 15c3-3(k) throughout the most recent fiscal year without exception, or
    - The broker-dealer met the identified exemption provisions except as described in the Exemption Report.
  - If applicable, an identification of each exception, a description of the nature of each exception, and the approximate date(s) on which the exception existed

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***Applicability of Auditor  
Independence Rules to Broker-  
Dealer Audits***



# *Applicability of Auditor Independence Rules to Broker-Dealer Audits*

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- ❖ **Auditors of both issuer and non-issuer broker-dealers are required to be qualified and independent in accordance with the Commission's auditor independence requirements in Rule 2-01 of Regulation S-X, *Qualifications of Accountants***
- ❖ **Recent enforcement activity in this area**
  - **Commission sanctioned 8 firms for not complying with Rule 2-01(c)(4)(i) – *Bookkeeping or Other Services Related to the Accounting Records or Financial Statements of the Audit Client.***  
(<http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543608588>)
  - **PCAOB settled disciplinary orders against 7 firms for independence violations.**  
([http://pcaobus.org/News/Releases/Pages/12082014\\_Enforcement.aspx](http://pcaobus.org/News/Releases/Pages/12082014_Enforcement.aspx))

# *Applicability of Auditor Independence Rules to Broker-Dealer Audits*

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- ❖ **Examples of applicable independence requirements:**
  - **Non-Audit Services – An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides, among others, the following non-audit services to an audit client:**
    - **Bookkeeping or other services related to the accounting records or financial statements of the audit client**
    - **Financial information systems design and implementation**
    - **Management Functions or Human Resources**

# *Applicability of Auditor Independence Rules to Broker-Dealer Audits*

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- ❖ **Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence**
  - **Auditors should not provide typing and word processing services nor financial statement templates that are not publicly available to broker-dealer audit clients**
  - **Auditors of non-issuer brokers-dealers are not subject to SEC rules related to:**
    - **Partner rotation requirements**
    - **Certain partner compensation arrangements**
    - **Audit committee administration requirements**
    - **“Cooling off” period requirements**

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***Office of Compliance Inspections  
and Examinations (OCIE) -  
Broker-Dealer Inspections***

# *OCIE Broker-Dealer Inspections*

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- ❖ ***Scoping involves, among other considerations:***
  - ***Review of Annual Reports, Form Custody and eFocus filings***
  - ***Compliance with the annual reporting requirements***
- ❖ ***Inspections – Recurring Common Themes***
  - **Expense Sharing Agreements**
  - **Capital contributions and withdrawals**
  - **Haircut computations**
  - **Classification of allowable vs. non-allowable assets**
  - **Compliance with Rule 15c3-3 exemption**
  - **Books & Records**
  - **Other**

# *Contact Information*

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## ❖ **Division of Trading and Markets**

- <http://www.sec.gov/divisions/marketreg/mrcontact.htm>
- Phone: (202) 551-5777
- E-mail : [tradingandmarkets@sec.gov](mailto:tradingandmarkets@sec.gov)

## ❖ **Office of the Chief Accountant**

- **Professional Practice Group (including Independence)**
- **Accounting**
- Phone: (202) 551-5300
- E-mail : [OCA@sec.gov](mailto:OCA@sec.gov)

# FINRA Perspectives

**PCAOB Forum for Auditors of Broker-Dealers**  
Chicago, IL – June 3, 2015

Susan DeMando Scott, Associate Vice President  
Risk Oversight and Operational Regulation  
Financial Operations Policy Group



# The Nature and Scope of FINRA's Financial Surveillance, and Risk-Based Examinations, and Programs





# FINRA's Financial Surveillance Program

- **Includes the routine review of a firm's financial and operational reports:**
  - Filed pursuant to SEC Rule:
    - FOCUS Report
    - Schedule I
    - Annual Report
    - Form Custody - Initial Filing as of 12/31/2013
  - Filed pursuant to FINRA Rule:
    - Form SSOI (Supplemental Statement of Income) - Initial Filing as of 09/30/2012
      - Regulatory Notice 12-11
    - Form OBS (Supplemental Schedule for Derivatives and Other Off-Balance Sheet Items) - Initial Filing as of 06/30/2013
      - Regulatory Notice 13-10
    - Form SIS (Supplemental Inventory Schedule) - Initial Filing as of 12/31/2014
      - Regulatory Notice 14-43
- **Reviews are largely determined by the creation of certain “exceptions.”**
- **Select, manual reviews are also conducted.**

# FINRA's Risk-Based Examination Program

- Risk-Based means that the scope, content, frequency, and nature of a firm's examination will depend on the characteristics of the firm.
- Characteristics include, but are not limited to firm size, business lines, and nature of operations.
- All firms are on a 1, 2, 3 or 4 year examination cycle.
- Nonetheless, examination frequency can be modified for various regulatory reasons.

# 2014 Examination Findings Trends



## 2014 Examination Findings – Supervisory Procedures

- **Same person assigned responsibility for posting to the general ledger and reconciliation of related accounts**
- **Failure to include supervisory review of reconciliations in written supervisory procedures**
- **Failure to document supervisory review of reconciliations**
- **Failure to supervise postings to the general ledger**
  - Clerical errors caused overstatement of balance sheet balances
  - Duplicate postings made to the general ledger
  - General lack of supervision
- **Failure to supervise post-closing entries to the books and records**

## 2014 Examination Findings – GAAP / Books and Records

- **Improper netting causing capital and/or reserve formula computation adjustments**
  - Frequent GAAP issue observed
- **Failure to properly report on an accrual basis or accrue on a timely basis**

# Application of the Net Capital Rule

## Minimum Net Capital Requirements, Haircuts, and Other Capital Charges



# Riskless Principal v. Principal Transactions

## Minimum Net Capital Requirement - \$100,000 MNCR v. \$5,000 MNCR

### SEA Rule 15c3-1(a)(2)(iii) Dealers

A dealer shall maintain net capital of not less than \$100,000. For the purposes of this section, the term "dealer" includes:

- (A) any broker or dealer that endorses or writes options otherwise than on a registered national securities exchange or a facility of a registered national securities association; and
- (B) any broker or dealer that effects *more than ten transactions in any one calendar year for its own investment account*.

### SEA Rule 15c3-1(a)(2)(vi) Other Brokers or Dealers

A broker or dealer that does not receive, directly or indirectly, or hold funds or securities for, or owe funds or securities to, customers and does not carry accounts of, or for, customers and does not engage in any of the activities described in paragraphs (a)(2)(i) through (v) of this section shall maintain net capital of not less than \$5,000. A broker or dealer operating under this paragraph may engage in the following dealer activities without being subject to the requirements of paragraph (a)(2)(iii) of this section:

- (A) in the case of a buy order, *prior to executing such customer's order*, it purchases as principal the same number of shares or purchases shares to accumulate the number of shares necessary to complete the order, which shall be cleared through another registered broker or dealer or
- (B) in the case of a sell order, *prior to executing such customer's order*, it sells as principal the same number of shares or a portion thereof, which shall be cleared through another registered broker or dealer.

### SEA Rule 15c3-1(a)(2)(vi)/01 Riskless Principal Transactions

A broker who does *riskless principal transactions in effectuating customer trades* may be subject to a \$5,000 minimum requirement, provided these transactions are made on a fully disclosed basis. (SEC Staff to NYSE)

*(Emphasis Added)*

# Moment to Moment Net Capital Requirement

## ■ Understanding Moment to Moment Net Capital Compliance

### SEA Rule 15c3-1(a)/001 Moment to Moment Net Capital Interpretation

Broker-dealers must maintain sufficient net capital at all times prior to, during and after purchasing or selling proprietary securities. Broker-dealers must have at all times (including intraday) sufficient net capital to meet the haircut requirements of the Capital Rule before taking on any new proprietary positions, even if the intention of the firm is to liquidate or cover the positions before the end of the same day. Broker-dealers are expected to be able to demonstrate moment to moment compliance with the Capital Rule.

(SEC Staff to NYSE) (No. 99-8, August 1999)

Interpretations of Financial and Operation Rules:

<http://www.finra.org/Industry/Regulation/Guidance/FOR/>



# Underwriting - Net Capital Implications

## ■ Underwriters

- No such thing as an underwriter “in name only”
  - Broker-dealer listed as such on prospectus is subject to a minimum net capital requirement of \$100,000
- Broker-dealer listed on prospectus may also have to take an open contractual commitment charge
  - Facts and Circumstances

# Selling Group Activities - Net Capital Implications

## SEA Rule 15c3-1(a)(2)(iv) Brokers of Dealers That Introduce Customer Accounts and Receive Securities

A broker or dealer shall maintain net capital of not less than \$50,000 if it introduces transactions and accounts of customer or other brokers or dealers to another registered broker or dealer that carries such accounts on a fully disclosed basis, and if the broker or dealer received but does not hold customer or other broker or dealer securities. A broker or dealer operating under this paragraph(a)(2)(iv) of this section *may participate in a firm commitment underwriting without being subject to the provisions of paragraph(a)(2)(iii) of this section, but may not enter into a commitment for the purchase of shares related to that underwriting.*

*(Emphasis Added)*

## ■ Selling Group Member

- Net Capital Requirement is based on the nature of the offering
  - Broker-dealer participating in such offering is subject to a minimum net capital requirement of \$50,000
- Broker-dealer may also have to take an open contractual commitment charge
  - Facts and Circumstances

Interpretations of Financial and Operation Rules:

<http://www.finra.org/Industry/Regulation/Guidance/FOR/>

# Dealer Status

## Other Activity that Conveys Dealer Status

### SEA Rule 15c3-1(a)(2)(iii) Dealers

A dealer shall maintain net capital of not less than \$100,000. For the purposes of this section, the term "dealer" includes:

(A) any broker or dealer that endorses or writes options otherwise than on a registered national securities exchange or a facility of a registered national securities association; and

(B) any broker or dealer that effects *more than ten transactions in any one calendar year for its own investment account.*

*(Emphasis Added)*

- **“More than ten transactions”**
  - Consideration of the “count”
- **“Investment Account”**
  - Meaning of...

Interpretations of Financial and Operation Rules:

<http://www.finra.org/Industry/Regulation/Guidance/FOR/>

# Application of the Net Capital Rule

## Aggregate Indebtedness



# Inaccurate Computation of Aggregate Indebtedness

## - Inaccurate Computation of Aggregate Indebtedness

### SEA Rule 15c3-1(c)(1)/12 Liability for Law Suit Damages, Penalties, etc.

Where long term liabilities, such as damages in a lawsuit, penalties, etc., are payable in installments or a lump sum over a long term, the full amount of the liability must be recorded and included in Aggregate Indebtedness.

In the event the liability is recorded on the books of account at present value under GAAP, *the full amount of the liability (not the present value amount) must be included in Aggregate Indebtedness.* (SEC Staff to NYSE) (No. 90-11, December 1990) (*Emphasis added*)

### SEA Rule 15c3-1(c)(1)/16 Court Judgment Rendered against a Broker-Dealer

A court judgment adverse to a broker-dealer is, at a minimum, a contingent liability of the firm and *included in the calculation of aggregate indebtedness unless an opinion of counsel indicates otherwise.* If the broker-dealer has exhausted its remedies, the liability must be booked. Each situation must be analyzed on the particular facts present in the matter. (Emphasis added)

(Letter from SEC Staff of DMR to NASD, February 8, 1978)

Interpretations of Financial and Operation Rules:

<http://www.finra.org/Industry/Regulation/Guidance/FOR/>

# Inaccurate Computation of Aggregate Indebtedness, *Continued*

## - Inaccurate Computation of Aggregate Indebtedness

### SEA Rule 15c3-1(c)(1)/26 Fines and Other Monetary Penalties Assessed by a Governmental Agency or Self-Regulatory Organization

A fine, an order to pay restitution or similar penalty imposed by a governmental agency or self-regulatory organization (“fine”), at a minimum, *shall be treated as a contingent liability of the broker-dealer and included in the computation of aggregate indebtedness at the time such fine is imposed.* (SEC Staff to FINRA) (FINRA Regulatory Notice 13-44) *(Emphasis Added)*

In addition, under Generally Accepted Accounting Principles (GAAP), broker-dealers have an ongoing obligation to assess the specific facts applicable to each pending or decided matter that may result or has resulted in the imposition of a fine and to make a determination as to whether an actual liability must be recorded in the financial statements.

In any event, once all available appeals or other remedies have been exhausted, the broker-dealer must record the full amount of the fine as a liability in its financial statements.

Interpretations of Financial and Operation Rules:

<http://www.finra.org/Industry/Regulation/Guidance/FOR/>



# Regulatory Concerns

## Related Party Transactions





# Related Party Transactions Securities Transactions

Related Party Transactions raise regulatory concerns for various reasons.


## ■ Securities Transactions

- With Affiliates – “Transfer” or Sale of Assets to Affiliate
  - Possibly done to avoid reflecting gain/loss in the broker-dealer, or to avoid haircuts, undue concentration, or blockage charges
- On behalf of Affiliates – Affiliate is the Issuer/Manager of Securities Sold
  - Common among FINRA members
- Assignment of Securities Based Compensation to Affiliate
  - Assignment done to avoid recognition of revenue on broker-dealer’s books
  - Recipient may have violated federal securities laws

# Related Party Transactions Securities Transactions

## Supplemental Statement of Income (SSOI)

C. Unregistered Offering (Excludes municipal offerings ) Section below refer to Operational Page – See Instructions

Did the broker or dealer filing this report participate in the sale of any unregistered offering during the reporting period for which it received no compensation? ..... Yes  No  11080 

1. Unregistered offerings, other than self or affiliate offerings. Section 1.....	\$ _____	<span style="border: 1px solid black; padding: 2px;">11081</span>
2. Unregistered offerings, self or affiliate offerings. Section 2.....	\$ _____	<span style="border: 1px solid black; padding: 2px;">11082</span>
Total Revenue from Unregistered Offerings: \$ _____		<span style="border: 1px solid black; padding: 2px;">11089</span>
Total Revenue from Underwritings and Selling Group Participation: \$ _____		<span style="border: 1px solid black; padding: 2px;">13955</span>

# Related Party Transactions

## Financial Transactions

Related Party Transactions raise regulatory concerns for various reasons.

### ■ Financial Transactions

- Loans/Advances that are never repaid
  - May be used to disguise capital withdrawals
    - Inaccurate books and records
    - May violate SEA Rule 17a-11 with respect to notification
- Expense Sharing Agreements (ESA)
  - Allocation of costs not done on a reasonable basis – most common ESA issue observed
- Management Services Agreements (MSA)
  - May be used to disguise capital withdrawals

# Related Party Transactions

## Expense Sharing Agreements

- Where warranted, the 2003 letter imposes “charges” in the Broker-Dealer’s (B/D) Net Capital Computation.
- A written ESA is required anytime a parent or an affiliate *assumes responsibility for*:
  - 1) costs incurred by the B/D (i.e., B/D is obligor to 3<sup>rd</sup> party service provider) OR
  - 2) parent or affiliate incurs costs which will benefit the B/D (i.e., parent or affiliate contracts for services that will be used by the B/D (in whole or in part)).
- The agreement between the B/D and parent/affiliate must:
  - 1) be with a parent/affiliate which has independent financial resources from B/D,
  - 2) make clear the nature of the responsibility of each party,
  - 3) identify the costs covered by the agreement and how they arise, and
  - 4) allocate costs on a reasonable basis and in a consistent manner.
- **Forgiveness of debt of B/D to parent/affiliate resulting in a capital contribution**

*Regulatory Notice 03-63 States: “The broker/dealer may not record the capital contribution until it demonstrates that the third party paid the expense, or has the financial wherewithal to pay the expense independent of the broker/dealer, and that the broker/dealer will not be obligated to repay the third party for any portion of the expense.”*

# Related Party Transactions Management Services Agreements

**An MSA describes services whereby a party (usually the broker-dealer's parent or affiliate) performs administrative or management services for the broker-dealer.**

For this purpose, we will distinguish an MSA from an ESA. In an MSA, the parent or affiliate is providing the services. In an ESA, there is a contract with a 3<sup>rd</sup> party that provides a good or service.

Considerations with Respect to MSAs:

- Does the parent or affiliate have the capacity to offer the service?
- Does the broker-dealer need the service to support its operations?
- Is there evidence that the services were actually performed?
- Was the cost for the services reasonable?

# Exemption Report Considerations

## Understanding paragraph (k) of SEA Rule 15c3-3

### (k)(1)

- Operates on a stand alone basis.

### (k)(2)(i) and (k)(2)(ii)

- Relate to a firm's *lines of business*.
- Therefore, a firm should report both exemptions if applicable to its business.

(See SEC Division of Trading and Markets (then Division of Market Regulation) Letter to P & I Equities Corporation, May 26, 1977)

- A firm that self clears some business through a (k)(2)(i) account and introduces the rest of its business on a fully disclosed basis to a clearing firm must claim the (k)(2)(i) and (k)(2)(ii) exemption on its FOCUS Report.
- The firm's Annual Report, the Exemption Report and the related Auditor's Review, must address both exemptions.

# SEC Division of Trading Markets No-Action Letter

## Re: NYLIFE Securities LLC, Dated March 12, 2015

### *Summary of Relief Requested:*

With respect to its subscription-way business, NYLIFE represented that it had procedures in place where its branch offices would forward an application for the purchase of securities, along with the customer's check made payable to the issuer, to its main office which performed suitability and other reviews. Once the main office approved the investment, the check and application were sent to the issuer.

Because of this process, NYLIFE represented that it was difficult to meaningfully supervise the sales practices of its representatives, including suitability of customer transactions, and comply with the requirement to forward the check to the issuer by noon of the next business day following its receipt by the registered representative.

In brief, NYLIFE asked if it could maintain its current processes, which would result in the firm being in the possession of the customer's check past noon of the next business day following receipt, if it were to promptly forward the check once it approved the transaction.

### *Relief Granted:*

"...the staff of the Division will not recommend enforcement action to the Commission if NYLIFE or any other broker-dealer in similar circumstances holds customers' checks payable to issuers if the purpose for holding the customers' checks is to complete principal suitability reviews of each sale of a recommended subscription way security and:..."



## SEC Division of Trading Markets No-Action Letter Re: NYLIFE Securities LLC, Dated March 12, 2015 (continued)

*Specified Conditions that must be met by a broker-dealer that seeks to rely on the letter:*

“(1) Establishes policies and procedures reasonably designed to ensure that each check is safeguarded and that a registered representative of the member who recommends a sale of a security on a subscription-way basis promptly prepares and forwards a complete and correct application package to an OSJ of the member regarding such security;

(2) Causes a registered principal to perform a suitability review in accordance with FINRA Rule 2111 and determines whether he or she approves of each recommended subscription-way sale within seven business days after an OSJ of the member receives a complete and correct application package.

ENDNOTE: ...FINRA Rule 3110.05 allows a member to use a risk-based review system to comply with the requirement in FINRA Rule 3110(b)(2) that a registered principal review all transactions relating to the member’s investment banking or securities business, NYLIFE represents that it requires a registered principal to review and approve each sale of a subscription-way security.

(3) Transmits the check no later than noon of the business day following the date the principal reviews and determines whether he or she approves the transaction;

(4) Maintains a copy of each such check and creates a record of the date the check was received from the customer and the date the check was transmitted to the issuer if approved, or was returned to the customer if rejected; and

(5) Discloses to customers its process for handling customer checks payable to issuers for subscription-way securities transactions in advance of each transaction.”

# Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934

Includes Amendments to:

- Net Capital Rule – Rule 15c3-1
- Customer Protection Rule – Rule 15c3-3
- Books and Records Rule – Rule 17a-4
- Confirmation of Transactions - Rule 10b-10

SEC Release Number 34-71174



## Deletion of NRSRO (Nationally Recognized Statistical Rating Organizations) References

*Summary of Changes from the Perspective of the Net Capital Rule*

- **On January 8, 2014, the Commission published a final rulemaking, amending certain SEA Rules, as noted.**
  - Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934
    - Release 34-71194, 79 FR 1521
- **Amendments in response to Section 939A of the Dodd-Frank Act.**
- **Amendments applicable to broker-dealers that maintain positions in commercial paper, nonconvertible debt, or preferred stock.**
- **Changes the manner in which firms determine the haircuts on positions in each of the above referenced securities.**
- **Effective Date July 7, 2014.**

## Deletion of NRSRO References

### *Summary of Changes from the Perspective of the Net Capital Rule (continued)*

#### ■ **Rule Language Prior to the Amendments – Haircut Charges:**

- Commercial Paper – SEA Rule 15c3-1(c)(2)(vi)(E)
  - Ratings: In one of the 3 highest categories by at least two NRSROs
  - Haircut: 0% to ½ of 1%, if securities have less than one year to maturity  
For longer maturities: as stated in Rule, 1 ½% to 6%
- Nonconvertible Debt - SEA Rule 15c3-1(c)(2)(vi)(F)
  - Ratings: In one of the 4 highest categories by at least two NRSROs
  - Haircut: 2% to 9% based on maturity
- Preferred Stock - SEA Rule 15c3-1(c)(2)(vi)(H)
  - Ratings: In one of the 4 highest categories by at least two NRSROs
  - Haircut: 10%

## Deletion of NRSRO References

### *Summary of Changes from the Perspective of the Net Capital Rule (continued)*

#### ■ Amended Rule - Haircuts:

- Broker-Dealer can continue to avail itself of the lower haircuts noted on the previous slide if the broker-dealer can establish that the securities involve a minimal amount of credit risk (MCR).
  - Note: No other changes to the referenced paragraphs were made.
    - For example, nonconvertible securities still may not be traded flat or in default as to principal or interest to be haircut under SEA Rule 15c3-1(c)(2)(vi)(F)
- Otherwise, haircut is 15% if the securities have a ready market.
- If no ready market, the position is treated as a non-allowable asset.

# Sources of Information

## Interpretations of Financial and Operation Rules

<http://www.finra.org/Industry/Regulation/Guidance/FOR/>

## FINRA Annual Regulatory and Examination Priorities Letter

<http://www.finra.org/industry/finra-annual-regulatory-and-examination-priorities-letter>

Questions?



# Securities Investor Protection Corporation

PREPARED FOR THE PCAOB

Karen L. Saperstein

VP-Operations

([www.sipc.org](http://www.sipc.org))

June 3, 2015



# Broker Dealer Annual Report Filing Obligation with SIPC

- On July 31, 2013 the SEC announced the adoption of rules designed to substantially increase protections for investors who turn over their money and securities to broker dealers registered with the SEC.
- All members of SIPC who are required to file annual reports with the SEC and their DEA pursuant to Rule 17a-5(d)(1), 17 C.F. R. § 240.17a-5(d)(1) (2014), are also required to file their annual report with SIPC.
- The effective date for the requirement to file annual reports with SIPC was for FYE December 31, 2013.
- The effective date for the requirement to file the compliance report or exemption report with SIPC was for FYE June 1, 2014.

# Benefits to SIPC of the Filing Requirement

- The filing requirement permits SIPC to better monitor industry trends and enhance its knowledge of firms.
- The requirement was also designed to address cases where the SIPC Fund has been used to pay an administrative expense of the liquidation of a failed broker dealer and SIPC sought to recover money damages from the broker dealer's auditing firm based on an alleged failure to comply with auditing standards.

# **How does the filing requirement assist SIPC?**

Receiving the annual reports may permit SIPC to overcome legal hurdles when bringing actions against accountants where the accountant's failure to adhere to professional standards in auditing a broker dealer caused a loss to the SIPC Fund.

# How is this achieved?

SIPC thoroughly reviews each filing and relies on the audit report provided to SIPC.

# What does SIPC review?

Though SIPC is not a regulator, in order to establish reliance on the reports, SIPC examiners conduct a thorough review. This review includes the following:

- ❖ Does the Oath or Affirmation list an exception or include a statement as to why no independent accountant's report is included?
- ❖ Are all required financial statements included in the filing?
- ❖ Do the notes on net capital requirements disclose non-compliance with required net capital?
- ❖ Does the report include the independent accountant's report and is that report signed?

# What does SIPC review? – cont'd

- ❖ Is the independent accountant's opinion clean, qualified, adverse, or does it mention a going concern issue or abstain from providing an opinion?
- ❖ Does the filing include a computation of reserve requirements and information relating to possession or control? If not, does it include an exemption report?
- ❖ Does the applicable supporting schedule indicate that the data is not materially different from that reported in the FOCUS filing?
- ❖ Is the opinion on supporting schedules clean or qualified, abstains from providing an opinion or not mentioned at all?
- ❖ If the opinion on 15c3-3 supporting schedules is not mentioned at all, does the filing contain an exemption report?

# What does SIPC review? – cont'd

- ❖ Is the compliance report or exemption report included and are there exceptions or instances of non-compliance noted?
- ❖ Is the independent accountant's report on the compliance report or exemption report included and was it conducted in accordance with PCAOB standards without restrictions?
- ❖ Does the independent accountant's report on the compliance report or exemption report provide that management's statements are fairly stated and do not require material modifications?

# **What does SIPC do if it finds something missing or if the report raises an issue of concern?**

- If the report is missing one or more documents, the broker dealer is notified and advised to refile the entire report.
- If the report raises an issue of concern, SIPC notifies the SEC and FINRA.



# What does SIPC do if the annual report is not filed timely?

- SIPC notifies the broker dealer if the report is not filed within the prescribed time period.
- If the broker dealer fails to remediate the filing delinquency, SIPC notifies FINRA and/or the SEC.

# **How many notifications have been made to FINRA or the SEC for reports which raise a concern?**

Since the inception of the filing requirement, SIPC has identified over 50 reports that require follow up.

# How long does SIPC retain the annual reports?

SIPC will retain the annual reports for the later of:

- 3 years after termination of membership of the applicable SIPC member, or
- until the date of the court order discharging the trustee for the liquidation of the broker dealer or the closing of a direct payment procedure for the broker dealer.

# Address for Filing of Annual Reports

Annual Reports are only accepted electronically and must be e-mailed to:

[SIPCAuditReports@sipc.org](mailto:SIPCAuditReports@sipc.org)

The subject line of the email must include:

- the SEC 8- number,
- the name of the member, and
- the fiscal year end for the Annual Report.



**Break**

# **Division of Enforcement and Investigations Update**

**John Abell**

**Associate Director, Accountant**

**Division of Enforcement and Investigations**

**June 3, 2015**

**Chicago, IL**

# Agenda

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- ❑ Today, we would like to discuss:
  - ❑ Scope of Authority to Investigate
  - ❑ Disciplinary Proceedings and Hearings
  - ❑ Priorities for 2015
  - ❑ Select Settled Disciplinary Proceedings
  - ❑ Other Matters of Note

# The Scope of the PCAOB's Enforcement Authority

- ❑ The Board may investigate possible violations of the Sarbanes-Oxley Act, the Board's rules, the securities laws related to audit reports, or professional standards
- ❑ The Board may impose appropriate sanctions if violations are found, ranging from additional professional training to revoking or suspending a firm's registration, imposing monetary penalties, or barring or suspending a person from participating in audits of public companies, brokers or dealers
- ❑ As required by the Act, the Board's investigations are confidential and nonpublic
- ❑ All disciplinary orders are made public upon settlement or when final decision imposing sanctions is issued; litigated disciplinary proceedings are non-public, as required by the Act, through any review by the Securities and Exchange Commission ("SEC"), unless the SEC orders otherwise



# Disciplinary Proceedings & Hearings

- ❑ Non-public hearings (trials) are conducted by the Board's Hearing Officer to determine whether firms or associated persons committed violations and should be disciplined
- ❑ Any sanctions imposed can be appealed to the Board, the SEC, and up through the federal court system
- ❑ Litigated proceedings remain nonpublic, and sanctions are automatically stayed, through any appeal to the SEC, unless the SEC orders otherwise

# Select Settled Disciplinary Proceedings

- ❑ Broker-Dealer Auditor Independence Matters – December 2014
- ❑ Randall A. Stone, CPA
- ❑ Morrill & Associates, LLC, Douglas W. Morrill, CPA, and Grant L. Hardy, CPA

*In all of the settled disciplinary proceedings, the firms and the associated persons neither admitted nor denied the Board's findings, except as to the Board's jurisdiction over them and the subject matter of the proceedings.*

# Broker-Dealer Auditor Independence Matters – December 8, 2014

- ❑ The PCAOB Board settled disciplinary orders against seven firms for violating independence rules
- ❑ The seven firms prepared at least portions of the financial statements, including notes, filed by their broker-dealer audit clients with the Securities and Exchange Commission
- ❑ The financial statements were also audited by the sanctioned firms
- ❑ Each auditor's preparation of portions of the financial statements was a prohibited non-audit service that impaired independence
- ❑ Each firm settled to a censure, a \$2,500 penalty, and significant remedial measures

# Broker-Dealer Auditor Independence Matters – December 8, 2014

- ❑ The SEC simultaneously settled with eight firms for violating independence rules
- ❑ The SEC found that the audit firms generally took data from financial documents provided by clients during audits and used it to prepare their financial statements and notes to the financial statements.
  - ❑ Firms cannot jeopardize their objectivity and impartiality in the auditing process by providing such non-audit services to audit clients.
  - ❑ By preparing the financial statements, these particular firms essentially put themselves in the position of auditing their own work, and they inappropriately aligned themselves more closely with the interests of clients' management teams.
- ❑ Findings included that the firms (1) violated Rule 17a-5(i) of the Exchange Act, (2) caused their broker-dealer audit clients to violate Section 17(a) of the Exchange Act and Rule 17a-5, and (3) engaged in improper professional conduct pursuant to Exchange Act Section 4C(a)(2) and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

*The firms consented to the orders without admitting or denying the findings.*

# Randall A. Stone, CPA - July 7, 2014

- ❑ Stone, a former partner of PricewaterhouseCoopers LLP ("PwC"), was in charge of the 2007 audit of ArthroCare Corporation
  - ❑ Stone failed to properly address numerous indicators that ArthroCare was improperly recognizing revenue on sales to one of its largest distributors ("DiscoCare")
  - ❑ Arthrocare recorded sales to DiscoCare on the sell-in method and paid DiscoCare an upfront consulting fee
  - ❑ Stone failed to address the red flags, despite identifying specific fraud risks relating to revenue recognition

# Randall A. Stone, CPA - July 7, 2014

- ❑ Stone was aware that:
  - ❑ DiscoCare was given unique and advantageous payment terms of up to 360 days, while it received its consulting fee upfront
  - ❑ The upfront payments to DiscoCare, as percentage of purchases by DiscoCare, exceeded payments from DiscoCare to Arthrocare
  - ❑ DiscoCare receivables represented a large and growing portion of accounts receivable and sales (slightly less than 10% FYE 2007 sales and 29% A/R at 12/31/07)
  - ❑ Short sellers had alleged potential wrongdoing related to the DiscoCare relationship and eventually communicated directly with PwC
  - ❑ The CMO resigned a day before audit report release, due to concerns about DiscoCare relationship
- ❑ In response to the short seller allegations, Stone's response was to obtain management and audit committee representations

# Randall A. Stone, CPA - July 7, 2014

- ❑ On December 31, 2007, ArthroCare acquired DiscoCare for \$25M
- ❑ Stone failed to adequately assess the fair value of the receivables recorded in the acquisition
- ❑ Stone also improperly consented to the incorporation of PwC's 2007 audit opinion in ArthroCare's June 2008 Form S-8 Registration Statement, after receiving new allegations regarding ArthroCare's relationship to that distributor, without a sufficient investigation of subsequent events
- ❑ In November 2009, ArthroCare restated several years of financial statements
- ❑ In August 2014, the CEO and CFO were sentenced to prison terms for orchestrating the fraud
- ❑ The Board barred Stone with the right to reapply after 3 years, and imposed a \$50,000 penalty and a censure

# Morrill & Associates, LLC, Douglas W. Morrill, CPA, and Grant L. Hardy, CPA – Jan. 12, 2015

- ❑ Deficiencies on two audits relate to re-audits of audits previously performed by a PCAOB-sanctioned firm whose registration was revoked
- ❑ In three separate audits, the firm and the partner failed to gather sufficient audit evidence for assets representing over 70% of the total assets of the audited entity
- ❑ Failure to perform adequate audit procedures over significant risk areas, including revenue
- ❑ Failure to perform engagement quality reviews, in compliance with AS No. 7
- ❑ Violation of the SEC's auditor rotation requirements
- ❑ Quality control standard violations



## Other Matters of Note

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- ❑ Settled Disciplinary Proceedings
  - ❑ Akiyo Yoshida, CPA – December 17, 2014
  - ❑ Madsen & Associates, CPAs, Inc. and Ted A. Madsen, CPA – January 15, 2015
- ❑ Adjudicated Proceedings
  - ❑ Ron Freund, CPA – January 25, 2015

<http://pcaobus.org/Enforcement/Decisions/Pages/default.aspx>

# PCAOB Center for Enforcement Tips, Complaints and Other Information

- ❑ Website:  
<http://pcaobus.org/Enforcement/Tips/Pages/default.aspx>
- ❑ E-mail: [TIPS@pcaobus.org](mailto:TIPS@pcaobus.org)
- ❑ Letter  
PCAOB Complaint Center  
1666 K Street, NW  
Washington, DC 20006
- ❑ FAX: 202-862-0757
- ❑ Telephone: 800-741-3158

# Questions



# **Inspections: Observations and Trends**

**Bob Maday and Kate Ostasiewski**

Division of Registration and Inspections

June 3, 2015

Chicago, IL

# Agenda

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- ❑ Summary of Interim Inspection Program
- ❑ Inspection Observations
- ❑ 2015 Inspection Plan
- ❑ Actions for Auditors
- ❑ Questions

## Interim Inspection Program - Objective

- ❑ 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
- ❑ Assist in the development of the approach to inspections under a permanent inspection program

# Interim Inspection Process

- ❑ Communication and scheduling
- ❑ Inspection of audit work
- ❑ Information gathering
- ❑ Communication of findings/observations
- ❑ Firm response to findings and responsibilities
- ❑ Reporting
- ❑ Communication with the SEC and other regulators
- ❑ Enforcement

# AU Section 390: Considerations of Omitted Procedures After the Report Date

- ❑ Applies when an auditor concludes that one or more auditing procedures considered necessary at the time of the audit was omitted, but there is no indication that those financial statements are not stated fairly.
- ❑ Auditor should assess the importance of the omitted procedure(s) on auditor's present ability to support the previously expressed opinion



## AU Section 390: Considerations of Omitted Procedures After the Report Date (continued)

- ❑ If the auditor concludes that the omission impairs the present ability to support the previously supported opinion, the auditor should apply the omitted procedures or alternative procedures
- ❑ If the auditor becomes aware of facts that would have affected that report then the auditor should apply AU Section 561.05–.09.

# Interim Inspection Program - Disclaimer

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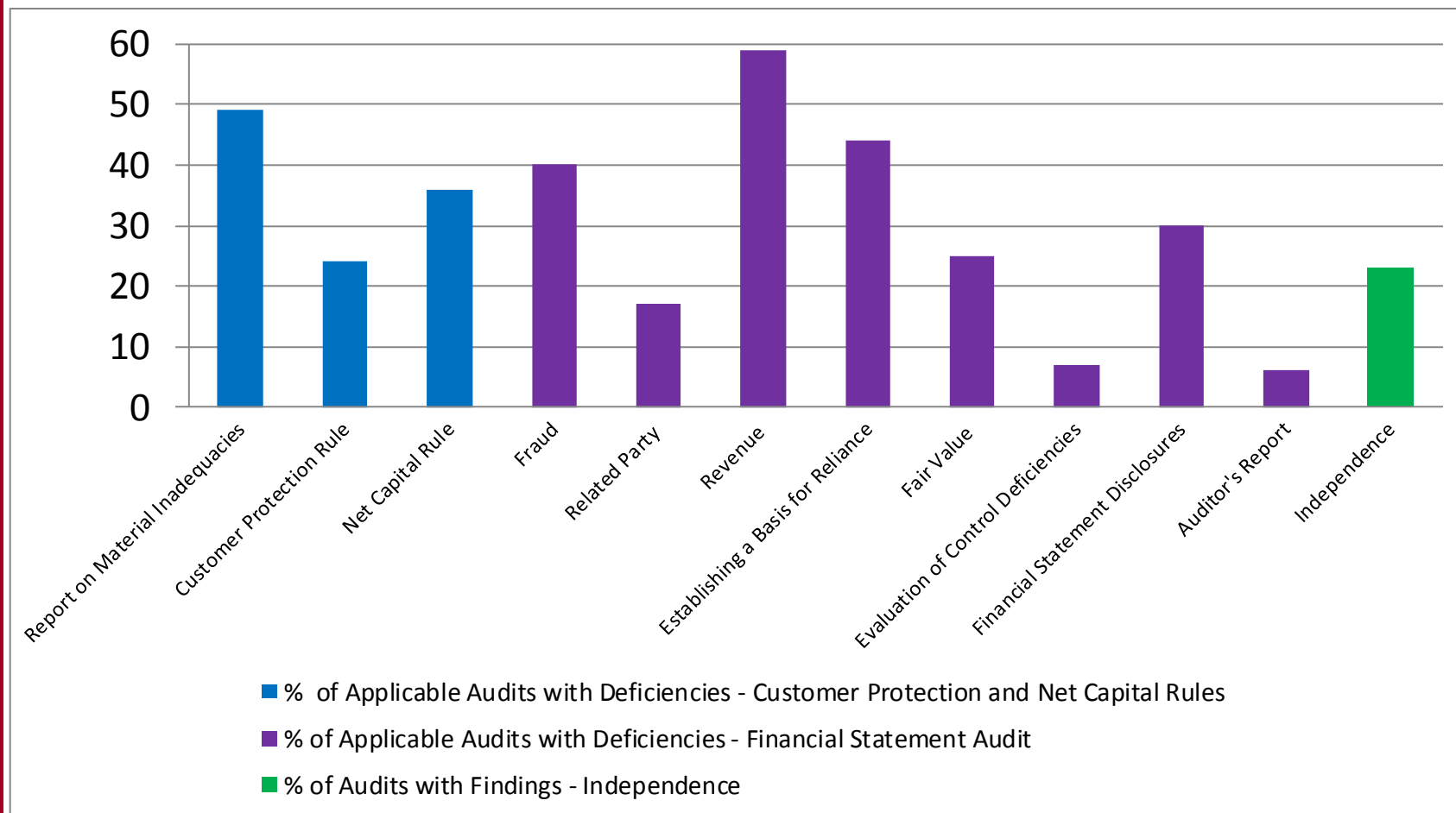
The information presented in the following slides is not necessarily indicative of the population of firms or of audits of brokers and dealers because the selection of firms and of audits of brokers and dealers for inspection is not necessarily representative of these populations.

# 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
- ❑ Supplemental Report
  - Inspected 5 firms and portions of 5 audits

# Inspections Observations by Audit Area - 2013

## % of Applicable Audits with Observations



# Compliance with Independence Requirements

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

- ❑ Preparing, or assisting 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)

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- ❑ 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 ending on or after June 1, 2014 certain PCAOB independence rules apply to auditors of broker-dealers

# Net Capital Requirements and Customer Protection Rule

Deficiencies noted related to testing compliance with net capital requirements:

- ❑ Minimum net capital requirements
- ❑ Allowable assets
- ❑ Haircuts

Deficiencies noted related to testing compliance with the customer protection rule:

- ❑ Customer credits or debits
- ❑ Special Reserve Bank Account
- ❑ Possession or control requirements

# Net Capital Requirements and Customer Protection Rule (continued)

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



# Financial Statement Audit

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Deficiencies noted related to:

- ❑ Revenue
- ❑ Fraud
- ❑ Related Parties
- ❑ Establish a Basis for Reliance
- ❑ Evaluation of Internal Control Deficiencies
- ❑ Financial Statement Disclosures

# Financial Statement Audit (continued)

## Inspection Observations and Relevant PCAOB Standards

	<b>Audit Procedure</b>	<b>PCAOB Standard(s)</b>
<b>Revenue</b>	<ul style="list-style-type: none"> <li>• <i>Identifying and Assessing Risk</i></li> <li>• <i>Responding to Risk of Material Misstatement</i></li> <li>• <i>Substantive Analytical Procedures</i></li> </ul>	<ul style="list-style-type: none"> <li>• <b>AS 12</b></li> <li>• <b>AS 13</b></li> <li>• <b>AU 329</b></li> </ul>
<b>Fraud</b>	<ul style="list-style-type: none"> <li>• <i>Identifying and Assessing Risk</i></li> <li>• <i>Responding to Fraud Risk</i></li> <li>• <i>Addressing Risk of Management Override</i></li> </ul>	<ul style="list-style-type: none"> <li>• <b>AS 12</b></li> <li>• <b>AS 13</b></li> <li>• <b>AU 316</b></li> </ul>
<b>Related Parties</b>	<ul style="list-style-type: none"> <li>• <i>Identifying RP Relationships/Transactions</i></li> <li>• <i>Evaluating RP Accounting and Disclosure</i></li> </ul>	<ul style="list-style-type: none"> <li>• <b>AU 334</b></li> </ul>
<b>Basis for Reliance</b>	<ul style="list-style-type: none"> <li>• <i>Evaluating Sufficiency of Audit Evidence</i></li> <li>• <i>Use of Service Organizations</i></li> </ul>	<ul style="list-style-type: none"> <li>• <b>AS 15</b></li> <li>• <b>AU 324</b></li> </ul>
<b>Evaluation of Deficiencies</b>	<ul style="list-style-type: none"> <li>• <i>Responses to Risk of Material Misstatement</i></li> <li>• <i>Evaluating Audit Results</i></li> <li>• <i>Communications about Control Deficiencies</i></li> </ul>	<ul style="list-style-type: none"> <li>• <b>AS 13</b></li> <li>• <b>AS 14</b></li> <li>• <b>AU 325</b></li> </ul>
<b>FS Disclosures</b>	<ul style="list-style-type: none"> <li>• <i>Evaluating FS Presentation, Including Disclosures and Communicating Results</i></li> </ul>	<ul style="list-style-type: none"> <li>• <b>AS 14</b></li> <li>• <b>AS 16</b></li> </ul>

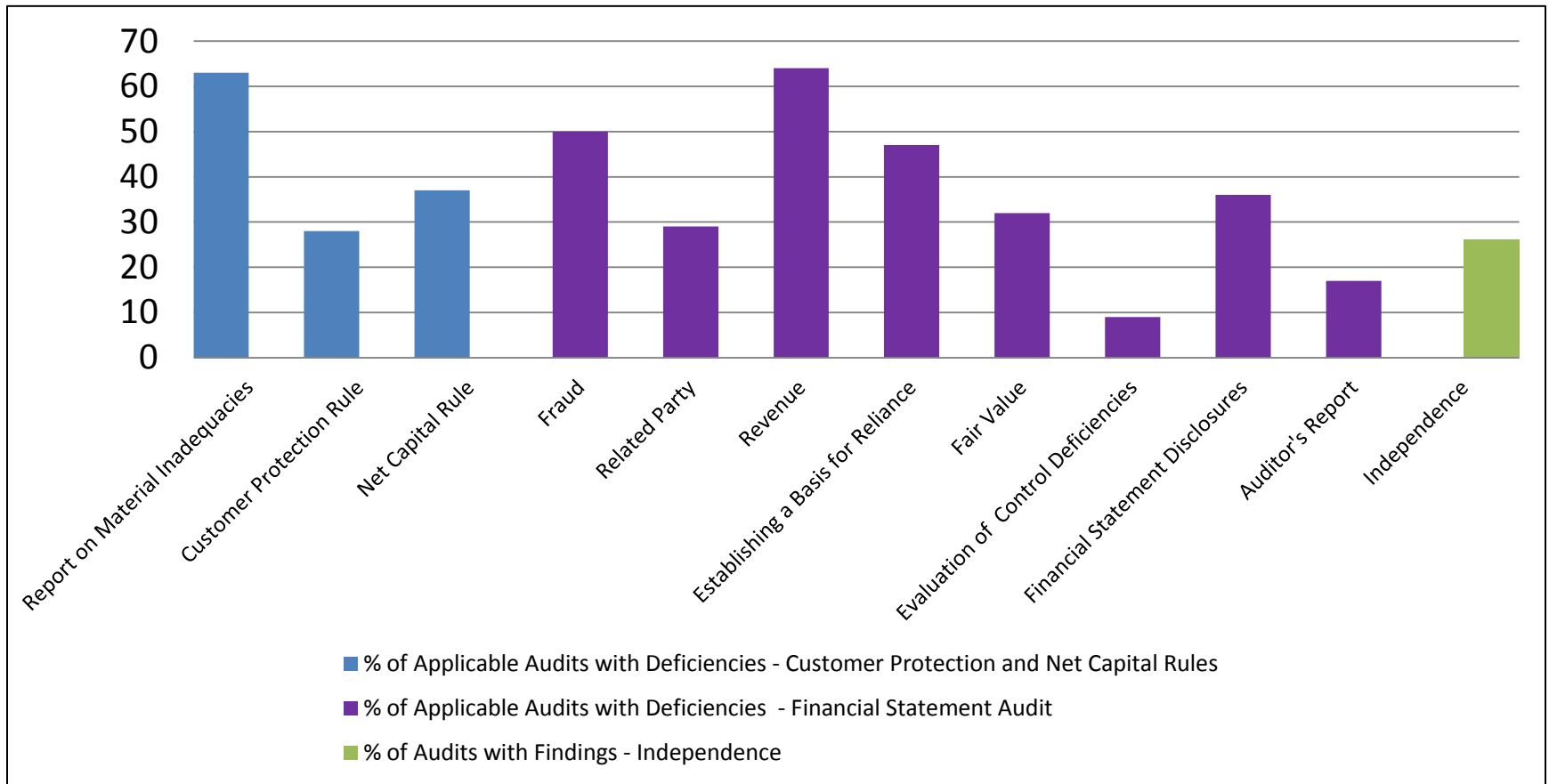
# Summary of Inspection Observations: Since Inception of Interim Inspection Program

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- ❑ 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

# Inspections Observations by Audit Area - Inception of the Program Through 2013

## % of Applicable Audits with Observations



# Summary of Inspection Observations: 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

## Interim Inspection Program – 2014

- ❑ 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 / AT1
  - Review Report / AT2
  - Engagement Quality Review / AS7
  - Engagement Completion Document / AS3
  - Other Deficiencies Similar to Previously Reported

# 2015 Interim Inspection Program 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
  - 75 firms and portions of 115 audit and attestation engagements



# Actions 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

## Actions 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

# Questions?

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# Lunch

(75 minutes)

# Inspections: Case Studies

**Kate Ostasiewski and Mike Walters**  
Division of Registration and Inspections

June 3, 2015  
Chicago, IL

# Agenda

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- Audit Documentation
- Internal Controls
- Engagement Quality Review

# Summary – Relevant PCAOB Standards

## □ Audit Documentation

- Auditing Standard No. 3, *Audit Documentation*

## □ Internal Controls

- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*
- Auditing Standard No. 14, *Evaluating Audit Results*

## □ Engagement Quality Review

- Auditing Standard No. 7, *Engagement Quality Review*

# Audit Documentation



# Audit Documentation Objectives

AS 3 paragraph 2 describes the objectives of audit documentation:

...Audit documentation also **facilitates the planning, performance, and supervision of the engagement**, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes **records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached** by the auditor...

# Audit Documentation Requirements

To facilitate audit planning, the engagement partner for the audit of Broker-Dealer X decides to hold an initial meeting with the audit team to discuss the use of PCAOB standards, including audit documentation requirements.

As described in AS No. 3, which of the following should the engagement partner indicate that audit documentation accomplishes?

- a. Demonstrates that the engagement complied with the standards of the PCAOB.
- b. Supports the basis for the auditor's conclusions concerning every relevant financial statement assertion.
- c. Demonstrates that the underlying accounting records agreed or reconciled with the financial statements.
- d. All of the above.

# Audit Documentation – Work Paper Review

## Exercise

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You are reviewing the work performed related to the audit of Broker-Dealer X, which was conducted in accordance with PCAOB standards.

Refer to the sample 12b-1 receivables and operating expense work papers included in your materials.

What elements of documentation are missing from each work paper, considering the requirements of AS No. 3?

# Documentation of Significant Findings or Issues

Which does not represent a significant finding or issue that must be documented as required by paragraph 12 of AS No. 3?

- a. Accounting principles for revenue recognition of underwriting fees, a new, significant revenue source.
- b. Significant deficiencies in internal control over recognition and/or deferral of revenue recognition.
- c. Audit adjustments – recorded and unrecorded.
- d. Alternative audit procedures performed in conjunction with non-replies to customer account confirmations which revealed no exceptions.
- e. Audit evidence obtained relating to valuation of private-label mortgage-backed securities, an area of significant risk.

# Engagement Completion Document

AS 3 paragraph 13 states:

The auditor must identify all significant findings or issues in an **engagement completion document** . This document may include either **all information necessary to understand the significant findings, issues** or cross-references, as appropriate, to other available supporting audit documentation. This document, along with any documents cross-referenced, should collectively **be as specific as necessary** in the circumstances for a reviewer to gain a thorough understanding of the significant findings or issues.

# Subsequent Changes to Audit Documentation

The Audit Firm, LLP gave permission to XYZ Brokers, Inc., a registered broker dealer, to use its audit report on February 27, 2015. On March 12, 2015, the firm received a reply to an outstanding cash confirmation request. Does AS No. 3 allow for the firm to include the confirmation in the audit documentation?

- a. Yes.
- b. No, additional documentation may not be added after the report release date.
- c. It depends on whether the confirmation supports, or contradicts, the firm's final conclusions.

# Internal Controls

# Scenario, Part 1 – Internal Controls

## Background

- ❑ XYZ Brokers, Inc., is a registered broker dealer which claims exemption from Rule 15c3-3 and is an audit client of The Audit Firm, LLP.
- ❑ All trades (about 1,000 per month / 12,000 per year) are executed through the clearing broker.
- ❑ XYZ Trades appear similar in nature (mainly equity securities).
- ❑ XYZ's process for recording commissions revenue was uniform throughout the year and occurs monthly.
- ❑ The Audit Firm LLP is engaged to conduct an audit of XYZ Brokers in accordance with PCAOB standards.



# Scenario, Part 1 – Internal Controls (continued)

## Audit Approach

- ❑ Annual commission revenue exceeded auditor materiality.
- ❑ Inherent risk for commission revenue was considered moderate.
- ❑ Control risk was assessed at “moderate to low”.
- ❑ Controls in operation at December 31, 2015, the audit year-end, over all relevant assertions for commission revenue were identified and tested for design and operating effectiveness, without exception.

Has The Audit Firm LLP performed sufficient tests of controls to reduce the nature, timing and extent of planned substantive procedures for the audit period over relevant assertions for commission revenue?

Why or why not?

# Scenario, Part 2 – Internal Controls

## Understanding Gained of XYZ Brokers, Inc. Period-End Financial Reporting Process

- ❑ The Owner of XYZ Brokers, Inc. also serves as the Chief Executive Officer and Chief Compliance Officer for the broker-dealer.
- ❑ The Owner has 20 years of industry experience. Previously, he was a FINOP at another broker-dealer before starting XYZ Brokers, Inc.
- ❑ The Chief Financial Officer is also the FINOP for XYZ Brokers, Inc. She is a CPA who previously worked at an audit firm with several broker-dealer clients.
- ❑ The Chief Financial Officer prepares monthly financial statements, net capital computations, and reviews various reconciliations.

# Scenario, Part 2 – Internal Controls (continued)

## Understanding Gained of XYZ Brokers, Inc. Period-End Financial Reporting Process (continued)

- ❑ Accounting staff consist of a bookkeeper and bookkeeping assistant. Each has taken basic accounting classes. The bookkeeper also has 10 years of industry experience.
- ❑ Accounting staff handle daily accounting, posting to the general ledger and reconciling cash and clearing related accounts monthly.
- ❑ The Owner, the Chief Financial Officer and the accounting staff all have the ability to post journal entries to the QuickBooks general ledger.

What questions would you have if you were The Audit Firm LLP when considering whether controls exist and are designed effectively over the period-end financial reporting process?

# Scenario, Part 3 – Internal Controls

## Testing Controls related to Period-End Financial Reporting

- ❑ For a sample of 2 months The Audit Firm LLP obtained the clearing statement reconciliation package prepared by Accounting Staff at month end.
- ❑ The Audit Firm LLP observed that each package included a reconciliation and supporting documentation, including the clearing firm statement and a copy of the related general ledger balances.
- ❑ The Audit Firm LLP observed that the reconciliation was initialed by the CFO indicating her review and approval.
- ❑ The Audit Firm LLP concluded that controls are operating effectively and reduced the nature, timing and extent of substantive procedures with respect to affected balances.

Given these facts is there sufficient audit evidence to support the operating effectiveness of the CFO's review of reconciliations?

# Scenario, Part 3 – Internal Controls (continued)

## Control Considerations as the Audit Progresses

- ❑ During its substantive procedures over cash, The Audit Firm LLP identified that the operating account balance in the general ledger did not agree with the bank balance at year end.
- ❑ The difference (the general ledger balance was higher) was just under Audit Firm LLP's tolerable misstatement.
- ❑ The cash reconciliation prepared by the Accounting staff also identified the difference, but there was no explanation.
- ❑ The cash reconciliation was signed by the CFO, indicating her review and approval.

Given these facts, pursuant to Auditing Standard No. 14, what should Audit Firm LLP consider when evaluating the results of its audit?

# Engagement Quality Review

# Engagement Quality Review Objectives

The objective of the engagement quality reviewer, as indicated in Auditing Standard No. 7, is to perform an evaluation of the significant judgments made by the engagement team and the related conclusions reached. Given this objective, which of the following do you believe the EQR should review?

- a. Rationale for the assessment of risk of material misstatement for occurrence of underwriting revenue as high, and the audit evidence obtained to respond to the risk.
- b. Walkthrough of controls relating to commissions expense.
- c. Substantive procedures to test the valuation of level 3 securities.
- d. Investment Committee meeting minutes discussing current year portfolio performance and strategy.
- e. a and c.
- f. All of the above.

# Engagement Quality Reviewer Qualifications

Engagement quality reviewers:

- ❑ Must be an associated person of a registered public accounting firm
- ❑ May be
  - A partner or another individual in an equivalent position from the firm that issues the report; or
  - An individual from outside the firm
- ❑ Must have competence, independence, integrity, and objectivity



# Engagement Quality Review Process - Audit

The EQR performed the following procedures below. Which procedure performed is not a requirement of Auditing Standard No. 7?

- a. evaluated the overall materiality and tolerable misstatement, and the rationale including XYZ's revenue, regulatory environment, and significant transactions.
- b. evaluated the significant judgments and conclusions made with respect to fraud risks related to revenue recognition and reviewed audit procedures performed to address the risk.
- c. reviewed the engagement work papers relating to the tests of details for fixed assets accounts, balances of which in combination, were quantitatively material.
- d. reviewed client acceptance documentation, including scope of non-audit services provided to XYZ, and evaluated SEC independence implications.

# Engagement Quality Reviewer Qualifications (continued)

Which of the following would preclude an otherwise qualified individual from outside the firm to serve as an engagement quality reviewer?

- a. Receiving compensation from the firm issuing the report for performing the review.
- b. Holding a brokerage account with the broker-dealer subject to the review, with value exceeding SIPC limits.
- c. Possessing 20 years of experience in auditing broker-dealer clients.
- d. Being assisted by a senior manager, who was independent, objective, and performed the assigned procedures with integrity.

# Engagement Quality Review Documentation

AS No. 7 paragraph 19 states:

Documentation ... should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer... including information that identifies:

- ❑ The engagement quality reviewer, and others who assisted the reviewer,
- ❑ The documents reviewed by the engagement quality reviewer, and others who assisted the reviewer,
- ❑ The date the engagement quality reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval.

# Questions?

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# **Risk Assessment and Related Case Studies**

Barbara Vanich, Kate Ostasiewski, and Mike Walters  
Division of Registration and Inspections

June 3, 2015

Chicago, IL

# Agenda

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- ❑ Objectives
- ❑ PCAOB Risk Assessment Standards
- ❑ Case Study

# Objectives

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- ❑ Demonstrate the role of risk assessment throughout the audit process
- ❑ Emphasize coordination of the audit of the financial statements, audit procedures performed on supplemental information and the examination or review engagement
- ❑ Target case study examples in areas where the PCAOB has identified recurring audit quality deficiencies

# PCAOB Risk Assessment Standards

- ❑ Auditing Standard No. 8, *Audit Risk*
- ❑ Auditing Standard No. 9, *Audit Planning*
- ❑ Auditing Standard No. 10, *Supervision of the Audit Engagement*
- ❑ Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*
- ❑ Auditing Standard No. 12, *Identifying and Assessing the Risks of Material Misstatement*
- ❑ Auditing Standard No. 13, *The Auditor's Responses to the Risk of Material Misstatement*
- ❑ Auditing Standard No. 14, *Evaluating Audit Results*
- ❑ Auditing Standard No. 15, *Audit Evidence*



# Case Study – Trusted Securities, Inc.

# Background

- ❑ Trusted Securities Inc. (TSI) is an introducing broker-dealer and also trades for its own account
  - Historically reported \$100,000 minimum capital requirement
  - Historically claimed an exemption under Rule 15c3-3 under paragraph (k)(2)(ii)
  - Has a clearing and custody arrangement with Clearview
- ❑ TSI is 100% owned by Trusted Parent, Inc. (TPI), which has another subsidiary: Affiliated Securities, Inc. (ASI)
- ❑ ASI engages in proprietary trading and is introduced on a fully disclosed basis to Clearview by TSI
- ❑ Key personnel at TSI include: the President, the FINOP, an Investment Officer, accounting and support staff and 50 registered representatives across 8 cities
- ❑ TSI employees operate out of office space leased from TPI

# Background (*continued*)

- ❑ TSI's customer base is primarily individuals, with some institutional customers
- ❑ TSI has a standard customer agreement with standard commission rates by product type
- ❑ TSI receives a significant number of securities orders (both fixed income and equity) each month
- ❑ TSI maintains a blotter of trades and records of aggregate trade volume by security type
- ❑ TSI receives monthly statements from Clearview which are used by accounting staff to record commissions earned in the general ledger
- ❑ Clearview statements include both trade-level detail and monthly totals

# Planning, Risk Assessment and Materiality

## □ Revenue

- Inquired of FINOP and Accounting personnel to update understanding of TSI's process for recording revenue
- Inherent risk high for occurrence, moderate for all other assertions
- Improper revenue recognition related to the occurrence of commissions revenue is both a significant risk and a fraud risk

# Planning, Risk Assessment and Materiality

## □ Related Party Transactions

- Obtained from FINOP listing of TSI's related parties and transactions and compared to unaudited financial statement disclosures
- Included amounts paid to TPI under expense sharing and management services agreements
- Commissions revenue earned from introducing trades of ASI
- Inherent risk moderate for all assertions and no significant or fraud risk

# Planning, Risk Assessment and Materiality

## □ Securities Owned

- Portfolio is a mix of US Treasury Bills, Corporate Bonds, Agency Mortgage Backed Securities and Equity Securities
- All securities owned classified as L1 or L2 in fair value hierarchy
- Clearview prices securities using third party vendor IPC
- Investment officer assesses fair values reported by Clearview for reasonableness
- Inherent risk:
  - Moderate for valuation
  - Low for all other assertions
- No significant risk or fraud risk

# Planning, Risk Assessment and Materiality

## □ Supplemental Information

- Excess net capital several times actual minimum net capital requirement
- Significant to net capital computation: commissions receivable, securities owned (haircuts) and the net capital requirement (minimum dollar amount and aggregate indebtedness computation)
- Risk of Material Misstatement assessed at low

# Planning, Risk Assessment and Materiality

## □ Review of Exemption Report

- Key personnel are experienced, competent and have not changed
- All key personnel and processes operate from corporate location
- TSI claimed a (k)(2)(i) exemption in its Exemption report, in addition to (k)(2)(ii)
- TSI identified two exceptions to the identified exemption provisions in its Exemption report
- Risk of misappropriation of assets considered low



# Engagement Coordination

- Engagement partner to discuss basis for exemption claim and any related change in business with FINOP
- Engagement team coordinated responsibility for review of key documents that could affect various parts of audit and review engagements
- Audit and supplemental information procedures coordinated:
  - Commissions Receivable
  - Securities Owned
  - Net Capital

# Materiality

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- ❑ Overall materiality for financial statements set at \$40,000
- ❑ Tolerable misstatement set at \$30,000
- ❑ \$40,000 used as materiality for audit of supplemental information

# Questions and Discussion

# Response to Risk Assessment - Commissions

- Control Risk high for all assertions
- Performed substantive tests of detail
- Three scenarios:
  - Scenario #1 – use of Clearview as a service organization
  - Scenario #2 – performed substantive tests of Clearview information
  - Scenario #3 – performed substantive tests of Clearview information

# Questions and Discussion

# Results of Commissions Testing

- ❑ Performed substantive procedures and found no audit differences
- ❑ Obtained and read TSI's updated membership agreement with FINRA
  - Approved to act as placement agent for private securities offerings
  - Earns revenue based on percentage of investment amount
- ❑ Met with President and FINOP to obtain more information to evaluate significance of new business
- ❑ Total placement fees earned for 2015 were \$260,000 of which \$100,000 was uncollected at December 31, 2015

# Questions and Discussion



**Break**



# Revenue – Updated Audit Response

- ❑ Inherent risk high for completeness and occurrence, moderate for all other assertions
- ❑ Revenue recognition and cutoff identified as both significant and fraud risks
- ❑ Control risk high for all assertions
- ❑ Performed substantive tests of detail
- ❑ Performed additional procedures

# Questions and Discussion

# Response to Risk Assessment - Supplemental Information

- ❑ Evaluated methods to prepare supplemental information and inquired regarding changes
- ❑ Tested 3 months (including December) net capital computation and FOCUS filing
- ❑ For December net capital computation:
  - Assessed treatment of commissions receivables
  - Tested securities haircuts and supporting information
- ❑ Identified that TSI included placement fees of \$100,000 as allowable for net capital purposes
- ❑ Resulted in an overstatement of net capital at December 31, 2015

# Questions and Discussion

# Review Procedures

- Reviewed documents including:
  - FINRA membership agreement
  - Current year FINRA examination letter
  - Current BrokerCheck report
  - Written Supervisory procedures manual
  - Example registered representative agreement
  - Customer complaint log
- Inquired of the President, FINOP, accounting personnel and two registered representatives
- Reviewed documentation supporting two instances of non-compliance identified and reported by TSI
- Performed additional procedures regarding (k)(2)(ii) exemption

# Questions and Discussion

# PCAOB/SEC/FINRA and SIPC Panel

Moderator: Mary Sjoquist

# Closing Remarks