Forum for Auditors of Broker-Dealers

October 28, 2015

West Palm Beach, FL

Caveat

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

Public Company Accounting Oversight Board

PCAOB Highlights

Lewis Ferguson
Board Member

PCAOB
Public Company Accounting Oversight Board

PCAOB
Public Company Accounting Oversight Board

Compliance and Industry Trends

Tim Gustafson
Office of Research & Analysis

October 28, 2015
West Palm Beach, FL

Office of Research & Analysis

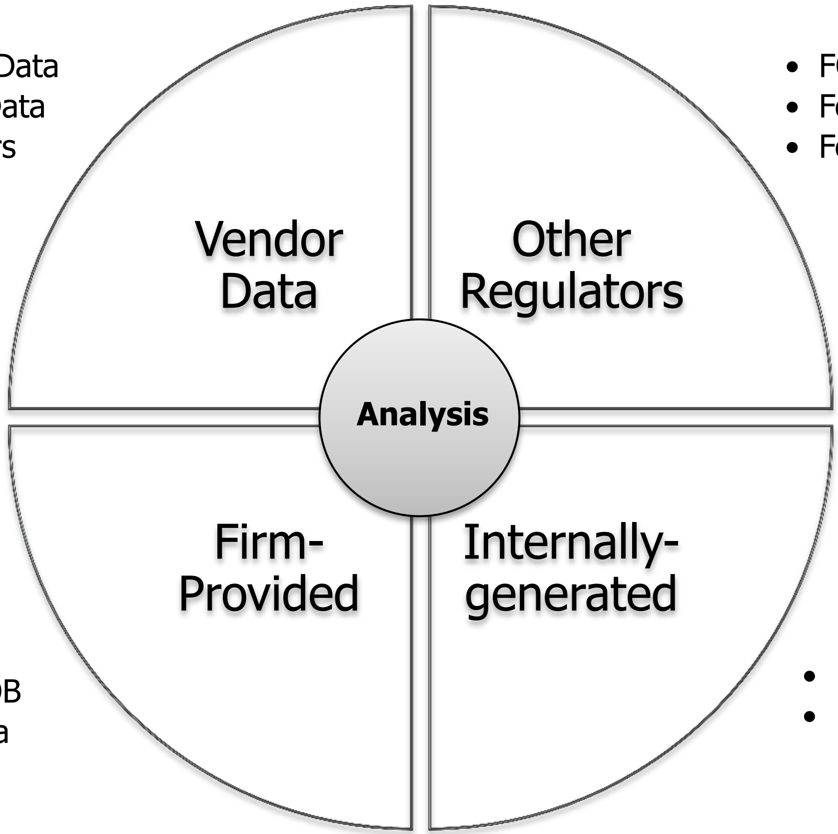
ORA's contribution to the Board's broker-dealer audit oversight responsibilities include:

- Aggregating information on risk for other divisions,
- Presenting data analysis for inspection planning, and
- Evaluating trends affecting the audit market.

Sources:

- Annual Report Data
- Issuer Parent Data
- Related Advisors

- FOCUS Report
- Form Custody
- Form BD



- Filings to PCAOB
- Inspection Data

- Original Research
- Inspections Findings

Three trends affecting the BD audit market

BD Migration to firms with more clients

- ❑ Fewer firms + fewer BDs
- ❑ Single BD client auditors leaving market
- ❑ Recent acceleration in trend

New Compliance requirements

- ❑ Enforcement*
- ❑ Inspection*
- ❑ ORA study of Rule 17a-5 amendment adoption

Pressures on Financial Condition

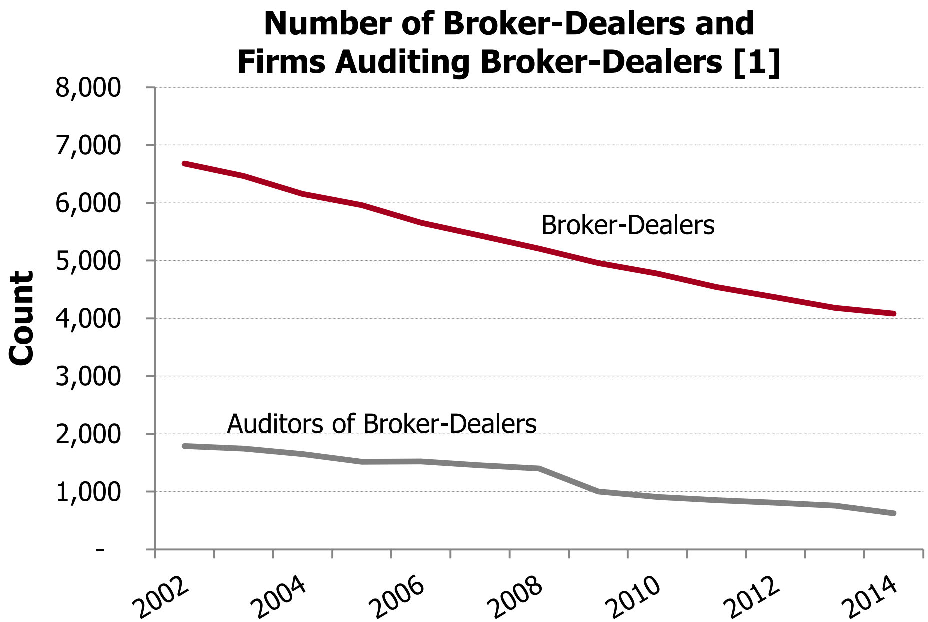
- ❑ Going concern rates
- ❑ Volatility in P&L
- ❑ Net capital deficiency patterns

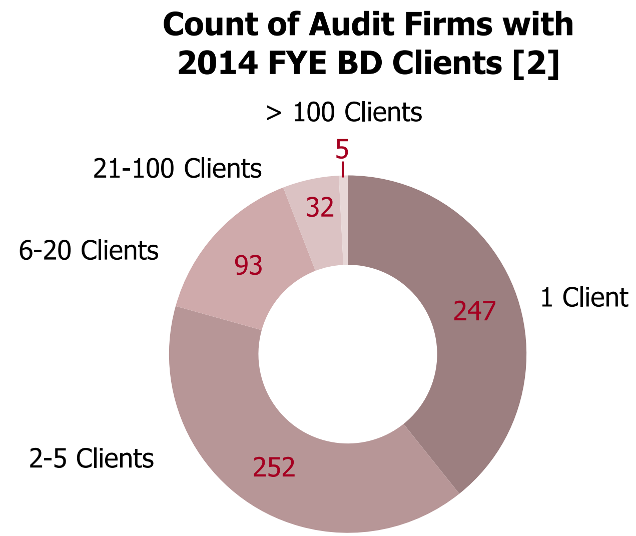
Opportunity to specialize in BDs & differentiate on audit quality

**Topics to be discussed in more detail by others at today's forum*

Decline in population

BD Migration to firms with more clients





16%

% of BDs that changed auditors between their 2013 and 2014 FYEs (This is higher than years 2010 through 2013).

79%

% of BD audit firms with 5 or fewer clients for 2014 FYEs

24%

% of BDs that are audited by firms with 5 or fewer BD clients. BDs audited by these firms are decreasing.

Source: [1] Broker and dealer counts are based on SIPC membership (which approximates similar patterns in the broader population of brokers and dealers). Audit firm counts are derived from Audit Analytics data through May 23, 2015, which includes firms that have not been registered by the PCAOB in years preceding the registration requirement. This auditor information is grouped by the fiscal year end of the financial statements audited.

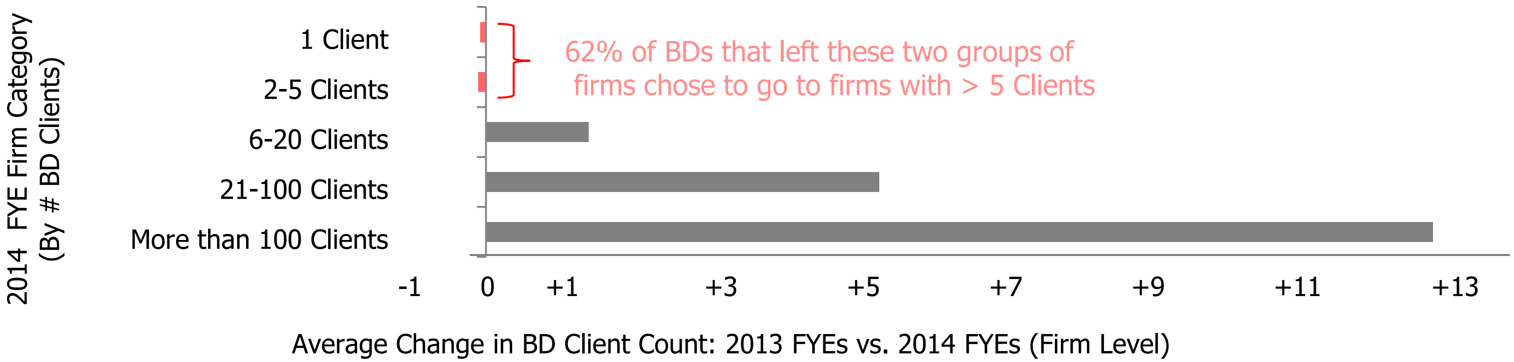
[2] Count of audit firms is based on brokers and dealer financial statements through May 15, 2015, for fiscal years ended during 2014, that included audit reports issued by firms registered with the PCAOB.

Shifting toward specialization

Summary of auditor changes between 2013 and 2014 FYE (BD Level)

Predecessor Auditor	Client Count of Successor Auditor Relative to Predecessor: Decreased More than 20%	Within 20%	Increased More than 20%	Total BDs with auditor changes
1 Client	0%	0%	15%	15%
2-5 Clients	3%	3%	20%	26%
6-20 Clients	6%	3%	9%	18%
21-100 Clients	11%	2%	4%	17%
More than 100 Clients	13%	1%	10%	24%
	32%	10%	58%	100%

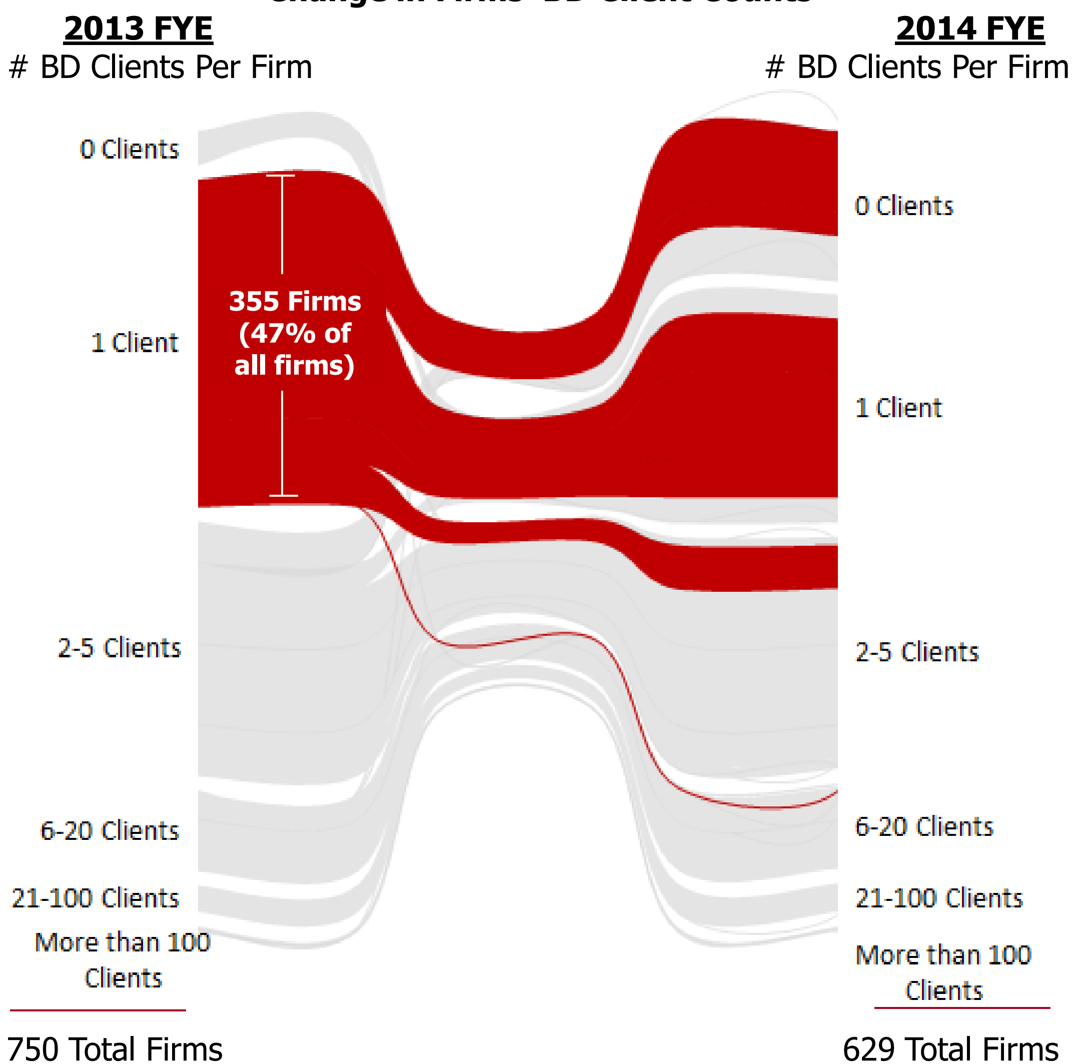
Impact BD auditor changes noted above have on overall firm BD client counts (Audit Firm Level)



Source: Count of audit firms with 2014 broker and dealer clients is based on the number of brokers and dealers who filed financial statements through May 15, 2015, for fiscal years ended during 2014, that included audit reports issued by firms registered with the PCAOB. Count of Audit Firms with 2013 broker and dealer clients is based on the number of brokers and dealers who filed financial statements through May 27, 2014, for fiscal years ended during 2013, that included audit reports issued by firms registered with the PCAOB

Firms with 1 BD client are leaving the market

Change in Firms' BD Client Counts



355

# of firms with 1 BD client for the prior FYE (2013)

32%

% of firms with 1 BD client that left the BD audit market in following year

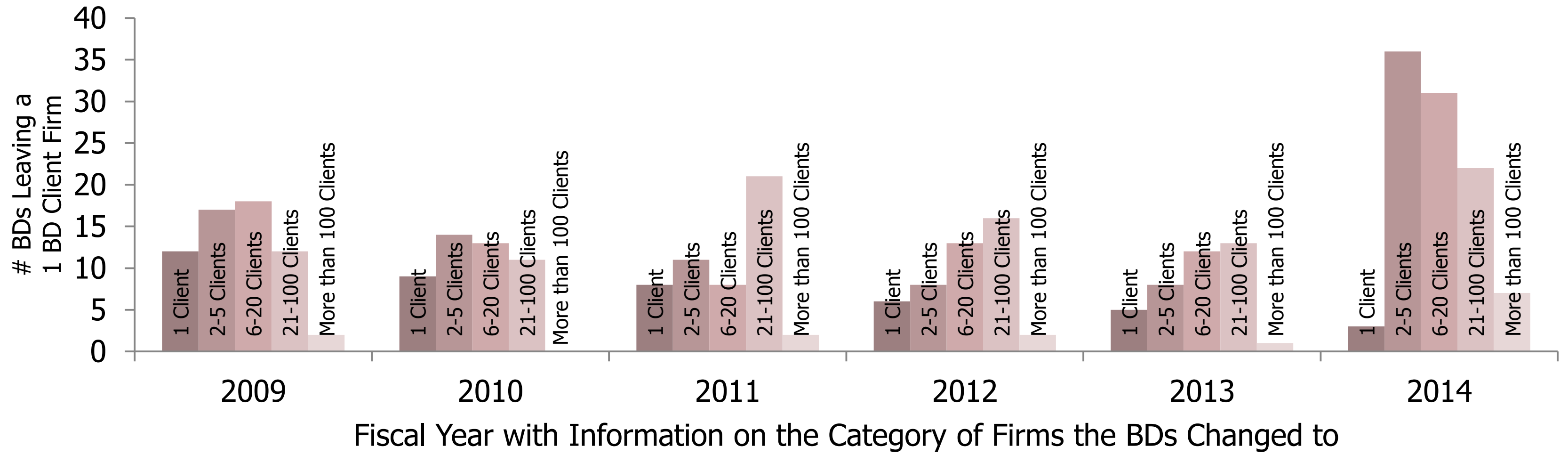
70%

% of firms that left the BD audit market that only had 1 BD audit client

Source: See prior slide. The height of the graphic, for each firm size category, represents the proportion of the firms that were that size for the respective year. The red portion depicts change in size--between 2013 and 2014--of those firms that opined on only one broker or dealer client with a 2013 fiscal year end.

BDs leaving 1 client firms are now more likely to go to a 2-5 client firm relative to other size firms

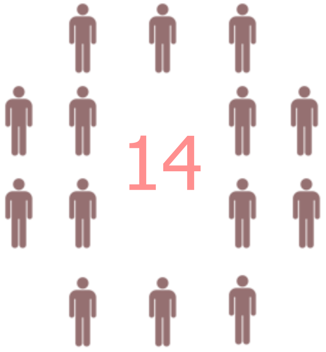
BDs leaving 1 client firms summarized by the size of firm they change to [1]



BDs leaving 1 client firms are also choosing firms with more CPAs [2]:

Median number of CPAs in 2013 for 1 Client Firms that BDs left

Median number of CPAs in 2014 for the firms those same BDs engaged



Source: [1] Counts of auditor changes with various characteristics are based on the brokers and dealers who filed financial statements for fiscal years ended during 2009 through 2014 that included audit reports issued by firms registered with the PCAOB. [2] Counts of CPAs are derived from the PCAOB Form 2 submitted for reporting years ended during 2013 and 2014 submitted to the PCOAB through August 20, 2015.

Firms with 2-5 BD clients were more successful in maintaining clients than those with 1 BD client

273

# of firms with 2-5 BD clients for the prior FYE (2013)

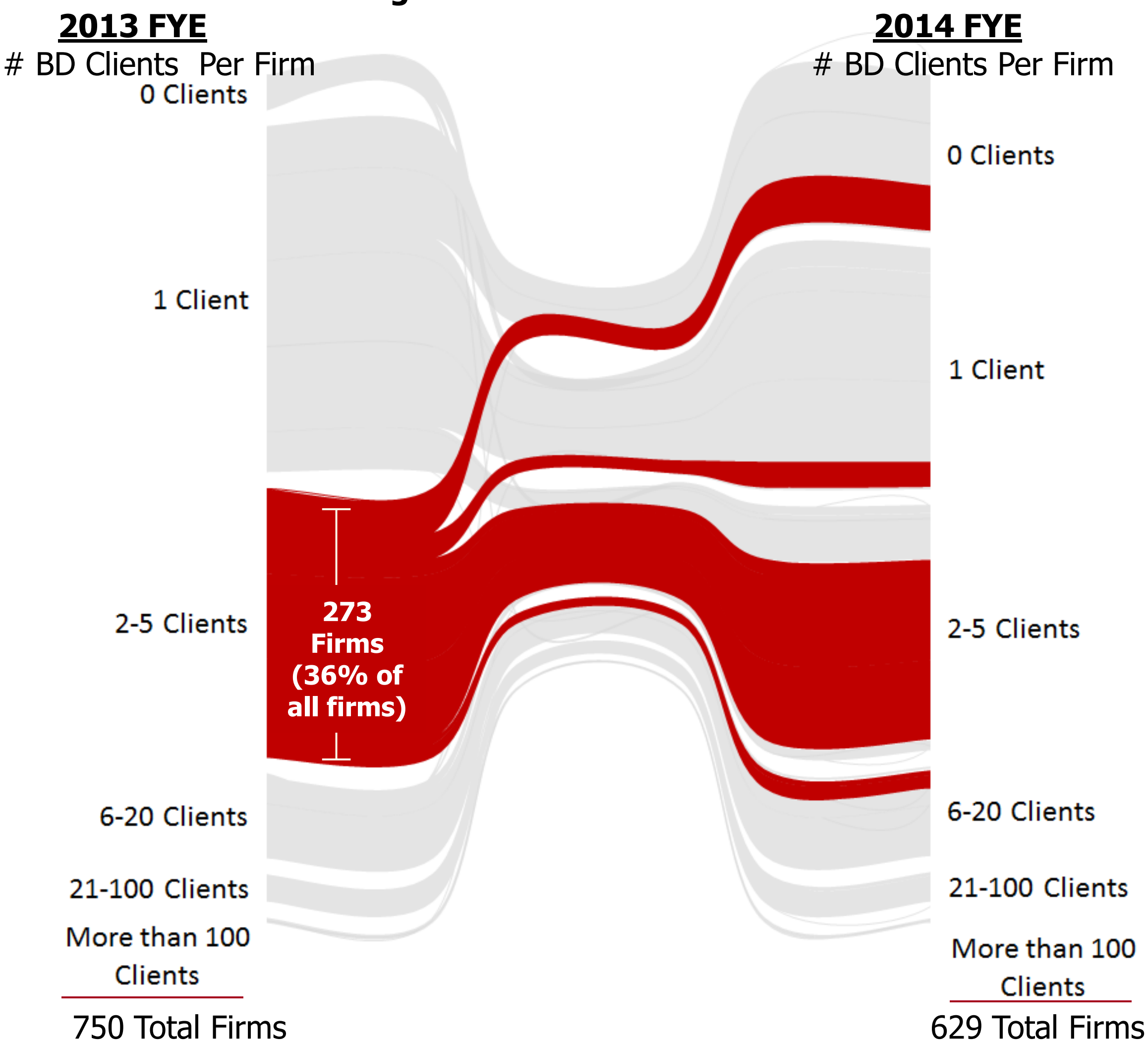
17%

% of firms with 2-5 BD clients leaving the audit market in following year

74%

% of firms with 2-5 BD clients that maintained or gained BD clients.

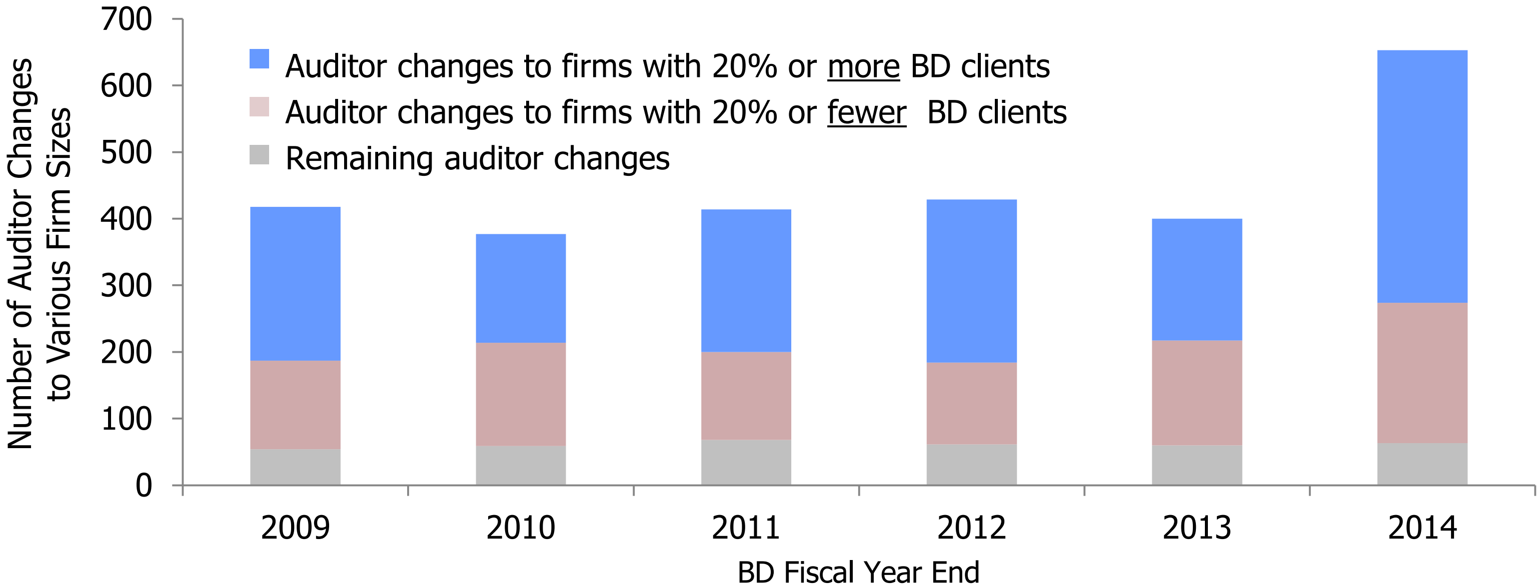
Change in Firms' BD Client Counts



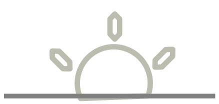
The height of the graphic, for each firm size category, represents the proportion of the firms that were that size for the respective year. The red portion depicts change in size--between 2013 and 2014--of those firms that opined on between 2 and 5 broker and dealer clients with a 2013 fiscal year end.

Overall, BDs are now more likely to select a firm with 20% or more BD clients than the prior firm

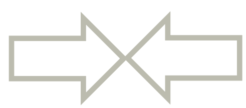
Number of auditor changes by BD client counts of successor firms relative to predecessor firms:



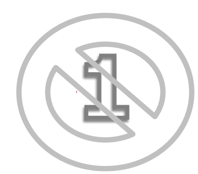
Trend Drivers:



General downward trend in the number of firms, after Madoff, PCAOB registration requirement, etc.



Major auditor acquisitions are one element at the larger end of the scale



Much of the increase in 2014 FYE auditor changes is the result of single-BD client firms getting out of the BD audit space

Source: Counts of auditor changes with various characteristics are based on the brokers and dealers who filed financial statements for fiscal years ended during 2009 through 2014 that included audit reports issued by firms registered with the PCAOB.

3 compliance studies we will discuss

April 2015: Slight improvement after amendments:

After amendments, the overwhelming majority of December FYE filings at least included the required reports, but irregularities were still identified in 9% of review reports (in a sample of 200 filings)

December 2014 FYE Filings: Wave of amendments:

At least 10% of BDs amended annual audited reports

June 2014 FYE Filings:

Approximately 20% non-compliance with basic requirements for brokers claiming Rule 15c3-3 exemption brokers to include an exemption report and review report

June 2014 FYE: ~20% non-compliance with several basic aspects of 17a-5 amendments and the related PCAOB audit and attestation standards

	BDs that do not claim exemption ***Sample=10****	**BDs that claim exemption** ***Sample=160***
Management is required to prepare:	✖ Compliance Report *10% omitted report**	✖ Exemption Report *21% omitted report*
Auditor is engaged to perform attestation and issue:	✖ Examination Report *10% omitted the report and instead issued "Report on Material Inadequacies" **	✖ Review Report 20% either issued a "Report on Material Inadequacies" or issued a review report on an exemption report which was not present. 1% issued neither a "Report on Material Inadequacies" nor a review report.
Auditor is required to conduct audit under PCAOB standards:	✖ *10% performed the audit under US GAAS ** *(not PCAOB standards)*	✖ *9% performed the audit under US GAAS* *(not PCAOB standards)*

*The 10 in this sample of those not claiming exemption is too small of a group to base conclusions about the broader population.
Source: The information is based on a review of annual audited reports filed by a broker or dealer through October 15, 2014, for fiscal years ended on June 30, 2014, that included audit reports issued by firms registered with the PCAOB.

Findings from amendments of December 2014 FYE annual audited reports filed during Q1 2015

Classification of Main Cause of Amendment	
Exemption Report, Compliance Report, Review Report, or Examination Report	75%
Oath & Affirmation	10%
SIPC Assessment	4%
Audited Financial Statement Changes	5%
Supplemental schedules opined on by the auditor	3%
Auditor's report over financial statements and supplemental information	3%
Total (Among 383 Available Amended Filings)	**100%**

Source: The information is based on a review of amendments to annual audited reports filed by a broker or dealer through April 2, 2015, for fiscal years ended on December 31, 2014, that included audit reports issued by firms registered with the PCAOB.

December 2014 FYE: review of sample of filings

(after wave of amendments)

	BDs that do not claim exemption *Sample=11*	**BDs that claim exemption** *Sample=189*
Management is required to prepare:	✔ Compliance Report *0% omitted report*	✖ Exemption Report *5% omitted exemption report.* *6% not properly executed.* *4% omitted statement on compliance with exemption throughout the period.*
Auditor is engaged to perform attestation and issue:	✔ Examination Report *0 % omitted report*	✖ Review Report *2% omitted review report.* *4% included review report that mentions an exemption provision that is different than the exemption provision mentioned by management.* *5% included review reports that did not include all 12 elements under Attestation Standard 2 Paragraph 16.*
Auditor is required to conduct audit under PCAOB standards:	✔ *0% performed audit under US GAAS (not PCAOB standards)*	✖ *1% performed audit under US GAAS (not PCAOB standards)*

Source: The information is based on a review of annual audited reports filed by a broker or dealer through April 11, 2015, for fiscal years ended on December 31, 2014, that included audit reports issued by firms registered with the PCAOB.

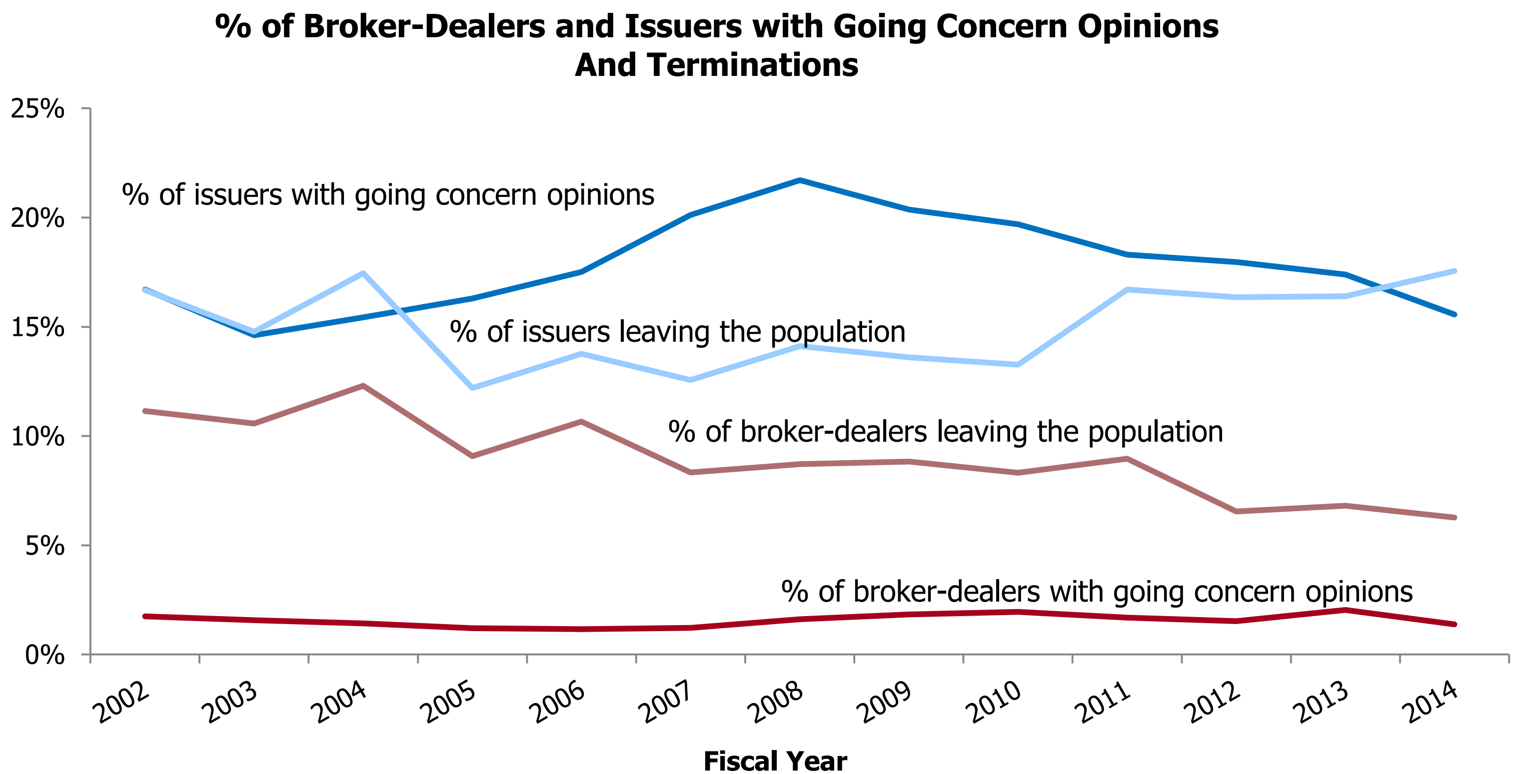
Exceptions noted in exemption report in sample of 200 filings

- Only 3% of exemption reports in sample noted exceptions.
- All BDs with exceptions noted were audited by global network firms except for one. For the one BD audited by a smaller firm, the exceptions were identified by a FINRA exam.
- Most exceptions noted related to delays in forwarding checks.
- In the 3% of reports with exceptions noted, there was disclosure of 4,200 checks in total that were not properly forwarded.

Source: The information is based on a review of annual audited reports filed by a broker or dealer through April 11, 2015, for fiscal years ended on December 31, 2014, that included audit reports issued by firms registered with the PCAOB.

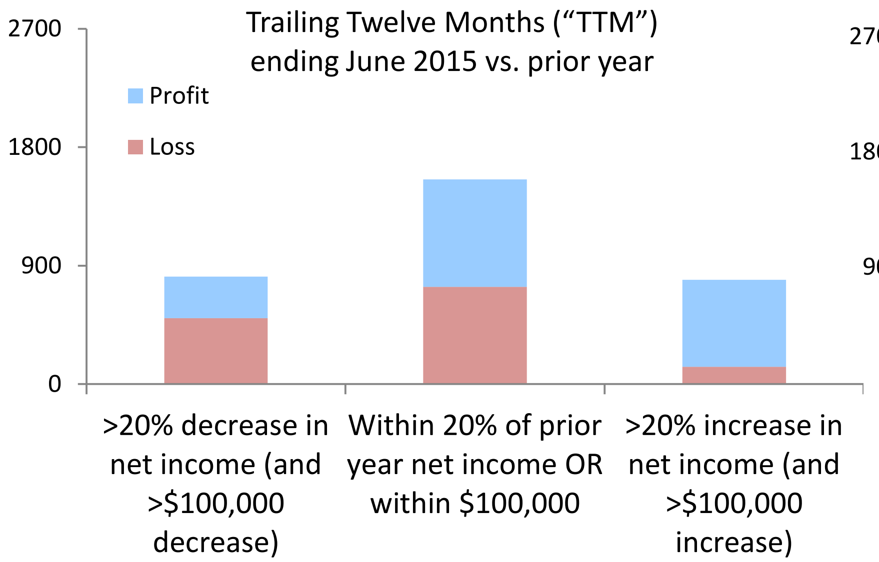
Comparison in rate of going concern: broker-dealers vs. issuers

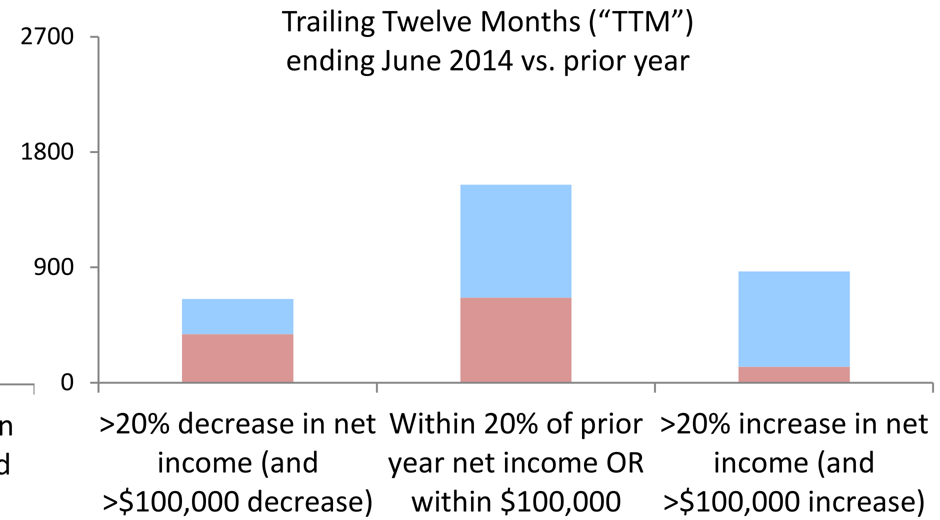
Pressures on Financial Condition



Source: Counts of audit reports with information on going concern paragraphs is derived by Audit Analytics audit report data for SEC filings through May 29, 2015. Counts of brokers and dealers leaving the population are derived from SIPC annual reports for SIPC members which approximates similar patterns in the broader population of brokers and dealers. Counts of issuers leaving the population are derived from Audit Analytics audit report data on SEC registrants (excluding benefit plans, brokers and dealers). Issuers are counted as leaving the population in the year following the fiscal year of their last audited financial statements.

BDs audited by smaller firms show volatility in net income





25%

% of BDs audited by smaller firms that reported more than a 20% increase in net income in one of the two prior TTM periods and a 20% decrease in the other (changes of <100,000 excluded)

43%

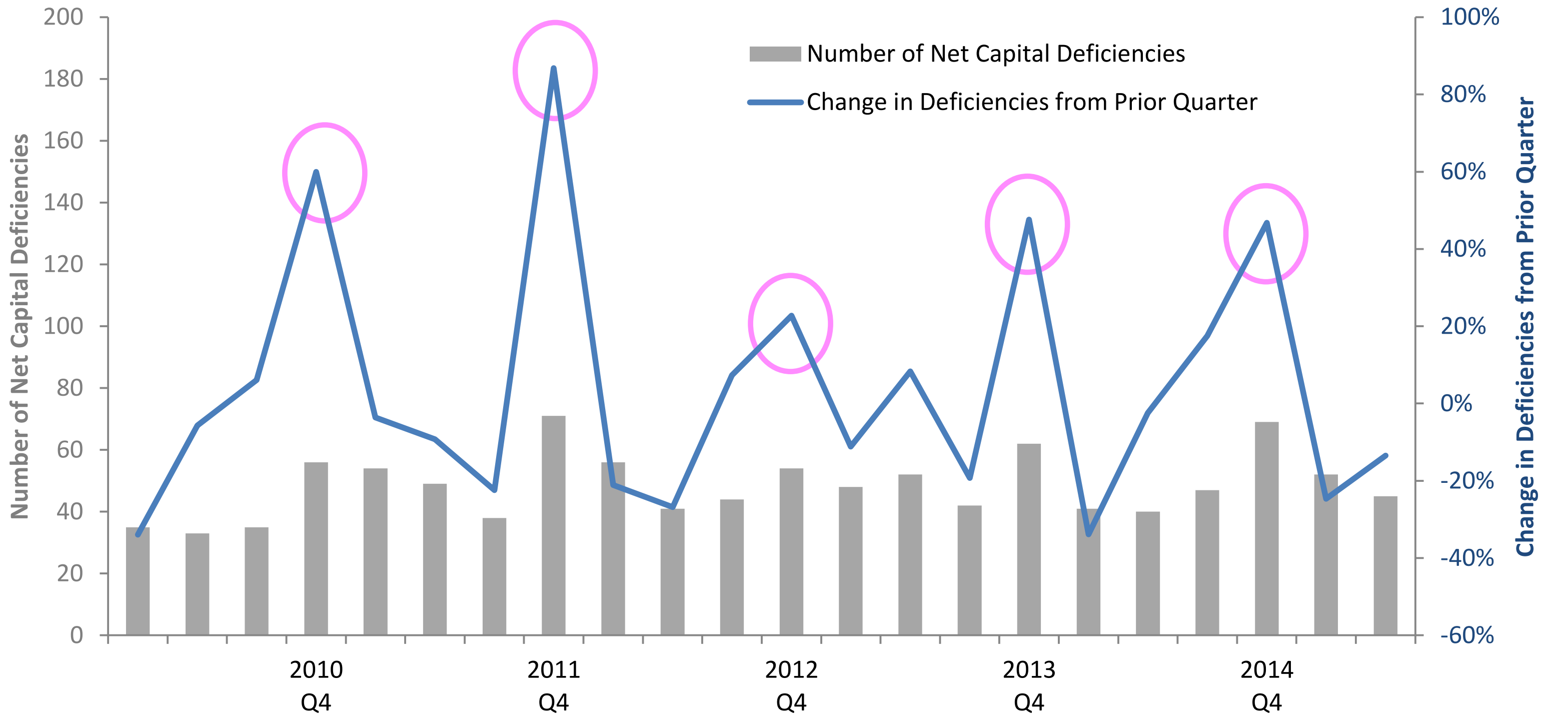
% of BDs audited by smaller firms that reported a loss in the TTM ending during June 2015.

24%

% of BDs audited by smaller firms that reported a loss in the two consecutive TTM ending during June 2015.

Source: This net income information is based on unaudited Financial and Operational Combined Uniform Single ("FOCUS") reports filed with FINRA through August 28, 2015, for the calendar quarters ended during the trailing 12 months ended June 30, 2015, June 30, 2014 and June 20, 2013. Audit firm information is based on brokers and dealer financial statements filed through May 15, 2015, for fiscal years ended during 2014, that included audit reports issued by firms registered with the PCAOB that are not part of the 6 largest global network firms.

Evidence of the impact audits have on BD financial reporting quality



Source: This information is based on FOCUS Reports filed with FINRA by FINRA and NYSE members for the periods noted through October 19, 2015.

FINRA Perspectives

PCAOB Forum for Auditors of Broker-Dealers

West Palm Beach, FL - October 28, 2015

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

Financial Industry Regulatory Authority

Nature and Scope of FINRA's Financial Surveillance and Risk-Based Examination Programs

Financial Industry Regulatory Authority

FINRA's Financial Surveillance Program

- **Includes the routine review of a firm's financial and operational reports:**
  - Filed pursuant to SEA 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

FINRA's Risk-Based Examination Program

- **Scope, content, frequency and nature of a firm's examination depends on the characteristics of the firm**
  - Characteristics include, but are not limited to, firm size and complexity, business lines, and nature of operations
- **FINRA's routine examinations are conducted on a one to four year cycle**
  - Nonetheless, examination frequency can be modified for various regulatory reasons
- **Certain events may result in accelerated or special examinations**

2015 Examination Priorities & Trends (Fin/Op Examinations)

Financial Industry Regulatory Authority

2015 FINRA Examination Priorities
Select Financial and Operational Priorities

- **Funding and Liquidity**
  - Regulatory Notice 15-33: Guidance on Liquidity Risk Management Practices
- **Cybersecurity**
  - FINRA 2015 Report on Cybersecurity Practices
- **Outsourcing**
  - NASD Notice to Members 05-48: Outsourcing
  - FINRA Regulatory Notice 11-14: Third Party Service Providers

FINRA Perspectives as they relate to PCAOB and SEC OCIE Findings

Financial Industry Regulatory Authority

PCAOB Inspection Observations by Audit Area – Inception of Program Through 2014 and SEC Office of Compliance Inspection and Examination (OCIE) Inspections – Common Themes

- **In addition to auditor independence issues, the PCAOB reported that their observations fell into 11 areas. My comments today will deal with 4 of the areas as follows:**
  - Customer Protection and Net Capital Rules
    1. Customer Protection Rule
    2. Net Capital Rule
  - Audited Financial Statements
    1. Related Party
    2. Revenue

  In each of the four, audit deficiencies were noted in 20% or more of the applicable audits.
- **Inspections of broker-dealers conducted by OCIE reveal recurring issues in several areas including, but not limited to:**
  - Expense Sharing Agreements
  - Capital contributions and withdrawals
  - Classification of allowable vs. non-allowable assets
  - Compliance with Rule 15c3-3 exemption
  - Books and Records
- **My comments today, in the FINRA Perspective portion of my presentation, deal with the areas noted.**
  - My goal is to share observations that may assist you in conducting an audit of a broker-dealer

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?

Financial Industry Regulatory Authority

PCAOB Forum for Auditors of Broker-Dealers

Khalid Shah
Associate Chief Accountant

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

October 28, 2015

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Agenda

- 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

Overview of the Annual Reporting Requirements

Overview of the Annual Reporting Requirements

- **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

- **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

- **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 1 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

- **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

- **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

- ***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**

Applicability of Auditor Independence Rules to Broker-Dealer Audits

Applicability of Auditor Independence Rules to Broker-Dealer Audits

- **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 disciplinary orders**

Applicability of Auditor Independence Rules to Broker-Dealer Audits

- **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

- **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**

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

OCIE Broker-Dealer Inspections

- ***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

- **Division of Trading and Markets**
  - **http://www.sec.gov/divisions/marketreg/mrcontact.htm**
    - **Phone: (202) 551-5777**
    - **E-mail : tradingandmarkets@sec.gov**
- **Office of the Chief Accountant**
  - **Professional Practice Group (including Independence)**
  - **Accounting**
  - **Phone: (202) 551-5300**
  - **E-mail : OCA@sec.gov**

Break

Inspections:
Case Studies

Kate Ostasiewski and Mike Walters
Division of Registration and Inspections

October 28, 2015
West Palm Beach, FL

Agenda

- 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 – Work Paper Review Exercise

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.

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.

Questions?

Division of Enforcement and Investigations Update

John Abell
Associate Director, Division of Enforcement and Investigations

October 28, 2015
West Palm Beach, FL

Agenda

- Today we'll discuss:
  - Broker-Dealer Auditor Independence Matters
  - Engagement Quality Review Matters
  - Other Matters of Note

Broker-Dealer Auditor Independence Matters – December 8, 2014

- The 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
- The SEC simultaneously settled with eight firms for violating independence rules

Broker-Dealer Auditor Independence Matters – December 8, 2014

- In each case, the preparation consisted of one or more of the following:
  - Addition or deletion of line items
  - Aggregation of line items
  - Classification of line items
  - Changes to line item descriptions or amounts
  - Addition or deletion of captions
  - Addition of columns or tabular presentations

Broker-Dealer Auditor Independence Matters – July 9, 2015

- The Board settled disciplinary orders against seven additional firms and two associated persons for independence violations
- The steps taken to prepare the financial statements included same as in December 2014 orders, plus changes to captions and disaggregation of line items
- The offenders fell into three groups:
  - Aggravated repeat offenders
  - Repeat offenders
  - Basic offenders

Broker-Dealer Auditor Independence Matters – July 9, 2015

- Aggravated repeat offenders
  - Two firms and two associated persons
  - Prepared audit client's financial statements after receiving inspection comments noting that preparation impaired independence
  - Each firm sanctioned with a censure, a $20,000 penalty, a 1-year prohibition on new broker-dealer clients, and remedial measures
  - Each associated person sanctioned with a censure and a 1-year bar from association with a registered firm
  - One associated person also sanctioned with a $10,000 penalty; other associated person was sole owner of firm

Broker-Dealer Auditor Independence Matters – July 9, 2015

- Repeat offenders
  - Two firms
  - Prepared audit client's financial statements after receiving inspection comments noting that preparation impaired independence
  - Did things differently the next year, but still engaged in preparation
    - *CST Group*: Prepared draft with placeholders for dollar amounts
    - *Walker & Armstrong*: Obtained draft but made extensive changes
  - Each firm sanctioned with a censure, a $7,500 penalty, and remedial measures

Broker-Dealer Auditor Independence Matters – July 9, 2015

- Basic offenders
  - Two firms
  - Prepared audit client’s financial statements
  - Non-repeat offenders; comparable to seven broker-dealer audit firms sanctioned in December 2014
  - Each firm sanctioned with a censure, a $2,500 penalty, and remedial measures

Broker-Dealer Auditor Independence Matters – July 9, 2015

- The Board also announced that an unnamed eighth firm had prepared financial statements, but would <u>not</u> be sanctioned.
- The Board awarded credit for extraordinary cooperation based on the firm's:
  - timely and voluntary self-reporting to the PCAOB Tip Line; and
  - timely, voluntary, and meaningful remedial actions, including communicating the violation to the client and discussing the conduct and violation at an annual firm training session.

Engagement Quality Review Matters – July 23, 2015

- The Board settled disciplinary orders against seven firms and seven associated persons for conduct including violations of AS 7, *Engagement Quality Review*
- AS 7 requires EQRs of audits, interim reviews, and examinations/reviews of broker-dealer compliance/exemption reports
- Each firm violated one of two requirements:
  - 5 firms - EQR requirement: "An engagement quality review and concurring approval of issuance are required…." (AS 7 ¶ 1) "In an audit, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance." (AS 7 ¶ 13)
  - 2 firms – cooling off requirement: "The person who served as the engagement partner during either of the two audits preceding the audit subject to the engagement quality review may not be the engagement quality reviewer." (AS 7 ¶ 8)

Engagement Quality Review Matters – July 23, 2015

- With respect to sanctions, the firms fell into three groups:
  - One or two violations of cooling off requirement

    = censure
  - One or two violations of requirement to have EQR performed

    = censure, remedial measures, penalty ($5K, $7.5K)
  - Multiple violations of requirement to have EQR performed

    = censure, revocation, larger penalty ($10K, $15K)
- Two cases included other conduct (*e.g.*, audit standard violations)
- Each associated person sanctioned with censure and bar (where firm received revocation) or otherwise censure
- Note in particular:
  - *R.R. Hawkins*: Inspectors had reminded firm of requirement
  - *Keith K. Zhen, CPA*: Firm had EQR done in earlier audits

Other Matters of Note

- Akiyo Yoshida, CPA (Dec. 17, 2014)
- Morrill & Associates, LLC, Douglas W. Morrill, CPA, and Grant L. Hardy, CPA (Jan. 12, 2015)
- David A. Aronson, CPA, P.A. and David A. Aronson, CPA (Oct. 2, 2015)
- Ron Freund, CPA (Jan. 25, 2015) (adjudicated proceeding)

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
- Letter
  PCAOB Complaint Center
  1666 K Street, NW
  Washington, DC 20006
- FAX: 202-862-0757
- Telephone: 800-741-3158

Questions

Lunch

(75 minutes)

PCAOB
Public Company Accounting Oversight Board

Inspections: Observations and Trends

Bob Maday and Kate Ostasiewski
Division of Registration and Inspections

October 28, 2015
West Palm Beach, FL

Agenda

- Summary of Interim Inspection Program
- 2015 Inspection Plan
- Inspection Observations
- 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 Program and Status of Permanent Program

- Interim Inspections
  - Continue
  - Results
- Permanent Inspection Program
  - Rule Proposal Process
  - Timing

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

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
  - 75 firms and portions of 115 audit and attestation engagements

2015 Interim Inspection Program Plan (continued) – Areas of Inspection Focus

- Audit deficiencies in the financial statement audit
- Attestation standards
- Auditing supplemental information accompanying audited financial statements
- Engagement Quality Review
- Auditor independence

2015 Inspections – Observations

- Financial Statement Audit
- Attestation standards
- Supplemental information
- Engagement Quality Review
- Independence

Interim Inspection Program – Reporting

- Past Annual Reports
  - 2011 - inspected 10 Firms and portions of 23 audits
  - 2012 - inspected 43 Firms and portions of 60 audits
  - 2013 - inspected 60 Firms and portions of 90 audits
- Supplemental Report
  - Inspected 5 firms and portions of 5 audits
- Inspections – 2015 Annual Report
  - 2014 - inspected 66 firms and portions of 106 audits

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

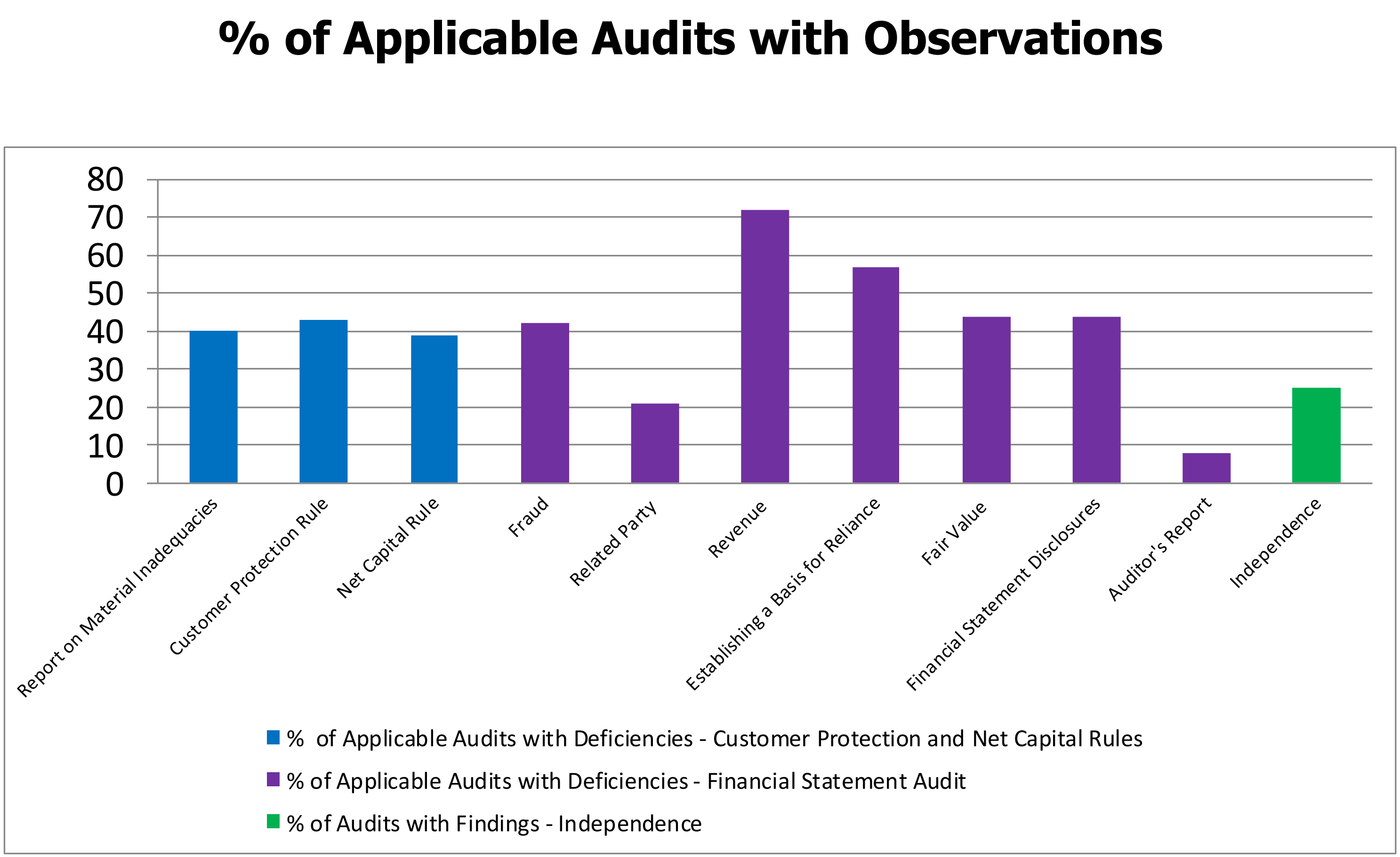
Interim Inspection Program – 2014

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

Interim Inspection Program - Disclaimer

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

Inspections Observations by Audit Area - 2014



Compliance with Independence Requirements - 2014

24 out of 66 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
- Indemnity clauses included in the engagement letter

Compliance with Independence Requirements - 2014 (continued)

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

Net Capital Requirements and Customer Protection Rule - 2014

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 - 2014 (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 - 2014

The most frequent audit deficiencies related to:

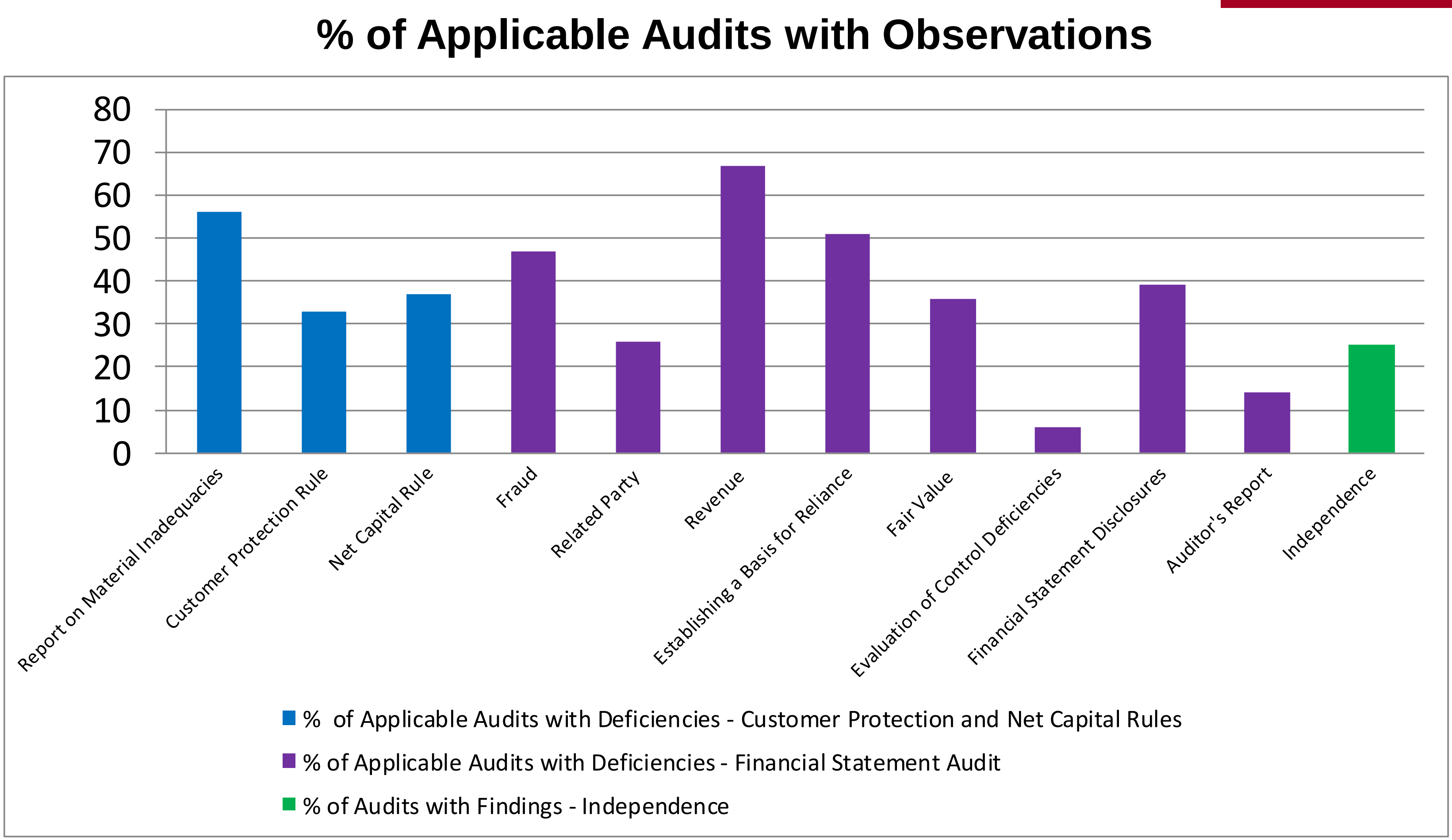
- Revenue (72%)
- Reliance on Records and Reports (57%)
- Fair Value Accounting Estimates (44%)
- Financial Statement Presentation and Disclosures (44%)

Financial Statement Audit – 2014 (continued)

Inspection Observations and Relevant PCAOB Standards

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

Inspections Observations by Audit Area - Inception of the Program Through 2014



Summary of Inspection Observations: Since Inception of Interim Inspection Program

- Observations identified in portions of approximately 87% of audits (243 of 279)
- Independence findings identified in 71 of 279 audits
- Higher percentage of audits with deficiencies during 2014 as compared to 2013
- Deficiencies were found across various stratifications of *firm* characteristics
- Deficiencies were found across various stratifications of *broker-dealer* characteristics

Actions for Auditors

- Take appropriate action when audit deficiencies are discovered after the date of the audit report
- Be proactive – seek ways to better anticipate and address risks
- Take action now regarding identified independence and audit deficiency observations
- Review PCAOB guidance and participate in periodic Forums and webcasts

Questions?

Risk Assessment and Related Case Studies

Kate Ostasiewski, Greg MacCune and Mike Walters

Division of Registration and Inspections

October 28, 2015

West Palm Beach, FL

Agenda

- Objectives
- PCAOB Risk Assessment Standards
- Case Study

Objectives

- 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
  - <u>Inherent risk high for occurrence, moderate for all other assertions</u>
  - <u>Improper revenue recognition related to the occurrence of commissions revenue is both a significant risk and a fraud risk</u>

Materiality

- 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

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)
  - <u>Risk of Material Misstatement assessed at low</u>

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
  - <u>Risk of misappropriation of assets considered low</u>

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

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

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

BREAK – 15 Minutes

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 Panel

Moderator: Lew Ferguson

Closing Remarks

Lew Ferguson