

## Forum for Auditors of Broker-Dealers

December 7, 2016  
Las Vegas, NV

## Welcome

Mary Sjoquist  
Director, Office of Outreach  
and Small Business Liaison

## 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.

## Learning Objectives

To discuss important information concerning the PCAOB with PCAOB-registered public accounting firms that audit smaller broker-dealers that are registered with the Securities and Exchange Commission (SEC). More specifically, PCAOB staff from the Division of Registration and Inspections, the Office of Chief Auditor, and the Division of Enforcement and Investigations, will discuss topics including: trends in broker-dealer audits; guidance for applying PCAOB auditing standards to audits of broker-dealers; inspection findings and case studies related to broker-dealers; and enforcement settlements and program goals. The forum also will include presentations from the SEC staff and staff from the Financial Industry Regulatory Authority (FINRA), as well as a panel focusing on a discussion of AS 18 (AS 2410 as reorganized), Related Parties, and a related case study. A closing panel from PCAOB, SEC, and FINRA will cover topic suggestions and questions.

## Stay Connected

- Stay up-to-date on current PCAOB activities (including announcements about future forums!) by signing up for our email list.
- <https://pcaobus.org/About/Pages/PCAOBUpdates.aspx>

5



## Polling Test Question

Go to <https://pcaobbd.cnf.io/> and select the "Welcome Remarks" session to respond

How far did you travel to attend today's forum?

- A. Less than 10 miles
- B. 10-24 miles
- C. 25-50 miles
- D. More than 50 miles

6



This page intentionally left blank

7



## PCAOB Highlights

Jay D. Hanson  
Board Member



## Panel: Related Parties

Mary Sjoquist, Moderator

Kate Ostasiewski, Associate Director, Division of  
Registration and Inspections

Brian Degano, Associate Chief Auditor,  
Office of Chief Auditor

Ann Duguid, Director, Regulatory Development  
& Services, FINRA

## Case Study No. 1: Related Parties

Mike Walters

Division of Registration and Inspections

Brian Degano

Office of Chief Auditor

## Risk Assessment Procedures

Per AS 2410 the auditor performs risk assessment procedures to understand: "*relationships and transactions with... related parties that might reasonably be expected to affect risks of material misstatement...*"

Risk assessment procedures required by AS 2410 include:

- ❑ Obtaining an understanding of the broker-dealer's process
- ❑ Performing inquiries of management, the audit committee, and others
- ❑ Communicating with the engagement team

## Background

- ❑ XYZ Brokers, Inc. ("XYZ") is a client of The Audit Firm, LLP.
- ❑ XYZ is an SEC registered broker-dealer that introduces customer trades to a clearing firm under a fully-disclosed clearing arrangement. XYZ also sells mutual funds and variable annuities.
- ❑ XYZ does not carry customer accounts or hold customer funds or securities.
- ❑ XYZ's key personnel include its President, an in-house FinOp, and a Chief Compliance Officer ("CCO").
- ❑ XYZ's President is the managing member of, and owns a controlling interest in AAA, an unaudited affiliated entity of XYZ.
- ❑ The FinOp maintains the books and records of XYZ (including the general ledger) and prepares draft FOCUS reports and financial statements. The FinOp also maintains the accounting records for AAA

## Background (continued)

- XYZ's President signs an engagement letter for the audit of XYZ's financial statements and supplemental information, and the review of the XYZ's Exemption Report per Attestation Standard No. 2.
- During audit planning, the engagement team set materiality at \$80,000 for the audit of XYZ.
- XYZ's draft financial statements as of and for the year ended December 31 include a related party footnote which disclosed:
  - Tax payments of \$2 million made in cash to the President and a corresponding \$2 million receivable from the President; and
  - Reimbursements of \$120,000 for personnel and other administrative costs received from AAA relating to accounting services provided by XYZ's FinOp to AAA as well as other administrative services.

13

PCAOB

## Risk Assessment Procedures

The engagement team performed the following risk assessment procedures:

- Obtained an organization chart and a schedule of XYZ's related party transactions ("RPTs") and balances
- Inquired of the President and the FinOp regarding:
  - XYZ's processes and controls for identifying, authorizing, and accounting for and disclosing RPTs
  - Names, background information, and the nature of relationships with related parties
  - RPTs entered into, modified or terminated during the period, including terms and business purpose (or lack thereof)
  - Whether undisclosed RPTs exist
  - Whether RPTs exist that were not authorized and approved or for which exceptions to XYZ established policies and procedures were made, and the reasons

14

PCAOB

## Risk Assessment Procedures (continued)

The XYZ engagement team held a team meeting and discussed the following information:

- The XYZ org chart identified the President as owner of AAA
- The RPT schedule included cash distribution of \$2 million to the President for tax payments
- AAA provided funding for the cash distribution. XYZ has a payable to AAA and a receivable from the President on its balance sheet
- Per the FinOp, the cash distribution was a temporary loan which the President would repay once he finalized his tax return
- Per the President, the cash distribution was related to excessive IRS penalties for an unsettled tax matter
- Both the FinOp and the President indicated there was no written agreement regarding the distribution
- All RPTs on the schedule were approved in accordance with XYZ's policies. XYZ policies required the President to authorize RPTs

15

PCAOB

## Risks of Material Misstatement and Responses to Assessed Risks

The engagement team identified a **significant and fraud** risk for the relevant assertions associated with the receivable from the President and payable to AAA.

1. What are some key facts which should be considered as part of the risk assessment?
2. Do you agree with this assessment? Why or why not?
3. What procedures would you perform to respond to the identified risk(s)?
4. Should the engagement team consider the cash distribution a "significant unusual transaction"?

7

PCAOB

## Relevant PCAOB Standard

Auditing Standard No. 2410: Related Parties

- <http://pcaobus.org/Standards/Auditing/Pages/AS2410.aspx>

9



**Break**



## *PCAOB Forum for Auditors of Broker-Dealers*

**Khalid Shah**  
Associate Chief Accountant

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

December 7, 2016



## *Disclaimer*

*The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the staff of the Commission.*

## *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
  - Reporting Updates
- ❖ **Applicability of Auditor Independence Rules to Broker-Dealer Audits**
- ❖ **Office of Compliance Inspections and Examinations - Broker-Dealer Inspections**
- ❖ **Enforcement Update**
- ❖ **Other Topics**

## *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
  - Exceptions to exemption provision
- ❖ **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
  - May request relief from filing a Compliance Report

## *Reporting Updates*

## *Reporting Updates*

- ❖ **Electronic filing of broker-dealer annual reports**
  - Staff No Action Letter to Ms. Kris Dailey, FINRA, issued December 21, 2015
- ❖ **SIPC Rule 600 – *Rules Relating to Supplemental Report of SIPC Membership***
  - Agreed upon procedures to be performed in accordance with PCAOB standards
  - Supplemental report to be filed only with SIPC
  - FAQs

## *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***
- ❖ **PCAOB inspections of audits of broker-dealers continue to identify violations of Rule 2-01**
  - **Rule 2-01(c)(4) – *Non-audit services***
    - **Bookkeeping and financial statement preparation services**

### *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, word processing services, or any other administrative support related to the production of the financial statements
  - Auditors should not provide financial statement templates that are not available publicly 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

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

---

- ❖ **Consider preliminary note 2 - Rule 2-01 when evaluating a relationship or provision of service that**
  - Creates a mutual or conflicting interest between the accountant and the audit client;
  - Places the accountant in the position of auditing his or her own work;
  - Results in the accountant acting as management or an employee of the audit client; or
  - Places the accountant in a position of being an advocate for the audit client

### *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

## *Enforcement Update*

---

## *Enforcement Update*

---

- ❖ Recent SEC enforcement activity
  - 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*.
    - December 8, 2014  
<http://www.sec.gov/News/PressReleases/Detail/PressRelease/1370543608588>
  - Commission sanctioned 2 audit firms and one individual for non-compliance with professional standards
    - February 26, 2016 - Halpern & Associates LLC and Barbara Halpern, CPA  
<https://www.sec.gov/ai/jalidec201634-77248.pdf>
    - December 22, 2015 – Spicer Jeffries LLP  
<https://www.sec.gov/litigation/admin/201534-76734.pdf>

## *Enforcement Update*

---

- ❖ Recent PCAOB enforcement activity
  - PCAOB settled disciplinary orders against firms for independence violations and granted extraordinary cooperation credit for 2 audits of broker-dealers
    - March 15, 2016  
<http://pcaobus.org/News/Releases/Pages/Five-BD-independence-orders-one-cooperation-3-15-16.aspx>
    - July 9, 2015  
[http://pcaobus.org/News/Releases/Pages/07092015\\_Enforcement.aspx](http://pcaobus.org/News/Releases/Pages/07092015_Enforcement.aspx)
    - December 8, 2014  
[http://pcaobus.org/News/Releases/Pages/12082014\\_Enforcement.aspx](http://pcaobus.org/News/Releases/Pages/12082014_Enforcement.aspx)

## *Other Topics*

## *Other Topics*

- ❖ **Broker-dealer related consultations with OCA**
  - Recent Examples
- ❖ **New Accounting Standards**
  - Revenue Recognition Accounting Standard
    - AICPA Revenue Recognition Task Force – Brokers and Dealers in Securities
  - Leases
- ❖ **Coordination**
  - SEC
  - FINRA
  - PCAOB

## *Contact Information*

- ❖ **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**  
December 7, 2016

Ann Duguid, Director  
Risk Oversight and Operational Regulation  
Financial Operations Policy Group



## FINRA Perspectives

1. The Nature and Scope of FINRA's Financial Surveillance, and Risk-Based Examinations, and Programs
2. Update on Relevant FINRA notices
3. Change to the Derivatives and Other Off-Balance Sheet Items Schedule Pursuant to FINRA Rule 4524 (Supplemental FOCUS Information)
4. SEC Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934
5. Exam Observations



Copyright 2016 FINRA | 41

# 1 The Nature and Scope of FINRA's Financial Surveillance and Risk-Based Examination Program



42

## FINRA's Financial Surveillance Program

- **Ongoing reviews of firm's periodic financial reporting including submission of FOCUS Reports, Supplemental Schedules, Annual Audits, Form Custody**
- **Alert Reporting: FINRA Regulatory Notice 10-44**
  - Certain conditions warrant accelerated reporting
- **Supplemental Schedules/Reports: Rule 4524**
  - Supplemental Schedule to the Statement of Income
  - Supplemental Schedule for Derivatives and Off-Balance Sheet Items
    - <http://www.finra.org/industry/notices/16-11>
    - FAQ: <http://www.finra.org/industry/derivatives-and-other-balance-sheet-items-obs/supplemental-quarterly-schedule-focus-report>
  - Supplemental Inventory Schedule
    - <https://www.finra.org/industry/notices/14-43>



Copyright 2016 FINRA | 43

## 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 & 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**



Copyright 2016 FINRA | 44

## Sources of Information

- **Interpretations of Financial and Operational Rules**
  - <http://www.finra.org/industry/interpretationsfor>
- **What to expect in a cycle exam**
  - [https://www.finra.org/sites/default/files/14\\_0453%201\\_What%20to%20Expect\\_Cycle%20Exam.pdf](https://www.finra.org/sites/default/files/14_0453%201_What%20to%20Expect_Cycle%20Exam.pdf)



Copyright 2016 FINRA | 45

## 2016 FINRA Regulatory and Exam Priorities

- FINRA's Annual Regulatory and examination priorities letter
  - <http://www.finra.org/industry/2016-regulatory-and-examination-priorities-letter>
  - Broad Issues
    - Culture, Conflicts of Interest and Ethics
    - Supervision, Risk Management and Controls
      - Management of Conflicts of Interest
      - Technology
      - Outsourcing
      - AML Controls
    - Liquidity



Copyright 2016 FINRA | 46

## 2 Regulatory and Information Notices



47

## Other Relevant FINRA Regulatory Notices

- **Liquidity**
  - Regulatory Notice 15-33: Guidance on Liquidity Risk Management Practice
- **Electronic Filing: Annual Reporting**
  - Reg Notice 16-05: SEC No-Action Guidance on Electronic Filing of Broker-Dealer Annual Reports
- **Definition of "Ready Market" for Certain Foreign Equity Securities**
  - Reg Notice 16-13
- **Margin Requirements for Covered Agency Transactions**
  - Reg Notice 16-31



Copyright 2016 FINRA | 48

## Other Relevant FINRA Information Notices

- **2016 Holiday Information Notice**
  - 12/22/15: 2016 Holiday Trade Date, Settlement Date and Margin Extensions Schedule
- **2016 and 1Q 2017 report due date**
  - 12/14/2015: 2016 and First Quarter of 2017 Report Filing Due Dates



## Other Relevant SEC Notices

- **Swaps Margin Posted away: SEC relief under 15c3-1**
  - <https://www.sec.gov/divisions/marketreg/mr-noaction/2016/finra-081916-15c3-1.pdf>
- **SEC DTM No-Action Letter regarding prompt forwarding**
  - <https://www.sec.gov/divisions/marketreg/mr-noaction/2016/mml-investors-services-llc-071916.pdf>
- **SEC DTM No-Action Letter regarding capital treatment under the new lease accounting standard**
  - <https://www.sec.gov/divisions/marketreg/mr-noaction/2016/sifma-111016-15c3.pdf>



# 3

## Derivatives and Other Off-Balance Sheet Items Schedule (Supplemental FOCUS Information)

New filing requirement for non-carrying & non-clearing firms



## OBS Filing Requirement

- **SEC approval of rule change on January 6, 2016**
  - In December 2015, pursuant to rule filing SR 2015-059 ("FINRA") filed with the Securities and Exchange Commission a proposed rule change to amend the instructions to the Derivatives and Other Off-Balance Sheet Items Schedule ("OBS") to expand the application of the OBS to certain non-carrying/non-clearing firms that have significant amounts of off-balance sheet obligations. The SEC published for comment the amended rule change in the Federal Register on January 7, 2016. The Commission did not receive written comments in response to the proposed rule change.
- **On February 9, 2016 the SEC approved the proposed rule change**
  - The Public notice can be found in the Federal Register dated January 7, 2016
  - FINRA Notice 16-11 provides the implementation date of June 30, 2016 and other filing requirements.



## OBS Filing Requirement

### Who must file:

- Non-clearing firms that have a minimum dollar net capital requirement equal to or greater than \$100,000, and at least \$10 million in reportable items pursuant to the OBS will be required to file the report\*. The rule change will impact approximately 100 firms. (\* a De minimis exception is detailed in Reg. Notice 16-11)

### When does the updated requirement take effect:

- Newly filing firms must file with FINRA their initial OBS disclosing off-balance sheet information as of June 30, 2016, on or before August 2, 2016.
- Firms that were already subject to OBS reporting shall continue to file on a quarterly basis, as required, without interruption.



Copyright 2016 FINRA 53

## OBS Filing Requirement

### Why is the OBS required?

- FINRA noted the need, in the aftermath of the financial crisis, to obtain more comprehensive and consistent information regarding carrying or clearing firms' off-balance sheet assets, liabilities and other commitments.
- The OBS includes such information as underwriting commitments, financing arrangements which receive off balance sheet treatment, TBA, delayed delivery and cleared and non-centrally cleared derivative information.



Copyright 2016 FINRA 54

## OBS Filing Requirement

### Why was this updated requirement necessary?

- Since the OBS became effective FINRA has observed considerable principal trading activities of some non-clearing firms. FINRA has become aware of non-clearing firms with both material TBA transactions as well as other types of securities transactions with extended settlement dates.
- These transactions may present significant financial exposure for non-clearing firms. FINRA is concerned about firms appropriately monitoring their financial exposure and applying capital charges for these transactions as required for compliance with SEA Rule 15c3-1.
- Such transactions are not reported on non-clearing firms' balance sheets, making it difficult to monitor their compliance with capital requirements.



Copyright 2016 FINRA 55

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

General themes



56

## Removal of credit ratings

### ■ Removal of NRSRO credit ratings:

- **SEC Release No. 34-71194:** removal of references to credit ratings of nationally recognized statistical rating organizations (NRSRO) from Rule 15c3-1 for computing haircut charges on certain investments became effective on July 7, 2014.
- The computation of Net Capital includes taking deductions ("haircuts") from the mark-to market value of proprietary positions (e.g., securities, money market instruments, and commodities) that are included in the broker-dealer's tentative net capital.
- Previously commercial paper, non-convertible debt and preferred stock haircuts could be determined based on an objective approach of using NRSRO credit ratings. The new standard is a subjective approach because it allows broker-dealers to determine through their credit assessments whether a lower haircut is applicable to a given position.



Copyright 2016 FINRA | 57

## Removal of credit ratings

### ■ Removal of NRSRO credit ratings:

- New standard requires firms to:
  - Firms are required to substitute an alternative standard of creditworthiness as a condition for qualifying for the lower haircut treatment if the position had only a minimal amount of credit risk as determined by the broker-dealer pursuant to written policies and procedures the broker-dealer established, maintained and enforced to assess creditworthiness. (Commercial paper: zero to ½ of 1%; nonconvertible debt (i.e.: between 2-9%; preferred stock: i.e., 10%) [CFR 240.15c3-1(c)(2)(vi)]
  - OR.....A broker-dealer would be required to take a larger deduction, normally the 15% "catchall" haircut, on its proprietary positions if the firm did not have procedures to assess the creditworthiness or determine the position was not of minimal credit risk.
  - If the proprietary position did not trade in a ready market, the broker dealer would apply a 100% haircut.



Copyright 2016 FINRA | 58

## Removal of credit ratings

### ■ Removal of NRSRO credit ratings:

- The SEC identified factors a broker-dealer could consider, to the extent appropriate, when assessing credit risk for purposes of determining whether an issuance of commercial paper, nonconvertible debt, or preferred stock was of minimal credit risk:
  - Credit spreads; securities-related research; internal or external credit risk assessments; default statistics; inclusion in an index; price, yield and/or volume and others. The list was not intended to be exhaustive.



Copyright 2016 FINRA | 59

# 5 Exam Observations



60

## FinOp Regulatory Issues and Concerns

- **GAAP Financial Statement Accuracy**
  - Revenue and Expense recognition
  - Accruals and Disclosures for loss contingencies
  - Monthly FOCUS reporting vs. Annual Financial Statement
- **Accuracy of Net Capital Calculation**
  - GAAP Netting: circumstances with capital implications
  - Allowable vs. Non-allowable Assets



Copyright 2016 FINRA 61

Questions?



## Enforcement Update and Audit Work Papers

R. Davis Taylor  
Associate Director, Accountant,  
Division of Enforcement and Investigations

Brian Degano  
Associate Chief Auditor, Office of the Chief Auditor

## Agenda

- Today we will discuss:
  - Settled Enforcement Matters Involving Independence in Audits of Broker-Dealers
  - Settled Enforcement Matters Involving Engagement Quality Review Issues
  - PCAOB Ethics and Independence Rules Applicable to Broker-Dealer Audits
  - Staff Practice Alert No. 14, *Improper Alteration of Audit Documentation*

Unless otherwise noted, in 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.

64

## Broker-Dealer Auditor Independence Matters – Timeline of Settlements

- Since December 2014, the Board has entered into settled orders with 25 firms and certain associated persons for violations of independence associated with maintaining the financial records or preparing financial statements of an audit client of the firm
  - December 2014 – seven firms (ordinary offenders)
    - The SEC also settled concurrently with eight other firms for violating independence rules
  - July 2015 – seven firms (ordinary, repeat, and aggravated repeat offenders)
  - October 2015 – three firms (ordinary offenders)
  - March 2016 – five firms (ordinary offenders)
  - September 2016 – three firms (ordinary and aggravated repeat offenders) (first cases in the BD context to involve admissions)

65

## Broker-Dealer Auditor Independence Matters – Timeline of Settlements

- The Board has also announced that two unnamed firms had prepared financial statements, but would not be sanctioned
- The Board awarded credit for extraordinary cooperation based on the firms':
  - Timely and voluntary self-reporting to the PCAOB Tip Line
  - Timely, voluntary, and meaningful remedial actions, including, in one case, communicating the violation to the client and discussing the conduct and violation at an annual firm training session

66

## Broker-Dealer Auditor Independence Matters – Offender Types

- Ordinary Offenders
  - Maintained and prepared accounting records, or prepared client financial statements, but had not received specific inspection comments on this conduct
- Repeat Offenders
  - Received inspection comments noting that preparation of financial statements impaired independence
  - Did things differently thereafter, but still engaged in financial statement preparation activities
- Aggravated Repeat Offenders
  - Continued to prepare audit client's financial statements after receiving inspection comments noting that preparation impaired independence

67

## Broker-Dealer Auditor Independence Matters – Sanctions

- Ordinary Offenders
  - All 19 firms were sanctioned with a censure, a \$2,500 penalty, and remedial measures for independence
- Repeat Offenders
  - The 2 firms were sanctioned with a censure, a \$7,500 penalty, and remedial measures for independence
- Aggravated Repeat Offenders
  - The 4 firms were sanctioned with a censure, a \$15,000-\$20,000 penalty, a 1-year prohibition on new broker-dealer clients, and remedial measures for independence
  - The 4 associated persons sanctioned with a censure and a bar from association, with a right to reapply after one year
  - Three of the associated persons also sanctioned with a \$5,000-\$10,000 penalty; the fourth associated person was sole owner of firm

68

## Broker-Dealer Auditor Independence Matters – Sanctionable Conduct

- For one or more of its Broker-Dealer audit clients
  - Prepared all or a portion of the financial statements, including notes
    - Addition or deletion of line items
    - Aggregation or disaggregation of line items
    - Classification of line items
    - Changes to line item descriptions or amounts
    - Addition, change or deletion of captions
    - Addition of columns or tabular presentations

69

## Broker-Dealer Auditor Independence Matters – Sanctionable Conduct

- For one or more of its Broker-Dealer audit clients
  - Prepared draft statements with placeholders for dollar amounts
  - Obtained drafts but made extensive changes
  - Directed or supervised professionals from another firm to prepare all or a portion of the financial statements that were the subject of the firm's audit opinion
  - Maintained and prepared accounting records

70

## Engagement Quality Review Matters – July 23, 2015 Settlements

- The Board settled disciplinary orders against eight firms and eight associated persons for conduct including violations of AS No. 7, *Engagement Quality Review*
  - EQRs are required for issuer audits and interim reviews, broker-dealer audits, and examinations/reviews of broker-dealer compliance/exemption reports
- Each firm violated one of two requirements
  - **6 firms** – No concurring approval of an EQR was obtained prior to granting permission to the client to use the firm's audit report
    - "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** – Engagement quality reviewer had not satisfied the 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)

71

## Engagement Quality Review Matters – July 23, 2015 Settlements

- With respect to sanctions, the firms fell into one of 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)**
- Each associated person sanctioned with censure and, where firm received revocation, a bar
- Two cases included other audit standard or rule violations
- Note in particular:
  - *R.R. Hawkins*: Inspectors had reminded firm of requirement
  - *Keith K. Zhen, CPA*: Firm had EQR done in earlier audits

72

## Engagement Quality Review Matters

- Engagement Quality Reviewer have a “cooling-off” period requirement (AS No. 7 ¶ 8)
  - Although not subject to partner rotation requirements, engagement quality reviewers are subject to “cooling-off” requirement, unless they qualify for the small firm exemption
  - 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
- Small firm exemption
  - Registered firms that qualify for the exemption under Rule 2-01 (c)(6)(ii) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(6)(ii), are exempt from the “cooling-off” requirement
  - Small Firm = Firm with less than 5 issuer audit clients and less than 10 partners shall be exempt, provided the PCAOB conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence

73

## PCAOB Ethics and Independence Rules Applicable to Broker-Dealer Audits

PCAOB Rule	Applies to B-D Audits
Overall Framework (Rules 3502 and 3520)	Yes
Contingent Fees (Rule 3521)	Yes
Tax Transactions (Rule 3522)	Yes
Tax Services for Persons in Financial Reporting Oversight Roles (Rule 3523)	No
Audit Committee Pre-approval of Certain Tax Services (Rule 3524)	No
Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting (Rule 3525)	No
Communication with Audit Committees Concerning Independence (Rule 3526)	Yes

74

## PCAOB Ethics and Independence Rules Applicable to Broker-Dealer Audits

- Rule 3526 – Communication with Audit Committees Concerning Independence
  - Requires auditors that, prior to being engaged
    - Describe in writing to the audit committee
      - All relationships between the firm or any affiliates of the firm, and the potential audit client or persons in financial reporting oversight roles that may reasonably be thought to bear on the auditor's independence
    - Discuss with the audit committee the potential effects of those relationships on independence
    - Document the substance of the discussion with the audit committee

75

## PCAOB Ethics and Independence Rules Applicable to Broker-Dealer Audits

- Rule 3526 – Communication with Audit Committees Concerning Independence
  - Requires auditors at least annually
    - Perform all the steps required to be performed prior to being engaged
    - Affirm annually, in writing, that the auditor is independent in compliance with Rule 3520
  - Audit Committee (or equivalent body)
    - If none, then individuals overseeing the accounting or financial reporting processes and the audits of the financial statements

76

**Staff Audit Practice Alert No. 14**  
*Improper Alteration of Audit Documentation*

- ❑ Issued April 21, 2016
- ❑ Reminds firms that improper alteration of audit documentation violates PCAOB rules requiring cooperation with Board's oversight activities
- ❑ AS 1215, Audit Documentation (Auditing Standard No. 3) sets forth requirements when making changes to audit documentation after the report release date
  - Audit documentation must not be deleted or discarded after the audit completion date
  - Added documentation must indicate:
    - Date the information was added
    - Name of the person who prepared the additional documentation
    - Reason for adding it

77

**Staff Audit Practice Alert No. 14**  
*Improper Alteration of Audit Documentation*

- ❑ Registered firms should take actions to assure:
  - Work papers are properly archived
  - Work papers, once archived, are not improperly altered
  - Documentation provided to PCAOB inspectors or enforcement staff for an audit is the originally-archived documentation for that audit (supplemented, as appropriate, in accordance with AS1215)
- ❑ Reporting potential violations

78

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

79

PCAOB

**Questions**



## Case Study No. 2: Attestation Standard No. 2

Greg MacCune  
Division of Registration and Inspections

## Overview of Applicable Rules and Standards related to Exemption Report

- ❑ Securities Exchange Act of 1934 ("SEC") Rule 17a-5
- ❑ Attestation Standard No. 2 ("AT 2"), *Review Engagements Regarding Exemption Reports of Brokers and Dealers*

## Engagement Coordination

Where have you found opportunities to coordinate your review engagements with your audits of the broker dealer's financial statements, including the supplemental schedules?

## Background

- ❑ Another Broker Case, Inc. (ABC) introduces customers' transactions to a clearing firm on a fully-disclosed basis
- ❑ ABC's products include equities, bonds, options, and exchange traded funds
- ❑ ABC is required to promptly transmit customer funds and securities to the clearing firm by noon of the business day following receipt
- ❑ ABC's required minimum net capital is \$5,000
- ❑ Key personnel at ABC include its President, FinOP, and Accounting Manager

## Exemption Report

- ABC's Exemption Report for the period January 1, 2015 through December 31, 2015, stated:
  - ABC claimed an exemption from SEC Rule 15c3-3 under the provisions of paragraph (k)(2)(ii), as it carries no margin accounts, promptly transmits all customer funds and securities and does not otherwise hold customer funds or securities
  - ABC met the identified exemption provisions throughout the period, without exceptions
- ABC's Exemption Report was dated February 29, 2016, and signed by its FinOp, who also signed the oath (or affirmation) included in its financial report

85

PCAOB

## Operational Information

- ABC's FinOp, Accounting Manager, and the Accounting Clerk are involved in monitoring compliance with the exemption provisions
- The current FinOp was hired during the year by the President and is the third FinOp in the past two years
- Internal controls relating to the exemption provisions include:
  - Accounting Manager review of the daily checks received log
  - FinOp and Accounting Manager review of deposits to ensure the prompt daily transmittal of customer checks

86

PCAOB

## Operational Information (continued)

- ABC opened its first branch office this year and customers were instructed to send checks and securities directly to the head office
- ABC had a FINRA examination during the year for which the examination report has not yet been issued
- ABC's prior year FINRA examination report revealed findings related to customer checks that were not promptly transmitted

87

PCAOB

## Evaluation of Risk Factors

Given the information provided, what are some potential risk factors associated with the review of ABC's Exemption Report?

88

PCAOB

### Relevant Evidence From Financial Statement Audit Procedures

- ❑ ABC maintains only one bank account per its general ledger, an operating cash account
- ❑ ABC's checks received logs include several checks for which there is not a corresponding deposit in the operating account
- ❑ Through inquiry, the engagement team determined the following:
  - These checks are customer checks received by ABC either at the head office or a branch location
  - Checks are made payable to the clearing broker

89



### Relevant Evidence From Financial Statement Audit Procedures

- ❑ The engagement team selected a sample of cash receipts recorded in the GL and performed tests of details
- ❑ Support obtained for each cash receipt tested indicated that each item was received by the head office and was not received directly from a customer
- ❑ No evidence of exceptions to the exemption provisions were noted through its audit procedures related to cash

90



### Nature, Timing and Extent of Review Procedures

How would the risk factors identified and the procedures performed as part of the financial statement audit affect your review procedures?

91



### Identifying Exceptions

The auditor is required to perform procedures to identify exceptions to the exemption provisions

True or False?

92



## Identifying Exceptions

This page intentionally left blank

93

PCAOB

## Review Procedures and Results

This page intentionally left blank

94

PCAOB

## Reporting

### Report of Independent Registered Public Accounting Firm (Excerpt)

We have reviewed management's statements, included in the accompanying Exemption Report, in which ABC identified the following provisions... under which the Company claimed an exemption from 17 C.F.R. § 240.15c3-3: (k)(2)(i) (the "exemption provisions") and (2) the Company stated that it met the identified exemption provisions...without exception...

...Based on our review, we are not aware of any material modifications that should be made to management's statements referred to above for them to be fairly stated, in all material respects, based on the provisions set forth in paragraph (k)(2)(i)...

*Audit Firm*

City, State

February 22, 2016

95

PCAOB

## Reporting (continued)

Are there any issues with the report as presented based on what we know from the facts of the case study?

96

PCAOB

## Relevant PCAOB Standard

Attestation Standard No. 2: Review Engagements Regarding Exemption Reports of Brokers and Dealers

- <http://pcaobus.org/Standards/Attestation/Pages/AT2.aspx>

97



## Questions?



98



# Lunch

(75 minutes)

## Reorganization of PCAOB Auditing Standards

Brian Degano  
Associate Chief Auditor

100



## Reorganization of PCAOB Auditing Standards

Action	Date
PCAOB adopted amendments to reorganize auditing standards	March 31, 2015
Securities and Exchange Commission approved the amendments	September 17, 2015
<b>Effective date</b>	<b>December 31, 2016</b>

Auditors may begin to use and reference the reorganized PCAOB auditing standards prior to December 31, 2016

101

## Reorganization of PCAOB Auditing Standards – What is Changing?

- The new organizational structure:
  - Renumbers and reorders existing “interim” and Board-issued standards without redrafting, imposing new requirements, or making substantive changes to existing requirements
  - Presents standards in a logical order that generally follows the flow of the audit process
  - Helps users navigate the standards more easily
  - Provides structure for future standard setting

102

## Reorganization of PCAOB Auditing Standards – What is Changing?

In addition, the PCAOB’s amendments to reorganize auditing standards:

- Rescinds certain interim standards no longer necessary
- Retains almost all of the AICPA auditing interpretations
- Replaces references to GAAS throughout with references to PCAOB auditing standards
- Updates titles, cross-references, etc.

103

## Reorganization of PCAOB Auditing Standards – How Will It Be Reorganized?

- Categories in the reorganized framework:
  - AS 1000 General Auditing Standards
  - AS 2000 Audit Procedures
  - AS 3000 Auditor Reporting
  - AS 4000 Matters Relating to Filings Under Federal Securities Laws
  - AS 6000 Other Matters Associated with Audits

104

## Reorganization of PCAOB Auditing Standards – Tools and Other Changes

- ❑ Tools available map:
  - Pre-organized standards to reorganized standards and vice versa
  - PCAOB auditing standards with the analogous standards of the ASB and IAASB
- ❑ Links to applicable guidance within each standard
- ❑ Expands table of contents within each standard for easier navigation
- ❑ Enhances the "Guidance" page to include all auditing interpretations

105

## Reorganization of PCAOB Auditing Standards – How to Access the Reorganized Standards?

The screenshot shows the PCAOB website's 'Auditing Standards' section. A yellow arrow points to the 'Auditing standards - reorganized' link in the left-hand navigation menu.

106

## Reorganization of PCAOB Auditing Standards – Revised Layout

The screenshot shows the 'General Auditing Standards' section of the PCAOB website. A yellow arrow points to the 'AS 1204 - Supervision of the Audit Engagement' link in the table of contents.

107

## Reorganization of PCAOB Auditing Standards – Revised Layout (continued)

The screenshot shows the 'AS 1201: Supervision of the Audit Engagement' page. Two yellow arrows point to specific sections: one points to the 'Guidance' section and another points to the 'Standard appendices' section.

108

## Reorganization of PCAOB Auditing Standards – Reference Tools

The screenshot shows the PCAOB website's 'Auditing Standards' page. A yellow arrow points to a 'Reference Tools' dropdown menu on the right side of the page. The menu options include 'Reference Tools', 'Reorganized by Reorganized', 'PCAOB by 2002 and 2003', and 'Previous Reference Tools'.

109

## Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

The screenshot shows the 'Find an Auditing Standard After the Reorganization' page. A callout box points to a dropdown menu labeled 'Select a PCAOB Standard Before Reorganization'. The callout text reads: 'Select a standard from the drop down list. (e.g., Auditing Standard No. 10, Supervision of the Audit Engagement).'

110

## Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

The screenshot shows the 'Find an Auditing Standard After the Reorganization' page. A callout box points to a table row under 'Corresponding Standards'. The table has two columns: 'BEFORE REORGANIZATION' and 'AFTER REORGANIZATION'. The row for 'AS No. 10, Supervision of the Audit Engagement' has a link in the 'AFTER REORGANIZATION' column. The callout text reads: 'The reorganized standard that appears is an active link to open the respective standard.'

111

## Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

The screenshot shows the 'Find an Auditing Standard After the Reorganization' page. A callout box points to the 'Corresponding Standards' table. The callout text reads: 'Alternatively, you can view a table that includes all auditing standards before and after the reorganization.'

112

## Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

**Find an Auditing Standard After the Reorganization**

BEFORE REORGANIZATION	AFTER REORGANIZATION
AS No. 3, Audit Documentation	AS 1210, Audit Documentation
AS No. 4, Supervision Whether a Privately Reported Material Weakness Constitutes an Error	AS 1145, Supervision Whether a Privately Reported Material Weakness Constitutes an Error
AS No. 6, An Auditor's Internal Control Over Financial Reporting: Threats to Independence and Audit Process	AS 2201, An Auditor's Internal Control Over Financial Reporting: Threats to Independence and Audit Process
AS No. 8, Evaluating Consistency of Financial Statements	AS 2208, Evaluating Consistency of Financial Statements
AS No. 17, Engagement Quality Reviews	AS 1208, Engagement Quality Reviews
AS No. 21, Audit Trail	AS 1201, Audit Trail

113

## Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

**Auditing Standards**

The standards presented below reflect the reorganization of PCAOB auditing standards, which is effective as of December 31, 2010. Transmigrated standards can be searched and selected by auditor before the effective date for existing standards before the reorganization on the found here. (See PCAOB Release No. 2010-0207.)

**General Auditing Standards**

- 1000 General Principles and Philosophical Objectives
  - AS 1001, Independence and Function of the Independent Auditor
  - AS 1002, Independence
  - AS 1003, Training and Proficiency of the Independent Auditor
  - AS 1005, Due Professional Care in the Performance of Work
- 1000 General Concepts
  - AS 1101, Audit Trail
  - AS 1102, Audit Evidence
  - AS 1103, Relationship of Auditing Standards to Quality Control Standards
- 1000 General Activities
  - AS 1201, Supervision of the Audit Engagement
  - AS 1202, Field of the Audit Performed by Other Independent Auditors
  - AS 1203, Receipt of Work of a Specialist
  - AS 1204, Audit Representation

**Reference Tools**

- Reorganized by This Organization
- Reorganized by Reorganized
- PCAOB to ASB and IAASB
- Private Reference Tool

114

## Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

**View All Analogous Standards**

Find PCAOB auditing standards by the analogous standards of the ASB and the IAASB or view all analogous standards.

Select a PCAOB Standard

Select an ASB Standard

Select an IAASB Standard

Select a standard from the drop-down list (e.g., AS 2101, Audit Planning).

115

## Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

Find PCAOB auditing standards by the analogous standards of the ASB and the IAASB or view all analogous standards.

Select a PCAOB Standard

Select an ASB Standard

Select an IAASB Standard

**Analogous Standards**

PCAOB STANDARD	ASB STANDARD	IAASB STANDARD
AS 2101, Audit Planning	ALL-C 302, Planning an Audit	ISA 300, Planning an Audit of Financial Statements

116

As in the previous example, the reorganized standard is an active link to open the respective standard.

## Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

Find PCAOB auditing standards by the analogous standards of the ASB and the IAASB or view all analogous standards.

Select a PCAOB Standard  
AS 2101: Audit Planning

Select an ASB Standard  
AU-C 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards

Select an IAASB Standard  
ISA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Standards on Auditing

Analogous Standards

PCAOB STANDARD	ASB STANDARD	IAASB STANDARD
AS 2101: Audit Planning	AU-C 200: Planning an Audit	ISA 200: Planning an Audit of Financial Statements

117

## Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

Analogous Standards

PCAOB STANDARD	ASB STANDARD	IAASB STANDARD
AS 1101: Responsibilities and Functions of the Independent Auditor	AU-C 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards	ISA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Standards on Auditing
AS 1005: Independence	AU-C 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards	ISA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Standards on Auditing
AS 1010: Training and Proficiency of the Independent Auditor	AU-C 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards	ISA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Standards on Auditing

118

## Reorganization of PCAOB Auditing Standards – Reference Tools (continued)

PCAOB  
U.S. Securities and Exchange Commission

Standards | Regulation & Reporting | Inspections | Enforcement | International | Economic & Risk Analysis | Careers

Auditing Standards

The standards presented below reflect the reorganization of PCAOB auditing standards, which is effective as of December 31, 2010. The reorganized standards can be used and referenced by auditors effective with the auditing standards, before the reorganization can be found here. (See PCAOB Release No. 303-0027.)

General Auditing Standards

- 1000-General Principles and Responsibilities
- AS 1001-Responsibilities and Functions of the Independent Auditor
- AS 1002-Independence
- AS 1003-Training and Proficiency of the Independent Auditor
- AS 1004-Due Professional Care in the Performance of Work

1000-General Concepts

- AS 1101-Audit Risk
- AS 1102-Audit Evidence
- AS 1103-Effectiveness of Auditing Standards to Quality Control Standards

1000-General Activities

- AS 1200-Requirements of the Audit Engagement
- AS 1205-Part of the Audit Performed by Other Independent Auditors
- AS 1210-Unaffiliated Work of Specialist
- AS 1215-Audit Documentation

Reference Tools

- Reorganized by Date
- Reorganized by Responsibility
- PCAOB by ASB and IAASB
- Interactive Reference Tools

119

## Reorganization of PCAOB Auditing Standards – Location of Auditing Interpretations:

At the bottom of "Guidance Related to Standards" page

Auditing Interpretations

The auditing interpretations presented below have been reissued in conjunction with the reorganization of the auditing standards, which is effective as of December 31, 2010. The auditing interpretations before the reorganization can be found here: (See PCAOB Release No. 303-0027.)

The following are auditing interpretations issued by the American Institute of Certified Public Accountants' Auditing Elements Board as to evidence on April 19, 2005, to the extent not superseded or amended by the PCAOB. The auditor should be aware of and consider auditing interpretations applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable auditing interpretation, the auditor should be prepared to explain how he or she complies with the purposes of the auditing standard addressed by such auditing guidance.

- AS 101 - Part of the Audit Performed by Other Independent Auditors: Auditing Interpretations of AS 1205
- AS 11 - Using the Work of a Specialist: Auditing Interpretations of AS 1102
- AS 12 - Communications About Control Deficiencies to the Field of External Stakeholders: Auditing Interpretations of AS 1210
- AS 13 - Requirements for E-Files: Auditing Interpretations of AS 1215

120

## Keeping Current with Standards-Related Activities

- Our website –  
<http://www.pcaobus.org/Standards/Pages/default.aspx>
  - PCAOB standards and related rules, including interim standards
  - PCAOB proposed standards
  - Staff Questions and Answers
  - Staff Audit Practice Alerts
  - Standing Advisory Group
- Contact the Standards-Inquiry Line via the web form or at (202) 591-4395
- Sign up for the PCAOB Updates service to receive a notification via e-mail that briefly describes significant new postings to our website at:  
<http://pcaobus.org/About/Pages/RSSFeeds.aspx>

121

## Questions?



## Case Study No. 3: Proprietary Transactions - Risk Assessment

Mike Walters and Kate Ostasiewski  
Division of Registration and Inspections

## PCAOB Reorganized Standards

### Audit Procedures

#### 1100 General Concepts

- AS 1101 (AS No. 8): *Audit Risk*

#### 2100 Audit Planning and Risk Assessment

- AS 2101 (AS No. 9): *Audit Planning*
- AS 2105 (AS No. 11): *Consideration of Materiality in Planning and Performing an Audit*
- **AS 2110 (AS No. 12): *Identifying and Assessing Risks of Material Misstatement***

124

## Significant Risks

To determine whether an identified and assessed risk is a significant risk, the auditor should evaluate whether the risk requires special audit consideration because of the nature of the risk or the likelihood and potential magnitude of misstatement related to the risk.

125

## Significant Risks

- What are examples of significant risks you have identified on your broker-dealer audits?

126

## Fraud Risks

- A fraud risk is a significant risk
- Presumption of fraud risk involving improper revenue recognition
  - Evaluation is required
- Other factors relevant to identifying fraud risks
  - Incentives / pressures, opportunities, and rationalization
  - Incomplete or inaccurate disclosures
  - Risk of management override of controls

127

Case Study 3: Trusted Securities, Inc.

128

## Background

- Trusted Securities Inc. (TSI) is a broker-dealer that introduces customer trades and trades for its own account:
  - Has a December 31 fiscal year-end
  - Reported \$100,000 minimum dollar net capital requirement
  - Claimed an exemption under Rule 15c3-3 paragraph (k)(2)(ii)
  - Has a clearing and custody arrangement with Clearview
  - Has no recent history of regulatory violations
- Key personnel at TSI include:
  - President (owns 100% of TSI and is the Chief Compliance Officer)
  - Chief Financial Officer (also the Investment Officer)
  - Outside FinOp
  - Ten traders and 25 registered representatives
  - Two accounting and support staff members

129

## Preliminary Information

- Revenues
  - Through September 30, proprietary trading revenues are 70% of total revenues, compared to 21% of total revenues for the prior fiscal year
- Securities Owned
  - As of September 30, 75% of total assets comprised of listed equities and corporate bonds
- Personnel and Compensation Changes
  - Compensation now includes quarterly incentive payments to the traders and the CFO, based on proprietary trading gains

130

## Prior Year Risk Assessment

Account & Assertions	Inherent Risk	Control Risk	RoMM	Significant/Fraud Risk?
Proprietary Trading Revenue (E/O, V/A, C, P&D)	Low	Maximum	Normal	No
Securities Owned (E/O, V/A, C, R&O, P&D)	Low	Maximum	Normal	No

131

## Risk Assessment Procedures

- What risk assessment procedures would you perform for Proprietary Trading Revenue and Securities Owned during planning for this year's audit?

132

## Risk Assessment Procedures

Key components of performing a risk assessment per AS 2110 include:

- ❑ Obtaining an understanding of the company and its environment (paragraphs 7–17);
- ❑ **Obtaining an understanding of internal control over financial reporting (paragraphs 18–40);**
- ❑ Considering information from the client acceptance and retention evaluation, audit planning activities, past audits, and other engagements performed for the company (paragraphs 41–45);
- ❑ Performing analytical procedures (paragraphs 46–48);
- ❑ Conducting a discussion among engagement team members regarding the RoMM (paragraphs 49–53);
- ❑ Inquiring of the audit committee, management, and others within the company about the RoMM (paragraphs 54–58); and
- ❑ Identify significant accounts and disclosures and their relevant assertions (paragraphs 60–64).

133

## Understanding Internal Control Over Financial Reporting

- ❑ Obtain an understanding sufficient to:
  - a) Identify the types of potential misstatements
  - b) Assess the factors that affect the risks of material misstatement
  - c) Design further audit procedures
- ❑ Evaluate design and implementation
- ❑ Understand internal control over financial reporting
- ❑ Understand controls responsive to fraud risks

134

## Understanding Internal Control Over Financial Reporting (continued)

Inquired of President, CFO, and FinOp regarding TSI's processes for recording Proprietary Transaction (PT) Revenue and Securities Owned transactions, and understood the following:

1. Each trader records PT transactions in a trade blotter
2. The accounting staff reconciles each trade blotter to Clearview statements and reports monthly, and records PT Revenue and Securities Owned in the G/L based on the statements / reports
3. The CFO performs a detailed monthly review of these reconciliations related to PT Revenue and Securities Owned, and approves any adjusting entries
4. The President reviews monthly cash reconciliations prepared by the accounting staff, including cash held in Clearview accounts

135

## Understanding Internal Control Over Financial Reporting (continued)

- ❑ How would you evaluate the design and implementation of the control?
- ❑ What additional procedures would you perform, if any, to reach your conclusion?

136

## Revised Risk Assessment

- ❑ Based on the risk assessment procedures performed, what changes to the prior year risk assessment related to PT Revenue and Securities Owned would you recommend and why?
- ❑ Have you identified any significant or fraud risks in these areas? Why or why not?

137

## Risk Assessment

Account & Assertions	Inherent Risk	Control Risk	RoMM	Significant/ Fraud Risk?
Proprietary Trading Revenue (E/O, V/A, C)	High	Maximum	High	Yes
Proprietary Trading Revenue (P&D)	Normal	Maximum	Normal	No
Securities Owned (E/O, V/A, C, R&O, P&D)	Normal	Maximum	Normal	No

138

## Relevant PCAOB Standards

- ❑ AS 1101: Audit Risk
  - <http://pcaobus.org/Standards/Auditing/Pages/AS1101.aspx>
- ❑ AS 1105: Audit Evidence
  - <http://pcaobus.org/Standards/Auditing/Pages/AS1105.aspx>
- ❑ AS 2110: Identifying and Assessing Risks of Material Misstatement
  - <http://pcaobus.org/Standards/Auditing/Pages/AS2110.aspx>
- ❑ AS 2301: The Auditor's Responses to the Risks of Material Misstatement
  - <http://pcaobus.org/Standards/Auditing/Pages/AS2301.aspx>

139

## Questions?



## Inspections: Observations and Trends

Bob Maday and Kate Ostasiewski  
Division of Registration and Inspections

Brian Degano  
Office of the Chief Auditor

## Agenda

- ❑ Summary of Interim Inspection Program
- ❑ 2016 Inspection Plan
- ❑ Inspection Observations
- ❑ Actions for Auditors
- ❑ Questions

1  
4  
2

## Interim Inspection Program - Objective

- ❑ Assess compliance with applicable Board and Commission rules and PCAOB 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

1  
3  
4

## Interim Inspection Process

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

1  
4  
4

### 2016 Interim Inspection Program Plan

- ❑ 75 firms and portions of 115 audit and attestation engagements
- ❑ Audits of financials statements and supplementary schedules of brokers and dealers required to be performed in accordance with PCAOB standards
- ❑ Examination and Review Engagements required to be performed in accordance with PCAOB standards
- ❑ Areas of Inspection Focus

1  
4  
5

### Interim Inspection Program - Disclaimer

The information presented in the following slides is not necessarily indicative of the full population of firms, or of all audit and attestation engagements of brokers and dealers, because the selection of firms for inspection and the audit and attestation engagements for brokers and dealers covered by the inspections is not necessarily representative of these populations.

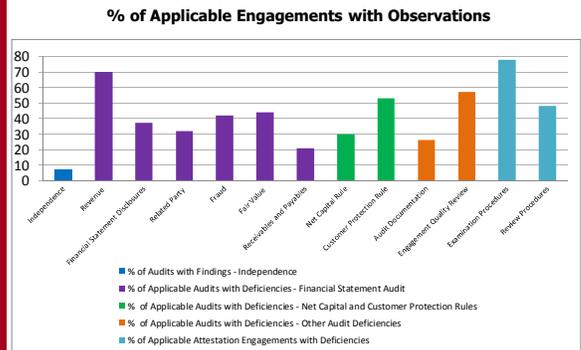
1  
4  
6

### Interim Inspection Program – Reporting

- ❑ Annual Report on the Interim Inspection Program related to Audits of Brokers and Dealers (August 18, 2016)
- ❑ Staff Inspection Briefs
  - Preview of Observations from 2015 Inspections of Auditors of Brokers and Dealers (April 2016)
  - Information about 2016 Inspections of Auditors of Brokers and Dealers (July 2016)

1  
4  
7

### Inspections Observations by Area - 2015



148

## Compliance with Independence Requirements

- ❑ 8 firms failed to satisfy independence requirements by:
  - Performing bookkeeping or other services related to the accounting records or the financial statements
  - Assisting in the preparation of the Broker-Dealer's exemption report
- ❑ 12 instances where firms failed to comply with PCAOB Rule 3526: *Communications with Audit Committees Concerning Independence*

149

## Financial Statement Audit

Frequency of audit deficiencies related to:

- ❑ Revenue (70%)
- ❑ Engagement Quality Review (57%)
- ❑ Fair Value Measurements (44%)
- ❑ Fraud (42%)
- ❑ Related Party Transactions (32%)
- ❑ Receivables and Payables (21%)

150

## 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
- ❑ Possession or control requirements

151

## Attestation Engagements

Examination Procedures

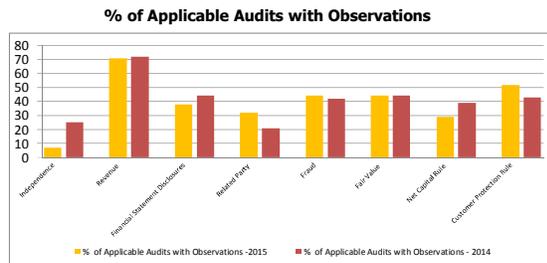
- ❑ Planning the examination
- ❑ Testing controls over compliance
- ❑ Performing compliance tests

Review Procedures

- ❑ Reading the exemption report
- ❑ Inquiring and other procedures
- ❑ Evaluating the evidence

152

## Inspections Observations by Audit Area – 2015 Compared to 2014



153

## 2015 Inspections

### Engagement Quality Review

- Required
- Evaluation of significant judgments and conclusions

### Audit Documentation

- Engagement completion document required
- Identification of significant findings or issues

154

PCAOB

## Engagement Completion Document – Question #1

- Which is not an example of a significant finding or issue that must be documented in an engagement completion document per AS 1215, *Audit Documentation*?
  - A. Significant matters regarding the selection, application, and consistency of accounting principles and disclosures
  - B. Accumulated misstatements and an evaluation of uncorrected misstatements
  - C. Risks of material misstatement determined to be significant risks and the results of auditing procedures performed
  - D. Assessment of the skills and qualifications of the engagement team
  - E. Circumstances that cause difficulty in applying auditing procedures

155

PCAOB

## Engagement Completion Document – Question #1

This page intentionally left blank

156

PCAOB

## Engagement Completion Document – Standards

This page intentionally left blank

157

PCAOB

## Audit Documentation Completion – Question #2

- The auditor must have completed all necessary auditing procedures and obtained sufficient evidence to support the representations in the auditor's report prior to the report release date. Per AS 1215, *Audit Documentation*, a complete and final set of audit documentation should be assembled for retention as of a date not more than:
  - A. 60 days after the report release date
  - B. 45 days after the report release date
  - C. 30 days after the report release date
  - D. None of the above

158

PCAOB

## Audit Documentation Completion – Question #2

This page intentionally left blank

159

PCAOB

## Audit Documentation Completion – Standards

This page intentionally left blank

160

PCAOB

### Engagement Quality Reviewer Qualifications – Question #3

- What are required qualifications for an engagement quality reviewer per AS 1220, *Engagement Quality Review*:
  - A. Must be independent, perform the review with integrity, and maintain objectivity
  - B. Must have served as the engagement partner on at least one of two audits preceding the audit subject to review
  - C. If from the firm that issues the report, must be a partner or another individual in an equivalent position
  - D. All of the above
  - E. Both A and C

161

PCAOB

### Engagement Quality Reviewer Qualifications – Question #3

This page intentionally left blank

162

PCAOB

### Engagement Quality Reviewer Qualifications

This page intentionally left blank

163

PCAOB

### Engagement Quality Review Process – Question #4

- The engagement quality reviewer is not required to review or evaluate per AS 1220, *Engagement Quality Review*:
  - A. The engagement completion document
  - B. The engagement team's evaluation of the firm's independence in relation to the engagement
  - C. The engagement team's assessment of, and audit responses to, significant risks, including fraud risks
  - D. The management representation letter
  - E. Significant judgments about materiality and the disposition of corrected and uncorrected identified misstatements

164

PCAOB

## Engagement Quality Review Process – Question #4

This page intentionally left blank

165

PCAOB

## Engagement Quality Review Process – Standards

This page intentionally left blank

166

PCAOB

## Actions for Auditors

- ❑ Be proactive – consider how to prevent similar deficiencies from occurring
- ❑ Take appropriate action when audit and attest deficiencies are discovered after the date of the reports
- ❑ Ensure understanding of, and compliance with, independence requirements
- ❑ Review PCAOB guidance and participate in periodic Forums and webcasts
- ❑ Standards Inquiry: 202-591-4395

167

PCAOB

## Questions?



PCAOB

Break

## Case Study No. 4: Proprietary Transactions – Audit Response

Greg MacCune and Kate Ostasiewski  
Division of Registration and Inspections

### PCAOB Reorganized Standards

2300 Audit Procedures in Response to Risks—Nature, Timing, and Extent

- **AS 2301 (AS No. 13): *The Auditor's Responses to the Risks of Material Misstatement***

2500 Audit Procedures for Certain Accounts or Disclosures

- AS 2502 (AU No. 328): *Auditing Fair Value Measurements and Disclosures*

2600 Special Topics

- AS 2601 (AU No. 324): *Consideration of an Entity's Use of a Service Organization*

2700 Auditor's Responsibilities Regarding Supplemental and Other Information

- AS 2701 (AS No. 17): *Auditing Supplemental Information Accompanying Audited Financial Statements*

Case Study 4: Trusted Securities, Inc.

## Response to Risks of Material Misstatement

Account & Assertions	Inherent Risk	Control Risk	RoMM	Significant/ Fraud Risk?
Proprietary Trading Revenue (E/O, V/A, C)	High	Maximum	High	Yes
Proprietary Trading Revenue (P&D)	Normal	Maximum	Normal	No
Securities Owned (E/O, V/A, C, R&O, P&D)	Normal	Maximum	Normal	No

## Response to Risks of Material Misstatement (continued)

Account & Assertions	Inherent Risk	Control Risk	RoMM	Significant/ Fraud Risk?
Proprietary Trading Revenue (E/O, V/A, C)	High	Maximum	High	Yes
Proprietary Trading Revenue (P&D)	Normal	Maximum	Normal	No
Securities Owned (E/O, V/A, C, R&O, P&D)	Normal	Maximum	Normal	No

How should the risk assessments affect the auditor's procedures?

## Response to the Risks of Material Misstatement (continued)

- Plan and perform procedures to address the risks at the relevant assertion level
- Perform substantive procedures in response to fraud risks
- Evaluate the relevance of other standards
- Coordinate the audit of the financial statements and supplemental information

## Response to Risks of Material Misstatement (continued)

As the auditor of TSI, how would you address the following:

- Plan procedures to address the risks at the assertion level
- Substantive procedures in response to the assessed fraud risk
- The relevance of other standards
- Coordination of the audit of the financial statements and supplemental information

## Audit Procedures

These are the procedures performed by the engagement team to test PT Revenue:

1. From TSI's monthly trade blotter, selected a sample of trades and trace to the corresponding Clearview trading reports
2. From the monthly Clearview trading reports, selected a sample of trades and trace to TSI's monthly trade blotter
  - a) For both, agreed trade relevant information including whether it is a buy or sell, date, securities price, quantity, trader, and totals
3. Selected a sample of transactions throughout the year from Clearview statements and tested the pricing of the securities traded
4. Recalculated the realized gain or loss without material exception for the total purchases and sales of the Clearview report

## Audit Procedures (continued)

5. Traced net PT gains / losses from a sample of monthly Clearview statements to TSI's general ledger and vouched net cash settlements to the Clearview trading account
6. Recalculated the total unrealized PT gains and losses using the current year-end and prior year-end fair values
7. Reviewed the financial statement disclosures related to PT revenue and compared to GAAP disclosure requirements noting transactions are accounted for on a trade date basis; and
8. Reconciled the total PT gain per the financial statements to the general ledger

## Audit Procedures (continued)

Regarding the first two audit procedures.

1. From TSI's monthly trade blotter, selected a sample of trades and trace to the corresponding Clearview trading reports
2. From the monthly Clearview trading reports, selected a sample of trades and trace to TSI's monthly trade blotter

If these procedures were not performed, what would the engagement team need to consider regarding information from Clearview?

## Use of a Service Organization

*AS 2601: Consideration of Entity's Use of a Service Organization*

## Securities Owned

- At year-end, TSI holds exchange-traded equity securities and corporate bonds
- TSI's agreement with Clearview includes a custody arrangement
- Footnotes to TSI's financial statements disclosed the following:

	Level 1	Level 2
Equities	\$10,000,000	\$ -
Corporate bonds	\$ -	\$20,000,000

## Audit Procedures

These are the procedures performed by the engagement team to test Securities Owned:

1. Obtained a confirmation from Clearview of all TSI securities held in custody at year end and their respective fair values
2. Compared individual positions confirmed to an inventory listing provided by TSI
3. Traced the total fair value of all securities confirmed to the general ledger
4. Traced total equity and corporate bond fair values to the financial statement footnotes

Note: Revenue procedures included testing pricing for a sample of securities traded during the year

## Audit Procedures (continued)

What other procedures should the engagement team perform?

## Supplemental Information

What opportunities are there to coordinate the audit of the financial statements and supplemental information?

## Audit Procedures

These are the procedures performed by the engagement team to test Haircut Charge on Securities:

1. Obtain and review TSI's detailed haircut schedule and tested the mathematical accuracy
2. Compare the haircuts per the haircut schedule to the amounts disclosed on the supplemental schedule and FOCUS report
3. Compare a sample of individual securities per the haircut schedule to the report used to test the securities owned
4. Recalculate the haircut taken for a sample of individual securities

## Audit Procedures (continued)

What additional procedures, if any, might be necessary to obtain reasonable assurance regarding the securities haircuts?

## Relevant PCAOB Standards

- ❑ AS 1105: *Audit Evidence*
  - <http://pcaobus.org/Standards/Auditing/Pages/AS1105.aspx>
- ❑ AS 2110: *Identifying and Assessing Risks of Material Misstatement*
  - <http://pcaobus.org/Standards/Auditing/Pages/AS2110.aspx>
- ❑ AS 2301: *The Auditor's Responses to the Risks of Material Misstatement*
  - <http://pcaobus.org/Standards/Auditing/Pages/AS2301.aspx>
- ❑ AS 2502: *Auditing Fair Value Measurements and Disclosures*
  - <http://pcaobus.org/Standards/Auditing/Pages/AS2502.aspx>
- ❑ AS 2601: *Consideration of an Entity's Use of a Service Organization*
  - <http://pcaobus.org/Standards/Auditing/Pages/AS2601.aspx>
- ❑ AS 2701: *Auditing Supplemental Information Accompanying Audited Financial Statements*
  - <http://pcaobus.org/Standards/Auditing/Pages/AS2701.aspx>

187

## Questions?



## Audit Risk Considerations- Fraud

Bob Maday and Kate Ostasiewski  
Division of Registration and Inspections

### Agenda

- Perspective on Fraud
- Frauds
  - Overview
  - Schemes, Conversion, and Concealment Techniques
  - Examples
- Audit Considerations

100

### Overview

- Well-Known Frauds
  - Madoff (2008) - \$20 billion, clearing and carrying broker-dealer
  - Stanford (2009) - \$8 billion, introducing broker-dealer

101

### Overview (continued)

- SIPC liquidations from 1995 to 2010 : 77
  - \$900 million of SIPC advances paid to customers
- Not covered by SIPCs
  - Reported amounts were \$28 billion
- Occurred at broker-dealers with varied characteristics
- Owners or registered representatives often the perpetrators
- Related parties frequently played a role
- SIPC coverage

102

### Fraud Action Triangle



### Schemes

- ❑ Theft of customer assets
- ❑ Market and price manipulation
- ❑ Unauthorized trading
- ❑ Financial reporting

### Schemes – Audit Considerations

- ❑ General Standards and Responsibilities
- ❑ Assessing Risk of Material Misstatement
- ❑ Responding to Risk and Evaluating Audit Results
- ❑ Attestation Engagements

### Concealment

- ❑ False sales offering disclosures
- ❑ "Off the books" record keeping, falsified financial statements
- ❑ Fictitious holdings, false customer statements, fake trade confirmations
- ❑ Misstated net capital and reserve requirements
- ❑ Related party structures, fraudulent charges and transactions
- ❑ General ledger entries that hide trading losses
- ❑ Hire auditor with limited industry experience

### Concealment – Audit Considerations

- ❑ Audit Evidence
  - Assets
  - Revenues
  - Supplemental Information
  - Journal Entries
  - Trade Confirmations / Customer Statements
- ❑ Related Party Audit Requirements

107

### Conversion

- ❑ “Off the books” bank accounts
- ❑ Divert customer checks to indistinguishable affiliates
- ❑ Management fees
- ❑ Gains on principal trading
- ❑ Commissions earned
- ❑ Partner draw/profits

108

### Conversion – Audit Considerations

- ❑ Cash and Revenue
- ❑ Related Party Audit Requirements
- ❑ Supplemental Information
  - Net Capital
  - Reserve
- ❑ Attestation Engagements

109

### Examples

- ❑ Example 1: Introducing broker-dealer
  - *Perpetrator:* Registered Representative
  - *Scheme:* Sale of fictitious certificates of deposit and promissory notes
  - *Customer losses:* \$2.3 million, 27 customers
- ❑ Example 2: Introducing broker-dealer
  - *Perpetrator:* Owner
  - *Scheme:* Sale of unauthorized promissory notes, fictitious money market funds
  - *Customer losses:* \$35 million
- ❑ Example 3: Introducing broker-dealer
  - *Perpetrator:* Owner
  - *Scheme:* Sale of fictitious tax-free bonds, money market funds
  - *Customer losses:* \$10 million, 131 customers

200

## Overall Audit Considerations

- ❑ Knowledge of industry, broker-dealer operations
- ❑ Understand relationships with affiliates
- ❑ Professional skepticism
- ❑ Testing of revenues and customer trades
- ❑ Assessment of exemption claimed related to the receipt of customer funds
- ❑ Net capital computation
- ❑ Validity of adjusting entries

204

## Relevant PCAOB Standards

AS No. 1015, *Due Professional Care in the Performance of Work*

<http://pcaobus.org/Standards/Auditing/Pages/AS1015.aspx>

AS No. 2110, *Identifying and Assessing Risks of Material Misstatement*

AS No. 2301, *The Auditor's Responses to the Risks of Material Misstatement*

AS No. 2401, *Consideration of Fraud in a Financial Statement Audit*

<http://pcaobus.org/Standards/Auditing/Pages/AS2401.aspx>

AS No. 2410, *Related Parties*

AS No. 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements*

AT No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*

<http://pcaobus.org/Standards/Attestation/Pages/AT1.aspx>

AT No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*

203

## PCAOB/SEC/FINRA Panel

Moderator: Jay Hanson

PCAOB

PCAOB

## Closing Remarks