

Webinar: Update for Auditors of Broker-Dealers

December 5, 2019

Welcome

Brian Goodnough, Office of External Affairs

Disclaimer

One of the benefits of today's session is that you will hear firsthand from numerous PCAOB staff members. 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 PCAOB activities with registered public accounting firms that audit the financial statements of broker-dealers. The webinar, facilitated by staff from the PCAOB's Division of Registration and Inspections, features a discussion of current topics; an overview of inspection findings; and case studies covering auditing of revenue, audit sampling, and review procedures for broker-dealer exemption reports.

Course Description

The PCAOB Broker-Dealer Forum webinar is a 2.5 hour program that will offer attendees the opportunity to interact with the PCAOB and learn more about its programs and activities, including updates on current activities.

Program Evaluation

Your feedback is very important to us. Please take a moment and complete the program evaluation via the link below.

<https://www.surveymonkey.com/r/OEA-BDFwebinar>

Contact the PCAOB

Contact Link

<https://pcaobus.org/About/Pages/Contact.aspx>

General Information

info@pcaobus.org **OR** outreach@pcaobus.org

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Broker-Dealer Auditor Oversight: Overview and Current Topics

Kate Ostasiewski, Division of Registration and Inspections

Mike Walters, Division of Registration and Inspections

Poll: Which option best describes your firm?

1. My firm audits Exemption Report and Compliance Report filers
2. My firm audits Exemption Report filers only
3. My firm audits Compliance Report filers only
4. My firm audits issuers, but does not audit broker-dealers
5. My firm does not audit issuers or broker-dealers

System of Quality Control

The quality control policies and procedures applicable to a firm's accounting and auditing practice should encompass the following elements:

- Independence, Integrity, and Objectivity
- Personnel Management
- Acceptance and Continuance of Clients and Engagements
- Engagement Performance
- Monitoring

Poll: Which element of quality control do you view as the strongest at your firm?

1. Independence, Integrity, and Objectivity
2. Personnel Management
3. Acceptance and Continuance of Clients and Engagements
4. Engagement Performance
5. Monitoring

Audit Materiality

Materiality affects each phase of the audit:

- Planning and Risk Assessment
- Execution
- Evaluating Audit Results

Poll: Which of the following have you most frequently used as a benchmark when establishing materiality for broker-dealer audits?

1. Revenues
2. Net Income
3. Assets
4. Net Capital
5. Excess Net Capital
6. Something Else

Internal Controls

- Management review controls
- Controls-reliance strategies

Poll: Which of the following technologies have you encountered in broker-dealer audits?

1. Distributed Ledger Technology Applications (such as cryptocurrencies)
2. Web-Based Applications
3. Robotic Process Automation
4. All of the above
5. None of the above

Emerging Technologies

Consider the following questions as you encounter emerging technologies:

- Have you performed an appropriate risk assessment?
- Do you have the right people?
- Do you understand the audit evidence you need?

SEC FAQ Concerning Rule 17a-5

Concerning the July 30, 2013 Amendments to the Broker-Dealer Financial Reporting Rule:

“The broker-dealer’s exemption report should fully reflect the nature of all of its business activities. It is common for both of the exemption provisions in paragraph (k)(2) of Rule 15c3-3 to apply to the business activities of an introducing broker-dealer. In such cases, the broker-dealer should reflect both exemption provisions supporting its claim of exemption in the exemption report, and should also identify any applicable exceptions under each.”

(Updated November 29, 2018)

Poll: Which of the following best describes your broker-dealer client base?

1. Broker-dealers that have included more than one exemptive provision in their Exemption Report
2. Broker-dealers that have filed Exemption Reports without specifying a provision under paragraph (k) of Rule 15c3-3
3. Both 1 and 2
4. Neither 1 nor 2

Questions



Inspections Update

Kate Ostasiewski, Division of Registration and Inspections

Mike Walters, Division of Registration and Inspections

Agenda

- Inspection Program Overview
- 2019 Inspections
- 2018 Inspection Results
 - Overview
 - System of Quality Control
 - Review Engagements (AT No. 2)
 - Audit Engagements
- Actions for Auditors

Inspection Program Overview

- 2002 – Sarbanes-Oxley Act
- 2008 – Expiration of SEC waiver from PCAOB registration for auditors of non-public broker-dealers
- 2010 – Dodd Frank Wall Street Reform and Consumer Protection Act
- 2011 – PCAOB adopts Rule 4020T, *Interim Inspection Program Related to Audits of Brokers and Dealers*, and inspections begin in the fourth quarter
- 2013 – SEC adopts amendments to Rule 17a-5 and Financial Responsibility Rules
- 2013 – PCAOB adopts AT No.1 and AT No. 2
- 2014 – PCAOB standards required for audits and attestation engagements and broker-dealers required to file Compliance or Exemption Reports (fiscal years ended on or after June 1)

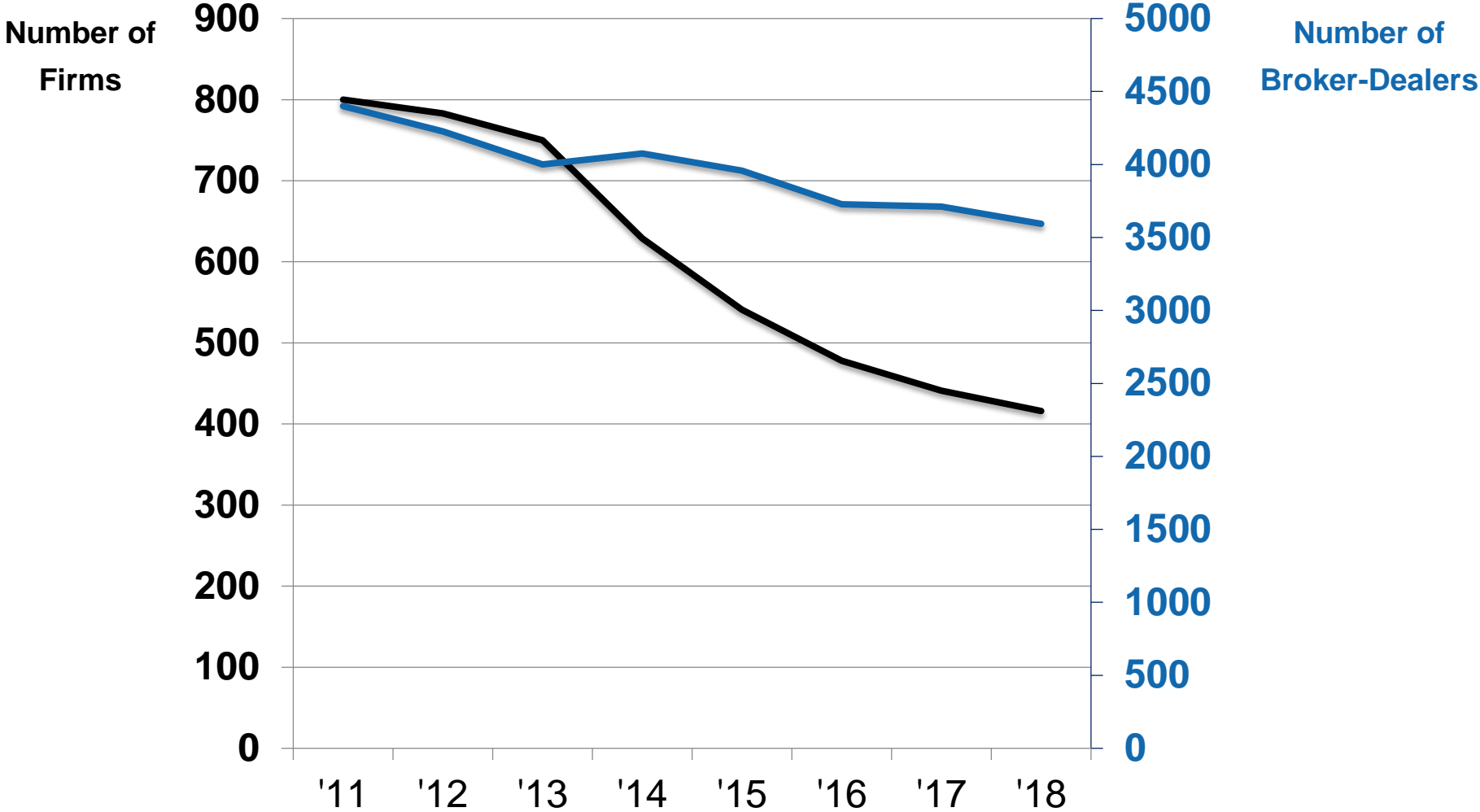
Inspection Program Objectives

- 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

PCAOB Webpage for Auditors of Broker-Dealers

- Information for Auditors of Broker-Dealers:
<https://pcaobus.org/Pages/BrokerDealers.aspx>
- Annual Report on Inspections of Broker-Dealer Auditors during 2018
- Inspection Program Background
- Useful Links
 - Previous Annual Reports and Staff Inspection Briefs
 - Standards and Staff Guidance
 - Other Releases and Guidance
 - Enforcement, Including Recent Settled Orders
 - Outreach, Including Forums and Webinars

Firms Auditing Broker-Dealers and Number of Broker-Dealers



Source: PCAOB Office of Economic and Risk Analysis

Firms Auditing Broker-Dealers

Broker-Dealer Audits per Firm	Number of Firms - 2018	Percentage of Firms - 2018	Number of Firms - 2012	Percentage of Firms - 2012
1	128	31%	363	46%
2 to 20	247	59%	383	49%
21 to 50	26	6%	23	3%
51 to 100	11	3%	8	1%
More than 100	4	1%	6	1%
Total	416	100%	783	100%

Source: PCAOB Office of Economic and Risk Analysis

2019 Inspections

- Firm quality control procedures
- Audits of the financial statements and supporting schedules, required to be performed in accordance with PCAOB standards
- Examination and review engagements, required to be performed in accordance with PCAOB standards

Inspection Results

- Not necessarily indicative of the full population of firms, or of all audit and attestation engagements of brokers and dealers
- The selection of firms for inspection and the audit and attestation engagements for brokers and dealers covered by the inspections are not necessarily representative of these populations

Poll: Have you read the most recent Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers, issued August 20, 2019?

1. Yes
2. No

2018 Inspections By the Numbers

2018 Inspections By the Numbers	
67	Firms inspected
3	with no deficiencies
105	Audit engagements
25	with no audit deficiencies
55	with audit and attestation deficiencies
25	with audit deficiencies, but no attestation deficiencies
24	Examination engagements
6	with no deficiencies
79	Review engagements
36	with no deficiencies

Source: Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers, August 20, 2019

Systems of Quality Control

- Engagement Performance
 - Audit Methodology
 - Engagement Quality Review
 - Auditor's Report
 - Audit Documentation
- Monitoring

Summary of Findings and Deficiencies – 2018

Percentage of				
Audits with Independence Findings	Audits with Audit and Other Deficiencies	Areas with Audit and Other Deficiencies	Examinations with Attestation and Other Deficiencies	Reviews with Attestation and Other Deficiencies
5%	76%	32%	75%	54%

Source: Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers, August 20, 2019

Audits per Firm – Cumulative* Deficiencies

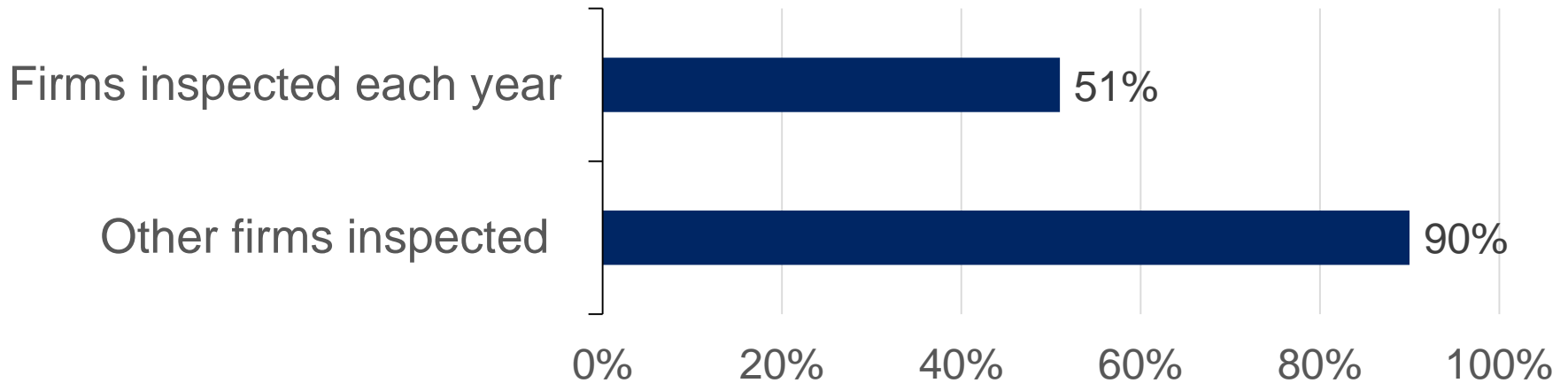
Number of Broker-Dealer Audits per Firm	Percentage of			
	Audits with Audit and Other Deficiencies	Areas with Audit and Other Deficiencies	Examinations with Attestation and Other Deficiencies	Reviews with Attestation and Other Deficiencies
1	90%	54%	100%	69%
2 to 20	94%	45%	93%	61%
21 to 50	72%	31%	100%	32%
51 to 100	78%	35%	100%	35%
More than 100	55%	14%	55%	19%

* Includes inspections conducted 2014 - 2018 that covered engagements required to be performed in accordance with PCAOB standards.

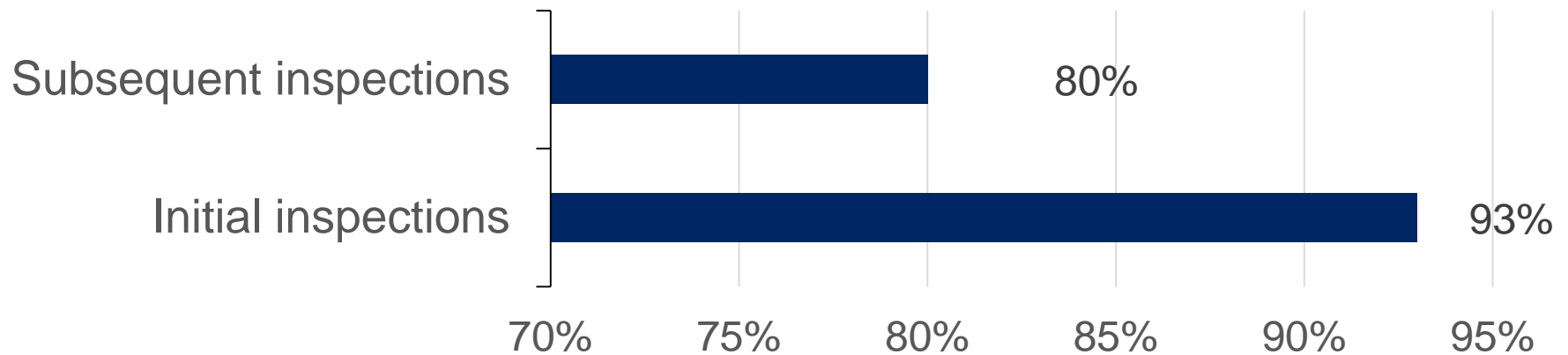
Source: Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers, August 20, 2019

Inspection Frequency – 2015 through 2018

Percentage of 2018 Audits with Deficiencies



Audit Deficiency Percentage for Firms Inspected Twice



Sources: Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers, August 20, 2019 and 2018 inspection results.

Attestation, Audit, and Other Deficiencies

Deficiencies	Applicable Engagements with Deficiencies	
	Number	Percentage
Deficiencies in Attestation Procedures		
Examination Engagements	18	75%
Review Engagements	40	51%
Deficiencies in Auditing Supporting Schedules		
Net Capital Rule	19	29%
Customer Protection Rule	9	36%
Deficiencies in Auditing Financial Statements		
Revenue	60	60%
Risks of Material Misstatement Due to Fraud	8	47%
Related Party Relationships and Transactions	21	45%
Financial Statement Presentation and Disclosures	38	36%
Receivables and Payables	6	21%
Fair Value Measurements	3	14%

Source: Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers, August 20, 2019

Attestation, Audit, and Other Deficiencies

Deficiencies	Applicable Engagements with Deficiencies	
	Number	Percentage
Deficiencies in Auditor's Report		
Auditor's Report on the Financial Statements and Supporting Schedules	19	18%
Deficiencies in Auditor Communications		
Communications to the Audit Committee (or equivalent)	9	18%
Communications about Control Deficiencies	4	4%
Deficiencies in Documentation		
Audit Documentation	26	25%
Examination Documentation	0	0%
Review Documentation	13	16%
Deficiencies in Engagement Quality Reviews		
Audit Engagements	54	65%
Examination Engagements	5	26%
Review Engagements	22	43%

Source: Annual Report on the Interim Inspection Program Related to Audits of Brokers and Dealers, August 20, 2019

Revenue

- Risk Assessment Procedures
- Extent of Testing
- Substantive Analytical Procedures
- Information about Controls at the Broker-Dealer's Service Organization
- Information Produced by the Broker-Dealer or the Broker-Dealer's Service Organization
- Other Procedures to Test Revenue

Review Engagements

- An Understanding of Exemption Provisions
- Inquiries of Management
- Evaluation of Evidence
- Evaluation of Results
- Management Representations
- Auditor's Review Report

Financial Statement Presentation and Disclosures

- Financial Statement Presentation
- Related Party Disclosures
- Going Concern Disclosures
- Revenue Recognition Policy Disclosures
- Risks and Uncertainties Disclosures
- Fair Value Disclosures

Supporting Schedules - Net Capital Rule

- Minimum Net Capital Requirements
- Adjustments to Net Worth
- Allowable Assets and Assets not Readily Convertible into Cash
- Haircuts for Securities Positions
- Operational Charges and Other Deductions
- Securities Classified as Marketable

Related Party Relationships and Transactions

- Risk Assessment Procedures
- Audit Responses to Risks of Material Misstatement
- Evaluation of the Broker-Dealer's Identification of Related Parties and Relationships and Transactions with Related Parties

Engagement Quality Reviews

- Reviews were not performed
- Qualifications for reviewers
- Evaluation of the engagement team's significant judgments and conclusions

Questions



BREAK (10 minutes)

Case Studies

Kate Ostasiewski, Division of Registration and Inspections

Mike Walters, Division of Registration and Inspections

Auditing Revenue

Revenue Recognition – ASC 606

Step 1:

Identify the contract(s) with a customer

Step 2:

Identify the performance obligations in the contract

Step 3:

Determine the transaction price

Step 4:

Allocate the transaction price to the performance obligations

Step 5:

Recognize revenue when (or as) each performance obligation is satisfied

Poll: The accounting for which of the following was NOT affected by ASC 606?

1. Interest and dividend income from financial instruments owned
2. Interest income from reverse repos and securities borrowed
3. Proprietary trading income
4. All of the above
5. None of the above

Poll: The accounting for which of the following was NOT affected by ASC 606?

1. Interest and dividend income from financial instruments owned
2. Interest income from reverse repos and securities borrowed
3. Proprietary trading income
- 4. All of the above**
5. None of the above

Auditing Revenue - Case Study Facts

- Broker-dealer provides advisory services related to mergers and acquisitions
- Contracts with customers include success fees and nonrefundable retainer fees; the retainer fees are payable at execution, and credited to success fees (if any)
- Engagement team assessed improper revenue recognition to be a fraud risk
- Engagement team procedures included reviewing a sample of customer contracts and obtaining an understanding of (1) the services to be provided and (2) the broker-dealer's compensation. In addition:
 - For success fees, obtaining evidence that the merger or acquisition closed, and vouching payments received
 - For retainer fees, reviewing invoices and vouching payments received

Poll: The engagement team's procedures for success fees provide sufficient evidence regarding which of the following?

1. Completeness
2. Cutoff
3. Occurrence
4. Valuation or Allocation
5. Presentation & Disclosure

Poll: The engagement team's procedures for success fees provide sufficient evidence regarding which of the following?

1. Completeness

2. Cutoff

3. Occurrence

4. Valuation or Allocation

5. Presentation & Disclosure

Poll: For retainer fees, in addition to reviewing invoices and vouching payments received, the engagement team compared the invoiced amounts to the customer's contract with the broker-dealer. When evaluating the broker-dealer's recognition of the retainer fees, the engagement team should also evaluate the broker-dealer's consideration of which of the following?

1. The performance obligation(s) in the contract
2. Whether the criteria for over time recognition has been met
3. Whether the customer simultaneously receives and consumes the benefits provided by the broker-dealer as the broker-dealer performs
4. All of the above

Poll: For retainer fees, in addition to reviewing invoices and vouching payments received, the engagement team compared the invoiced amounts to the customer's contract with the broker-dealer. When evaluating the broker-dealer's recognition of the retainer fees, the engagement team should also evaluate the broker-dealer's consideration of which of the following?

1. The performance obligation(s) in the contract
2. Whether the criteria for over time recognition has been met
3. Whether the customer simultaneously receives and consumes the benefits provided by the broker-dealer as the broker-dealer performs
- 4. All of the above**

Poll: Which of the following is a required disclosure under ASC 606?

1. Revenue recognized from contracts with customers
2. Disaggregation of revenue
3. Information about performance obligations
4. Significant judgments in applying ASC 606
5. All of the above

Poll: Which of the following is a required disclosure under ASC 606?

1. Revenue recognized from contracts with customers
2. Disaggregation of revenue
3. Information about performance obligations
4. Significant judgments in applying ASC 606
- 5. All of the above**

Auditing Revenue – Example of Effective Procedures

Auditors should perform procedures to assess whether revenue has been reported at the proper amount. A broker-dealer earns asset management fees based on the value of each customer's account holdings. After assessing the risks of material misstatement, the auditor performed procedures to test the occurrence and completeness of revenue transactions. The auditor also performed procedures to test the valuation of revenue by testing the completeness and accuracy of customer account holdings and the accuracy of the management fee rates that the broker-dealer used to determine the amount of revenue reported.

Note: The example provides a brief scenario and related example of procedures that may be effective, depending on facts and circumstances, but do not modify or establish auditing or attestation standards. These procedures are not contemplated in isolation but rather in combination with other relevant procedures.

Audit Sampling

Poll: What factors should an auditor consider in determining an appropriate sample size for a substantive test of details?

1. Tolerable misstatement
2. Allowable risk of incorrect acceptance
3. Expected size and frequency of misstatements
4. All of the above
5. None of the above

Poll: What factors should an auditor consider in determining an appropriate sample size for a substantive test of details?

1. Tolerable misstatement
2. Allowable risk of incorrect acceptance
3. Expected size and frequency of misstatements
- 4. All of the above**
5. None of the above

Audit Sampling - Case Study Facts

- Commissions revenue = \$5,000,000
- Inherent risk = lower
- Control risk = maximum
- Assurance from other substantive procedures = some
- Substantive test of details sample size = 25 transactions
- Basis for sample size was the firm's attribute sampling methodology requirements

Poll: Did the engagement team establish a reasonable basis for its sample size?

1. Yes, a sample of 25 is always a statistically valid sample for a large population
2. Yes, attribute sampling methodologies are appropriate to develop sample sizes for tests of detail
3. No, the engagement team should have taken into account other factors when establishing the sample size
4. No, the engagement team should have tested more to obtain an appropriate coverage of the account balance

Poll: Did the engagement team establish a reasonable basis for its sample size?

1. Yes, a sample of 25 is always a statistically valid sample for a large population
2. Yes, attribute sampling methodologies are appropriate to develop sample sizes for tests of detail
- 3. No, the engagement team should have taken into account other factors when establishing the sample size**
4. No, the engagement team should have tested more to obtain an appropriate coverage of the account balance

Audit Sampling – Example of Effective Procedures

When sampling, auditors should make selections that can be expected to be representative of the entire population, and provide all items an opportunity to be selected. A broker-dealer earns a spread for underwriting securities offerings and also advises clients on mergers and acquisitions. Both sources of revenue are material. The auditor tested all individually significant underwriting transactions and a sample from the remaining population of underwriting transactions using a statistically valid sampling technique. The auditor also selected a representative sample from the population of advisory fee transactions using a random number generator.

Note: The example provides a brief scenario and related example of procedures that may be effective, depending on facts and circumstances, but do not modify or establish auditing or attestation standards. These procedures are not contemplated in isolation but rather in combination with other relevant procedures.

AT No. 2 Review Procedures

AT No. 2 – Case Study Facts

Broker-Dealer's Exemption Report

To the best of its knowledge and belief, the Broker-Dealer states the following:

- The Broker-Dealer claimed an exemption from 17 C.F.R. 240.15.15c3-3 under the following provision of 17 C.F.R. 240.15c3-3 (k)(2)(ii).

I, John Smith, affirm that, to the best of my knowledge and belief, this Exemption Report is true and correct.

[Signature]

AT No. 2 – Case Study Facts

Report of Independent Registered Public Accounting Firm

We have reviewed management's statements, included in the accompanying Exemption Report, in which (1) the Broker-Dealer identified the following provisions of 17 C.F.R. 240.15c3-3(k) under which the Broker-Dealer claimed an exemption from 17 C.F.R. 240.15c3-3: (k)(2)(ii) (exemption provisions) and (2) the Broker-Dealer stated that it met the identified exemption provisions throughout the most recent fiscal year without exception. The Broker-Dealer's management is responsible for compliance with the exemption provisions and its statements.

[Scope Paragraph]

[Review Results Paragraph]

[Signature]

[City and State or County]

[Date]

Poll: Which of the following statements regarding the auditor's review report is true?

1. The review report referred to an incorrect exemptive provision
2. The review report referred to management assertion that was not included in the broker-dealer's exemption report
3. The review report was not signed and dated
4. The review report included an inappropriate title

Poll: Which of the following statements regarding the auditor's review report is true?

1. The review report referred to an incorrect exemptive provision
- 2. The review report referred to management assertion that was not included in the broker-dealer's exemption report**
3. The review report was not signed and dated
4. The review report included an inappropriate title

AT No. 2 – Case Study Facts

Broker-Dealer's Exemption Report

To the best of its knowledge and belief, the Broker-Dealer states the following:

1. The Broker-Dealer may file an Exemption Report because the Broker-Dealer had no obligations under 17 C.F.R. 240.15c3-3, and
2. The Broker-Dealer had no obligations under 17 C.F.R. 240.15c3-3 throughout the most recent fiscal year ending December 31, 2018.

[Signature]

Poll: In its exemption report, the broker-dealer did not include a statement that identifies the provisions under which it claimed exemption, but included other statements explaining its basis for filing an exemption report. How should the auditor respond?

1. Obtain an understanding of the exemption conditions and other rules and regulations that were relevant to the broker-dealer's ability to file an exemption report
2. Perform procedures as necessary to obtain moderate assurance regarding whether a material modification should be made to the broker-dealer's statements
3. Refer to the statements made by the broker-dealer in the auditor's review report
4. All of the above

Poll: In its exemption report, the broker-dealer did not include a statement that identifies the provisions under which it claimed exemption, but included other statements explaining its basis for filing an exemption report. How should the auditor respond?

1. Obtain an understanding of the exemption conditions and other rules and regulations that were relevant to the broker-dealer's ability to file an exemption report
2. Perform procedures as necessary to obtain moderate assurance regarding whether a material modification should be made to the broker-dealer's statements
3. Refer to the statements made by the broker-dealer in the auditor's review report
- 4. All of the above**

AT No. 2 – Example of Effective Procedures

During its audit of revenue, the auditor obtained evidence that the broker-dealer, in addition to its business of introducing customers to its clearing broker, sold mutual fund shares to customers directly from the funds and not through a clearing broker. This mutual fund business did not fall within the exemption claimed by the broker-dealer under paragraph (k)(2)(ii) of the Customer Protection Rule, as stated in the broker-dealer's exemption report. The auditor, therefore, performed additional review procedures to address this evidence that indicated the broker-dealer's exemption report may not be fairly stated.

Note: The example provides a brief scenario and related example of procedures that may be effective, depending on facts and circumstances, but do not modify or establish auditing or attestation standards. These procedures are not contemplated in isolation but rather in combination with other relevant procedures.

Questions



Program Evaluation

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