

Illustrative Examples for Auditors of Broker-Dealers

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DISCLAIMER

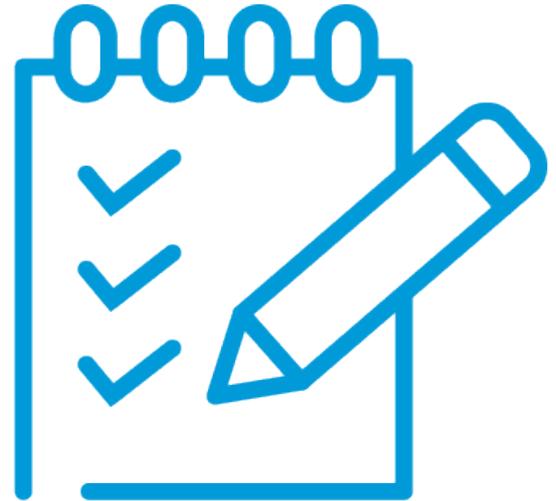
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EXAMPLES OF EFFECTIVE PROCEDURES

- Examples of effective procedures describe brief scenarios and possible procedures that may be effective to address that scenario
- These effective procedures are provided as examples and do not modify or establish auditing or attestation standards
- Auditors should consider the specific facts and circumstances of their engagements when designing audit procedures

AGENDA

- Fraud risk assessment
- Revenue
- Securities owned
- Net capital
- Examination engagement



Example 1

EXAMPLE 1 – BD CLAIMS EXEMPTION

Background Information – About the Broker-Dealer

- Your firm is auditing the December 31, 2020 financial statements of the broker-dealer
- Broker-dealer earns revenue from three distinct lines of business
 - Introducing customer securities transactions to a clearing firm (commissions)
 - Advising on mergers and acquisitions (success fees)
 - Bond principal transactions (principal transaction revenue)
- Broker-dealer has a large network of branches and registered representatives that regularly accept customer funds and securities
- Broker-dealer files an exemption report under Rule 17a-5

EXAMPLE 1 – BACKGROUND INFORMATION

Financial Data (\$ in thousands)

	2020	2019
Commissions	\$700	\$700
Success fees	200	500
Principal transactions	(100)	500
Total Revenue	800	1,700
Pretax (loss) income	(300)	400
Cash flow (used in) from operations	(500)	200
Securities owned	4,000	5,000
Excess net capital	50	500

EXAMPLE 1 – FRAUD RISK ASSESSMENT

- Engagement Team Fraud Discussions
- Identified Risks
 - Improper revenue recognition
 - Management override of controls
 - Misappropriation of customer assets
- Additional information helpful in identifying and assessing fraud risks



EXAMPLE 1 – REVENUE

Risk Assessment

- Identified fraud risk related to the occurrence of success fees for private transactions

Audit Procedures – Occurrence Assertion

- Selected recorded success fees from private transactions from throughout the year and subsequent to year-end
 - Vouched cash receipts
 - Requested confirmation of related receivables
 - Requested confirmation of key transaction terms, including closing date
 - Inspected closing documents

EXAMPLE 1 – SECURITIES OWNED

Background Information – Securities Owned

- Inventory comprised primarily of municipal bonds and nonconvertible, fixed-rate corporate bonds
- Classified as Level 2 instruments in the fair value hierarchy
- Broker-dealer recorded fair values based on information included on its monthly clearing broker statement
- Clearing broker obtained fair value information from a pricing service and included that information without modification on statements provided to its broker-dealer customers
 - The fair value information is not a broker quote

EXAMPLE 1 – SECURITIES OWNED

Risk Assessment

- Assessed risk of material misstatement for valuation as moderate

Audit Procedures – Valuation Assertion

- Approach - develop an independent expectation
- Testing - for a sample of securities owned
 - Requested pricing information from a pricing service
 - Compared the fair values from the pricing service to the broker-dealer's estimate and evaluated the difference
- Assessed the reliability of the pricing information

EXAMPLE 1 – SECURITIES OWNED

Reliability of Pricing Information

- Experience and expertise of the pricing service
- Methodology used by the pricing service
- Relationship between the broker-dealer and the pricing service



EXAMPLE 1 – SECURITIES OWNED

Pricing Information Based on Similar Financial Instruments

- Evaluate the process used by the pricing service, including how transactions are:
 - Identified
 - Considered comparable
 - Used to value the types of financial instruments selected for testing

EXAMPLE 1 – NET CAPITAL

Audit Procedures – Securities Haircuts

- Financial statement audit procedures
 - Fair value of positions on securities inventory
 - Maturity dates of positions on securities inventory
- Obtained a haircut report from the broker-dealer and selected a sample of bonds. For each selection:
 - Compared the maturity dates to the securities inventory
 - Tested the classification of investment grade securities by independently obtaining credit ratings from an independent source
 - Recalculated the days to maturity
 - Obtained the applicable haircut percentages from Rule 15c3-1
 - Recalculated the haircuts per the report
- Completeness of the haircut report

Example 2



EXAMPLE 2 – BD DOES NOT CLAIM EXEMPTION

Background Information – About Broker-Dealer

- Your firm is auditing the December 31, 2020 financial statements of the broker-dealer
- Broker-dealer earns revenue from four distinct lines of business
 - Clearing customer securities transactions (clearing fees)
 - Advising on mergers and acquisitions (success fees)
 - Bond principal transactions (principal transaction revenue)
 - Securities borrowing and lending (rebate income)
- Broker-dealer files a compliance report and does not claim exemption from Rule 15c3-3

EXAMPLE 2 – EXAMINATION ENGAGEMENTS

Background Information – ICOC, Net Capital Rule

- The CFO's monthly review of the broker-dealer's net capital is an important control
- Securities borrowed and loaned charges and securities haircuts are subject to monthly variation
- The CFO used a securities borrowed and loaned report to determine the appropriate net capital charge, and verified that amounts from the report were accurately captured in the computation.

EXAMPLE 2 – EXAMINATION ENGAGEMENTS

Examination Procedures – ICOC, Net Capital Rule

- Inquired of the CFO regarding nature of the review, information used, expectations, thresholds for variances requiring investigation, and errors identified
 - Minimum net capital, assets not readily convertible into cash, nonmarketable securities, operational charges and deductions
 - Nature of errors in applying the Net Capital Rule identified
- For a sample of monthly net capital computations:
 - Inspected evidence of management's review, including evidence that variances exceeding the threshold were resolved
- Tested controls over the accuracy and completeness of the information in the securities borrowed and loaned report
- Additional risks to compliance with Rule 15c3-1

QUESTIONS

Please submit any questions or feedback you might have on this presentation to forum@pcaobus.org.

