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Public Company Accounting Oversight Board
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Re: PCAOB Rulemaking Docket Matter No. 35, *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards*

Dear Board Members and Staff:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) proposed attestation standards, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, and *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, and the related amendments. We respectfully submit our comments and recommendations thereon. Any capitalized terms herein that are undefined have the same meaning assigned to them within these proposals.

As we indicated in our letter, dated August 26, 2011, to the U.S. Securities and Exchange Commission (SEC or Commission) in response to their proposed amendments to the broker-dealer financial reporting rule under the Securities Exchange Act of 1934, we commend the Commission and the PCAOB for concurrently releasing proposed rules and standards that are intended to work together. We believe that this approach not only facilitates a better understanding of what is expected by the SEC and PCAOB, but will also result in more constructive and valuable feedback from respondents. We strongly encourage adopting such an approach for all future joint proposals.

The following provides our specific observations and recommendations pertaining to the Board's proposed standards. We generally support these proposals and applaud the PCAOB as the proposed standards have been clearly aligned with the SEC's proposed rule amendments. Some of our comments are similar to those provided to the SEC related to their proposed rule amendments. We encourage the Board to obtain and review the comments received by the SEC on their proposal prior to finalizing the related examination and review standards.

Compliance examination engagement

The following provides comments that are specific to the proposed attestation standard, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* (proposed examination

standard). Overall, we support the proposed examination standard and, for the most part, believe it is clear and appropriate.

Material non-compliance

In the majority of compliance examination engagements, the evaluation of what constitutes material non-compliance with a specific compliance requirement is both subjective and difficult. We agree with the proposed definition of material non-compliance in the Commission's proposed rule amendments and the Board's proposed examination standard. In order to achieve more consistency in practice regarding application of the definition, we encourage the SEC and PCAOB to collaborate and provide additional interpretive guidance. This would be particularly important for requirements that are more subjective and those that are not quantifiable in monetary terms.

Also, the release includes an extensive discussion about identifying and assessing the risks of material non-compliance, as well as evaluating the sufficiency and appropriateness of evidence. Some of the examples provided, however, seem to impose certain incremental requirements. As we have previously expressed to the Board, we continue to be concerned with establishing requirements outside of the Board's standards, as well as requirements based on illustrative examples. We believe that to achieve consistent application of the Board's standards and rules, including reporting, that is in the best interests of investors, the PCAOB should ensure that the Board's standards clearly define the necessary requirements.

Books and records

With regard to the broker-dealer's assertions addressed by the proposed examination standard, please note that our letter to the SEC indicates that we do not believe it is clear what is expected of the auditor with respect to the broker-dealer's assertion that the information used to assert compliance with the Financial Responsibility Rules was derived from the books and records. We understand that an auditor would likely evaluate the appropriateness of the broker-dealer's books and records during the course of the engagement, including whether the broker-dealer can support its assertion with sufficient documentation (discussed further below). A separate opinion on this specific assertion, however, may entail more detailed procedures as to the source of each piece of information used by the broker-dealer at the time of its assessment. We question whether this is what is actually intended by the auditor's opinion; therefore, we requested that the SEC, in finalizing its proposed rule amendments, provide more context or interpretive guidance to clarify their intention as to management's assertion and the auditor's opinion thereon. In this regard, additional guidance with regard to the procedures necessary to achieve reasonable assurance with respect thereto is necessary in the related proposed examination standard.

Using the work of others

The Board requested comments as to whether the proposed examination standard should establish requirements that govern the use of the work of other auditors. Although it may not be possible to clearly identify, at this point, all of the instances in which the auditor may use the work of other auditors or others, we anticipate that this scenario is possible. Accordingly, we believe that the Board may need to further contemplate whether to maintain an umbrella

standard, similar to AT sec. 101, that addresses matters such as these, regardless of the type of attest engagement being performed. For the time being, we suggest that the Board recognize that this may be possible and utilize the interim inspection program to inform the Board's future standard-setting initiatives in this area.

Written representations

We believe that a written representation letter is necessary and should be required for the examination. There are some matters upon which the examination is premised, and written representations provide essential evidence as to management's assertions and verbal representations. If management is unwilling or unable to provide the requested representations, it is highly likely that additional procedures could not be performed to overcome the substantial doubt about the broker-dealer's assertions.

With respect to the written representations that we believe are necessary, we believe that the following additional representations should be obtained:

- Management's responsibility for compliance with the Financial Responsibility Rules.
- That management has performed an evaluation of compliance.
- That management did not use the auditor's procedures performed during the audit of the financial statements and supplemental information or the examination as part of the basis for management's assertions. (Refer to our specific comments regarding evidence supporting management's assertions below.)
- That management has disclosed to the auditor all known non-compliance.
- That management has disclosed to the auditor any fraud relevant to the assertions.

The proposed examination standard should also include the date through which the written representations should be obtained; typically, the report date.

Reporting

Overall, we agree with the proposed form and content of the examination report. However, we believe that the standard examination report could be expanded by:

- Including a definition of internal control over compliance and a description of its inherent limitations. We believe this will assist users in further understanding the auditor's report.
- Maintaining the extant statement indicating that the examination does not provide a legal determination. We believe that this is a factual statement that is relevant to investors, as legal determinations can only be made by a court of law. As indicated in extant standards, the auditor's report may assist legal counsel or others in making such determinations.

We also note that management's assertion with respect to internal control over compliance is consistent with the SEC's proposed rule amendments. From a user's perspective, however, we

are concerned with the form of opinion that indicates that there were no instances of material weakness, as internal control over compliance and the auditor's examination only provide reasonable assurance to this effect. This would seem to further support the need to define internal control over compliance and to describe its inherent limitations, as noted above.

Further, if there are compliance requirements that do not specifically apply to a particular broker-dealer, we would expect those requirements to be clearly excluded from management's assertion and the auditor's report. For example, this may be the case for broker-dealers that are reporting as a carrying firm because of certain limited past activities. In this circumstance, the scope paragraph of the auditor's report could specifically identify the requirements that are excluded based on management's determination that they are not applicable. We refer the Board to a standard auditor's report issued pursuant to the requirements of Regulation AB.

Report modifications

There are two matters with regard to examination report modifications that we would like the Board to consider and address. The first relates to the form of report when an adverse opinion on one or more management assertions is required. In this circumstance, the auditor should report directly on the subject matter for all assertions, rather than the respective assertion necessitating the adverse opinion. We believe that this form of reporting will result in a more comprehensible report. The second matter relates to misstatements of fact in management's assertion, particularly when management's assertion is improperly presented. In addition to communicating this issue to management and the audit committee, an explanatory paragraph in the auditor's report may be necessary, consistent with the requirements in an audit of internal control over financial reporting. We believe that this should be specifically addressed by the Board's examination standard. Also refer to our comments on report modifications related to the review engagement, particularly with respect to scope limitations and the requirement to describe omitted procedures.

Exemption review engagement

The following provides comments that are specific to the proposed attestation standard, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* (proposed review standard). As we indicated to the SEC, because performing a review, thereby obtaining only a moderate level of assurance of compliance with specified requirements, is a fairly new concept, it is important for the proposed review standard to clearly describe the auditor's responsibilities and for the review report to clearly describe the nature of the review engagement and its inherent limitations.

Non-compliance requiring material modification

The proposed review standard makes reference to material modifications that should be made to the broker-dealer's assertion and non-compliance that would cause the assertion not to be fairly stated, in all material respects. Such references seem to be consistent with the concept of a review engagement. However, we believe that the proposed review standard could be further clarified in the context of material non-compliance. In other words, the overall concept seems appropriate, but the proposed review standard could more clearly indicate that the auditor plans and performs the review in the context of obtaining a moderate level of assurance as to the absence of material non-compliance with the exemption conditions.

Review procedures and evaluating results

The review procedures and the matters affecting their nature, timing, and extent are, for the most part, appropriate for an engagement to obtain a moderate level of assurance. We also generally agree with the requirements to evaluate the results of the review procedures. We do, however, have the following recommendations:

- Clarifying the note in paragraph 10f to explicitly indicate that the examples of procedures are those that may be performed during the audit of the financial statements. Currently, this is more implicit.
- Incorporating the guidance on page A4-43 of the release that relates to the risk of fraud and centralized or decentralized operating environments (the first two full paragraphs). This is helpful guidance, particularly with respect to the Board's intent, that should be included within the standard.
- Explaining the intent of the requirement in paragraph 10h and how it differs from the requirement in paragraph 12. It may help to link paragraph 10h to the consideration of the matters in paragraph 9. That said, however, we question the need for paragraph 10h in consideration of paragraph 12. With respect to the reference to *substantial doubt* in paragraph 12, we believe that a better link to the possibility of *material* non-compliance is warranted.
- Carrying forward the guidance in paragraph .56 of AT sec. 101, *Attest Engagements*, which addresses the performance of other or additional procedures. This guidance seems necessary because AT sec. 101 will not apply to the review engagement. It could also help differentiate between paragraphs 10h and 12, particularly if paragraph 10h is retained.
- Incorporating the guidance on page A4-48 of the release that identifies the procedures (additional inquiries, reading documents, or search and verification procedures) that may be performed in the situations described by paragraph 12.

Written representations

Similar to our comments on the proposed examination standard, we believe that a written representation letter is necessary and should be required for the review. With respect to the written representations that we believe are necessary for the review engagement, we believe that the following additional representations should be obtained:

- Management's responsibility for establishing and maintaining effective internal control over compliance with the exemption conditions.
- That management has performed an evaluation of compliance with the exemption conditions.
- That management did not use the auditor's procedures performed during the audit of the financial statements and supplemental information or the review as part of the basis for

management's assertion. (Refer to our specific comments regarding evidence supporting management's assertions below.)

- That management has disclosed to the auditor all known non-compliance related to the exemption conditions.
- That management has disclosed to the auditor any fraud relevant to the exemption conditions.

The proposed review standard should also include the date through which the written representations should be obtained; typically, the report date.

Reporting

In general, we believe that the proposed form and content of the review report is accurate and supportable. However, the standard review report could be expanded in two regards:

- To address the inherent limitations of a review engagement by including the concept of moderate assurance and summarizing the auditor's objective, as described in paragraphs 3 and 4.
- To indicate that the review does not provide a legal determination. We believe this clarification is important, as discussed above.

Hence, to provide more transparency to users, the scope paragraph of the review report may be revised to read as follows:

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform inquiries and other review procedures to obtain moderate assurance about whether one or more instances of material non-compliance exist with respect to the exemption conditions that would cause management's assertion not to be fairly stated. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on whether management's assertion is fairly stated, in all material respects. Accordingly, we do not express such an opinion. We believe that our review provides a reasonable basis for our conclusion. Our review does not provide a legal determination on the Company's compliance with the provisions for exemption under Rule 15c3-3.

Report modifications

When instances of material non-compliance are identified (that is, the broker-dealer's assertion is not fairly stated, in all material respects, because of an instance(s) of non-compliance), the auditor is required by paragraph 20 to modify the report to describe those instances and to state that the broker-dealer is not in compliance with the specified exemption conditions. Ordinarily, in a review engagement, matters that contradict management's assertion are disclosed and reported on using an *except for* type of conclusion. This form of conclusion differentiates an

audit (or examination) from a review engagement by more clearly indicating that other matters contradicting management's assertion may exist but have not been identified. Thus, we believe that it is necessary for the PCAOB to provide the form of auditor's conclusion that is expected when management's assertion is not fairly stated. We are comfortable with the assumed form of conclusion, provided that there is some indication in the auditor's report, consistent with the notion of moderate assurance, that had the auditor performed additional procedures, other instances of material non-compliance may have been identified and reported.

With respect to scope limitations, we question the appropriateness of the requirement in paragraph 21 for the auditor to describe the omitted procedures and the reason for their omission. To begin with, we believe that the reason for their omission is the description of the scope limitation itself. With respect to the review procedures, their performance or omission is not described in detail today because such discussion is believed to overshadow the disclaimer. We believe that it would be more appropriate to generally describe the effect of the scope limitation on the engagement, without providing a list of omitted procedures that may have been considered necessary. In addition, the proposed review standard should be clear as to the elimination of the scope paragraph when issuing a review report in this circumstance.

Also, we note that the proposed review standard does not address the auditor's responsibility as it relates to report modifications when management's assertion is improperly presented or contains additional information. We believe that these are matters that should be addressed by the Board's standard.

Overall, we understand that some of these situations may be rare. Yet, we believe that it is the Board's responsibility, in the interests of investors, to clearly define and describe the auditor's responsibilities to achieve consistent reporting in practice.

Proposed amendments

We understand and support specific documentation and engagement quality review requirements for attestation engagements performed under PCAOB standards. We are concerned, however, with the Board's approach in adopting such standards. Thus far, the audit and attestation standards have been separate bodies of literature. To promote compliance with PCAOB standards, we believe that the Board should continue to maintain this structure. We also believe that the use of an amendment to adopt such significant changes in the literature may not sufficiently take into account a broader consideration of the affected engagements. For those firms that do not audit broker-dealers, such changes also may go unnoticed.

That said, we do not have significant concerns with the documentation requirements that will be imposed on the examination and review engagements, other than the fact that they may need to be adapted and applied more broadly. Although some firms may apply the same documentation requirements to audit and attestation engagements, all firms will need some time to determine compliance with those requirements for all attestation engagements being performed under PCAOB standards. With regard to the performance of an engagement quality review, we also believe that, although some adaptation may be necessary, the requirements are generally appropriate. A key change, however, relates to the rotation or *cooling off* requirements.

It appears as though the Board's cooling off requirements will apply to non-public broker-dealers. Non-public broker-dealers, however, are not subject to the SEC's independence rules regarding partner rotation. The PCAOB has previously provided the same exemption as it relates to its cooling off requirements that the SEC has afforded to smaller registered firms as it relates to partner rotation. In analogizing to this situation, we question whether a similar exemption with respect to the cooling off period should be afforded to auditors of non-public broker-dealers, since the underlying SEC partner rotation rules do not apply.

Other matters

Evidence supporting management's assertions

Similar to management's responsibility related to an assessment of the effectiveness of internal control over financial reporting, we believe that management is responsible for maintaining evidential matter, including documentation, to provide reasonable support for its broker-dealer related assertions. Such evidence allows the auditor to understand and consider management's work, including determining the ability to perform the examination or review engagement. We suggest that the PCAOB collaborate with the SEC on this matter to more appropriately address management's and the auditor's responsibilities in regards to management's documentation in support of its assertions.

Report restriction

The proposed examination and review reports do not include a paragraph restricting their use to certain specified parties. Based on extant requirements regarding the suitability and availability of criteria, we understand why such a paragraph was not included. However, a general report user may not fully understand the Financial Responsibility Rules or the exemption provisions of Rule 15c3-3. Accordingly, we believe that some form of notification to report users, if not a report restriction, that indicates the intended purpose of the report and the knowledge necessary to use it appropriately may be necessary.

Applicability of PCAOB standards

The Board indicates that auditors of non-public broker-dealers are not subject to the provisions of PCAOB Rules 3521 through 3526, until the Board completes a separate rulemaking process and appropriate amendments. We appreciate the Board's thoughtful consideration of the applicability of these rules. In conjunction with finalizing the proposed examination and review standards, we suggest that the Board issue a more formal amendment to its overarching Rule 3520 to this effect. We believe that this is necessary to clearly indicate the PCAOB standards that apply to the examination and review, as well as the related financial statement audit.

Relationship to interim attestation standards

The release indicates that AT sec. 101 is not specific to any particular type of engagement and that the proposed standards are more specific because they have been designed for the required broker-dealer examination and review engagements. It also notes that the proposed standards allow auditors to perform these engagements without looking to multiple standards, such as AT sec. 101 and AT sec. 601, *Compliance Attestation*.

AT sec. 101 has always been viewed as an umbrella standard for all other attest engagements, and AT sec. 601 has always been viewed as the relevant standard addressing compliance attestation engagements. We can appreciate the use of separate, single standards to address the required broker-dealer examination and review engagements, provided those standard are comprehensive. Nevertheless, we believe that there continues to be some relevant guidance in both AT sec. 101 and 601 that could be encompassed directly within the proposed standards; some matters are discussed herein. We also believe that if the Board is using an all-inclusive approach, the proposed standards should eliminate any references to AT sec. 101 or 601 and incorporate all necessary requirements and guidance therein.

Commodity Futures Trading Commission Rule 1.16

For broker-dealers that are also registered as a Futures Commission Merchant with the Commodity Futures Trading Commission (CFTC), we believe that it will be necessary for the PCAOB to recognize and address the requirements related to CFTC Rule 1.16 for the auditor to report on compliance therewith. We recognize, however, that the SEC and CFTC will likely need to work together to align their respective rules.

We would be pleased to discuss our letter with you. If you have any questions, please contact Karin A. French, National Managing Partner of Professional Standards, at (312) 602-9160.

Sincerely,

