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**REPORT ON THE PROGRESS
OF THE INTERIM INSPECTION PROGRAM
RELATED TO AUDITS OF BROKERS AND DEALERS**

**PCAOB Release No. 2012-005
August 20, 2012**

Executive Summary

The Public Company Accounting Oversight Board (the "PCAOB" or the "Board") is issuing this document to describe the progress and significant observations of its interim inspection program for auditors of brokers and dealers registered with the Securities and Exchange Commission ("SEC" or the "Commission"). The program commenced in August 2011 in response to the Board's new authority with respect to inspections, standards-setting, investigations, and disciplinary proceedings over auditors of brokers and dealers provided in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank amendments").

The Board's interim inspection program will help inform the Board in its process of developing a permanent inspection program. The interim inspection program is currently expected to include inspections of approximately 100 registered public accounting firms covering portions of over 170 audits by the end of 2013. Inspections under the interim inspection program will continue until rules for a permanent inspection program take effect, currently anticipated to be sometime after 2013. The interim inspection program will also assist the Board in assessing auditors' compliance with the requirements and professional standards applicable to the audits of brokers and dealers.

Approximately 4,400 brokers and dealers filed audited annual financial statements with the SEC for fiscal periods ended during 2011. Approximately 800 registered public accounting firms audited broker and dealer filings for these periods.

This report contains information about compliance and reporting requirements for SEC-registered brokers and dealers. It also includes a summary of the audit deficiencies identified in the Board's inspections of portions of 23 audits conducted by ten firms. The audits inspected were required to be conducted under generally accepted auditing standards ("GAAS") issued by the American Institute of Certified Public Accountants ("AICPA"). The Board urges interested persons to read the full report for a more detailed description of the inspection findings.

All registered public accounting firms that issue audit reports for SEC-registered brokers and dealers should consider whether the audit deficiencies described in this report might be present in audits they currently perform, and should take appropriate action to prevent or correct any such deficiencies identified.

Net Capital and Customer Protection Requirements

Brokers and dealers have various lines of business and may receive, handle, or hold customer securities or cash. These are all factors that are included in the determination of which requirements apply to SEC-registered brokers and dealers under the Securities Exchange Act of 1934 ("Exchange Act") rules regarding net capital requirements and protection of customer assets. Exchange Act Rule 15c3-1 ("Rule

15c3-1" or the "Net Capital Rule") prescribes minimum liquidity standards for brokers and dealers, requiring brokers and dealers to maintain certain specified levels of net capital. In addition, Exchange Act Rule 15c3-3 ("Rule 15c3-3" or the "Customer Protection Rule") is designed to protect customers by requiring brokers and dealers to segregate customer securities and cash from the broker's or dealer's proprietary business activities.

Annual Reporting Requirements for SEC-Registered Brokers and Dealers

Generally, brokers and dealers are required to file with the SEC audited financial statements along with (1) audited supporting schedules relating to the computation of net capital, the computation of the customer reserve requirement, and information relating to the possession or control requirements of the Customer Protection Rule; and (2) an accountant's supplemental report on, among other things, material inadequacies in the accounting system, internal accounting controls, and procedures for safeguarding securities of the broker or dealer. If the broker or dealer is exempt from the Customer Protection Rule, the auditor is required to ascertain whether the broker or dealer complied with the applicable conditions for exemption.

Exchange Act Rule 17a-5 ("Rule 17a-5") requires, among other things, that the scope of the audit procedures be sufficient to provide reasonable assurance that any material inadequacies in the accounting system, internal accounting controls, and procedures for safeguarding securities would be disclosed in the accountant's supplemental report on material inadequacies.

Deficiencies Noted on Audits Inspected

This report presents observations from inspections of portions of 23 audits at ten firms conducted as part of the interim inspection program. The audits and firms selected are not necessarily representative of all broker and dealer audits and their auditors. The approach used in the selection of audits of brokers and dealers considered a number of different factors intended to provide the Board with information necessary to inform future Board actions. This approach differs from the methodology used in the selection of audits of issuers by firms subject to regular inspection.

The Inspections staff identified deficiencies in all of the audits inspected. While these results cannot be generalized to all broker and dealer audits, the nature and extent of the findings are of concern to the Board. Following is a summary of the deficiencies noted.

Audit Deficiencies Related to the Customer Protection and Net Capital Rules

- **Accountant's Supplemental Report on Material Inadequacies** - In 21 of the 23 audits, Inspections staff found that firms failed to perform sufficient audit procedures to obtain reasonable assurance that any material inadequacies found to exist since the date of the last examination in the accounting system, internal accounting controls, and procedures for safeguarding securities would have been disclosed in the accountant's supplemental report. Inspections staff found that firms did not test or sufficiently test controls related to the areas covered in this report.
- **Exemption from Provisions of the Customer Protection Rule** - For all of the 14 audits of brokers and dealers that claimed an exemption from Rule 15c3-3, Inspections staff found that firms did not perform sufficient procedures to ascertain that the broker or dealer complied with the conditions of the exemption. Inspections staff found that firms did not perform sufficient inquiries or other procedures related to the exemption claimed by the broker or dealer under the Customer Protection Rule.
- **Customer Protection Rule** - For two of the nine audits of brokers and dealers that were required to maintain a customer reserve, Inspections staff found that firms failed to verify that the special reserve bank accounts were designated for the exclusive benefit of customers and that the account agreements contained the required restrictive provisions.
- **Net Capital Rule** - In seven of the 23 audits, Inspections staff found that firms failed to sufficiently test components of the broker's or dealer's minimum net capital computation.

Deficiencies Related to the Financial Statement Audit

- **Consideration of Risks of Material Misstatement Due to Fraud** - In 13 of the 23 audits, Inspections staff found that firms did not perform sufficient procedures to identify, assess, and respond to the risks of material misstatement of the financial statements due to fraud.
- **Related Party Transactions** - In ten of the 23 audits, Inspections staff found that firms did not perform sufficient procedures to identify the existence of related parties and material related party transactions, or in instances where evidence of related parties existed, did not perform sufficient procedures regarding material related party transactions.

- **Revenue Recognition** - In 15 of the 23 audits, Inspections staff found that firms did not perform sufficient procedures to test the occurrence, accuracy, and completeness of revenue.
- **Establishing a Basis for Reliance on Records and Reports** - In 12 of the 23 audits, Inspections staff found that firms did not perform sufficient procedures to place reliance on records and reports of the broker or dealer or reports from service organizations that were used in audit procedures.
- **Fair Value Measurements** - In six of the nine audits where securities valuation was included in the inspection, Inspections staff found that firms did not perform sufficient procedures to test the valuation of securities.
- **Evaluation of Control Deficiencies** - In four of the 23 audits, Inspections staff found that firms did not sufficiently evaluate identified control deficiencies to assess the risk of material misstatement or did not evaluate identified errors to determine whether a control deficiency existed.
- **Financial Statement Disclosures** - In seven of the 23 audits, Inspections staff found that firms did not perform sufficient audit procedures to test the accuracy and completeness of certain financial statement disclosures.

Failures to Satisfy Independence Requirements

SEC rules on auditor independence apply to audits of brokers and dealers. In two audits, Inspections staff found that a firm failed to maintain independence in accordance with those rules. In each case, the failure resulted from the firm preparing, or assisting in the preparation of, the financial statements that were being audited.

Next Steps in the Interim Inspection Program

The Board will continue the interim inspection program until rules for a permanent inspection program take effect. During 2012, the Board anticipates inspecting over 40 firms and portions of approximately 60 audits. The Board will issue future progress reports and continue to hold forums and participate in other public outreach activities. These activities are intended to inform auditors of SEC-registered brokers and dealers of the observations and findings from our interim inspection program, developments in standards-setting, and updates from the SEC and the Financial Industry Regulatory Authority ("FINRA").

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Background Information on the Establishment of the Interim Inspection Program Related to Audits of Brokers and Dealers

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act amended various provisions of the Sarbanes-Oxley Act of 2002 (the "Act"). Among other things, the Dodd-Frank amendments gave the Board explicit oversight authority with respect to audits of brokers and dealers that are registered with the Commission. Specifically, the Dodd-Frank amendments provided the Board with authority to carry out the same oversight responsibilities for auditors of brokers and dealers as it has carried out with respect to auditors of issuers^{1/} – inspections, standards-setting, investigations, and disciplinary proceedings.

Since December 31, 2008, as previously required by the Act, all auditors of brokers or dealers have been required to register with the PCAOB. On June 14, 2011, in light of the Dodd-Frank amendments, the Board adopted Rule 4020T (the "Temporary Rule") to establish an interim inspection program related to the audits of brokers and dealers. The SEC approved this rule on August 18, 2011.^{2/}

The interim inspection program has two purposes. First, it enables the Board to begin the process of assessing the compliance of registered public accounting firms and their associated persons with the Act, the Board's rules, the Commission's rules, and professional standards in connection with the performance of audits, issuance of audit

^{1/} The term "issuer" encompasses, in general, public companies, investment companies, and certain employee benefit plans. See definition of "issuer" in Section 2(a)(7) of the Act.

^{2/} See Exchange Act Release No. 65163 (August 18, 2011).

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reports, and related matters involving brokers and dealers.^{3/} Second, it will help inform the Board's eventual determinations about the scope and elements of a permanent inspection program, including whether and how to differentiate among classes of brokers and dealers, whether to exempt any category of registered public accounting firm, and the establishment of minimum inspection frequency schedules.

The Temporary Rule provides that, no less frequently than every twelve months, the Board will publish a report that describes the progress of the interim inspection program and any significant observations.

This report contains four parts: Part I provides an overview of net capital, customer protection, and annual reporting requirements for brokers and dealers registered with the Commission;^{4/} Part II describes the inspections of firms and audits selected; Part III describes the observations identified from inspections of audits pursuant to Exchange Act rules;^{5/} and Part IV summarizes next steps related to the interim inspection program of the PCAOB.

^{3/} See Section 104(a) of the Act.

^{4/} Under Section 15 of the Exchange Act, most brokers and dealers must register with the SEC and join a self-regulatory organization, such as FINRA. Hereinafter, the use of the terms "broker(s) and dealer(s)" or "broker(s) or dealer(s)" refers to brokers and dealers registered with the SEC.

^{5/} As per Rule 17a-5, audits of brokers and dealers are to be conducted in accordance with GAAS. Following the enactment of the Dodd-Frank amendments, the SEC provided transitional guidance in Exchange Act Release No. 62991 (September 24, 2010), stating that "references in Commission rules and staff guidance and in the federal securities laws to GAAS or to specific standards under GAAS, as they relate to non-issuer brokers or dealers, should continue to be understood to mean auditing standards generally accepted in the United States of America, ... plus any applicable rules of the Commission." References to auditing standards contained within this report are those of the AICPA. Our inspections of audits of brokers and dealers were based on the requirements of GAAS, and not PCAOB auditing standards.

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Part I: Net Capital, Customer Protection, and Annual Reporting Requirements for SEC-Registered Brokers and Dealers

This section provides an overview of brokers and dealers with a focus on:

- Net capital requirements under Rule 15c3-1;
- The protection of customer assets as prescribed by Rule 15c3-3; and
- Annual reporting requirements and the responsibilities of registered public accounting firms.

Minimum Net Capital Requirements of SEC-Registered Brokers and Dealers

Brokers and dealers registered with the SEC can engage in a variety of securities-related lines of business, including services for buying and selling securities, and capital raising activities. Other examples of brokers' and dealers' lines of business include acting as prime brokers, market makers, specialists, municipal securities brokers, and distributors of shares of registered investment companies. The lines of business conducted by the broker or dealer are factors in the determination of a broker's or dealer's minimum net capital requirement as prescribed in the Net Capital Rule.^{6/}

In general, Rule 15c3-1 prescribes minimum liquidity standards for brokers and dealers, requiring brokers and dealers to maintain certain specified levels of net capital (i.e., liquid assets). Whether a broker or dealer receives, handles, or holds customer securities or cash in conducting its business will have an effect on the amount of minimum net capital that the broker or dealer must maintain under Rule 15c3-1. For example, brokers and dealers that carry customer, broker, or dealer accounts and receive or hold securities or cash for those persons are generally required by Rule 15c3-1 to maintain greater amounts of net capital than brokers and dealers that do not handle securities or cash for others.

^{6/} Generally, a broker's or dealer's required minimum net capital is the greater of (1) one of a number of fixed-dollar amounts prescribed in Rule 15c3-1 applicable to the broker or dealer relative to its lines of business, or (2) an amount computed using one of two financial ratios. The first financial ratio generally provides that a broker or dealer shall not permit its aggregate indebtedness to exceed 1500% of its net capital. See Rule 15c3-1(a)(1)(i). The second financial ratio provides that a broker or dealer shall not permit its net capital to be less than \$250,000 or 2% of aggregate customer debit items. See Rule 15c3-1(a)(1)(ii).

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Customer Protection

As noted above, in operating their lines of business, brokers and dealers may receive, handle, or hold customer securities or cash. The provisions of the Customer Protection Rule relate to protecting customer securities and cash that a broker or dealer holds for customers.^{7/} In general, Rule 15c3-3 is designed to prevent brokers and dealers from using customer funds to finance their businesses, except as related to customer transactions. As a result, brokers and dealers must provide the capital to finance their trades and activities and may not use customer funds left with them for such purposes.

One aspect of the Customer Protection Rule requires a broker or dealer to have possession or control of fully paid and excess margin securities of their customers.^{8/} A broker or dealer must make a daily determination to help ensure that it is complying with this aspect of the rule.^{9/}

Another aspect of the Customer Protection Rule covers customer securities and cash and requires each broker or dealer not exempt from the provisions of this rule to make a periodic computation to determine the amount of funds it is holding that is either customer cash or cash obtained from the use of customer securities (customer credits).^{10/} From that figure, the broker or dealer subtracts the amount of funds that it is owed by customers or by other brokers and dealers relating to customer transactions (customer debits). If the customer credits exceed customer debits, the broker or dealer must deposit the excess in a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (a "Special Reserve Bank Account"). If the customer debits exceed customer credits, no deposit is necessary. Funds deposited in a Special Reserve Bank Account cannot be withdrawn until the broker or dealer completes another computation

^{7/} See Rule 15c3-3.

^{8/} See Rule 15c3-3(b)(1). Subparagraph (a)(3) of Rule 15c3-3 defines "fully paid securities" as securities carried in any type of account for which the customer has made full payment. Subparagraph (a)(5) of Rule 15c3-3 defines "excess margin securities" as securities having a market value in excess of 140% of the amount the customer owes the broker or dealer and which the broker or dealer has designated as not constituting margin securities.

^{9/} See Rule 15c3-3(d).

^{10/} See Rule 15c3-3(e).

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that shows that the broker or dealer has on deposit more funds than are required in the Special Reserve Bank Account.

Annual Reporting Requirements and the Responsibilities of Registered Public Accounting Firms

Brokers and dealers are required to make and maintain accurate books and records.^{11/} Pursuant to Rule 17a-5, brokers and dealers are also generally required to file with the SEC and other regulators, among other things (1) annual financial statements, (2) supporting schedules relating to the computation of net capital and determination of the reserve requirement for the Special Reserve Bank Account, if applicable, and (3) an accountant's supplemental report on material inadequacies.^{12/}

Under Rule 17a-5, the financial statements and supporting schedules are generally required to be audited by a registered public accounting firm.^{13/} In addition, the

^{11/} See Exchange Act Rules 17a-3 and 17a-4.

^{12/} Rule 17a-5(g)(3) states that a material inadequacy in the accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures of a broker or dealer includes any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to (i) inhibit a broker or dealer from promptly completing securities transactions or promptly discharging his responsibilities to customers, other brokers, dealers or creditors; (ii) result in material financial loss; (iii) result in material misstatements of the broker's or dealer's financial statements; or (iv) result in violations of the SEC's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described above.

^{13/} Rule 17a-5(d) generally requires that brokers or dealers registered pursuant to Section 15 of the Exchange Act shall file annually, on a calendar or fiscal year basis, a report which shall be audited by an independent public accountant. The annual audited report shall contain a Statement of Financial Condition (in a format and on a basis which is consistent with the totals reported on the Statement of Financial Condition contained in Form X-17A-5, Part II or Part IIA), a Statement of Income, a Statement of Cash Flows, a Statement of Changes in Stockholders' or Partners' or Sole Proprietor's Equity, and Statement of Changes in Liabilities Subordinated to Claims of General Creditors. Supporting schedules shall include, from Part II or Part IIA of Form X-17A-5, a Computation of Net Capital Under Rule 15c3-1, a Computation For Determination of the Reserve Requirements under Exhibit A of Rule 15c3-3 and Information Relating to the Possession or Control Requirements Under Rule 15c3-3.

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scope of the accountant's supplemental report on material inadequacies includes a review of the broker's or dealer's accounting system, internal accounting controls, and procedures for safeguarding securities. Rule 17a-5 provides that the scope of the audit and review shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination would be disclosed. These procedures are to include a review of the practices and procedures of the broker or dealer in making the periodic computations of aggregate indebtedness and net capital under Rule 15c3-1.

In addition to the above, Rule 17a-5 provides that, for those brokers and dealers that are not exempt from the provisions of Rule 15c3-3, the audit is to include a review of the practices and procedures followed by the broker or dealer related to:

- Making the periodic computations of the reserve required by Rule 15c3-3(e);
- Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Exchange Act Rule 17a-13;^{14/}
- Complying with the requirements for prompt payment for securities under Regulation T of the Board of Governors of the Federal Reserve System; and
- Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.

In addition, Rule 17a-5(g)(2) provides that if the broker or dealer is exempt from the Customer Protection Rule, the accountant shall ascertain whether the broker or dealer complied with the applicable conditions for exemption.

Part II: Inspections of Registered Public Accounting Firms and Audits Selected

The Dodd-Frank amendments did not prescribe a specific program of inspection of registered public accounting firms that provide audit reports for brokers and dealers. The Board is taking a careful and informed approach in establishing a permanent

Rule 17a-5(j) requires the broker or dealer to file concurrently with the annual audit report a supplemental report by the accountant describing any material inadequacies found to exist or found to have existed since the date of the previous audit.

^{14/} This rule requires brokers and dealers to perform securities counts not less than once each calendar quarter.

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inspection program that appropriately protects the public interest, including consideration of potential costs and regulatory burdens that would be imposed on different categories of registered public accounting firms and classes of brokers and dealers. At this point, the Board is continuing to gather and assess information to inform an eventual rule proposal concerning the elements of a permanent inspection program and has made no decisions about such a proposal.

Approximately 800 registered public accounting firms issued audit reports for the financial statements of brokers and dealers for fiscal periods ended during 2011 that were filed with the SEC.^{15/} Some of these firms audited as few as one broker or dealer, while others audited over 150 brokers or dealers.^{16/} Approximately 300 of these firms also reported issuing audit reports for issuers.^{17/} There were approximately 4,400 brokers and dealers that filed audited annual financial statements for fiscal periods ended during 2011 with the SEC.^{18/}

The Board currently expects to select and inspect approximately 100 registered public accounting firms that issue audit reports for brokers and dealers and to select and inspect portions of audits of over 170 brokers and dealers by the end of 2013. The Board anticipates carrying out inspections under the interim inspection program until rules for a permanent inspection program take effect,^{19/} currently expected to be sometime after 2013.

This report addresses the inspections of the first ten of those firms selected under the interim inspection program. Selection of these firms for inspection took into

^{15/} This information is based on the number of firms registered with the PCAOB as of July 10, 2012 that issued audit reports for brokers and dealers filed with the SEC through May 17, 2012 for fiscal years ended during 2011.

^{16/} Id.

^{17/} This information is derived from data obtained from the most recently submitted Form 2 filed through July 10, 2012. Section 102(d) of the Act and PCAOB Rule 2200 require registered public accounting firms to file an annual report on Form 2 with the Board covering the twelve month period ended March 31 by June 30.

^{18/} This information is based on the number of firms registered with the PCAOB as of July 10, 2012 that issued audit reports for brokers and dealers filed with the SEC through May 17, 2012 for fiscal years ended during 2011.

^{19/} See PCAOB Release No. 2011-001 (June 14, 2011) at 15.

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consideration whether they also issued audit reports for issuers and, thus, were subject to regular inspection by the PCAOB, as well as other characteristics, to obtain a cross section of firms that audit brokers and dealers. At the time of the selection, three of the ten firms were subject to regular inspection because they also audited issuers. The remaining seven did not audit issuers and so were not subject to inspection other than under the interim inspection program.

The selections of brokers and dealers considered various factors, such as the lines of business, the minimum net capital requirement under Rule 15c3-1, and whether or not the brokers or dealers maintained a Special Reserve Bank Account under Rule 15c3-3. The Board did not exclude any audits of brokers or dealers from being eligible for selection.

For the ten firms inspected, 23 audits of brokers and dealers were selected with financial statement periods ended in December 2010 or June 2011. The audits selected included nine brokers and dealers that maintained a Special Reserve Bank Account and had minimum net capital requirements ranging from \$250,000 to approximately \$6,500,000. These brokers and dealers reported actual net capital ranging from approximately \$300,000 to \$120,000,000. The other 14 brokers and dealers whose audits were selected did not maintain a Special Reserve Bank Account and reported compliance with the exemptive provisions of Rule 15c3-3. The minimum net capital requirement for these brokers and dealers ranged from \$5,000 to approximately \$6,000,000, with reported actual net capital ranging from approximately \$100,000 to \$80,000,000.

The Board recognizes that the firms selected for inspections under the interim inspection program are not necessarily representative of all registered public accounting firms that issue audit reports for brokers and dealers registered with the SEC. The approach to select brokers and dealers and the portions of audits inspected is different from the risk-based methodology used in the inspection program for firms that audit issuers. Therefore, the nature of the findings in the interim inspection program may be different than those in the regular inspection program.

As indicated in the Board's release related to the adoption of the Temporary Rule, the inclusive scope of the interim inspection program should not be construed as either foreshadowing the likely scope of a permanent inspection program or suggesting that every auditor of a broker or dealer will be inspected as part of the interim inspection program. In addition, the criteria that were considered in making selections for the interim inspection program are not necessarily representative of any decision that the Board will make on whether and how to differentiate among categories of registered public accounting firms and classes of brokers and dealers.

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Part III: Observations from the Inspections

The inspections focused on portions of 23 audits that related to compliance with the Net Capital Rule, the Customer Protection Rule, and certain areas of the financial statements. Inspections staff identified deficiencies in the audit work it reviewed for each of the ten firms inspected. The deficiencies that exceeded a certain level of significance were communicated to the firms in writing. This section provides a summary of these deficiencies.

Under GAAS, when audit deficiencies are discovered after the date of the audit report, a firm must take appropriate action to assess the importance of the deficiencies to the firm's present ability to support its previously expressed audit opinions.^{20/} Depending upon the circumstances, compliance with these standards may require the firm to perform additional audit procedures, or to inform a client of the need for changes to its financial statements or the supplemental report on material inadequacies, or to take steps to prevent reliance on previously expressed audit opinions. Currently, the Board has not conducted a review of a firm's remedial actions to address deficiencies identified in these inspections. The Board expects firms to take appropriate action, and firms have represented that they have taken, are taking, or will take, action. If, through subsequent inspections or other processes, the Board determines that the firm failed to take appropriate action, that failure may be grounds for a Board disciplinary sanction.

Audit Deficiencies Related to the Customer Protection and Net Capital Rules

Accountant's Supplemental Report on Material Inadequacies

Rule 17a-5(g)(1) requires the scope of the audit and review of the accounting system, the internal accounting controls, and procedures for safeguarding securities to be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination are disclosed in the accountant's supplemental report.^{21/} For example, the identification of errors in the calculation of net capital or the customer reserve computation may indicate the existence of a material inadequacy.

^{20/} See AU sec. 390, *Consideration of Omitted Procedures After the Report Date*, and AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

^{21/} In order to obtain reasonable assurance to support the reporting of material inadequacies to the Commission, the auditor should follow the requirements contained in existing professional standards, including the AICPA's Statements on Standards for Attestation Engagements.

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Inspections staff observed that in 21 of the 23 audits selected, and for at least one audit performed by each of the firms inspected, Inspections staff found that the firms failed to perform sufficient audit procedures to obtain reasonable assurance that material inadequacies existing at the date of the examination were disclosed in the accountant's supplemental report. Inspections staff noted that firms performed a risk assessment and made inquiries of management regarding internal controls as part of the financial statement audit. However, Inspections staff noted these firms did not sufficiently test controls related to the broker's or dealer's accounting system, internal accounting controls, and procedures for safeguarding securities. For example, several firms limited their procedures to inquiries of management. In addition, with regard to the net capital calculation and the customer reserve computation, Inspections staff found that several firms only performed tests of details, which was not sufficient as the firms did not test controls over these calculations and computations.

Inspections staff found that in two audits, firms identified errors in the computations required under the Net Capital Rule, but failed to assess whether these errors indicated the existence of a material inadequacy.

Inspections staff also identified errors in the accountant's supplemental report on material inadequacies issued by the firms for seven of the audits inspected. For example, Inspections staff observed that for an audit of a broker or dealer that maintained a Special Reserve Bank Account, the report did not include certain required elements, such as elements relating to the practices and procedures followed by the broker or dealer in making the periodic computations of the reserve required by the Customer Protection Rule and in making the quarterly securities examinations required by Rule 17a-13.

When a broker or dealer claims an exemption from the Customer Protection Rule, auditors are required under Rule 17a-5(g)(2) to ascertain whether the conditions of the exemption were being complied with, as of the examination date, and whether facts came to the auditor's attention to indicate that the broker or dealer was not in compliance with the exemption during the period since the last examination. For all of the 14 audits of brokers and dealers that claimed an exemption from the requirement to maintain a Special Reserve Bank Account, Inspections staff found that the firms did not perform sufficient inquiries or other procedures related to the exemption claimed by the broker or dealer under the Customer Protection Rule.

Compliance with the Customer Protection Rule

The assets required to be held in a broker's or dealer's Special Reserve Bank Account may be maintained in multiple accounts at one or more banks. However, under Rule 15c3-3(f), these assets must be kept separate from the broker's or dealer's other

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bank accounts, and assets in the account may not be used by the bank as collateral nor may the bank attach any claim to the account.

Inspections staff observed on one audit that the firm failed to obtain sufficient audit evidence, when more than one Special Reserve Bank Account at the same depository institution was used, that the accounts were designated for the exclusive benefit of customers. On another audit, Inspections staff observed that the firm failed to obtain sufficient audit evidence that the terms of the bank account agreements contained the required restrictive conditions of Rule 15c3-3(f) with respect to the use of assets in the accounts.

Compliance with Net Capital Requirements

A broker's or dealer's net capital is disclosed in the notes to its financial statements as well as in a supporting schedule that presents the computation of net capital. Under Rule 17a-5, the registered public accounting firm is required to express an opinion on the computation of net capital. For the audits inspected, when information accompanied the basic financial statements, such as a schedule on net capital, the auditor's report indicated that this information was fairly stated in all material respects in relation to the basic financial statements as a whole.

Inspections staff observed that in seven audits, firms failed to sufficiently test the components of the broker's or dealer's net capital computation. For example, when computing net capital, the Net Capital Rule generally requires brokers and dealers to apply percentage reductions to the values of securities owned by the broker or dealer, referred to as "haircuts".^{22/} As a result, the valuation of the securities and the correct haircut percentage are critical to the net capital computation. In two of the audits, Inspections staff found that firms failed to perform sufficient audit procedures on schedules obtained from the broker or dealer related to securities positions. Further, in two other audits, Inspections staff found that firms failed to test the accuracy of the haircut percentages applied by the brokers or dealers, including tests of the relevant characteristics of securities positions. See *Fair Value Measurements* section for observations related to the tests of the valuation of securities.

The Net Capital Rule requires that assets not readily convertible into cash ("non-allowable assets") be deducted from equity when computing net capital.^{23/} Inspections

^{22/} See Rule 15c3-1(c)(2)(vi).

^{23/} See Rule 15c3-1(c)(2)(iv).

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staff observed three audits where the firms did not test the broker's or dealer's classification of allowable and non-allowable assets when computing net capital. In another audit, Inspections staff observed that a firm obtained representations from management regarding the netting of receivables and payables of affiliates that were not in accordance with existing rules and interpretations and failed to test or corroborate management's representation.

Rule 17a-11(c)(3) requires a broker or dealer to promptly send an early warning notice, within 24 hours, to the SEC and the broker's or dealer's designated examining authority, such as FINRA, if its total net capital is less than 120 percent of its required minimum net capital. In one instance, Inspections staff found that a firm did not detect that a broker's or dealer's net capital had fallen below 120 percent of its required minimum net capital. As a consequence, Inspections staff found that the firm did not ascertain whether the broker or dealer had made the proper notification or whether an indication of a material inadequacy existed.

Deficiencies Related to the Financial Statement Audit

Consideration of Risks of Material Misstatement Due to Fraud

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud.^{24/} AU sec. 316 describes the auditor's responsibilities for, among other things, identifying, assessing, and responding to the risks of material misstatement due to fraud. The two types of misstatements that are relevant to the consideration of fraud are misstatements arising from fraudulent financial reporting and misappropriation of assets.^{25/}

Due professional care requires the auditor to exercise professional skepticism.^{26/} The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about

^{24/} See Paragraph .01 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

^{25/} See Paragraph .06 of AU sec. 316.

^{26/} Paragraph .13 of AU sec. 316.

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management's honesty and integrity.^{27/} Furthermore, professional skepticism requires ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.^{28/}

Inspections staff observed that firms identified fraud risks in areas such as revenue recognition, lack of segregation of duties, and related party transactions. However, in four of the audits inspected, Inspections staff observed that the firms did not perform audit procedures to respond to the identified risks of fraud.

The auditor should perform procedures to examine journal entries and other adjustments for evidence of possible material misstatement due to fraud.^{29/} Inspections staff observed in 13 of the audits inspected, that the firms failed to perform sufficient journal entry testing in response to the risk of management override. For example, in four of these audits, Inspections staff observed that the firms did not test the completeness of the population of journal entries from which they selected a sample for testing. Inspections staff also observed four audits where the firms failed to consider the characteristics of potentially fraudulent entries or adjustments, such as those that were, to the extent present, (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically did not make journal entries, (c) recorded at the end of the period or as post-closing entries that had little or no explanation or description, (d) made either before or during the preparation of the financial statements that did not have account numbers, or (e) comprised of round numbers or a consistent ending number.^{30/}

Related Party Transactions

Related parties often play a significant role in the operations of brokers and dealers, for example, through direct participation in the activities of the brokers and dealers by principals and affiliates under shared service agreements. The auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of

^{27/} Id.

^{28/} Id.

^{29/} See Paragraph .58 of AU sec. 316.

^{30/} See Paragraph .61 of AU sec. 316.

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particular transactions rather than merely their legal form.^{31/} For example, relationships and transactions with related parties have been a contributing factor in prominent corporate scandals.

Auditors should be aware of the possible existence of material related party transactions that could affect the financial statements, as well as of possible common ownership or management control relationships that should be disclosed in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 850, *Related Party Disclosures*.^{32/} Procedures to address possible related party transactions are normally performed even if the auditor has no reason to suspect that related party transactions or control relationships exist.^{33/}

Inspections staff observed eight audits where the firms failed to perform sufficient audit procedures for the purpose of determining the existence of related parties and material related party transactions. In five of these audits, Inspections staff found that firms identified the existence of agreements between the broker or dealer and an affiliated entity, yet failed to test for undisclosed related parties and material related party transactions. Inspections staff also observed two audits in which firm personnel signed off on individual steps within the audit programs to indicate that they had performed certain audit procedures to test for related parties and material related party transactions, but there was no other evidence in sufficient detail to provide a clear understanding of the work performed, including the nature, timing, extent, and results of audit procedures performed.

In four of the audits inspected, the financial statements included disclosures pertaining to expense sharing agreements, service agreements, or revenue sharing agreements with related parties. Inspections staff observed that firms did not perform procedures necessary to obtain and evaluate sufficient appropriate audit evidence concerning the purpose, nature, and extent of these transactions and their effect on the financial statements.

^{31/} See Paragraph .02 of AU sec. 334, *Related Parties*.

^{32/} See Paragraph .04 of AU sec. 334.

^{33/} See Id.

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Revenue Recognition

Brokers and dealers generate revenue from a variety of securities-related lines of business. Auditors should assess the risk of material misstatement at the relevant assertion level as a basis for audit procedures.^{34/} The auditor should design and perform audit procedures whose nature, timing, and extent are responsive to the assessed risk.^{35/}

Inspections staff identified deficiencies in 15 of the audits inspected relating to the failure of firms to perform sufficient procedures to test the occurrence, accuracy, and completeness of revenue. For example, Inspections staff observed instances in which firms:

- Failed to test whether revenue from certain agreements with customers was recognized properly;
- Failed to test material classes of revenue transactions, including investment banking income, service fee income, principal transactions revenue, trading gains and losses, and research and incentive fees;
- Selected samples of revenue transactions for testing that were not representative of the underlying population or were not sufficient to form a conclusion about the reported revenue; and
- Performed tests of commission revenue without verifying that commission rates used in calculating commission revenue were consistent with the underlying agreements.

Establishing a Basis for Reliance on Records and Reports

When information produced by the entity being audited is used by the auditor to perform tests of controls or substantive tests, the auditor should obtain sufficient evidence about the accuracy and completeness of the information provided.^{36/}

^{34/} Paragraph .23 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*.

^{35/} See Paragraph .07 of AU sec. 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

^{36/} See Paragraph .10 of AU sec. 326, *Audit Evidence*.

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In 12 audits, Inspections staff found that firms did not perform sufficient procedures to place reliance on records and reports of the broker or dealer or reports from service organizations that were used in audit procedures.

Inspections staff observed that in nine of these audits, the firms failed to perform procedures to obtain evidence about the accuracy and completeness of records and reports produced by the brokers and dealers that were used in the performance of tests of controls and substantive tests. Examples of the records and reports included general ledgers, trial balances, and schedules and spreadsheets prepared by broker or dealer personnel. Such records and reports were used by the firms in performing tests of certain areas without performing tests of the accuracy and completeness of the information contained therein.

Certain brokers and dealers earn commission revenue by introducing clients to other brokers and dealers who perform trade processing, principally in the clearing and settling of customer transactions. AU sec. 324, *Service Organizations*, is applicable in the case where a company obtains services from another organization that are considered part of the company's information system. This includes services that affect the financial reporting process used to prepare the company's financial statements, significant accounting estimates, and disclosures.^{37/} AU sec. 324 also discusses the user auditor's consideration of the service organization's effect on the user organization's internal control, the user auditor's assessment of control risk, and the user auditor's response to risks identified, whether through tests of controls or substantive tests.^{38/}

Inspections staff observed in four of these audits, that the firms used reports from a service organization, such as a clearing broker, for purposes of testing commission revenue and the related commission receivable, but either did not obtain and evaluate a service auditor's report or failed to perform procedures regarding the accuracy and completeness of information obtained from the service organization. In instances where firms obtained a service auditor's report, Inspections staff observed in three of these audits that the firms failed to evaluate the service auditor's report or failed to consider whether the service auditor's report provided evidence about the design and operating effectiveness of the controls being relied upon.

^{37/} See Paragraph .03 of AU sec. 324.

^{38/} See Paragraphs .06-.21 of AU sec. 324.

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Fair Value Measurements

Brokers and dealers account for and disclose securities at fair value.^{39/} The auditor's approach to performing substantive tests of fair value measurements might include one or a combination of the following: (a) testing management's significant assumptions, the valuation model, and the underlying data, (b) developing an independent estimate of fair value for corroborative purposes, or (c) reviewing subsequent events or transactions.^{40/} When an auditor develops an independent estimate of fair value, an auditor should test the data used to develop the fair value measurement and should evaluate whether the data on which the fair value measurements are based is accurate, complete, and relevant.^{41/}

In six of nine audits, Inspections staff observed that the firms did not perform sufficient procedures to test the valuation of securities. For example, in four of these audits, Inspections staff found that firms failed to obtain an understanding of the specific methods or assumptions underlying certain fair value estimates that were obtained by the firms from pricing services or other third parties.

Evaluation of Internal Control Deficiencies in the Financial Statement Audit

In an audit of the financial statements, the auditor should obtain an understanding of the entity's internal controls sufficient to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and to design the nature, timing and extent of audit procedures.^{42/} During the course of an audit, the auditor may become aware of control deficiencies.^{43/} The auditor should evaluate the severity of each control deficiency identified during the audit to determine whether the

^{39/} FASB ASC Subtopic 940-320, *Financial Services - Broker and Dealers, Investments - Debt and Equity Securities*.

^{40/} Paragraph .23 of AU sec. 328, *Auditing Fair Value Measurements and Disclosures*.

^{41/} See Paragraphs .39 and .40 of AU sec. 328.

^{42/} Paragraph .40 of AU sec. 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

^{43/} See Paragraph .04 of AU sec. 325, *Communicating Internal Control Related Matters Identified in an Audit*.

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deficiencies, individually or in combination, represent a significant deficiency or material weakness.^{44/} The severity of a control deficiency does not depend on whether a misstatement has actually occurred.^{45/}

In two audits, Inspections staff observed that the firms identified one or more internal control deficiencies while performing procedures to obtain an understanding of internal control. Although the firms identified these deficiencies, the evaluations by the firms did not include a sufficient assessment of factors that affect the magnitude of a misstatement that might result from the deficiency. In addition, Inspections staff observed two audits where errors were identified during the performance of substantive tests, yet the firms failed to evaluate the severity and nature of the errors and the circumstances of their occurrences, including whether the errors were evidence of one or more control deficiencies.

Financial Statement Disclosures

The presentation of financial statements in conformity with generally accepted accounting principles includes adequate disclosure of material matters.^{46/} An auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which the auditor is aware at the time.^{47/}

Inspections staff reviewed the audit work performed related to financial statement disclosures for those audit areas included in the inspections. In seven of the audits inspected, Inspections staff observed that firms failed to perform sufficient audit procedures to test the accuracy and completeness of certain financial statement disclosures. For example, in three of these audits, Inspections staff observed instances in which firms failed to identify and address the omission of required disclosures pertaining to related parties and related party transactions, fair value, subsequent events, and income taxes, despite the fact that these matters were applicable and material to the financial statements. In addition, Inspections staff observed in four of these audits that firms failed to sufficiently test management's classification of securities

^{44/} See Paragraph .08 of AU sec. 325.

^{45/} Id.

^{46/} Paragraph .02 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

^{47/} Id.

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within the hierarchy established by FASB ASC 820, *Fair Value Measurements and Disclosures*.

Failures to Satisfy Independence Requirements

The independence of the registered public accounting firm plays an important role in fostering high quality audits. Auditors of brokers and dealers are subject to SEC independence requirements,^{48/} which differ from AICPA independence requirements. SEC rules provide, among other things, that an accountant is not independent if the accountant provides bookkeeping or other services related to the accounting records or financial statements of the audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures performed by the accountant during an audit of the client's financial statements.^{49/}

Inspections staff observed two audits where the firm prepared, or assisted in preparing, the financial statements of the brokers and dealers that were being audited.

Part IV: Next Steps of the Interim Inspection Program

The Board will continue carrying out procedures under the interim inspection program until the Board has developed rules for a permanent program and those rules take effect. The interim inspection program is currently expected to include inspections of approximately 100 registered public accounting firms, including the ten discussed herein, covering portions of over 170 audits by the end of 2013. During 2012, the Board anticipates inspecting over 40 firms and portions of approximately 60 audits. Inspections under the interim inspection program will continue until rules for a permanent inspection program take effect,^{50/} currently expected to be sometime after 2013. The scope and approach of these future inspections will continue to follow what was described earlier in Part II with substantially the same objectives. The Board will adjust its inspection approach, as deemed necessary, in consideration of the results of inspections, changes in the industry, and any future changes in rules or standards. Information will continue to be gathered to inform the Board of an eventual rule proposal concerning the elements of a permanent inspection program for auditors of brokers and dealers.

^{48/} See Rule 17a-5(f)(3).

^{49/} See Rule 2-01(c)(4)(i) of Regulation S-X.

^{50/} See PCAOB Release No. 2011-001 (June 14, 2011) at 15.

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In this regard, consideration is expected to be given to the range of brokers and dealers and the various lines of business with a focus on the risks associated with the protection of customer assets. Insights gained from inspections and information provided by other regulators, among other factors, are also expected to be considered. Factors will be considered in relation to the responsibilities of registered public accounting firms in performing the audits of brokers and dealers.

The Board will issue future progress reports that will describe significant observations from inspections, the publication of which may otherwise be appropriate to protect the interests of investors or to further the public interest. In addition, the Board will use information obtained from the interim inspection program and other research and outreach efforts to inform its future standards-setting activities relevant to the audits of brokers and dealers.

The Board will continue to hold forums and participate in other public outreach activities to inform registered public accounting firms that issue audit reports for brokers and dealers of observations from our interim inspection program, developments in Board standards-setting initiatives, and updates from the SEC and FINRA.