



September 9, 2011

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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington D.C. 20006-2803

Re: Request for Public Comment: Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ appreciates the opportunity to provide feedback to the Public Company Accounting Oversight Board's (the "PCAOB") Rulemaking Docket Matter No. 035, "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" (the "proposed standards"). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

Additionally, we encourage the PCAOB to review the CAQ's comment letter on the Securities and Exchange Commission's (the "Commission") Broker-Dealer Reports proposal (the "proposed rule"), which covers a majority of the topical areas discussed below.

OVERALL COMMENT

The proposed standards are intended to address the auditor's responsibilities for the examination of the Compliance Report and review of the Exemption Report as proposed within the Commission's proposed rule and include standards that, among other things:

- Establish examination requirements that are risk-based and allow for the independent registered public accounting firms (“auditors” or “audit firms”) to obtain reasonable assurance as to whether any material non-compliance or material weakness exists
- Establish review requirements that are commensurate with an auditor's responsibility to obtain moderate assurance that broker-dealers meet the identified conditions for an exemption

In general, the CAQ supports the PCAOB's proposed standards. We believe the proposed standards provide attestation procedures for both examination and review engagements that are consistent with the Commission's proposed rule. However, we recommend that the PCAOB consider the following observations that we believe will enhance the effectiveness of the proposed standards.

SPECIFIC COMMENTS

We have organized these observations around the following topical areas:

- Engagement Quality Reviews
- Examination and Review Reports
- Clarification of “Material Non-Compliance”
- Audit Scalability
- Exemption Report
- Proposed Effective Date
- Internal Control over Compliance with the Financial Responsibility Rules

ENGAGEMENT QUALITY REVIEWS

The proposed standards include certain amendments to PCAOB Auditing Standard No. 7 *Engagement Quality Review* (“AS 7”) that would require “an engagement quality review and concurring approval of issuance for examination engagements and review engagements of brokers and dealers.”¹ This includes both carrying broker-dealers that file a Compliance Report and non-carrying broker-dealers that are exempt from the Compliance Report requirement and file an Exemption Report. In addition, we note that the application of AS 7 to broker-dealers will also require an Engagement Quality Review (“EQR”) as part of the financial statement audit.

¹ Proposed Standards, Section V. A.



- **EQR Procedures for Examination and Review Engagements**

AS 7 includes specific guidance regarding the EQR process for audit engagements² as well as reviews of interim financial information.³ However, AS 7 does not include specific guidance for attestation examination and review engagements of broker-dealers, nor do the proposed standards provide any amendments to AS 7, for inclusion of such guidance. We believe audit firms would benefit from guidance regarding EQR procedures to be performed for examination and review engagements.

- **Non-Carrying Broker-Dealers**

The Exemption Report was established within the Commission's proposed rule to exempt broker-dealers that do not maintain customer funds from the rigors of the Compliance Examination. Broker-dealers that would file an Exemption Report typically tend to be smaller entities. Requiring an EQR for these types of review and audit engagements may present additional costs in excess of any related benefits, particularly as it relates to smaller broker-dealers. Audit firms would be required to perform EQR procedures on both the related audit and review engagements, which will increase the costs of the engagements. We believe the PCAOB should take this into consideration in determining whether the application of AS 7 is necessary for review and audit engagements of non-carrying broker-dealers.

EXAMINATION AND REVIEW REPORTS

- **Explanatory Language**

Broker-dealers' assertions are based principally upon regulatory requirements (e.g., net capital computations pursuant to Rule 15c3-1, reserve requirements pursuant to Rule 15c3-3) that may be subject to legal interpretation. As a result, we believe that the scope paragraph of the examination and review reports should be modified to include a sentence indicating that the auditor's examination or review did not provide for a legal determination of the broker-dealer's compliance with specific requirements, similar to established guidance within the PCAOB's Interim Standards.⁴

Similarly, evaluating a broker-dealer's compliance with certain regulatory requirements (e.g., net capital computations pursuant to Rule 15c3-1, reserve requirements pursuant to Rule 15c3-3) may be based on the interpretation of laws, regulations, or rules established by the Commission and/or Designated Examining Authorities. Therefore, we believe the proposed standards should permit the

² AS 7, paragraphs 9 – 13.

³ AS 7, paragraphs 14 – 18.

⁴ PCAOB Interim Standards Attestation Standard 601 ("AT 601"), paragraph 56.

inclusion of a paragraph within the examination and review reports stating the description and the source of interpretations made by the broker-dealer's management, similar to established guidance within the PCAOB's Interim Standards.⁵

- **Restriction of Use**

Audit firms have previously restricted the use of internal control reports required by the Commission's Rule 17a-5 to the board of directors, management, the Commission, and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934.⁶ However, the proposed standards do not include provisions that allow audit firms to restrict the use of examination and review reports to specified parties.⁷

We believe that a restriction on the use of an auditor's examination or review report may be appropriate in certain situations, given that general users of these reports may not have a sufficient understanding of the subject matter to which they relate, such as, the Financial Responsibility Rules or the exemptive provisions of Rule 15c3-3. As such, we request that the PCAOB consider allowing auditors to restrict the use of examination and review reports, as deemed appropriate by the auditors.

- **Modifications of Standardized Reports**

The proposed standards include examples of standardized examination and review reports, and indicate that these reports should be modified if certain conditions exist.⁸ However, the proposed standards do not include suggested wording or examples of modified reports. We believe that audit firms would benefit from specific examples of report modifications, similar to the standardized reports included within the proposed standards.

CLARIFICATION OF "MATERIAL NON-COMPLIANCE"

The proposed standards require auditors to plan and perform examination procedures to detect instances that individually, or in combination, would result in material non-compliance. The proposed standards also indicate that the auditor should consider "relevant quantitative and qualitative factors"⁹ and "devote more attention to the matters that are most significant to

⁵ AT 601, paragraph 59 provides that the following as an example of such a paragraph, which should directly follow the scope paragraph: "We have been informed that, under [*name of entity*]'s interpretation of [*identify the compliance requirement*], [*explain the source and nature of the relevant interpretation*]."

⁶ AICPA Audit and Accounting Guide: *Brokers and Dealers in Securities*, Appendix C.

⁷ Proposed Standards, Appendix 4, page 32 and page 50.

⁸ Proposed Standards, Appendix A, paragraphs A1 and Appendix 2, paragraphs 20 - 21.

⁹ Proposed Standards, Appendix 4, Section I. C. 3.

compliance with the specified Financial Responsibility Rules”¹⁰ in planning and performing procedures for a compliance examination engagement.

We believe that auditors would benefit from additional guidance related to the determination of material non-compliance, including wherever possible, specific examples regarding the consideration of qualitative and quantitative factors in the context of each of the Financial Responsibility Rules, and matters within each of the Financial Responsibility Rules that the PCAOB considers to be most significant to compliance.

Furthermore, as detailed within our response to the Commission’s proposed rule, we believe that broker-dealers and audit firms would benefit from guidance regarding the impact of material errors and/or misstatements discovered during the audit of the financial statements, on the determination of material non-compliance, as well as guidance related to the interaction between material weaknesses in internal control over financial reporting (“ICFR”) and material non-compliance.

AUDIT SCALABILITY

The proposed standards require that procedures to be performed as part of an examination or review engagement be designed to be “scalable based on the broker’s or dealer’s size and complexity.”¹¹ We believe that auditors would benefit from additional guidance, including wherever possible, specific examples regarding the application of scalability to both compliance examination and exemption review engagements. We believe that without such guidance, the application of the audit scalability concept could vary significantly across the audit profession.

EXEMPTION REPORT

As detailed within our response to the Commission’s proposed rule, the Exemption Report would require broker-dealers to assert that they are exempt from Rule 15c3-3 and identify the provision of the rule that they are relying on to qualify for the exemption. However, the proposed rule did not indicate whether broker-dealers should make these assertions for an annual period (e.g., for the year ending December 31) or an ‘as of date’ (e.g., as of December 31). We believe the PCOAB’s proposed standards should also indicate, consistent with the Commission’s final rule, whether the auditor’s review of the Exemption Report is either for an annual period or an ‘as of date.’

PROPOSED EFFECTIVE DATE

The proposed standards’ effective date for fiscal years ending on or after September 15, 2012 is consistent with the end of the transition period for carrying broker-dealers under the Commission’s

¹⁰ Proposed Standards, Appendix 4, Section I. C. 5.

¹¹ Proposed Standards, Section III. A.

proposed rule, but does not coincide with the proposed rule's effective date of December 15, 2011. We believe the effective date of the proposed standards is reasonable. However, we have expressed to the Commission the following concerns, regarding the effective date of its proposed rule.

The proposed rule's effective date is less than four months after the close of the related comment period (August 26, 2011) and provides little time for broker-dealers to prepare the additional reports and the documentation to support their assertions to facilitate an auditor's examination or review, as applicable.

The proposed rule's effective date also provides little time for auditors to review and evaluate the full body of PCAOB auditing standards (excluding those specifically required for integrated audits) including PCAOB Auditing Standard No. 3 *Audit Documentation Requirements* ("AS 3") and AS 7, among others, in order to identify all required changes to audit procedures, update auditing guidance, and provide any required training.

Additionally, for December 31, 2011 broker-dealer audit engagements, planning and interim procedures may have already begun. Engagement plans designed under GAAS would need to be revised, and related audit procedures would need to be modified in order for these audits to comply with PCAOB auditing standards. These changes may require audit plans (and engagement fees) to be re-approved by Audit Committees and other governing bodies.

Lastly, if the proposed rule's effective date remains unchanged, audit firms would be required to adopt a new set of auditing standards (existing PCAOB standards) during the transition period, and another set after the transition period (proposed PCAOB standards), which could create unnecessary costs for broker-dealers and their auditors.

In our view, and as communicated to the Commission in a separate comment letter on its proposed rule, the timing issues discussed above would be resolved by the Commission postponing the effective date of its proposed rule to align with the effective date of the PCAOB's proposed standards (i.e., September 15, 2012).

INTERNAL CONTROL OVER COMPLIANCE WITH THE FINANCIAL RESPONSIBILITY RULES

Also as detailed within our response to the Commission's proposed rule, we believe that audit firms would benefit from clarification as to the interaction between ICFR and the auditors' attestation on compliance with the Financial Responsibility Rules. Broker-dealers are not required to provide an assertion regarding the effectiveness of ICFR, nor are auditors required to perform procedures related to such an assertion. However, many of the aspects of the Financial Responsibility Rules (specifically Rule 15c3-1 and 15c3-3) are derived from the financial statements. Thus, ICFR testing



performed as part of the financial statement audit may impact the results of the auditors' attestation on compliance with the Financial Responsibility Rules.

Our final observation concerns the period covered in a broker-dealer's assessment of the effectiveness of internal control over compliance with the Financial Responsibility Rules and the related auditor's Examination Report. We recommend that the Board work with the Commission to align the proposed requirements with those that exist for issuer's assertions and auditor reporting for ICFR. As detailed within our response to the Commission's proposed rule, the broker-dealer's assertion related to the effectiveness of internal control over compliance with the Financial Responsibility Rules covers the entire fiscal year (except during the transition period). Any material weaknesses identified during the fiscal year would preclude broker-dealers from asserting to (and the auditor opining on) the effectiveness of internal control over compliance with the Financial Responsibility Rules, even if material weaknesses were remediated during the period. We acknowledge that the period covered by the Commission's proposed rule is consistent with the Investment Adviser Custody Rule, however, we believe that broker-dealers should have the opportunity to remediate material weaknesses identified during the compliance period and thus be able to assert (and auditors opine on) effectiveness of internal control over compliance with the Financial Responsibility Rules at the end of the compliance period. We believe this approach would better align the Commission's proposed rule and the PCAOB's proposed standards with guidance related to an issuer's report on ICFR.

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We appreciate the opportunity to comment on the PCAOB's proposed standards and would welcome the opportunity to respond to any questions you may have regarding any of our comments and recommendations.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:

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