



## **I. Introduction**

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is proposing two attestation standards, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers* ("examination engagements") and *Review Engagements Regarding Exemption Reports of Brokers and Dealers* ("review engagements"). These attestation standards would apply to compliance examination engagements or review engagements, respectively, of brokers<sup>1/</sup> and dealers,<sup>2/</sup> whichever is required, pursuant to proposed Exchange Act Rule 17a-5, *Reports to be made by certain brokers and dealers* ("SEC Proposed Rule 17a-5").

On July 21, 2010, Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amended various provisions of the Sarbanes-Oxley Act of 2002, and granted the Board oversight of the audits of brokers and dealers registered with the U.S. Securities and Exchange Commission ("SEC" or "Commission").<sup>3/</sup> Specifically, the PCAOB now has the authority to carry out the same type of oversight responsibilities it has carried out with respect to issuer audits, including standard-setting.

On June 15, 2011, the Commission proposed amendments to its Rule 17a-5 regarding the annual reporting by brokers and dealers to, among other things, update the existing requirements of Rule 17a-5 and facilitate the ability of the PCAOB to implement oversight of independent public accountants of brokers and dealers, as

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<sup>1/</sup> Section 110(3) of the Sarbanes-Oxley Act of 2002 (the "Act") defines the term "broker" to mean a broker (as defined in Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act")) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

<sup>2/</sup> Section 110(4) of the Act defines the term "dealer" to mean a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

<sup>3/</sup> Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

required by the Dodd-Frank Act.<sup>4/</sup> Further, these amendments "are intended to encourage, in connection with broker-dealer audits, greater focus by the auditor on internal control over compliance as it pertains to key regulatory requirements, including, in particular, greater focus on broker-dealer custody practices under the [f]inancial [r]esponsibility [r]ules" specified in the amendments.<sup>5/</sup>

Sections 17(a) and (e) of the Exchange Act and Rule 17a-5 together require a broker or dealer to, among other things, file an annual report with the SEC and the broker's or dealer's designated examining authority ("DEA").<sup>6/</sup> SEC Proposed Rule 17a-5 would require the broker's or dealer's annual report to include a financial report and a compliance report or an exemption report.<sup>7/</sup>

The compliance report generally would be filed by a broker or dealer that maintains custody of customer funds or securities and would include assertions by the broker or dealer that address:

- (i) Whether it was in compliance, in all material respects, with specified SEC rules related to net capital requirements, customer protection, including reserves and custody of securities, and quarterly security counts,<sup>8/</sup> as well

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<sup>4/</sup> See 17 CFR § 240.17a-5, *Reports to be made by certain brokers and dealers* and Section I. of SEC Release No. 34-64676 ("SEC Proposing Release").

<sup>5/</sup> See Section II.B.1. of the SEC Proposing Release.

<sup>6/</sup> See Section II.A. of the SEC Proposing Release.

<sup>7/</sup> The financial report required by SEC Proposed Rule 17a-5 would include financial statements and supporting schedules. The audit of the financial statements and supporting schedules would be conducted in accordance with PCAOB standards. In particular, Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements* (PCAOB Release No. 2011-005), would apply to the audit of the supporting schedules. The proposed attestation standard in Appendix 1 of this release would apply to an examination of the assertions in the compliance report. The proposed attestation standard in Appendix 2 of this release would apply to a review of the assertion in the exemption report.

<sup>8/</sup> See 17 CFR § 240.15c3-1, *Net capital requirements for brokers or dealers*, 17 CFR § 240.15c3-3, *Customer protection – reserves and custody of securities*, and 17 CFR § 240.17a-13, *Quarterly security counts to be made by certain exchange members, brokers, and dealers*, for the complete text of these SEC rules. Also, refer to Appendix 4 of this release for further discussion of these SEC rules.

as the rules of its DEA that require account statements to be sent to customers of the broker or dealer (referred to collectively in this release as "the specified Financial Responsibility Rules") as of the fiscal year end;

- (ii) Whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the books and records of the broker or dealer; and
- (iii) Whether internal control over compliance with the specified Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness.<sup>9/</sup>

The exemption report would be filed by a broker or dealer that claims exemption from the requirements of the SEC rule related to the safeguarding of customer assets and would identify the specific conditions that are the basis for claiming the exemption (referred to collectively in this release as "the exemption conditions").<sup>10/</sup>

In addition, the SEC's proposed amendments would require the broker or dealer to include in its annual report an examination report from an independent public accountant regarding the assertions in the compliance report or a review report regarding the assertion in the exemption report, as applicable.<sup>11/</sup> The auditor's examination report or review report would replace the existing requirement in Rule 17a-5 to report on material inadequacies identified in the accounting system, internal accounting controls, procedures of the broker or dealer for safeguarding securities, and certain practices and procedures related to customer protection and securities.<sup>12/</sup>

The requirement under existing Rule 17a-5 that brokers and dealers file a report consisting of audited financial statements and supporting schedules would remain unchanged.<sup>13/</sup> However, SEC Proposed Rule 17a-5 would require that financial

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<sup>9/</sup> See paragraph (d)(3)(i)(B) of SEC Proposed Rule 17a-5. The term "specified Financial Responsibility Rules" as used in this release and the proposed examination standard has the same meaning as the term "Financial Responsibility Rules" used in the SEC Proposing Release.

<sup>10/</sup> See paragraph (d)(4) of SEC Proposed Rule 17a-5.

<sup>11/</sup> See paragraph (d)(1)(i)(C) of SEC Proposed Rule 17a-5.

<sup>12/</sup> See 17 CFR § 240.17a-5(g)(1).

<sup>13/</sup> See Section II.B. of the SEC Proposing Release.

statement audits and examination and review engagements of brokers and dealers be performed in accordance with the standards of the PCAOB, instead of the standards or guidance of the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants ("AICPA").<sup>14/</sup>

## **II. Reasons for the Proposed Attestation Standards**

The Board is proposing two attestation standards to align its attestation standards more closely with the auditor's responsibilities under SEC Proposed Rule 17a-5.<sup>15/</sup> Specifically, these proposed attestation standards would establish requirements for examining the assertions in a broker's or dealer's compliance report and reviewing a broker's or dealer's assertion in an exemption report. These proposed attestation standards are tailored to the requirements in SEC Proposed Rule 17a-5.

Also, the proposed attestation standard for compliance examinations of brokers and dealers ("proposed examination standard") would revise the existing reporting to report on whether the broker's or dealer's assertions are fairly stated, in all material respects.<sup>16/</sup>

The requirement in the proposed examination standard for the auditor to obtain reasonable assurance in order to opine on whether the broker's or dealer's assertions are fairly stated, in all material respects, is similar to the requirement to obtain reasonable assurance in existing Rule 17a-5, which states that "[t]he scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in (a) the accounting system; (b) the internal accounting controls; (c) procedures for safeguarding securities; and (d) the practices and procedures whose review is specified [in Rule 17a-5] would be disclosed."<sup>17/</sup> Currently, however, under applicable guidance from the AICPA, instead of

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<sup>14/</sup> See paragraph (g) of SEC Proposed Rule 17a-5 and Section II.B. of the SEC Proposing Release.

<sup>15/</sup> See paragraph (g) of SEC Proposed Rule 17a-5.

<sup>16/</sup> See paragraph (g)(2)(i) of SEC Proposed Rule 17a-5.

<sup>17/</sup> See 17 CFR § 240.17a-5(g)(1). 17 CFR § 240.17a-5(g)(1) also states that "[a]dditionally, as specific objectives, the audit shall include reviews of the practices and procedures followed by the client: (i) In making the periodic computations of aggregate indebtedness and net capital under 17 CFR § 240.17a-3(a)(11) and the reserve required by 17 CFR § 240.15c3-3(e); (ii) In making the quarterly securities

issuing an opinion based on evidence providing reasonable assurance that all material inadequacies have been disclosed, an auditor may issue a report describing a "study" of certain practices and procedures followed by the broker or dealer.<sup>18/</sup> SEC Proposed Rule 17a-5 would require that auditors perform engagements under Rule 17a-5 in accordance with PCAOB standards instead of the standards or guidance of the AICPA.<sup>19/</sup> Because the proposed PCAOB standards do not provide for a "study," the auditor would no longer refer to such a "study" in his or her report. Instead, the auditor would express an opinion on the broker's or dealer's assertions based on the examination described in the proposed examination standard.

Both of the proposed attestation standards include requirements related to the auditor's consideration of fraud risks, including the risk of misappropriation of customer assets. Furthermore, both of the proposed attestation standards emphasize coordination between the examination engagement or review engagement and the audit of the broker's or dealer's financial statements and supporting schedules (referred to in this release as "supplemental information"). This emphasis on coordination, when properly executed, can avoid unnecessary redundancy in the work performed. For example, auditors can take into account, when appropriate, evidence obtained while planning and performing the audit of the financial statements and supplemental information in planning and performing the attestation engagement.

As an additional measure, the Board has issued for comment a proposed auditing standard regarding auditing supplemental information accompanying audited financial statements ("proposed auditing standard").<sup>20/</sup> The proposed auditing standard would apply when the auditor of the financial statements is engaged to audit and report on supplemental information accompanying audited financial statements, including

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examinations, counts, verifications and comparisons and the recordation of differences required by 17 CFR § 240.17a-13; (iii) In complying with the requirement for prompt payment for securities of section 4(c) of Regulation T (§ 220.4(c) of chapter II of title 12) of the Board of Governors of the Federal Reserve System; and (iv) In obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by 17 CFR § 240.15c3-3. Such review shall include a determination as to the adequacy of the procedures described in the records required to be maintained pursuant to 17 CFR § 240.15c3-3(d)(4)."

<sup>18/</sup> See Section II.A. of the SEC Proposing Release.

<sup>19/</sup> See paragraph (g) of SEC Proposed Rule 17a-5.

<sup>20/</sup> See PCAOB Release No. 2011-005.



schedules prepared pursuant to Rule 17a-5.<sup>21/</sup> The proposed auditing standard also includes a requirement for the procedures performed regarding the supplemental information to be planned and performed in conjunction with the audit of the financial statements and, for audits of brokers and dealers, to be coordinated with the attestation engagements related to compliance or exemption reports.<sup>22/</sup>

### **III. Overview of the Proposed Attestation Standards**

#### **A. Proposed Attestation Standard, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers***

Consistent with SEC Proposed Rule 17a-5, the proposed examination standard would require auditors to obtain sufficient appropriate evidence to opine on a broker's or dealer's assertions as to whether:

- The broker or dealer was in compliance, in all material respects, with the specified Financial Responsibility Rules as of the fiscal year end;
- The financial information used to assert compliance with the specified Financial Responsibility Rules was derived from the books and records of the broker or dealer; and
- Internal control over compliance with the specified Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness.<sup>23/</sup>

The proposed examination standard provides procedural requirements for auditors that:

- Establish a risk-based approach for the examination, focusing the auditor on the matters that are most important to the auditor's conclusions regarding the broker's or dealer's assertions;
- Are designed to be scalable based on the broker's or dealer's size and complexity; and

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<sup>21/</sup> See 17 CFR § 240.17a-5(d)(3) and paragraph (d)(2)(ii) of SEC Proposed Rule 17a-5.

<sup>22/</sup> Ibid.

<sup>23/</sup> See paragraphs (d)(3)(i)(B) and (g)(2)(i) of SEC Proposed Rule 17a-5.

- Coordinate the examination engagement with the audit of the financial statements and supplemental information.

The proposed examination standard establishes requirements designed specifically for the examination required by SEC Proposed Rule 17a-5.<sup>24/</sup> In addition, the emphasis on appropriately coordinating the examination engagement with the audit of the financial statements and supplemental information should result in avoiding unnecessary redundancy in the auditor's work.

Also, as discussed previously, the proposed examination standard would substantially change the language in the auditor's report, in connection with the requirements of the amendments to Rule 17a-5.

Appendix 1 of this release presents the proposed examination standard. Appendix 4 of this release discusses the proposed examination standard in more detail. It also discusses the proposed amendments to PCAOB standards related to the proposed attestation standards.

**B. Proposed Attestation Standard, Review Engagements Regarding Exemption Reports of Brokers and Dealers**

Consistent with SEC Proposed Rule 17a-5, the proposed attestation standard for reviewing a broker's or dealer's assertion in an exemption report ("proposed review standard") would establish requirements that apply when an auditor is engaged to perform a compliance review of the broker's or dealer's assertion in an exemption report.<sup>25/</sup>

The proposed review standard establishes requirements that are designed specifically for the review required by SEC Proposed Rule 17a-5.<sup>26/</sup> The proposed review standard would establish requirements for making inquiries and performing other procedures that are commensurate with the auditor's responsibility to obtain moderate assurance<sup>27/</sup> that the broker or dealer meets the identified conditions for an exemption

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<sup>24/</sup> See paragraph (g)(2)(i) of SEC Proposed Rule 17a-5.

<sup>25/</sup> See paragraphs (d)(4) and (g)(2)(ii) of SEC Proposed Rule 17a-5.

<sup>26/</sup> Ibid.

<sup>27/</sup> Obtaining moderate assurance in a review engagement is consistent with both existing PCAOB standards and the SEC Proposing Release. Paragraphs .55-.56 of AT sec. 101, *Attest Engagements*, states that "[i]n an attest engagement designed to provide a moderate level of assurance (referred to as a *review*), the objective is to



from Exchange Act Rule 15c3-3, *Customer protection – reserves and custody of securities*.<sup>28/</sup> These procedures include evaluating relevant evidence obtained from the audit of the financial statements and supplemental information and are designed to enable the auditor to scale the review engagement based on the broker's or dealer's size and complexity.

The proposed review standard would establish requirements for the content of the review report. Appendix 2 of this release contains the text of the proposed review standard. Appendix 4 of this release discusses the proposed review standard in more detail.

#### **IV. Effective Date**

The Board expects that the proposed attestation standards would be effective for fiscal years ending on or after September 15, 2012, subject to consideration of public comment, SEC rule-making,<sup>29/</sup> and approval by the SEC. This effective date coincides with the proposed end of the transition period for SEC Proposed Rule 17a-5.<sup>30/</sup>

#### **V. Other Board Considerations**

##### **A. Engagement Quality Review**

The Board is proposing certain amendments to Auditing Standard No. 7, *Engagement Quality Review*, that would require an engagement quality review and concurring approval of issuance for examination engagements and review engagements of brokers and dealers.

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accumulate sufficient evidence to restrict attestation risk to a moderate level. To accomplish this, the types of procedures performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures). Nevertheless, there will be circumstances in which inquiry and analytical procedures ... cannot be performed... In [this] circumstance, the practitioner should perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided." Section II.B.5. of the SEC Proposing Release states that a review results in "a moderate level of assurance."

<sup>28/</sup> See 17 CFR § 240.15c3-3.

<sup>29/</sup> See SEC Proposing Release.

<sup>30/</sup> See Section II.B.7. of the SEC Proposing Release.

## **B. Independence**

SEC Proposed Rule 17a-5 requires the auditor to be qualified and independent in accordance with the Commission's auditor independence requirements in 17 CFR § 210.2-01, *Qualification of Accountants*.<sup>31/</sup> The auditor should refer to 17 CFR § 210.2-01 for applicable independence requirements when performing audits and attestation engagements of non-public brokers and dealers. The auditor also should refer to PCAOB Rules 3500T and 3600T, which require registered public accounting firms and their associated persons, in connection with the preparation or issuance of any audit report, to comply with the Board's interim ethics and independence standards to the extent not superseded or amended by the Board. In addition, any person associated with a registered public accounting firm is subject to PCAOB Rules 3501 and 3502, which state that associated persons shall not take or omit to take an action knowing, or recklessly not knowing, that the act or omission would directly and substantially contribute to a violation by that registered public accounting firm of the Act, Board rules, applicable securities laws, SEC rules or professional standards.

The Board has auditor independence requirements in PCAOB Rules 3520 through 3526 that supplement the SEC's independence rules. Rule 3520 requires that a registered public accounting firm and its associated persons be independent throughout the audit and professional engagement period. This concept applies to audits of non-public brokers and dealers to the same extent that it applies to audits of public company audit clients. PCAOB Rules 3521 through 3526, however, contain auditor independence requirements that the Board drafted specifically to pertain to public company audit clients. These requirements generally relate to the provision of tax services for audit clients, auditor communications with audit committees, and audit committee pre-approval of services provided by the auditor. Until the Board completes a separate rulemaking process and appropriate amendments to those rules, if any, are adopted by the Board and approved by the SEC, auditors of non-public brokers and dealers are not subject to the specific provisions of PCAOB Rules 3521 through 3526.

## **VI. Opportunity for Public Comment**

The Board seeks comments on all aspects of the proposals, including the following:

1. Whether the proposed attestation standards are tailored appropriately for examinations and reviews related to compliance and exemption reports of brokers and dealers;

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<sup>31/</sup> See paragraph (f)(1) of SEC Proposed Rule 17a-5.

2. Whether the proposed attestation standards are appropriately scalable based on the size and complexity of the broker or dealer;
3. Whether the requirements in the proposed attestation standards sufficiently describe the auditor's responsibilities; and
4. Whether specific requirements should be added to either of the proposed attestation standards to further enhance protection of customer assets.

Appendix 4 of this release seeks comments in response to additional questions.

The Board will seek comment on the proposed attestation standards and amendments for a 60-day period. Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington DC 20006-2803. Comments also may be submitted by email to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the Board's Web site at [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to the PCAOB Rulemaking Docket Matter No. 035 on the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on September 12, 2011.

The Board will consider carefully all comments received. Following the close of the comment period, the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are rules of the Board under the Act.

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On the 12<sup>th</sup> day of July, in the year 2011, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour  
Secretary

July 12, 2011

APPENDIX 1 – Proposed Attestation Standard – *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*

APPENDIX 2 – Proposed Attestation Standard – *Review Engagements Regarding Exemption Reports of Brokers and Dealers*

APPENDIX 3 – Proposed Amendments to PCAOB Standards

APPENDIX 4 – Additional Discussion on the Proposed Attestation Standards and Questions for Public Comment

## **APPENDIX 1**

### **Proposed Attestation Standard**

#### ***Examination Engagements Regarding Compliance Reports of Brokers and Dealers***

##### ***Introduction***

1. This standard establishes requirements that apply when an auditor is engaged to perform an examination<sup>1/</sup> of the assertions made by a broker<sup>2/</sup> or dealer<sup>3/</sup> in a compliance report ("compliance report") prepared pursuant to the U.S. Securities and Exchange Commission's ("SEC's" or "Commission's") proposed amendments to Exchange Act Rule 17a-5 ("SEC Proposed Rule 17a-5").<sup>4/</sup>
2. SEC Proposed Rule 17a-5 requires a broker's or dealer's compliance report to contain the following assertions by the broker or dealer:<sup>5/</sup>

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<sup>1/</sup> On June 15, 2011, the Securities and Exchange Commission proposed amendments to 17 CFR § 240.17a-5, *Reports to be made by certain brokers and dealers*. Paragraph (g) of SEC Proposed Rule 17a-5 requires that the broker or dealer engage an independent accountant to issue the examination report covered by this standard.

<sup>2/</sup> Section 110(3) of the Sarbanes-Oxley Act of 2002 (the "Act") defines the term "broker" to mean a broker (as defined in Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act")) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

<sup>3/</sup> Section 110(4) of the Act defines the term "dealer" to mean a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

<sup>4/</sup> See paragraph (d)(3) of SEC Proposed Rule 17a-5.

<sup>5/</sup> See paragraph (d)(3)(i)(B) of SEC Proposed Rule 17a-5.

- a. Whether, as of the fiscal year end, the broker or dealer was in compliance, in all material respects, with Rule 15c3-1, Rule 15c3-3, Rule 17a-13,<sup>6/</sup> and any rule of the designated examining authority ("DEA") of the broker or dealer that requires account statements to be sent to the customers of the broker or dealer ("account statement rule");

Note: Rule 15c3-1, Rule 15c3-3, Rule 17a-13, and the account statement rule are referred to collectively as "the specified Financial Responsibility Rules."<sup>7/</sup>

- b. Whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the books and records of the broker or dealer; and
- c. Whether internal control over compliance with the specified Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness.<sup>8/</sup>

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<sup>6/</sup> See 17 CFR § 240.15c3-1, *Net capital requirements for brokers or dealers*, 17 CFR § 240.15c3-3, *Customer protection – reserves and custody of securities*, and 17 CFR § 240.17a-13, *Quarterly securities counts to be made by certain exchange members, brokers and dealers*, respectively.

<sup>7/</sup> The SEC's release accompanying SEC Proposed Rule 17a-5 ("SEC Proposing Release") refers to Rule 15c3-1, Rule 15c3-3, Rule 17a-13, and the account statement rule as the "Financial Responsibility Rules."

<sup>8/</sup> Paragraph (d)(3)(iii) of SEC Proposed Rule 17a-5 defines a material weakness as "a deficiency, or a combination of deficiencies, in internal control over compliance with [the specified Financial Responsibility Rules], such that there is a reasonable possibility that material non-compliance with [the specified Financial Responsibility Rules] will not be prevented or detected on a timely basis. For purposes of this paragraph a deficiency in internal control over compliance exists when the design or operation of a control does not allow the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect non-compliance with [the specified Financial Responsibility Rules] on a timely basis." Section II.B.1. of the SEC Proposing Release states that "[t]here is a reasonable possibility of an event occurring if it is 'probable' or 'reasonably possible'. An event is 'probable' if the future event or events are likely to occur. An event is 'reasonably possible' if the chance of the future event or events occurring is more than remote, but less than likely."



## **Objective**

3. When performing an examination of the assertions made by a broker or dealer in a compliance report (an "examination engagement"), the auditor's objective is to express an opinion regarding whether the assertions made by the broker or dealer in its compliance report are fairly stated, in all material respects.

4. A broker or dealer is not permitted to conclude that it is in compliance with the specified Financial Responsibility Rules if it identifies one or more instances of material non-compliance.<sup>9/</sup> Similarly, a broker or dealer is not permitted to conclude that its internal control over compliance with the specified Financial Responsibility Rules was effective if there were one or more instances of material weakness in internal control over compliance.<sup>10/</sup> Accordingly, to express an opinion on the assertions made by a broker or dealer in a compliance report, the auditor must plan and perform the examination engagement to obtain appropriate evidence that is sufficient<sup>11/</sup> to obtain reasonable assurance<sup>12/</sup> about whether (1) one or more instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion and (2) one or more instances of material weakness exist during the period specified in the broker's or dealer's assertion.

Note: Because the broker's or dealer's assertions apply to each specified Financial Responsibility Rule, the auditor's examination should evaluate compliance with each specified Financial Responsibility Rule, and the

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<sup>9/</sup> See paragraph (d)(3)(ii) of SEC Proposed Rule 17a-5. That paragraph also states that "material non-compliance would be a failure by the broker or dealer to comply with the requirements of [the specified Financial Responsibility Rules] in all material respects." Paragraphs 9-11 of this standard establish requirements regarding the auditor's consideration of materiality in planning and performing the examination engagement.

<sup>10/</sup> See paragraph (d)(3)(iii) of SEC Proposed Rule 17a-5.

<sup>11/</sup> In this standard, the terms "sufficiency" and "appropriateness" have the same meaning as "sufficiency" and "appropriateness" of audit evidence, as described in Auditing Standard No. 15, *Audit Evidence*.

<sup>12/</sup> Although not absolute assurance, reasonable assurance is a high level of assurance.

effectiveness of internal control over compliance with each specified Financial Responsibility Rule individually.

Note: The auditor is not required to express an opinion on the process the broker or dealer used to arrive at the conclusions stated in the broker's or dealer's assertions.

5. The auditor must also plan and perform the examination engagement to obtain appropriate evidence that is sufficient to obtain reasonable assurance about whether the information used to assert compliance with the specified Financial Responsibility Rules was derived, in all material respects, from the books and records of the broker or dealer.<sup>13/</sup>

## ***Performing the Examination Engagement***

### **General Requirements**

6. An auditor who performs an examination engagement must:
- a. Have adequate technical proficiency in attestation engagements,
  - b. Obtain an understanding of the specified Financial Responsibility Rules and other rules and regulations that are relevant to the broker's or dealer's assertions,
  - c. Determine the auditor's compliance with independence and ethics requirements, and
  - d. Exercise due professional care,<sup>14/</sup> which includes application of professional skepticism, in planning and performing the examination and the preparation of the report.

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<sup>13/</sup> See paragraph 28 of this standard.

<sup>14/</sup> This standard requires the same due professional care as required by paragraph .40 of AT sec. 101, *Attest Engagements*, which states, in part, that the "[e]xercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report."

7. The engagement partner is responsible for the examination engagement and performance of the examination procedures. Accordingly, the engagement partner is responsible for proper planning of the examination engagement, proper supervision of the work of engagement team members, and compliance with the requirements of this standard. The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Note: For purposes of this standard, the term "engagement partner" means the member of the engagement team with primary responsibility for the examination engagement.

Note: Proper planning includes establishing an overall strategy for the examination engagement and developing a plan for the engagement, which includes, in particular, identifying risks of material non-compliance and planned responses to those risks. Proper supervision includes supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.

### **Relationship Between the Examination Engagement and the Audit of the Financial Statements and Supplemental Information**

8. The examination engagement should be coordinated with the audit of the financial statements and supplemental information of the broker or dealer.<sup>15/</sup> The auditor should take into account relevant evidence from the audit in planning and performing procedures for the examination engagement and in evaluating the results of the procedures performed in the examination. However, the objectives of the audit and the examination engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.

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<sup>15/</sup> Under the definition of supplemental information included in PCAOB Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements* (PCAOB Release 2011-005), supplemental information includes the supporting schedules described in paragraph (d)(2)(ii) and (d)(2)(iii) of SEC Proposed Rule 17a-5, which are required to be filed with the SEC or DEAs by brokers and dealers. Such supporting schedules include 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 Possession or Control Requirements Under Rule 15c3-3.

Note: If the auditor performing the examination engagement does not audit the financial statements and supplemental information of the broker or dealer, then the auditor must obtain knowledge of the evidence obtained and results of procedures performed in the audit of the financial statements and supplemental information that is commensurate with that of the auditor of the financial statements and supplemental information. In addition, the auditor's own work on the examination engagement must be sufficient to support an opinion on the assertions made by the broker or dealer in the compliance report.

### **Consideration of Materiality in the Examination Engagement**

9. To obtain reasonable assurance about whether one or more instances of material non-compliance exist, the auditor should plan and perform examination procedures to detect instances of non-compliance that, individually or in combination, would result in material non-compliance. This includes being alert while planning and performing examination procedures for non-compliance that could be material due to quantitative or qualitative factors. Also, the auditor should take into account relevant quantitative and qualitative factors when evaluating identified non-compliance.

10. In an examination engagement, the auditor should take into account the following matters in his or her consideration of the materiality of non-compliance:

- a. The nature of the specified Financial Responsibility Rules, which may or may not be quantifiable in monetary terms;
- b. The nature and frequency of non-compliance; and
- c. Qualitative considerations.

11. In testing and evaluating the effectiveness of internal control over compliance with the specified Financial Responsibility Rules, the auditor should use the same materiality considerations he or she used for testing and evaluating compliance with the respective specified Financial Responsibility Rules.

### **Considerations for Brokers and Dealers with Multiple Divisions or Branches**

12. When the broker or dealer has multiple divisions or branches, the auditor should determine the extent to which he or she should perform examination procedures at selected divisions or branches to obtain sufficient appropriate evidence to support the conclusions expressed in the auditor's examination report. This includes determining the divisions or branches at which to perform examination procedures, as well as the

nature, timing, and extent of the procedures to be performed at those individual divisions or branches. In determining the extent of the examination procedures to be performed, the auditor should take into account:

- a. The degree to which the specified Financial Responsibility Rules relate to activities at the division or branch level;
- b. The nature and significance of the related assets, transactions, or activities at the division or branch to the specified Financial Responsibility Rules;
- c. The degree of centralization of records or information processing relevant to the specified Financial Responsibility Rules; and
- d. The degree and effectiveness of management supervision and monitoring of the relevant activities of the division or branch.

### **Identifying Risks of Material Non-Compliance**

13. The auditor should perform procedures that are sufficient to provide a reasonable basis for identifying the risks of material non-compliance, whether intentional or unintentional, associated with each specified Financial Responsibility Rule, and designing further examination procedures.<sup>16/</sup> To identify and assess risks of material non-compliance, the auditor should:

- a. Evaluate the evidence obtained and the results of procedures performed in the audit of the financial statements and supplemental information;
- b. Evaluate the nature of instances of non-compliance and deficiencies in internal control over compliance with the specified Financial Responsibility Rules identified during previous examination engagements;
- c. Obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the specified Financial Responsibility Rules;

Note: The nature, timing, and extent of procedures that are necessary to obtain an understanding of the broker's or

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<sup>16/</sup> Further examination procedures consist of testing controls over compliance (paragraphs 15-23) and performing compliance tests (paragraphs 24-26).

dealer's processes, including relevant controls, regarding compliance with the specified Financial Responsibility Rules depend on the size and complexity of the broker or dealer; the auditor's existing knowledge of the broker's or dealer's processes and controls; the degree to which the broker's or dealer's compliance depends on the completeness and accuracy of the broker's or dealer's internally generated data; the nature and extent of changes in systems and operations; and the nature of the broker's or dealer's documentation of its processes and controls.

Note: Obtaining an understanding of the broker's or dealer's processes regarding compliance includes obtaining an understanding of the degree to which the broker's or dealer's compliance depends on the completeness and accuracy of the broker's or dealer's internally generated data.

Note: Obtaining an understanding of the broker's or dealer's processes, including relevant controls, includes evaluating the design of controls that are relevant to the examination and determining whether the controls have been implemented.

- d. Obtain an understanding of instances of non-compliance and deficiencies in controls over compliance identified by management;
- e. Assess risks of material non-compliance associated with related parties,<sup>17/</sup> including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship;
- f. Obtain an understanding of management's competence regarding the relevant rules and regulations;
- g. Read the Financial and Operational Combined Uniform Single Reports filed by the broker or dealer and obtain an understanding of the reasons for resubmissions, if any;

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<sup>17/</sup> The auditor should look to the FASB Accounting Standards Codification Master Glossary with respect to the term "related parties."



- h. Read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's assertions;
- i. Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to the broker's or dealer's assertions;
- j. Read correspondence and notifications regarding non-compliance that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA that are relevant to the broker's or dealer's assertions, and, when necessary in the circumstances, make inquiries of the regulatory agencies; and
- k. Obtain an understanding of the nature and frequency of customer complaints that are relevant to compliance with the specified Financial Responsibility Rules.

14. In addition, when identifying and assessing risks of material non-compliance, the auditor should assess the risk of fraud, including the risk of misappropriation of customer assets, relevant to the specified Financial Responsibility Rules.

### **Testing Controls over Compliance**

15. The auditor must test those controls that are important to the auditor's conclusion about whether the broker or dealer maintains effective internal control over compliance for each specified Financial Responsibility Rule. The auditor must obtain evidence that the controls over compliance selected for testing are designed effectively and operated effectively during the entire fiscal year.<sup>18/</sup>

16. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control.

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<sup>18/</sup> See paragraph (d)(3)(i)(B)(3) of SEC Proposed Rule 17a-5, which requires the broker or dealer to assert on the effectiveness of its internal control over compliance with the specified Financial Responsibility Rules throughout the fiscal year. See also paragraph (d)(3)(i)(C), which requires the broker or dealer to describe each identified instance of material non-compliance and each identified material weakness in internal control over compliance.

The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

Note: Although the auditor must obtain evidence about the effectiveness of the selected controls for each specified Financial Responsibility Rule, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control.

17. Factors that affect the risk associated with a control include:

- The nature of the specified Financial Responsibility Rule,
- The risk of material non-compliance associated with the specified Financial Responsibility Rule,
- Changes in the broker's or dealer's policies or procedures that might adversely affect control design or operating effectiveness,
- The broker's or dealer's history of instances of non-compliance with the specified Financial Responsibility Rule that the control is intended to prevent or detect,
- The existence and effectiveness of controls that monitor other controls,
- The risk of management override of controls over compliance with the specified Financial Responsibility Rules,
- The nature of the control and the frequency with which it operates,
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls),
- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance,
- The extent of use of part-time personnel to perform controls over compliance,

- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective), and
- The complexity of the control and the significance of the judgments made in connection with its operation.

#### *Testing Design Effectiveness*

18. The auditor should test the design effectiveness of the selected controls over compliance with the specified Financial Responsibility Rules by determining whether the broker's or dealer's controls, if they are operating as prescribed by persons possessing the necessary authority and competence to perform the control effectively, can effectively prevent or detect instances of material non-compliance on a timely basis.

Note: If a broker or dealer makes changes to its policies and procedures or key personnel during the fiscal year, the auditor should obtain evidence regarding the design effectiveness of the selected controls before and after the change.

19. Procedures the auditor performs to obtain evidence about design effectiveness include inquiry of appropriate personnel, observation of the broker's or dealer's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

#### *Testing Operating Effectiveness*

20. The auditor should test the operating effectiveness of the selected controls over compliance with the specified Financial Responsibility Rules by determining whether each control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

Note: The auditor should obtain evidence regarding the operating effectiveness of the selected controls throughout the period.

21. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the broker's or dealer's operations, inspection of relevant documentation, and re-performance of the control.

22. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures.

Further, for an individual control, different combinations of the nature, timing, and extent of testing may provide sufficient evidence in relation to the risk associated with the control.

*Using Evidence Obtained in Past Examination Engagements*

23. The auditor should obtain evidence during the current year about the design and operating effectiveness of controls selected for testing. If controls selected for testing in the current year were tested in past examination engagements, and if the auditor plans to use evidence about the effectiveness of those controls that was obtained in prior years, the auditor should take into account the factors discussed in paragraph 17 and the following factors to determine the evidence needed during the current year examination:

- The nature, timing, and extent of procedures performed in previous examination engagements;
- The results of the previous years' testing of the control; and
- Changes in the control or the process in which the control operates since the previous examination engagement.

**Performing Compliance Tests**

24. The auditor must perform procedures ("compliance tests") that are sufficient to support the auditor's conclusions regarding whether the broker or dealer is in compliance with each specified Financial Responsibility Rule as of the specified date.

Note: The auditor should perform tests of the broker's or dealer's compliance with each of the specified Financial Responsibility Rules as of year end and tests of the broker's or dealer's compliance with Rule 17a-13 and the account statement rule during the fiscal quarter immediately preceding the broker's or dealer's year end.<sup>19/</sup>

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<sup>19/</sup> Section II.B.1. of the SEC Proposing Release states that "[t]he proposed assertions with respect to compliance with Rules 15c3-1 and 15c3-3 would relate to compliance as of the broker [or] dealer's fiscal year-end. The assertions as to compliance with Rule 17a-13 and the [a]ccount [s]tatement [r]ule also would be made as of the broker [or] dealer's fiscal year-end. However, because these rules impose obligations on a quarterly basis (the broker [or] dealer must conduct the quarterly count

Note: Procedures performed as part of the audit of the financial statements and supplemental information also might provide evidence regarding the broker's or dealer's compliance with the specified Financial Responsibility Rules. For example, paragraph (g)(1) of SEC Proposed Rule 17a-5 requires the auditor to audit the broker's or dealer's "financial report," which contains certain supplemental information, including supporting schedules that include 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 Possession or Control Requirements Under Rule 15c3-3.

25. The auditor should plan and perform compliance tests that are responsive to the risks of material non-compliance, including fraud risks. As the risk of material non-compliance associated with a particular specified Financial Responsibility Rule increases, the evidence that the auditor should obtain from compliance tests also increases. The evidence provided by the auditor's compliance tests depends upon the mix of the nature, timing, and extent of those procedures. Inquiry alone does not provide sufficient appropriate evidence to support the auditor's conclusions about the broker's or dealer's compliance with the specified Financial Responsibility Rules.

26. In connection with performing the compliance tests pursuant to paragraph 24, the auditor must perform procedures to obtain evidence about the existence of customer funds or securities held for customers.<sup>20/</sup>

Note: Examples of procedures that provide evidence about the existence of customer assets include (1) counting customer securities or observing and testing the broker or dealer's procedures for physical inspection and (2) confirming customer security positions directly with depositories and clearing organizations. Procedures performed in the audit of the financial statements and supplemental information to test the existence of assets

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of securities and must send statements to all customers at least once during each quarter, but not necessarily on the last day of the quarter), to be able to make the assertions in the [c]ompliance [r]eport, the broker [or] dealer would need to determine that it had satisfied the requirements over the course of the fiscal quarter immediately preceding the broker [or] dealer's fiscal year-end."

<sup>20/</sup> Paragraphs (a)(1) and (a)(2) of Rule 15c3-3 define the terms "customer" and "customer securities," respectively.

held for customers also provide evidence that is relevant to the requirement in this standard.

*Effect of Tests of Controls over Compliance on Compliance Tests*

27. The auditor should take into account tests of controls over compliance with the specified Financial Responsibility Rules in determining the necessary nature, timing, and extent of compliance tests. For a given specified Financial Responsibility Rule, if the results of the auditor's evaluation of controls over compliance indicates that the controls are effective, less evidence is needed from compliance tests. If the results of the auditor's evaluation of controls over compliance indicate that the controls are ineffective, the auditor should revise the planned compliance tests as necessary to obtain more evidence.

**Testing Information Used to Assert Compliance**

28. The auditor must perform procedures to determine whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records.

Note: Procedures performed in the audit of the financial statements and supplemental information might provide evidence relevant to determining whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records.

**Evaluating the Results of the Examination Procedures**

29. In forming an opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects, the auditor should evaluate all evidence obtained, regardless of whether the evidence corroborates or contradicts the broker's or dealer's assertions.

30. The auditor should evaluate:

- a. Instances of non-compliance to determine whether they are material, individually or in combination, as of the specified date;
- b. Instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records to determine whether they are material, individually or in combination; and



- c. Identified control deficiencies to determine whether the deficiencies, individually or in combination, are material weaknesses.

Note: A material weakness can exist even when no instances of material non-compliance exist.

Note: The auditor cannot assume that an identified instance of non-compliance or an identified control deficiency is an isolated occurrence. The auditor should evaluate the effect of any instance of non-compliance or identified control deficiency on the auditor's assessed risks of material non-compliance.

Note: The auditor also should evaluate the effect on the audit of the financial statements and supplemental information of any material non-compliance, material weaknesses, or instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records.

31. The auditor should evaluate whether he or she has obtained sufficient appropriate evidence to support the conclusions to be presented in the examination report taking into account the risks of material non-compliance, the results of the examination procedures performed and the appropriateness (i.e., the relevance and reliability) of the evidence obtained.

32. If the auditor has not obtained sufficient appropriate evidence about an assertion or has substantial doubt about an assertion, the auditor should perform procedures to obtain further evidence to address the matter. If the auditor is unable to obtain sufficient appropriate evidence about an assertion, the auditor should withdraw from the examination engagement or express a disclaimer of opinion.<sup>21/</sup>

### **Subsequent Events**

33. For the period from the end of the period specified in the broker's or dealer's assertions to the date of the auditor's examination report (the "subsequent period"), the

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<sup>21/</sup> See Appendix A of this standard, "Examination Report Modifications," which describes the situations in which the auditor should modify his or her examination report and the specific modifications to be made to the auditor's examination report.

auditor should perform procedures to identify subsequent events relevant to the auditor's conclusions about the assertions made by the broker or dealer in the compliance report. Such procedures should include, but are not limited to:

- a. Reading relevant reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors, and correspondence that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA during the subsequent period that is relevant to the broker's or dealer's assertions; and
- b. Evaluating information obtained through other engagements performed by the auditor for the broker or dealer, including subsequent events procedures performed in the audit of the financial statements and supplemental information.

34. The auditor should evaluate the results of the procedures described in the previous paragraph to determine whether the results corroborate or contradict the broker's or dealer's assertions.

#### **Obtaining a Representation Letter**

35. The auditor should obtain written representations from management of the broker or dealer:

- a. Acknowledging management's responsibility for establishing and maintaining a system of internal control to provide the broker or dealer with reasonable assurance that any instances of material non-compliance with the specified Financial Responsibility Rules will be prevented or detected on a timely basis;<sup>22/</sup>
- b. Stating the broker's or dealer's assertions included in the compliance report;
- c. Stating that management has made available to the auditor all records and other information relevant to the broker's or dealer's assertions, including all known matters contradicting the assertions, and all communications from regulatory agencies, internal auditors, others who perform an equivalent function, compliance functions, and other auditors,

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<sup>22/</sup> See paragraph (d)(3)(i)(A) of SEC Proposed Rule 17a-5.

that are relevant to the broker's or dealer's assertions, received through the date of the auditor's report; and

- d. Stating whether there were, subsequent to the period addressed in the broker's or dealer's assertions, any known events or other factors that might significantly affect the broker's or dealer's assertions.

36. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the engagement, as described in Appendix A of this standard.

### ***Communication Requirements***

37. The auditor should communicate to management identified instances of non-compliance, identified control deficiencies, and identified instances in which information used to determine compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records.

38. The auditor should communicate to management and the audit committee<sup>23/</sup> identified instances of material non-compliance, identified instances of material weakness, and identified instances in which information used to determine compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records.

Note: The auditor must also comply with the requirements of paragraph (h) of SEC Proposed Rule 17a-5, which requires the auditor to notify the Commission within one business day of determining that any material non-compliance exists during the course of preparing the reports required by SEC Proposed Rule 17a-5.

Note: See also paragraphs A8 and A10 of this standard.

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<sup>23/</sup> For purposes of this standard, the term "audit committee" refers to a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of a company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company. If a broker or dealer does not have an audit committee or a board of directors of the company, those responsible for the appointment, compensation, and oversight of the work of the auditor.

### ***Reporting on the Examination Engagement***

39. The auditor's examination report must include the following elements, modified as necessary in the circumstances and manner discussed in Appendix A:

- a. A title that includes the word *independent*;
- b. An identification of the compliance report and the broker's or dealer's assertions regarding compliance with the specified Financial Responsibility Rules, whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records, and the effectiveness of internal control over compliance with the specified Financial Responsibility Rules;
- c. A statement that management of the broker or dealer is responsible for establishing and maintaining a system of internal control to provide the broker or dealer with reasonable assurance that any instances of material non-compliance with the specified Financial Responsibility Rules will be prevented or detected on a timely basis;
- d. A statement that the auditor's responsibility is to express an opinion on the broker's or dealer's assertions based on his or her examination;
- e. A statement that the examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);
- f. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the examination engagement to obtain reasonable assurance about whether one or more instances of material non-compliance exist as of the specified date; whether the information used to assert compliance with the specified Financial Responsibility Rules was derived, in all material respects, from the books and records of the broker or dealer; and whether one or more instances of material weakness exist during the specified period;
- g. A statement that an examination engagement includes testing and evaluating the broker's or dealer's compliance with the specified Financial Responsibility Rules, determining whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records, testing and evaluating the

design and operating effectiveness of internal control over compliance with the specified Financial Responsibility Rules, and performing such other procedures as the auditor considered necessary in the circumstances;

- h. A statement that the auditor believes the examination provides a reasonable basis for his or her opinion;
- i. The auditor's opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects;
- j. The manual signature of the auditor's firm;<sup>24/</sup>
- k. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's examination report has been issued; and
- l. The date of the examination report.

40. The following example examination report expressing an unqualified opinion on the assertions made by a broker or dealer in a compliance report illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[ *Introductory paragraph* ]

We have examined W Broker's assertions, included in the accompanying [title of the compliance report], that (1) W Broker complied, in all material respects, with Rules 15c3-1, 15c3-3, 17a-13 under the Securities Exchange Act of 1934, and Rule [fill-in name/number] of [fill in DEA] that requires account statements to be sent to the customers of W Broker (collectively, "the specified Financial Responsibility Rules") as of [date]; (2) the information used to assert compliance with the specified Financial Responsibility Rules was derived from W Broker's books and records; and (3) internal control over compliance with the specified Financial Responsibility Rules was effective during the year ended [date] such that there were no instances of material weakness. W Broker's management is responsible for establishing and maintaining a system of internal control to

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<sup>24/</sup> Paragraph (i)(1)(ii) of SEC Proposed Rule 17a-5 requires the auditor's report to be manually signed.

provide W Broker with reasonable assurance that any instances of material non-compliance with the specified Financial Responsibility Rules will be prevented or detected on a timely basis. Our responsibility is to express an opinion on W Broker's assertions based on our examination.

[ *Scope paragraph* ]

We conducted our examination in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the examination to obtain reasonable assurance about whether one or more instances of material non-compliance exist as of the specified date; whether the information used to assert compliance with the specified Financial Responsibility Rules was derived, in all material respects, from W Broker's books and records; and whether one or more instances of material weakness exist during the specified period. Our examination includes testing and evaluating W Broker's compliance with the specified Financial Responsibility Rules, determining whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from W Broker's books and records, testing and evaluating the design and operating effectiveness of internal control over compliance with the specified Financial Responsibility Rules, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.



[ *Opinion paragraph* ]

In our opinion, W Broker's assertions that (1) W Broker complied, in all material respects, with Rules 15c3-1, 15c3-3, 17a-13 under the Securities Exchange Act of 1934, and Rule [fill-in name/number] of [fill in DEA] that requires account statements to be sent to the customers of W Broker as of [date]; (2) the information used to assert compliance with the specified Financial Responsibility Rules was derived from W Broker's books and records; and (3) internal control over compliance with the specified Financial Responsibility Rules was effective during the year ended [date] such that there were no instances of material weakness are fairly stated, in all material respects.

[ *Signature* ]

[ *City and State or Country* ]

[ *Date* ]

### **Examination Report Date**

41. The auditor should date the examination report no earlier than the date on which the auditor obtains sufficient appropriate evidence to support his or her opinion.

Note: Because of the coordination between the examination engagement and the audit of the financial statements and supplemental information, the date of the examination report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

## **APPENDIX A – Examination Report Modifications**

A1. The auditor should modify his or her examination report if any of the following conditions exist:

- a. There are one or more instances of material non-compliance as of the date specified in the broker's or dealer's assertion, one or more material weaknesses during the period specified in the broker's or dealer's assertion, or one or more instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the books and records of the broker or dealer (paragraphs A2-A3).
- b. There is a restriction on the scope of the examination engagement (paragraphs A4-A8).
- c. There is other information contained in the compliance report (paragraphs A9-A10).

### **Material Non-Compliance, Material Weakness, or Instance in which Information Used to Assert Compliance was not Derived, in all Material Respects, from the Broker's or Dealer's Books and Records**

A2. If (1) one or more instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion, (2) one or more material weaknesses exist during the period specified in the broker's or dealer's assertion, or (3) one or more instances exist in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the books and records of the broker or dealer, the auditor must express an adverse opinion directly on the subject matter of the respective assertions, rather than on the assertions themselves, unless there is a restriction on the scope of the examination engagement.

Note: The requirement in this paragraph to express an adverse opinion applies regardless of whether the material non-compliance, material weakness, or other matters preventing the unqualified opinion were identified by management or the auditor.

A3. When expressing such an adverse opinion, the auditor's examination report should include, as applicable:

- a. A statement that one or more instances of material non-compliance have been identified and an identification of the instances of material non-compliance described in the broker's or dealer's compliance report.
- b. A statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in the compliance report.
- c. A statement that one or more instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records have been identified.

Note: If a description of all identified instances of material non-compliance and all identified material weaknesses has not been included in the broker's or dealer's compliance report, the examination report must be modified to describe those instances of material non-compliance or material weaknesses that the auditor has identified but that are not described in the broker's or dealer's compliance report.<sup>25/</sup>

### **Scope Limitations**

A4. The auditor can express an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects, only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the examination engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion should state that the auditor does not express an opinion on the assertions made by the broker or dealer in the compliance report.

A5. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the examination engagement was not sufficient for the auditor to express an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer, including the procedures that were deemed necessary by the auditor that have been omitted and the reason for their omission. The auditor should

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<sup>25/</sup> Paragraph (d)(3)(i)(C) of SEC Proposed Rule 17a-5 requires the broker's or dealer's compliance report to contain a description of each identified instance of material non-compliance and each identified material weakness.

not identify the procedures that were performed nor include the statements describing the characteristics of an examination engagement.

A6. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that: (1) one or more instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion, (2) one or more material weaknesses exist during the period specified in the broker's or dealer's assertion, or (3) one or more instances exist in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the books and records of the broker or dealer, the auditor's report also must include the matters described in paragraph A3.

A7. The auditor may issue a report disclaiming an opinion on the assertions made by a broker or dealer in a compliance report as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

Note: In this case, in following the direction in paragraph 41 regarding dating the auditor's examination report, the report date is the date on which the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

A8. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the examination engagement, the auditor should communicate on a timely basis, in writing, to management and the audit committee that the examination engagement cannot be satisfactorily completed.

### **Other Information in the Compliance Report**

A9. If the compliance report contains other information in addition to the statements and assertions required by SEC Proposed Rule 17a-5,<sup>26/</sup> the auditor should disclaim an opinion on the other information.

A10. If the auditor believes that the other information in the compliance report contains a material misstatement of fact, he or she should discuss the matter with management of the broker or dealer. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify

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<sup>26/</sup> See paragraph (d)(3) of SEC Proposed Rule 17a-5.

management and the audit committee, in writing, of the auditor's views concerning the information.<sup>27/</sup>

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<sup>27/</sup> See also AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.

## **APPENDIX 2**

### **Proposed Attestation Standard**

#### ***Review Engagements Regarding Exemption Reports of Brokers and Dealers***

##### ***Introduction***

1. This standard establishes requirements that apply when an auditor is engaged to perform a compliance review<sup>1/</sup> of the assertion made by a broker<sup>2/</sup> or dealer<sup>3/</sup> in an exemption report ("exemption report") prepared pursuant to the U.S. Securities and Exchange Commission's ("SEC's" or "Commission's") proposed amendments to Exchange Act Rule 17a-5 ("SEC Proposed Rule 17a-5").<sup>4/</sup>
2. SEC Proposed Rule 17a-5 requires a broker's or dealer's exemption report to contain an assertion by the broker or dealer that it is exempt from the provisions of Rule

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<sup>1/</sup> On June 15, 2011, the Securities and Exchange Commission proposed amendments to 17 CFR § 240.17a-5, *Reports to be made by certain brokers and dealers*. Paragraph (g) of SEC Proposed Rule 17a-5 requires that the broker or dealer engage an independent accountant to issue the review report covered by this standard.

<sup>2/</sup> Section 110(3) of the Sarbanes-Oxley Act of 2002 (the "Act") defines the term "broker" to mean a broker (as defined in Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act")) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

<sup>3/</sup> Section 110(4) of the Act defines the term "dealer" to mean a dealer (as defined in Section 3(a)(5) of the Exchange Act) that is required to file a balance sheet, income statement, or other financial statement under Section 17(e)(1)(A) of that Act, where such balance sheet, income statement, or financial statement is required to be certified by a registered public accounting firm.

<sup>4/</sup> See paragraph (d)(4) of SEC Proposed Rule 17a-5.



15c3-3<sup>5/</sup> because it meets conditions set forth in paragraph (k) of Rule 15c3-3, and identify the specified conditions.<sup>6/</sup>

### **Objective**

3. When performing a review of the assertion made by a broker or dealer in an exemption report (a "review engagement"), the auditor's objective is to state a conclusion regarding whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertion for the assertion to be fairly stated, in all material respects.

4. To state such a conclusion, the auditor must plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance<sup>7/</sup> about whether one or more instances of non-compliance exist with respect to the conditions identified in the broker's or dealer's assertion ("exemption conditions") that, individually or in combination, would cause the broker's or dealer's assertion not to be fairly stated, in all material respects.

### **Performing the Review Engagement**

#### **General Requirements**

5. An auditor who performs a review engagement must:
- a. Have adequate technical proficiency in attestation engagements,
  - b. Obtain an understanding of the exemption conditions and other rules and regulations that are relevant to the broker's or dealer's assertion,
  - c. Determine the auditor's compliance with independence and ethics requirements, and

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<sup>5/</sup> See 17 CFR § 240.15c3-3, *Customer protection – reserves and custody of securities*.

<sup>6/</sup> See paragraph (d)(4) of SEC Proposed Rule 17a-5.

<sup>7/</sup> Moderate assurance is obtained by performing with due professional care the inquiries and other procedures required by this standard in order to reach a conclusion about whether there is a need to modify the broker's or dealer's assertion about its exemption for the assertion to be fairly stated in all material respects.

- d. Exercise due professional care,<sup>8/</sup> which includes application of professional skepticism, in planning and performing the review and the preparation of the report.

6. The engagement partner is responsible for the review engagement and performance of the review procedures. Accordingly, the engagement partner is responsible for proper planning of the review engagement, proper supervision of the work of engagement team members, and compliance with the requirements of this standard. The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Note: For purposes of this standard, the term "engagement partner" means the member of the engagement team with primary responsibility for the review engagement.

### **Relationship Between the Review Engagement and the Audit of Financial Statements and Supplemental Information**

7. The review engagement should be coordinated with the audit of the financial statements and supplemental information of the broker or dealer.<sup>9/</sup> The auditor should take into account relevant evidence from the audit in planning and performing procedures for the review engagement and in evaluating the results of the procedures performed in the review. However, the objectives of the audit and the review engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.

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<sup>8/</sup> This standard requires the same due professional care as required by paragraph .40 of AT sec. 101, *Attest Engagements*, which states, in part, that: "[e]xercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report."

<sup>9/</sup> Under the definition of supplemental information included in PCAOB Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements* (PCAOB Release 2011-005), supplemental information includes the supporting schedules described in paragraph (d)(2)(ii) and (d)(2)(iii) of SEC Proposed Rule 17a-5, which are required to be filed with the SEC or designated examining authorities ("DEAs") by brokers and dealers. Such supporting schedules include 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 Possession or Control Requirements Under Rule 15c3-3.

Note: If the auditor performing the review engagement does not audit the financial statements and supplemental information of the broker or dealer, then the auditor must obtain knowledge of the evidence obtained and results of procedures performed in the audit of the financial statements and supplemental information that is commensurate with that of the auditor of the financial statements and supplemental information. In addition, the auditor's own work on the review engagement must be sufficient to support his or her conclusion on the broker's or dealer's assertion.

### **Review Procedures**

8. A review engagement includes the following procedures:
  - a. Reading the exemption report to determine the exemption conditions on which the broker or dealer asserts its exemption,
  - b. Performing inquiries and other review procedures set forth in this standard, and
  - c. Evaluating whether the evidence indicates that there should be modifications to the broker's or dealer's assertion based on the results of the procedures performed.
  
9. The nature, timing, and extent of the necessary inquiries and other review procedures depend on:
  - a. The following risk factors:
    - (1) The broker's or dealer's history of instances of non-compliance with the exemption conditions;
    - (2) Changes in the broker's or dealer's procedures, controls or the process in which the controls operate since the prior year;
    - (3) Changes in the broker's or dealer's operations that are relevant to compliance with the exemption conditions;
    - (4) Competence of the personnel who are responsible for compliance with the exemption conditions or who perform important controls over compliance, and whether there have been changes in those personnel during the period of the review;

- (5) The risk of fraud, including the risk of misappropriation of customer assets, relevant to the exemption conditions;
  - (6) Potential non-compliance associated with related parties,<sup>10/</sup> including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship; and
  - (7) The degree to which the processes that relate to the exemption conditions are performed, monitored, or controlled in a centralized or decentralized environment.
- b. Evidence about the broker's or dealer's compliance with the exemption conditions or about the effectiveness of controls over the exemption conditions obtained from the audit of the financial statements and supplemental information.
10. In performing the review engagement, the auditor should:
- a. Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding:
    - (1) Whether the broker or dealer was in compliance with the exemption conditions for the year under review.
    - (2) Regulatory examinations and correspondence between the SEC or the broker's or dealer's designated examining authority ("DEA") and the broker or dealer that are relevant to compliance with the exemption conditions.

Note: If the broker or dealer has sent or received correspondence with the SEC or the broker's or dealer's DEA that is relevant to compliance with the exemption conditions, the auditor should read such correspondence and, when necessary in the circumstances, make inquiries of the regulatory agencies.

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<sup>10/</sup> The auditor should look to the FASB Accounting Standards Codification Master Glossary with respect to the term "related parties".

- (3) Subsequent events through the date of the auditor's review report that might have a material effect on the broker's or dealer's assertion that it is exempt from the provisions of Rule 15c3-3.
  - b. Inquire of individuals at the broker or dealer who have relevant knowledge of controls relevant to the broker's or dealer's compliance with the exemption conditions regarding:
    - (1) The controls that are in place to maintain compliance with the exemption conditions, including the nature of the controls and their frequency of operation.

Note: The auditor should take into account procedures performed during the audit of the financial statements and supplemental information in obtaining an understanding of controls or other activities relevant to the broker's or dealer's compliance with the exemption conditions.
    - (2) Whether the individual is aware of any deficiencies in controls over compliance or instances of non-compliance with the exemption conditions and, if so, the nature, frequency, and cause (if known) of the control deficiencies or instances of non-compliance.
  - c. Inquire of individuals who are responsible for monitoring compliance with the exemption conditions or the controls over compliance regarding:
    - (1) The nature and frequency of the monitoring activities.
    - (2) The results of those monitoring activities, including the nature, frequency, and cause (if known) of any instances of non-compliance with the exemption conditions or deficiencies in controls over compliance.
    - (3) The nature and frequency of customer complaints that are relevant to the broker's or dealer's compliance with the exemption conditions.
  - d. Read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's compliance with the exemption conditions.

- e. Read regulatory filings of the broker or dealer that are relevant to the broker's or dealer's compliance with the exemption conditions.
- f. Evaluate whether the evidence obtained and the results of the procedures performed in the audit of the financial statements and supplemental information corroborate or contradict the broker's or dealer's assertion regarding compliance with the exemption conditions.

Note: Examples of procedures that might provide evidence relevant to the broker's or dealer's compliance with the exemption conditions include testing of transactions related to customer trades, testing of specially designated cash accounts, testing investment inventory or transactions related to the broker's or dealer's trading for its own account, and reading the clearing agreement in connection with testing trade fee or commission revenue or expenses.

- g. Read the broker's or dealer's documentation regarding instances of non-compliance with the exemption conditions identified by the auditor or the broker or dealer.
- h. Perform other procedures as necessary in the circumstances to obtain moderate assurance.

### **Evaluating the Results of the Review Procedures**

11. The auditor should evaluate the identified instances of non-compliance with the exemption conditions to determine whether the instances of non-compliance, individually or in combination, cause the broker's or dealer's assertion not to be fairly stated, in all material respects.<sup>11/</sup> If the broker's or dealer's assertion is not fairly stated, in all material respects, the auditor should:

- a. Modify the review report, as discussed in paragraph 20; and

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<sup>11/</sup> The SEC's release accompanying SEC Proposed Rule 17a-5 states that "an example of a discovery that would necessitate a material modification would be a discovery that the broker [or] dealer failed to promptly forward any customer securities it received." Paragraph 20 of this standard describes modifying the auditor's standard review report for instances in which the broker's or dealer's assertion is not fairly stated, in all material respects, because of an instance or certain instances of non-compliance with the exemption conditions.



- b. Evaluate the effect of the matter on the audit of the financial statements and supplemental information.

12. If information coming to the auditor's attention indicates that one or more instances of non-compliance might exist that might cause the broker's or dealer's assertion not to be fairly stated, in all material respects, or if the auditor has substantial doubt about the broker's or dealer's assertion, the auditor should perform additional procedures as necessary to address the matter.

### **Obtaining a Representation Letter**

13. The auditor should obtain written representations from management of the broker or dealer:

- a. Acknowledging management's responsibility for compliance with exemption conditions;
- b. Stating the broker's or dealer's assertion;
- c. Stating that management has made available to the auditor all records and other information relevant to the broker's or dealer's assertion, including all communications from regulatory agencies, internal auditors, others who perform an equivalent function, compliance functions, and other auditors concerning possible non-compliance with the exemption conditions, received through the date of the auditor's review report; and
- d. Stating whether there were, subsequent to the period addressed in the broker's or dealer's assertion, any known events or other factors that might significantly affect the broker's or dealer's compliance with the exemption conditions.

14. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the review engagement as described in paragraph 21 of this standard.

### **Communication Requirements**

15. The auditor should communicate to management identified instances of non-compliance with the exemption conditions.

16. The auditor should communicate to management and the audit committee<sup>12/</sup> identified instances of non-compliance that cause the broker's or dealer's assertion about its exemption conditions not to be fairly stated in all material respects.

### ***Reporting on the Review Engagement***

17. The auditor's review report must include the following elements, modified as necessary in the circumstances and manner discussed in paragraphs 20-21:

- a. A title that includes the word *independent*;
- b. An identification of the exemption report and the broker's or dealer's assertion;
- c. A statement that management of the broker or dealer is responsible for compliance with the exemption conditions and for its assertion;
- d. A statement that the review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and accordingly, included inquiries and certain other procedures to obtain evidence about the broker's or dealer's compliance with the exemption conditions;
- e. A statement that a review is substantially less in scope than an examination, the objective of which is an expression of opinion on the assertion, and accordingly, no such opinion is expressed;
- f. A statement about whether the auditor is aware of any material modifications that should be made to the assertion for it to be fairly stated, in all material respects;

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<sup>12/</sup> For purposes of this standard, the term "audit committee" refers to a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of a company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company. If a broker or dealer does not have an audit committee or a board of directors of the company, those responsible for the appointment, compensation, and oversight of the work of the auditor.

- g. The manual signature of the auditor's firm;<sup>13/</sup>
- h. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's review report has been issued; and
- i. The date of the review report.

18. The following example report illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[ *Introductory paragraph* ]

We have reviewed management's assertion, included in the accompanying [*title of the exemption report*], that Z Broker is exempt from the provisions of Rule 15c3-3 under the Securities Exchange Act of 1934 because it meets conditions set forth in paragraph (k) ([*fill in which exemption provision – (1), (2)(i), (2)(ii), or (3)*]) of that rule (the "exemption conditions"). Z Broker's management is responsible for compliance with the exemption conditions and its assertion.

[ *Scope paragraph* ]

Our review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and, accordingly, included inquiries and certain other procedures to obtain evidence about Z Broker's compliance with the exemption conditions. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's assertion. Accordingly, we do not express such an opinion.

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<sup>13/</sup> Paragraph (i)(1)(ii) of SEC Proposed Rule 17a-5 requires the auditor's report to be manually signed.

[ *Review results paragraph* ]

Based on our review, nothing came to our attention that caused us to believe that management's assertion referred to above is not fairly stated, in all material respects, based on the conditions set forth in paragraph (k)(*fill-in which exemption provision – (1), (2)(i), (2)(ii), or (3)*) of Rule 15c3-3 under the Securities Exchange Act of 1934.

[ *Signature* ]

[ *City and State or Country* ]

[ *Date* ]

### **Review Report Date**

19. The auditor should date the review report no earlier than the date on which the auditor has completed his or her review procedures.

Note: Because of the coordination between the review engagement and the audit of the financial statements and supplemental information, the date of the review report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

### **Modifications of the Report**

20. If the broker's or dealer's assertion is not fairly stated, in all material respects, because of an instance or certain instances of non-compliance with the exemption conditions, the auditor must modify the review report to describe those instances of non-compliance and state that the broker or dealer is not in compliance with the specified exemption conditions.

21. *Scope Limitations.* If the auditor cannot perform the procedures required by this standard or other procedures that the auditor deems necessary in the circumstances, the review is incomplete because of the scope limitation. An incomplete review is not a sufficient basis for stating a conclusion regarding the broker's or dealer's assertion. In those circumstances, the auditor should withdraw from the engagement or should modify the review report to:

- a. Describe the scope limitation and any review procedures deemed necessary by the auditor that have been omitted and the reason for their omission;

- b. State that the auditor does not express any form of assurance on the broker's or dealer's assertion; and
- c. Disclose identified instances of non-compliance, if any, that, individually or in combination, cause the broker's or dealer's assertion not to be fairly stated, in all material respects.

## **APPENDIX 3**

### **Proposed Amendments to PCAOB Standards**

#### **Auditing Standards**

##### **Auditing Standard No. 3, "Audit Documentation"**

Auditing Standard No. 3, "Audit Documentation," as amended, is amended as follows:

- a. The following is added at the end of footnote 2 in paragraph 6:

In an engagement conducted pursuant to the attestation standards of the PCAOB, the relevant assertions are the assertions expressed by management or the responsible party regarding the subject matter of the attestation engagement. The documentation requirements in this standard regarding assertions apply to the aspects of the subject matter to which the assertions relate.

- b. The following note is added at the end of paragraph 12:

Note: In an engagement conducted pursuant to the attestation standards of the PCAOB, significant findings or issues include, when applicable: (a) the assessment of, and the responses to, risk requiring special consideration by the auditor; (b) significant matters involving systems, processes, and controls to ensure the appropriateness of the subject matter and management's related assertions; and (c) the evaluation of identified instances of nonconformity with the evaluation criteria (e.g., errors, instances of non-compliance, or control deficiencies).

- c. The following note is added as the second note to paragraph 13:

Note: When conducting an attestation engagement in conjunction with an audit of financial statements in accordance with the standards of the PCAOB, the auditor may include the documentation of significant findings or issues related to the attestation engagement in the



engagement completion document prepared in connection with the audit of financial statements.

Auditing Standard No. 7, "Engagement Quality Review"

Auditing Standard No. 7, "Engagement Quality Review," is amended as follows:

- a. Paragraph 1 is replaced with:

An engagement quality review and concurring approval of issuance are required for each audit engagement, for each engagement to review interim financial information, and for each attestation engagement performed in conjunction with an audit of financial statements conducted pursuant to the standards of the Public Company Accounting Oversight Board ("PCAOB").

- b. Paragraph 18A. is added:

**Engagement Quality Review for an Attestation Engagement Performed in Conjunction with an Audit of Financial Statements**

In an attestation engagement performed in conjunction with an audit of financial statements, the engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the attestation engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should (1) hold discussions with the engagement partner and other members of the engagement team, (2) read the engagement report and the document containing management's assertions, and (3) review the engagement completion document and other relevant documentation.

Note: For purposes of this standard, an attestation engagement performed pursuant to Proposed Attestation Standard, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Proposed Attestation Standard, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, is an attestation engagement

performed in conjunction with an audit of financial statements.

- c. Paragraph 18B. is added:

In an attestation engagement performed in conjunction with an audit of financial statements, the engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the review required by this standard, he or she is not aware of a significant engagement deficiency.

- d. The following note is added after paragraph 18B.:

Note: A *significant engagement deficiency* in an attestation engagement performed in conjunction with an audit of financial statements exists when (1) the engagement team failed to perform attestation procedures necessary in the circumstances of the engagement, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.

- e. Paragraph 18C. is added:

In an attestation engagement performed in conjunction with an audit of financial statements, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.

### **Attestation Standards**

#### **AT sec. 101, "Attestation Engagements"**

AT sec. 101, "Attestation Engagements," as amended, is amended as follows:

- f. The following is added at the end of paragraph .04:
- g. Engagements in which a practitioner is engaged to perform an examination of the assertions of a broker or dealer in a compliance report that is prepared pursuant to SEC Proposed Rule 17a-5. Such engagements must be conducted pursuant to Proposed

Attestation Standard, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*.

- h. Engagements in which a practitioner is engaged to perform a review engagement on assertions of a broker or dealer in an exemption report that is prepared pursuant to SEC Proposed Rule 17a-5. Such engagements must be conducted pursuant to Proposed Attestation Standard, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*.

AT sec. 601, "Compliance Attestation"

AT sec. 601, "Compliance Attestation," is amended as follows:

- a. Within paragraph .02, subparagraph e. is replaced with:

Apply to examination engagements of brokers and dealers covered by Proposed Attestation Standard, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*.

- b. Footnote 2 to paragraph .02.e. is deleted.
- c. The last sentence of paragraph .06 is deleted.
- d. Paragraph .07 is replaced with:

When a practitioner is engaged to perform a review engagement on assertions made by a broker or dealer in an exemption report that is prepared pursuant to SEC Proposed Rule 17a-5, the practitioner must conduct the review engagement pursuant to Proposed Attestation Standard, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*.

## **APPENDIX 4**

### ***Additional Discussion of the Proposed Attestation Standards and Questions for Public Comment***

This appendix discusses the proposed examination standard in Appendix 1, the proposed review standard in Appendix 2, and the related amendments to PCAOB standards in Appendix 3. In particular, this appendix discusses the basis for the Board's preliminary conclusions regarding certain requirements and contains specific questions for which the Board would like to obtain feedback in addition to those included in the release to the proposed attestation standards.

On June 15, 2011, the Securities and Exchange Commission ("SEC" or "Commission") proposed to amend its Rule 17a-5 regarding the annual reporting by brokers and dealers to, among other things, update the existing requirements of Rule 17a-5 and facilitate the ability of the PCAOB to implement oversight of independent public accountants of brokers and dealers as required by the Dodd-Frank Act.<sup>1/</sup>

Sections 17(a) and (e) of the Exchange Act and Rule 17a-5 together require a broker or dealer to, among other things, file an annual report with the SEC and the broker's or dealer's designated examining authority ("DEA").<sup>2/</sup> The SEC's proposed amendments to Rule 17a-5 ("SEC Proposed Rule 17a-5") would require the broker's or dealer's annual report to include a financial report and a compliance report or an exemption report.<sup>3/</sup> The compliance report generally would be filed by a broker or dealer

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<sup>1/</sup> See 17 CFR § 240.17a-5, *Reports to be made by certain brokers and dealers* and Section I. of SEC Release No. 34-64676 ("SEC Proposing Release").

<sup>2/</sup> See Section II.A. of the SEC Proposing Release.

<sup>3/</sup> The financial report required by SEC Proposed Rule 17a-5 would include financial statements and supporting schedules. The audit of the financial statements and supporting schedules would be conducted in accordance with PCAOB standards. In particular, Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*, would apply to the audit of the supporting schedules. The proposed attestation standard in Appendix 1 of this release would apply to an examination of the assertions in the compliance report. The proposed attestation standard in Appendix 2 of this release would apply to a review of the assertion in the exemption report.

that maintains custody of customer funds or securities and would include assertions by the broker or dealer that address:

- (i) Whether it was in compliance, in all material respects, with specified SEC rules related to net capital requirements, customer protection, including reserves and custody of securities, and quarterly security counts,<sup>4/</sup> as well as the rules of its DEA that require account statements to be sent to customers of the broker or dealer (referred to collectively in this release as "the specified Financial Responsibility Rules") as of the fiscal year end,
- (ii) Whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the books and records of the broker or dealer, and
- (iii) Whether internal control over compliance with the specified Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness.<sup>5/</sup>

The exemption report would be filed by a broker or dealer that claims exemption from the requirements of the SEC rule related to the safeguarding of customer assets and would identify the specific conditions that are the basis for claiming the exemption (referred to collectively in this release as "the exemption conditions").<sup>6/</sup>

In addition, the SEC's proposed amendments would require the broker or dealer to include in its annual report an examination report from an independent accountant regarding the assertions in the compliance report or a review report regarding the assertion in the exemption report, as applicable.<sup>7/</sup> The auditor's examination report or

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<sup>4/</sup> See 17 CFR § 240.15c3-1, *Net capital requirements for brokers or dealers*, 17 CFR § 240.15c3-3, *Customer protection – reserves and custody of securities*, and 17 CFR § 240.17a-13, *Quarterly security counts to be made by certain exchange members, brokers, and dealers*, for the complete text of these SEC rules.

<sup>5/</sup> See paragraph (d)(3)(i)(B) of SEC Proposed Rule 17a-5. The term "specified Financial Responsibility Rules" as used in this release and the proposed examination standard has the same meaning as the term "Financial Responsibility Rules" used in the SEC Proposing Release.

<sup>6/</sup> See paragraph (d)(4) of SEC Proposed Rule 17a-5.

<sup>7/</sup> See paragraph (d)(1)(i)(C) of SEC Proposed Rule 17a-5.

review report would replace the existing requirement in Rule 17a-5 to report on material inadequacies identified in the accounting system, internal accounting controls, procedures of the broker or dealer for safeguarding securities, and certain practices and procedures related to customer protection and securities.<sup>8/</sup>

The proposed attestation standards would establish requirements for performing and reporting on the examination engagement and the review engagement required by SEC Proposed Rule 17a-5.<sup>9/</sup>

**I. Proposed Attestation Standard, Examination Engagements Regarding Compliance Reports of Brokers and Dealers**

The proposed examination standard establishes requirements that apply when an auditor is engaged to perform an examination of the assertions made by a broker or dealer in a compliance report prepared pursuant to SEC Proposed Rule 17a-5.<sup>10/</sup> SEC Proposed Rule 17a-5 requires a broker's or dealer's compliance report to contain the following assertions by the broker or dealer:<sup>11/</sup>

- a. Whether, as of the fiscal year end, the broker or dealer was in compliance, in all material respects, with Rule 15c3-1, Rule 15c3-3, Rule 17a-13,<sup>12/</sup> and any rule of the broker's or dealer's DEA that requires account statements to be sent to the customers of the broker or dealer ("account statement rule");

Note: Rule 15c3-1, Rule 15c3-3, Rule 17a-13, and the account statement rule are referred to collectively as "the specified Financial Responsibility Rules."<sup>13/</sup>

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<sup>8/</sup> See 17 CFR § 240.17a-5(g).

<sup>9/</sup> See paragraph (d)(1)(i)(C) of SEC Proposed Rule 17a-5.

<sup>10/</sup> See paragraph (d)(3) of SEC Proposed Rule 17a-5.

<sup>11/</sup> See paragraph (d)(3)(i)(B) of SEC Proposed Rule 17a-5.

<sup>12/</sup> See 17 CFR § 240.15c3-1, 17 CFR § 240.15c3-3, and 17 CFR § 240.17a-13, respectively.

<sup>13/</sup> The SEC Proposing Release refers to Rule 15c3-1, Rule 15c3-3, Rule 17a-13, and the account statement rule as the "Financial Responsibility Rules."

- b. Whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the books and records of the broker or dealer; and
- c. Whether internal control over compliance with the specified Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness.<sup>14/</sup>

#### **A. Relationship to Interim Attestation Standards**

In general terms, the requirements in the proposed examination standard are consistent with the requirements of AT sec. 101, *Attest Engagements*, and AT sec. 601, *Compliance Attestation*. However, when an auditor performs an engagement pursuant to the proposed examination standard, AT sec. 101 and AT sec. 601 would not apply.

The proposed examination standard focuses specifically on performing an examination of the assertions made by a broker or dealer in a compliance report and allows auditors to perform such engagements without looking to multiple attestation standards. In addition, the emphasis in the proposed examination standard on appropriately coordinating the examination engagement with the audit of the financial statements and supplemental information should avoid unnecessary redundancy in the auditor's work.

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<sup>14/</sup> Paragraph (d)(3)(iii) of SEC Proposed Rule 17a-5 defines a material weakness as "a deficiency, or a combination of deficiencies, in internal control over compliance with [the specified Financial Responsibility Rules], such that there is a reasonable possibility that material non-compliance with [the specified Financial Responsibility Rules] will not be prevented or detected on a timely basis. For purposes of this paragraph a deficiency in internal control over compliance exists when the design or operation of a control does not allow the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect non-compliance with [the specified Financial Responsibility Rules] on a timely basis." Section II.B.1. of the SEC Proposing Release states that "[t]here is a reasonable possibility of an event occurring if it is 'probable' or 'reasonably possible'. An event is 'probable' if the future event or events are likely to occur. An event is 'reasonably possible' if the chance of the future event or events occurring is more than remote, but less than likely."



## **B. Objective of the Auditor**

When performing an examination of the assertions made by a broker or dealer in a compliance report, the auditor's objective is to express an opinion regarding whether the assertions made by the broker or dealer in its compliance report are fairly stated, in all material respects.

The use of the language "fairly stated, in all material respects," in the objective of the standard and in the examination report is the same language used in AT sec. 101 and AT sec. 601 for other examination engagements. The phrase "in all material respects" is also used in audit reports.<sup>15/</sup> Because an examination engagement provides users of the auditor's examination report with reasonable and not absolute assurance, similar to AT sec. 101 and AT sec. 601, the proposed examination standard requires the auditor to opine on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects.

Under SEC Proposed Rule 17a-5, a broker or dealer is not permitted to conclude that it is in compliance with the specified Financial Responsibility Rules if it identifies one or more instances of material non-compliance.<sup>16/</sup> Similarly, the broker or dealer is not permitted to conclude that its internal control over compliance with the specified Financial Responsibility Rules was effective if there were one or more instances of material weakness in internal control over compliance.<sup>17/</sup> Accordingly, to express an opinion on the assertions made by a broker or dealer in a compliance report, the auditor must plan and perform the examination engagement to obtain appropriate evidence that is sufficient<sup>18/</sup> to obtain reasonable assurance<sup>19/</sup> about whether (1) one or more

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<sup>15/</sup> See AU sec. 508, *Reports on Audited Financial Statements*, and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

<sup>16/</sup> See paragraph (d)(3)(ii) of SEC Proposed Rule 17a-5. Paragraph (d)(3)(ii) of SEC Proposed Rule 17a-5 states that "material non-compliance would be a failure by the broker or dealer to comply with the requirements of [the specified Financial Responsibility Rules] in all material respects."

<sup>17/</sup> See paragraph (d)(3)(iii) of SEC Proposed Rule 17a-5.

<sup>18/</sup> In the proposed examination standard, the terms "sufficiency" and "appropriateness" have the same meaning as "sufficiency" and "appropriateness" of audit evidence, as described in Auditing Standard No. 15, *Audit Evidence*.

<sup>19/</sup> Although not absolute assurance, reasonable assurance is a high level of assurance.

instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion and (2) one or more instances of material weakness exist during the period specified in the broker's or dealer's assertion.

Because the broker's or dealer's assertions apply to each specified Financial Responsibility Rule, the auditor's examination should evaluate compliance with each specified Financial Responsibility Rule, and the effectiveness of internal control over compliance with each specified Financial Responsibility Rule, individually. As each specified Financial Responsibility Rule includes multiple provisions, this involves obtaining evidence about the broker's or dealer's compliance and internal control over compliance with respect to each relevant provision of each specified Financial Responsibility Rule. For example, because Rule 17a-13 includes provisions regarding the performance of quarterly security counts, the recordation of the security count, rules on frequency and timing of performance, and requirements regarding who should supervise the counts, the auditor should obtain evidence about compliance and internal control over compliance with respect to each of these provisions. The nature, timing, and extent of the necessary procedures depend on the risks of material non-compliance and other factors set forth in the proposed examination standard.

Furthermore, because SEC Proposed Rule 17a-5 requires the broker's or dealer's assertion regarding internal control over compliance with the specified Financial Responsibility Rules to cover the entire fiscal year,<sup>20/</sup> any material weakness identified by the auditor at any point during the fiscal year would prevent the auditor from issuing an unqualified opinion, regardless of whether the identified material weakness continues to exist as of the broker's or dealer's fiscal year end.

SEC Proposed Rule 17a-5 also requires the broker or dealer to assert in its compliance report whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the books and records<sup>21/</sup> of the broker or dealer.<sup>22/</sup> Consistent with the concept of reasonable assurance, the proposed examination standard requires the auditor to plan and perform the examination engagement to obtain appropriate evidence that is sufficient to express an opinion about whether the information used to assert compliance with the specified Financial

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<sup>20/</sup> See paragraph (d)(3)(i)(B)(3) of SEC Proposed Rule 17a-5.

<sup>21/</sup> See, for example, 17 CFR § 240.17a-3, *Records to be made by certain exchange members, brokers and dealers*.

<sup>22/</sup> See paragraph (d)(3)(i)(B)(2) of SEC Proposed Rule 17a-5.

Responsibility Rules was derived, in all material respects, from the books and records of the broker or dealer.

The proposed examination standard does not require the auditor to express an opinion on the process the broker or dealer used to arrive at the conclusions stated in the broker's or dealer's assertions.

### **C. Performing the Examination Engagement**

#### *1. General Requirements*

Under the proposed examination standard, an auditor who performs an examination engagement must:

- *Have adequate technical proficiency in attestation engagements* – This requirement is similar to AT sec. 101.<sup>23/</sup> An auditor might obtain technical proficiency in attestation engagements through relevant technical training or experience.
- *Obtain an understanding of the specified Financial Responsibility Rules and other rules and regulations that are relevant to the broker's or dealer's assertions* – This requirement is similar to an existing requirement in AT sec. 101, which includes a requirement for the engagement to be performed by an auditor "having adequate knowledge of the subject matter."<sup>24/</sup>
- *Determine the auditor's compliance with independence and ethics requirements* – SEC Proposed Rule 17a-5 requires the auditor of the broker or dealer to be qualified and independent in accordance with 17 CFR § 210.2-01, *Qualification of Accountants*.<sup>25/</sup> SEC Proposed Rule 17a-5 also requires the auditor of the broker or dealer to perform the examination engagement in accordance with PCAOB standards.<sup>26/</sup>

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<sup>23/</sup> See AT sec. 101.19.

<sup>24/</sup> AT sec. 101.21.

<sup>25/</sup> See paragraph (f)(1) of SEC Proposed Rule 17a-5.

<sup>26/</sup> See paragraph (g) of SEC Proposed Rule 17a-5.

Auditors who perform engagements in accordance with PCAOB standards must comply with applicable PCAOB ethics and independence rules.<sup>27/</sup>

- *Exercise due professional care,*<sup>28/</sup> *which includes application of professional skepticism, in planning and performing the examination and the preparation of the report* – The proposed examination standard requires the same due professional care as required by AT sec. 101, which states that "[d]ue professional care shall be exercised in the planning and performance of the engagement."<sup>29/</sup> Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of the evidence obtained. In an examination engagement, the auditor's responses to the assessed risks of material non-compliance, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating evidence.

Under the proposed examination standard, the engagement partner<sup>30/</sup> is responsible for the examination engagement and performance of the examination procedures. Accordingly, the engagement partner is responsible for proper planning of the examination engagement, proper supervision of the work of engagement team members, and compliance with the requirements of this standard.

Proper planning includes establishing an overall strategy for the examination engagement and developing a plan for the engagement, which includes, in particular,

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<sup>27/</sup> See Section V. of the accompanying release, "Other Board Considerations," for further discussion regarding the applicability of PCAOB ethics and independence rules.

<sup>28/</sup> The proposed attestation standards require the same due professional care as required by AT sec. 101.40, which states, in part, that "[e]xercise of due professional care requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the engagement, including the preparation of the report."

<sup>29/</sup> AT sec. 101.39.

<sup>30/</sup> For purposes of this standard, the term "engagement partner" means the member of the engagement team with primary responsibility for the examination engagement.

identifying risks of material non-compliance and planned responses to those risks. Similar to an audit, proper supervision includes supervising the work of engagement team members so that the work is performed as directed and supports the conclusions reached.<sup>31/</sup> The engagement partner may seek assistance from appropriate engagement team members in fulfilling these responsibilities.

Questions:

1. Are the general requirements included in the proposed examination standard sufficiently clear?
  2. Are there additional general requirements that the Board should include for an examination engagement?
2. *Relationship Between the Examination Engagement and the Audit of the Financial Statements and Supplemental Information*

The proposed examination standard recognizes that the examination report covered by the proposed examination standard generally would be issued by the auditor of the financial statements of the broker or dealer.<sup>32/</sup> Accordingly, the proposed examination standard includes a requirement for the auditor to coordinate the examination engagement with the audit of the financial statements and supplemental information. For example, the proposed examination standard:

- Includes a requirement for the auditor to take into account relevant evidence from the audit of the financial statements and supplemental information in planning and performing procedures for the examination engagement and in evaluating the results of the procedures performed in the examination. In that regard, SEC Proposed Rule 17a-5 requires the auditor to audit certain supplemental information, including supporting schedules that include 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 Possession or

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<sup>31/</sup> Auditing Standard No. 10, *Supervision of the Audit Engagement*, establishes requirements regarding supervision of an audit engagement, including supervising the work of engagement team members.

<sup>32/</sup> See paragraph (g) of SEC Proposed Rule 17a-5.

Control Requirements Under Rule 15c3-3.<sup>33/</sup> The audit of these supporting schedules should also provide relevant evidence regarding (1) the broker's or dealer's compliance with Rule 15c3-1 and Rule 15c3-3 and (2) whether the information used to assert compliance with Rule 15c3-1 and Rule 15c3-3 was derived from the books and records of the broker or dealer.

- Includes a requirement for the auditor to evaluate the effect on the audit of the financial statements and supplemental information of any material non-compliance, material weaknesses, or instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records.
- Enables the auditor to plan, perform, and evaluate the results of the examination engagement concurrent with the audit of the financial statements because the proposed examination standard is structured similarly to, and contains many of the same concepts included in, auditing standards related to the auditor's assessment of and response to risk.<sup>34/</sup>

Although the proposed examination standard states that the examination engagement should be coordinated with the audit of the financial statements and supplemental information of the broker or dealer, the objectives of the audit and the examination engagement are not the same, so the proposed examination standard states that the auditor must plan and perform the work to meet the objectives of both engagements.

If the auditor performing the examination engagement does not audit the financial statements and supplemental information of the broker or dealer, the proposed examination standard requires the auditor to obtain knowledge of the evidence obtained and results of procedures performed in the audit of the financial statements and supplemental information that is commensurate with that of the auditor of the financial statements and supplemental information. That level of knowledge is necessary to have a reasonable basis to perform the evaluation of the broker's or dealer's assertions, as required by the proposed examination standard.

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<sup>33/</sup> See paragraph (g)(1) of SEC Proposed Rule 17a-5.

<sup>34/</sup> See Auditing Standards No. 8-15.



The proposed examination standard also states that the auditor's own work on the examination engagement must be sufficient to support an opinion on the assertions made by the broker or dealer in the compliance report, so that the auditor who performs only the examination engagement does not rely on the work of the auditor of the financial statements and supplemental information instead of performing the procedures required by the proposed examination standard.

Question:

3. In what other ways could the Board promote coordination of the examination engagement with the audit of the financial statements and supplemental information?

3. *Consideration of Materiality in the Examination Engagement*

The proposed examination standard requires the auditor to plan and perform examination procedures to detect instances of non-compliance that, individually or in combination, would result in material non-compliance. This includes being alert while planning and performing examination procedures for non-compliance that could be material due to quantitative or qualitative factors. Also, the auditor should take into account relevant quantitative and qualitative factors when evaluating identified non-compliance.

To describe factors that are relevant when determining whether an instance of non-compliance is material, the release accompanying SEC Proposed Rule 17a-5 ("SEC Proposing Release") draws upon existing concepts included in AT sec. 601 regarding the auditor's consideration of materiality.<sup>35/</sup> The SEC Proposing Release states that, "any failure by the broker [or] dealer to perform any of the procedures enumerated in the [specified] Financial Responsibility Rules would be an instance of non-compliance; therefore, the broker [or] dealer should evaluate any such failure to determine whether it is material. When determining whether an instance of non-compliance is material ... the broker [or] dealer should consider all relevant factors including but not limited to: (1) the nature of the [specified Financial Responsibility Rules], which may or may not be quantifiable in monetary terms; (2) the nature and frequency of non-compliance identified; and (3) qualitative considerations."<sup>36/</sup>

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<sup>35/</sup> See Section II.B.1. of the SEC Proposing Release and AT sec. 601.36.

<sup>36/</sup> See Section II.B.1. of the SEC Proposing Release.



Under the proposed examination standard, the auditor should take into account matters that are consistent with the factors described in the SEC Proposing Release in his or her consideration of the materiality of non-compliance.<sup>37/</sup> Taking into account the nature of the specified Financial Responsibility Rules, which may or may not be quantifiable in monetary terms, the nature and frequency of non-compliance, and qualitative considerations includes consideration of specific facts and circumstances surrounding any non-compliance. For example, non-compliance, even if relatively small in amount, may be significant to the broker's or dealer's compliance with regulatory thresholds. In addition, intentional non-compliance, even if relatively small in amount, could be material to users of the auditor's examination report for qualitative reasons.<sup>38/</sup>

Further, the SEC Proposing Release also describes examples of non-compliance that are necessarily instances of material non-compliance.<sup>39/</sup> The SEC Proposing Release states that, "failing to maintain the required minimum amount of net capital as required under Rule 15c3-1, or failing to maintain the minimum deposit requirement in a special reserve bank account for the exclusive benefit of customers under Rule 15c3-3, would be instances of material non-compliance. These two instances of material non-compliance would not, however, represent all possible instances of material non-compliance with respect to Rules 15c3-1 and 15c3-3.

SEC Proposed Rule 17a-5 defines an instance of material weakness as "a deficiency, or a combination of deficiencies, in internal control over compliance with [the specified Financial Responsibility Rules], such that there is a reasonable possibility that material non-compliance with [the specified Financial Responsibility Rules] will not be prevented or detected on a timely basis. For purposes of this paragraph a deficiency in internal control over compliance exists when the design or operation of a control does not allow the broker or dealer, in the normal course of performing their assigned functions, to prevent or detect non-compliance with [the specified Financial Responsibility Rules] on a timely basis."<sup>40/</sup>

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<sup>37/</sup> Ibid.

<sup>38/</sup> Users of the auditor's examination report may include, but are not limited to, the SEC, the Securities Investor Protection Corporation, and the broker's or dealer's DEA.

<sup>39/</sup> See Section II.B.1. of the SEC Proposing Release.

<sup>40/</sup> See paragraph (d)(3)(iii) of SEC Proposed Rule 17a-5. Section II.B.1. of the SEC Proposing Release states that "[t]here is a reasonable possibility of an event

Because SEC Proposed Rule 17a-5 links the definition of "an instance of material weakness" to the concept of "material non-compliance,"<sup>41/</sup> the proposed examination standard includes a requirement for the auditor to use the same materiality considerations used for testing and evaluating compliance with the respective specified Financial Responsibility Rules when testing and evaluating the effectiveness of internal control over compliance.

Similarly, when considering materiality in evaluating whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records, the auditor should take into account the matters set forth in paragraph 10 of the proposed examination standard. An important qualitative consideration is whether an identified instance in which information used to assert compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records results in material non-compliance with the respective specified Financial Responsibility Rules.

#### 4. *Considerations for Brokers and Dealers with Multiple Divisions or Branches*

When a broker or dealer conducts its operations through multiple divisions and branch offices, the proposed examination standard includes a requirement for the auditor to determine the extent to which examination procedures should be performed at selected divisions or branches to obtain sufficient appropriate evidence to support the conclusions expressed in the auditor's examination report. This includes determining the divisions or branches at which to perform examination procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual divisions or branches. Under the proposed examination standard, in determining the extent of the examination procedures to be performed, the auditor should take into account:

- *The degree to which the specified Financial Responsibility Rules relate to activities at the division or branch level* – For example, if a broker or dealer holds securities or executes security trades at the local branch level, then it would be necessary for the auditor to plan or perform procedures pertaining to Rule 17a-13 at the local branch level.

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occurring if it is 'probable' or 'reasonably possible'. An event is 'probable' if the future event or events are likely to occur. An event is 'reasonably possible' if the chance of the future event or events occurring is more than remote, but less than likely."

<sup>41/</sup> See paragraph (d)(3)(iii) of SEC Proposed Rule 17a-5.

- *The nature and significance of the related assets, transactions, or activities at the division or branch to the specified Financial Responsibility Rules* – For example, if a particular division of a broker or dealer handles large amounts of customer assets and performs the custodian function, including sending customers their periodic account statements, the auditor would need to perform procedures at that division to obtain relevant evidence of compliance with the relevant provisions of Rule 15c3-3, Rule 17a-13, and the account statement rule.
- *The degree of centralization of records or information processing relevant to the specified Financial Responsibility Rules* – For example, if a broker or dealer centralizes the process for computing and monitoring net capital and maintains relevant records at the location at which the computation is performed, most of the relevant evidence for evaluating compliance with Rule 15c3-1 can be obtained by planning and performing examination procedures at the centralized location.
- *The degree and effectiveness of management supervision and monitoring of the relevant activities of the division or branch* – If, for example, in the course of planning and performing the financial statement audit, the auditor identifies weaknesses in management's supervision and monitoring of particular activities at certain divisions, the auditor should take into account the effect of the identified weaknesses when assessing the risk of material non-compliance and adjust the extent of the planned examination procedures at those divisions to properly respond to the heightened risk of material non-compliance.

Questions:

4. Are the matters that the auditor should take into account in determining the extent of the examination procedures to be performed at selected divisions or branches adequate? Are there other matters that the auditor should take into account?
5. When a broker or dealer has multiple divisions or branches, do situations exist in which the auditor that is engaged to perform the examination engagement uses the work of other auditors? If so, should the proposed examination standard establish requirements that govern the use of the work of other auditors?

5. *Identifying Risks of Material Non-Compliance*

Under the proposed examination standard, the auditor should use a risk-based approach in planning and performing procedures for the examination engagement and in evaluating the results of the procedures performed in the examination. The proposed examination standard:

- Requires the auditor to devote more attention to the matters that are most significant to compliance with the specified Financial Responsibility Rules and internal control over compliance with the specified Financial Responsibility Rules,
- Enables the auditor to scale the examination to smaller or less complex brokers and dealers, and
- Enables the auditor to plan, perform, and evaluate the results of the examination engagement concurrent with the audit of the financial statements because the proposed examination standard is structured similarly to, and contains many of the same concepts included in, auditing standards related to the auditor's assessment of and response to risk.<sup>42/</sup>

Because a proper risk assessment is critical to a risk-based approach, under the proposed examination standard, the auditor should perform procedures that are sufficient to provide a reasonable basis for identifying the risks of material non-compliance, whether intentional or unintentional, associated with each specified Financial Responsibility Rule and designing further examination procedures.<sup>43/</sup> To identify and assess risks of material non-compliance, under the proposed examination standard, the auditor should:

- *Evaluate the evidence obtained and the results of procedures performed in the audit of the financial statements and supplemental information* – This requirement is consistent with the concept that the examination engagement should be properly coordinated with, and informed by, the audit of the financial statements and supplemental information. For example, if an auditor, in performing procedures for the financial statement

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<sup>42/</sup> See Auditing Standards No. 8-15.

<sup>43/</sup> Further examination procedures consist of testing controls over compliance and performing compliance tests.

audit, identifies control deficiencies regarding periodic counts of investment inventory related to the broker's or dealer's trading for its own account, the auditor should take into account the control deficiency when assessing the risk of material non-compliance with Rule 17a-13 and adjust the extent of the planned examination procedures to properly respond to the heightened risk of material non-compliance.

- *Evaluate the nature of instances of non-compliance and deficiencies in internal control over compliance with the specified Financial Responsibility Rules identified during previous examination engagements* – For example, if a broker or dealer does not take steps to address weaknesses in its system of internal control that were identified during a previous examination engagement, the auditor should evaluate the impact on the auditor's assessment of the risks of material non-compliance in the current year.
- *Obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the specified Financial Responsibility Rules* – Obtaining an understanding of the broker's or dealer's processes, including relevant controls, includes evaluating the design of controls that are relevant to the examination and determining whether the controls have been implemented. Obtaining such an understanding is important to identify important points at which a necessary control is missing or not designed effectively. The nature, timing, and extent of procedures that are necessary to obtain an understanding of the broker's or dealer's processes, including relevant controls, regarding compliance with the specified Financial Responsibility Rules depend on the size and complexity of the broker or dealer; the auditor's existing knowledge of the broker's or dealer's processes and controls; the degree to which the broker's or dealer's compliance depends on the completeness and accuracy of the broker's or dealer's internally generated data; the nature and extent of changes in systems and operations; and the nature of the broker's or dealer's documentation of its processes and controls. For example, the auditor's procedures to obtain an understanding of the broker's or dealer's processes, including relevant controls, would be more extensive if the broker's or dealer's internal control is more complex or if the broker's or dealer's controls have changed significantly.
- *Obtain an understanding of instances of non-compliance and deficiencies in controls over compliance identified by management* – Understanding

instances of non-compliance and deficiencies in controls over compliance identified by management informs the auditor's assessment of the risks of material non-compliance. However, the proposed examination standard does not require the auditor to evaluate the effectiveness of the process used by the broker or dealer to arrive at its conclusions.<sup>44/</sup>

- *Assess risks of material non-compliance associated with related parties,<sup>45/</sup> including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship* – Relationships and transactions with related parties may heighten the risk of material non-compliance by, for example, providing opportunities to conceal material non-compliance or misappropriate customer assets. In an audit of financial statements, the auditor should perform procedures regarding related parties. These procedures include (1) determining the existence of, and identifying transactions with, related parties,<sup>46/</sup> (2) examining identified related party transactions,<sup>47/</sup> (3) conducting a discussion among key engagement team members that includes a discussion of the susceptibility of the financial statements to material misstatement through related party transactions,<sup>48/</sup> and (4) making inquiry of individuals within the broker or dealer involved in initiating, recording, or processing complex or unusual transactions, including significant related party transactions.<sup>49/</sup> Evidence obtained from performing these procedures

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<sup>44/</sup> Section II.B.2. of the SEC Proposing Release states that "[b]ecause the report of the independent public accountant required by proposed paragraph (g) of Rule 17a-5 would require the accountant to perform its own independent examination of the related controls and procedures, the Commission preliminarily does not believe that it is necessary for the independent public accountant to provide an opinion with regard to the process that the broker [or] dealer used to arrive at its conclusions.

<sup>45/</sup> The auditor should look to the FASB Accounting Standards Codification Master Glossary with respect to the term "related parties."

<sup>46/</sup> See paragraphs .07 and .08 of AU sec. 334, *Related Parties*.

<sup>47/</sup> See AU sec. 334.09.

<sup>48/</sup> See paragraph 52 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

<sup>49/</sup> See paragraph 57 of Auditing Standard No. 12.



helps inform the auditor's assessment of the risks of material non-compliance associated with related parties.

- *Obtain an understanding of management's competence regarding the relevant rules and regulations* – Under SEC Proposed Rule 17a-5, a broker's or dealer's compliance report should contain a statement that the broker or dealer has established and maintained a system of internal control to provide the broker or dealer with reasonable assurance that any instances of material non-compliance with the specified Financial Responsibility Rules will be prevented or detected on a timely basis.<sup>50/</sup> A sound understanding of the specified Financial Responsibility Rules increases the likelihood that management's compliance report is prepared in accordance with SEC Proposed Rule 17a-5 and that management's system of internal control is designed and maintained effectively. Evidence obtained during the audit of the financial statements and supplemental information helps inform the auditor's understanding of management's competence regarding the specified Financial Responsibility Rules. For example, in performing the audit of the financial statements and supplemental information, auditors are required to obtain an understanding of the company's control environment.<sup>51/</sup>
- *Read the Financial and Operational Combined Uniform Single Reports ("FOCUS reports") filed by the broker or dealer and obtain an understanding of the reasons for resubmissions, if any* – Reading the broker's or dealer's FOCUS reports might alert the auditor to instances of material non-compliance during the most recent fiscal year. In addition, if a broker or dealer regularly resubmits FOCUS reports or deems it necessary to make significant changes to previously submitted FOCUS reports, this might be indicative of weaknesses in the broker's or dealer's system of internal control over compliance with the specified Financial Responsibility Rules.
- *Read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the*

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<sup>50/</sup> See paragraph (d)(3)(i)(A) of SEC Proposed Rule 17a-5.

<sup>51/</sup> See paragraphs 23-25 of Auditing Standard No. 12, for a description of the auditor's responsibilities for obtaining an understanding of a company's control environment in a financial statement audit.



*broker's or dealer's assertions* – Many brokers and dealers have internal audit and compliance functions. Reviewing and testing internal controls over compliance with SEC rules are often important responsibilities of these functions. In addition, some brokers and dealers engage other auditors to perform work and issue reports that are of relevance to the auditor performing the examination engagement.

Under the Securities Exchange Act of 1934, all brokers and dealers are required to be members of self-regulatory organizations, such as the Financial Industry Regulatory Authority ("FINRA"), which performs routine surveillance and monitoring of its members. In performing such surveillance and monitoring activities, FINRA and other regulators may identify matters relevant to a broker's or dealer's compliance with the specified Financial Responsibility Rules. As such, when identifying and assessing risks of material non-compliance, under the proposed examination standard, the auditor should perform specific procedures related to regulatory examinations and correspondence. In particular, the proposed examination standard includes requirements for the auditor to:

- Inquire of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to the broker's or dealer's assertions.
- Read correspondence and notifications regarding non-compliance that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA that are relevant to the broker's or dealer's assertions, and, when necessary in the circumstances, make inquiries of the regulatory agencies.

#### 6. *Consideration of Fraud*

The proposed examination standard has multiple requirements regarding the auditor's consideration of fraud when performing the examination.

The proposed examination standard includes a requirement for the auditor to assess the risk of fraud, including the risk of misappropriation of customer assets, relevant to the specified Financial Responsibility Rules when identifying and assessing the risks of material non-compliance. The relevant fraud risks relating to material non-compliance include the risk of misappropriation of customer assets and intentional

manipulation of the books and records to conceal material misappropriations or material non-compliance.

The requirement to coordinate the examination engagement with the audit of the financial statements and supplemental information is important for the proper assessment of fraud risk in the examination engagement. The auditor's assessment of fraud risk in the examination engagement will be informed to a substantial degree by the procedures performed and the fraud risk assessments in the audit of the financial statements and supplemental information. Many of the fraud risk factors identified in the financial statement audit regarding (1) incentives or pressures to misappropriate assets or commit fraudulent financial reporting and (2) attitudes and rationalizations that justify such fraudulent actions,<sup>52/</sup> are relevant when identifying and assessing risks of misappropriation of customer assets or intentional manipulation of the books and records to conceal misappropriation of customer assets or material non-compliance. Also, weaknesses in controls regarding safeguarding of assets or stock records can result in opportunities for misappropriation of customer assets or material non-compliance. In addition, the evaluation of misstatements for indications of fraud or matters identified during the audit that might affect the assessment of fraud risks in the audit of the financial statements also might affect the assessment of fraud risks in the examination engagement.<sup>53/</sup>

The proposed examination standard also includes a requirement for the auditor to obtain an understanding of the nature and frequency of customer complaints that are relevant to compliance with the specified Financial Responsibility Rules, which can provide evidence relevant to the assessment of fraud risks, especially if there is a high incidence of customer complaints, thematic issues in the complaints that indicate the potential for fraudulent misappropriation of customer assets, or specific allegations of fraud by the broker's or dealer's customers.

In addition, the proposed examination standard includes a requirement for the auditor to perform compliance tests that are specifically responsive to fraud risks. In particular, under the proposed examination standard, the auditor must perform

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<sup>52/</sup> See paragraphs 65-66 of Auditing Standard No. 12 and paragraph 85 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

<sup>53/</sup> See paragraphs 20-23, 28-29 and Appendix C of Auditing Standard No. 14, *Evaluating Audit Results*.

procedures to obtain evidence about the existence of customer funds or securities held for customers.<sup>54/</sup>

SEC Proposed Rule 17a-5 also requires that auditors directly contact the Commission and the broker's or dealer's DEA within one business day of finding material non-compliance in the course of preparing the auditors reports required by the rule.<sup>55/</sup>

Questions:

6. Is a risk-based approach to the examination engagement appropriate? What alternative approaches should the Board consider and why?
7. Are the procedures required by the proposed examination standard to identify and assess risks of material non-compliance sufficiently clear? Are there additional procedures that the Board should require?

7. *Testing Controls over Compliance*

SEC Proposed Rule 17a-5 requires the broker's or dealer's compliance report to include an assertion regarding the effectiveness of internal control over compliance with the specified Financial Responsibility Rules during the most recent fiscal year.<sup>56/</sup> Accordingly, the proposed examination standard requires the auditor to obtain evidence about the design and operating effectiveness of relevant controls over compliance during the entire fiscal year.<sup>57/</sup>

The proposed examination standard requires the auditor to test those controls that are important to the auditor's conclusion about whether the broker or dealer

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<sup>54/</sup> Paragraphs (a)(1) and (a)(2) of Rule 15c3-3 define the terms "customer" and "customer securities," respectively.

<sup>55/</sup> See paragraph (h) of SEC Proposed Rule 17a-5.

<sup>56/</sup> See paragraph (d)(3)(i)(B)(3) of SEC Proposed Rule 17a-5, which requires the broker or dealer to assert on the effectiveness of its internal control over compliance with the specified Financial Responsibility Rules throughout the fiscal year.

<sup>57/</sup> See paragraph (d)(3)(i)(C) of SEC Proposed Rule 17a-5, which requires the broker or dealer to describe each identified instance of material non-compliance and each material weakness in internal control over compliance.

maintains effective internal control over compliance for each specified Financial Responsibility Rule. As the broker's or dealer's assertion regarding internal control over compliance relates to each specified Financial Responsibility Rule individually, the auditor should obtain evidence about the effectiveness of the selected controls for each specified Financial Responsibility Rule. However, when testing controls over compliance, the auditor's objective is not to support an opinion about the effectiveness of each individual control, rather, the objective is to form an opinion about whether the broker's or dealer's assertion regarding internal control over compliance is fairly stated, in all material respects. This allows the auditor to focus his or her effort on the controls that are important to each of the specified Financial Responsibility Rules and to vary the level of evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

The risk associated with an individual control consists of the risk that a control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with a control increases, the evidence that the auditor should obtain also increases. The proposed examination standard identifies certain factors including, for example, the extent of use of part-time personnel to perform controls over compliance, that affect the risk associated with a control.

The proposed examination standard requires the auditor to test the design and operating effectiveness of the selected controls over compliance. The requirements in the proposed examination standard for testing design and operating effectiveness of controls over compliance are analogous to the requirements for testing controls in Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

Under the proposed examination standard, the auditor should obtain evidence each year, but like testing controls in a financial statement audit, the proposed examination standard provides factors for the auditor to consider if the auditor plans to use evidence obtained in prior years in determining the extent of test work in the current year.

As noted above, the auditor is required to obtain evidence about the effectiveness of internal control over compliance during the entire fiscal year. For example, if a broker or dealer makes changes to its policies and procedures or key personnel during the fiscal year, the auditor should obtain evidence regarding the design effectiveness of the selected controls before and after the change.

Questions:

8. Are the requirements in the proposed examination standard for testing controls over compliance sufficiently clear?
9. Are there additional factors that should be considered in assessing the risk associated with a control?

8. *Performing Compliance Tests*

With respect to compliance tests, the auditor's objective is to form a conclusion about whether the broker's or dealer's assertion regarding compliance with each specified Financial Responsibility Rule is fairly stated, in all material respects. To satisfy this objective, the proposed examination standard requires the auditor to perform procedures that are sufficient to support the auditor's conclusions regarding whether the broker or dealer is in compliance with each specified Financial Responsibility Rule as of the specified date. The Board considered two alternatives when developing the requirements for compliance tests: 1) prescribing specific testing procedures for each specified Financial Responsibility Rule and 2) using a more general approach to establishing the requirements. In general, the Board decided to take the latter approach as it requires the auditor to devote more attention to the matters that are most significant to compliance with the specified Financial Responsibility Rules and focuses the auditor's effort on the areas of greater risk. However, in connection with testing compliance with Rule 17a-13 and paragraph (b) of Rule 15c3-3, the proposed examination standard specifically requires the auditor to perform procedures to obtain evidence about the existence of customer funds or securities held for customers.<sup>58/</sup> Examples of procedures that provide evidence about the existence of customer assets include (1) counting customer securities or observing and testing the broker's or dealer's procedures for physical inspection and (2) confirming customer security positions directly with depositories and clearing organizations. Procedures performed in the audit of the financial statements and supplemental information to test the existence of assets held for customers also provide evidence that is relevant to this requirement in the examination engagement.

The SEC Proposing Release, in discussing the broker's or dealer's assertion regarding compliance with the specified Financial Responsibility Rules at fiscal year end, states that "because [Rule 17a-13 and the account statement rule] impose

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<sup>58/</sup> Paragraphs (a)(1) and (a)(2) of Rule 15c3-3 define the terms "customer" and "customer securities," respectively.

obligations on a quarterly basis (the broker [or] dealer must conduct the quarterly count of securities and must send statements to all customers at least once during each quarter, but not necessarily on the last day of the quarter), to be able to make the assertions in the [c]ompliance [r]eport, the broker [or] dealer would need to determine that it had satisfied the requirements over the course of the fiscal quarter immediately preceding the broker [or] dealer's fiscal year-end."<sup>59/</sup> Accordingly, under the proposed examination standard, the auditor should perform tests of compliance over each of the specified Financial Responsibility Rules as of year end and, for Rule 17a-13 and the account statement rule, the auditor should perform tests of compliance during the fiscal quarter immediately preceding the broker's or dealer's year end.

Under the proposed examination standard, as the risk of material non-compliance associated with a particular specified Financial Responsibility Rule increases, the evidence that the auditor should obtain from compliance tests also increases. The results of the auditor's tests of controls over compliance also affect the nature, timing, and extent of compliance tests. If the results of the auditor's evaluation of controls over compliance indicate that the controls are ineffective, the auditor should revise the planned compliance tests as necessary to obtain more evidence.

When planning and performing compliance tests, the auditor should take into account the evidence obtained from procedures performed as part of the audit of the financial statements and supplemental information. For example, certain audit procedures performed to test the valuation and classification of the broker's or dealer's investments as of year end may provide relevant evidence regarding the broker's or dealer's compliance with Rule 15c3-1. Further, when testing the broker's or dealer's cash and cash equivalents, certain audit procedures may provide evidence regarding the existence of special reserve bank accounts for the exclusive benefit of customers, as well as evidence about the deposits to, and withdrawals from, those bank accounts. Such evidence may be relevant to the broker's or dealer's compliance with Rule 15c3-3 regarding whether the broker or dealer maintains a special reserve bank account for the exclusive benefit of customers. However, as the objectives of the audit and the examination engagement are not the same, the auditor must plan and perform the work to meet the objectives of both engagements.

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Section II.B.1. of the SEC Proposing Release.



Question:

10. Are the principles in the proposed examination standard for performing compliance tests sufficiently clear? Should the standard include specific procedures that should always be performed?

9. *Testing Information Used to Assert Compliance*

The proposed examination standard requires the auditor to perform procedures to determine whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records. Proper coordination of these procedures with the audit of the financial statements and supplemental information allows the auditor to avoid unnecessary redundancy in the auditor's work. For example, the PCAOB's Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*, includes a requirement for the auditor to determine that the supplemental information reconciles to the underlying accounting and other records or to the financial statements themselves, as applicable. Such supplemental information includes the supporting schedules that broker or dealers are required to include in their financial reports pursuant to SEC Proposed Rule 17a-5.<sup>60/</sup>

Although the proposed examination standard does not require the auditor to perform tests of controls that are relevant to whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records, if the auditor plans to rely on controls to reduce the planned extent of other procedures, the auditor must obtain evidence that the controls selected for testing are designed and operating effectively.

10. *Evaluating the Results of the Examination Procedures*

Under the proposed examination standard, in forming an opinion on whether the assertions made by the broker or dealer in the compliance report are fairly stated, in all material respects, the auditor should evaluate all evidence obtained regardless of whether the evidence corroborates or contradicts the broker's or dealer's assertions. This includes evaluating evidence obtained from compliance tests, tests of controls, and the audit of the broker's or dealer's financial statements and supplemental information. Under the proposed examination standard, the auditor's evaluation of results includes evaluating: (1) instances of non-compliance to determine whether they are material,

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<sup>60/</sup> See paragraphs (d)(2)(ii) and (d)(2)(iii) of SEC Proposed Rule 17a-5.



individually or in combination, as of the specified date; (2) instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records to determine whether they are material, individually or in combination; and (3) identified control deficiencies to determine whether the deficiencies, individually or in combination, are material weaknesses.

Because SEC Proposed Rule 17a-5 requires the broker or dealer to assert on the effectiveness of internal control over compliance with the specified Financial Responsibility Rules during the entire fiscal year,<sup>61/</sup> the auditor should evaluate control deficiencies to determine whether the deficiencies, individually or in combination are, or were at some point during the specified period, material weaknesses.

Although the existence of a material weakness in internal control over compliance does not necessarily mean that an instance of material non-compliance exists at the specified date, the auditor nonetheless should take into account the existence of the material weakness in determining the necessary nature, timing, and extent of compliance tests and in evaluating the evidence obtained.

Furthermore, an auditor cannot assume that an identified instance of non-compliance or an identified control deficiency is an isolated occurrence. The auditor should evaluate the effect of any instance of non-compliance or identified control deficiency on the auditor's assessed risks of material non-compliance. This evaluation is important to inform the auditor's conclusions about whether the auditor's risk assessments remain appropriate and whether he or she has obtained sufficient appropriate evidence to support the opinion to be expressed in the auditor's examination report.

Under the proposed examination standard, the auditor should evaluate the effect on the audit of the financial statements and supplemental information of any material non-compliance, material weaknesses, or instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records. This includes determining whether sufficient appropriate audit evidence has been obtained to support the relevant financial statement assertions, including assertions related to the completeness and accuracy of disclosures, taking into account materiality considerations for the audit of the financial statements. For example, if, in performing procedures related to net capital requirements under Rule 15c3-1, the auditor identifies

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<sup>61/</sup> See paragraph (d)(3)(i)(B)(3) of SEC Proposed Rule 17a-5.

that the broker's or dealer's net capital position is misstated because the information used in the calculation was not derived from the broker's or dealer's books and records, the auditor would need to evaluate whether the broker's or dealer's financial statement disclosures and supplemental information are also materially misstated.

The proposed examination standard also includes a requirement for the auditor to evaluate whether he or she has obtained sufficient appropriate evidence to support the conclusions to be presented in the examination report. Factors that are relevant to this evaluation include the following:

- a. The results of procedures performed in the examination engagement and evidence obtained from procedures performed as part of the audit of the financial statements and supplemental information, including whether the evidence obtained supports or contradicts the broker's or dealer's assertions;
- b. The nature and frequency of any non-compliance identified, including the facts and circumstances surrounding such non-compliance, the period covered, and the total number of occurrences, and the likelihood of the non-compliance having a material effect, individually or in combination, considering the possibility of further undetected non-compliance;
- c. The significance of any identified instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records and the likelihood of the instances having a material effect, individually or in combination, considering the possibility of further undetected instances;
- d. The nature and frequency of any identified deficiencies in controls over compliance with the specified Financial Responsibility Rules, including the facts and circumstances surrounding such deficiencies, the period covered, the total number of occurrences, and the likelihood of the control deficiencies resulting in a material weakness, individually or in combination, considering the possibility of further undetected deficiencies;
- e. The risks of material non-compliance associated with each specified Financial Responsibility Rule; and

- f. The appropriateness (i.e., the relevance and reliability) of the evidence obtained.<sup>62/</sup>

Under the proposed examination standard, if the auditor has not obtained sufficient appropriate evidence about an assertion or has substantial doubt about an assertion, he or she should perform additional procedures to obtain further evidence to address the matter. For example, if, during the audit of the broker's or dealer's financial statements, the auditor identified control deficiencies that existed during the year that may cause the broker or dealer to use incorrect securities hair-cut percentages when computing its net capital under Rule 15c3-1,<sup>63/</sup> the auditor should (1) determine whether such deficiencies individually or in combination are material weaknesses and (2) revise the planned compliance tests as necessary to obtain more evidence about whether the broker's or dealer's year-end net capital computation complies with the requirements of Rule 15c3-1.

If the auditor is unable to obtain sufficient appropriate evidence about an assertion to provide a reasonable basis for forming a conclusion, the auditor should withdraw from the examination engagement or express a disclaimer of opinion. See Section I.E. of this appendix, "Reporting on a Broker or Dealer Compliance Examination", for further discussion regarding scope limitations.

Question:

11. Are the requirements in the proposed examination standard for evaluating identified instances of non-compliance, instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records, and deficiencies in internal control over compliance, sufficiently clear?

11. *Subsequent Events*

The auditor also has responsibilities regarding events occurring from the end of the period specified in the broker's or dealer's assertions to the date of the auditor's examination report (the "subsequent period"). Under the proposed examination standard the auditor should perform procedures, in addition to those performed as part

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<sup>62/</sup> Paragraphs 5-9 of Auditing Standard No. 15, discuss matters that affect the sufficiency and appropriateness of evidence.

<sup>63/</sup> See paragraph (c)(2)(vi) of Rule 15c3-1.

of the financial statement audit,<sup>64/</sup> for the purpose of identifying subsequent events relevant to the auditor's conclusions about the assertions made by the broker or dealer in the compliance report. Rather than repeat the subsequent event procedures included in AU sec. 560, *Subsequent Events*, the proposed examination standard includes requirements relevant to the examination engagement designed to supplement the procedures performed during the audit of the financial statements. Under the proposed examination standard, procedures to identify subsequent events should include, but are not limited to: (a) reading relevant reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors, and correspondence that the broker or dealer has sent to or received from the SEC or the broker's or dealer's DEA during the subsequent period that is relevant to the broker's or dealer's assertions and (b) evaluating information obtained through other engagements performed by the auditor for the broker or dealer, including subsequent events procedures performed in the audit of the financial statements and supplemental information.

Question:

12. Should the proposed examination standard require additional procedures to identify subsequent events relevant to the auditor's opinion on the assertions made by a broker or dealer in a compliance report?

12. *Representation Letter*

The proposed examination standard includes a requirement for the auditor to obtain written representations from management of the broker or dealer. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the examination engagement. See Section I.E. of this appendix, "Reporting on a Broker or Dealer Compliance Examination," for further discussion regarding scope limitations.

Question:

13. Are the representations the auditor is required to obtain from management necessary for the auditor to express an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects?

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<sup>64/</sup> See AU sec. 560, *Subsequent Events*.

#### **D. Communication Requirements**

Under the proposed examination standard, the auditor should communicate to management identified instances of non-compliance, identified control deficiencies, and identified instances in which information used to determine compliance with the specified Financial Responsibility Rules was not derived from the broker's or dealer's books and records.

Further, the proposed examination standard states that the auditor should communicate to management and the audit committee<sup>65/</sup> identified instances of material non-compliance, identified instances of material weakness, and identified instances in which information used to determine compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records.

Importantly, in addition to the requirements of this proposed examination standard, the SEC has also proposed to establish additional communication requirements for the auditor regarding notification of material non-compliance. Whereas existing Rule 17a-5 requires the auditor to call any "material inadequacy" to the attention of the broker's or dealer's chief financial officer (who is then obligated to notify the SEC), SEC Proposed Rule 17a-5 requires, among other things, the auditor, upon determining that any material non-compliance exists, to notify the SEC directly within one business day.<sup>66/</sup>

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<sup>65/</sup> For the purposes of this standard, the term "audit committee" refers to a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of a company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company. If a broker or dealer does not have an audit committee or a board of directors of the company, those responsible for the appointment, compensation, and oversight of the work of the auditor.

<sup>66/</sup> Paragraph (h) of SEC Proposed Rule 17a-5 states that "[u]pon determining any material non-compliance exists during the course of preparing the independent public accountant's reports, the independent public accountant must notify the Commission within one business day of the determination by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations and provide a

Question:

14. Are there other matters related to the examination that the auditor should communicate to the broker's or dealer's audit committee?

**E. Reporting on the Examination Engagement**

The proposed examination standard requires the auditor to issue a single report that expresses an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects, when expressing an unqualified opinion. However, the proposed examination standard requires direct reporting on the subject matter if one or more instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion, one or more material weaknesses exist during the period specified in the broker's or dealer's assertion, or one or more instances exist in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the books and records of the broker or dealer. Direct reporting is preferable in these circumstances because it communicates more effectively the nature and results of the examination.

Under the proposed examination standard, the auditor's examination report includes certain elements that are not required by AT sec. 101, but that are important for a reader of the auditor's examination report to understand regarding the auditor's responsibilities. For example, under the proposed examination standard, the auditor's examination report must include:

- A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the examination engagement to obtain reasonable assurance about whether one or more instances of material non-compliance exist as of the specified date; whether the information used to assert compliance with the specified Financial Responsibility Rules was derived, in all material respects, from the books and records of the broker or dealer; and whether one or more instances of material weakness exist during the specified period; and
- A statement that an examination engagement includes testing and evaluating the broker's or dealer's compliance with the specified Financial

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copy of such notification in the same manner to the principal office of the designated examining authority for the broker or dealer within one business day of the finding."



Responsibility Rules, determining whether the information used to assert compliance with the specified Financial Responsibility Rules was derived from the broker's or dealer's books and records, testing and evaluating the design and operating effectiveness of internal control over compliance with the specified Financial Responsibility Rules, and performing such other procedures as the auditor considered necessary in the circumstances.

SEC Proposed Rule 17a-5 requires the auditor's examination report to comply with certain technical requirements, make certain representations, and state clearly the auditor's opinion.<sup>67/</sup> The requirements of the proposed examination standard are aligned with these requirements. For example, the proposed examination standard requires the auditor to manually sign the examination report,<sup>68/</sup> whereas AT sec. 101 allows either a manual or printed signature of the auditor's firm.<sup>69/</sup> Furthermore, unlike AT sec. 101, the proposed examination standard includes a requirement for the auditor to include the city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's examination report has been issued.<sup>70/</sup>

Unlike AT sec. 101, the proposed examination standard does not include provisions that allow the auditor to restrict the use of the review report to specified parties.

The proposed examination standard includes an example of the auditor's examination report expressing an unqualified opinion on the assertions made by a broker or dealer in a compliance report.

Questions:

15. Do the required elements of the auditor's examination report clearly communicate the auditor's responsibilities for the examination engagement?

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<sup>67/</sup> See paragraph (i) of SEC Proposed Rule 17a-5.

<sup>68/</sup> See paragraph (i)(1)(ii) of SEC Proposed Rule 17a-5.

<sup>69/</sup> See AT sec. 101.85.

<sup>70/</sup> See paragraph (i)(1)(iii) of SEC Proposed Rule 17a-5 and AT sec. 101.85.



16. What changes, if any, should be made to the format or content of the report as described in the proposed examination standard? Are there additional auditor representations or other information that should be included in the auditor's report?

1. *Examination Report Date*

Under the proposed examination standard, the auditor should date the examination report no earlier than the date on which the auditor obtains sufficient appropriate evidence to support his or her opinion. Because of the coordination between the examination engagement and the audit of the financial statements and supplemental information, the date of the examination report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

2. *Examination Report Modifications*

The proposed examination standard includes an appendix ("Appendix A") that builds on existing concepts described in AT sec. 101 regarding report modifications and adapts them as appropriate to make the requirements more specific to the examination engagement.

Under the proposed examination standard, if (1) one or more instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion, (2) one or more material weaknesses exist during the period specified in the broker's or dealer's assertion, or (3) one or more instances exist in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the books and records of the broker or dealer, the auditor must express an adverse opinion directly on the subject matter of the respective assertions, rather than on the assertions themselves, unless there is a restriction on the scope of the examination engagement.<sup>71/</sup> This requirement is different from AT sec. 101 which states that "[r]eservations about the subject matter ... can result in either a qualified or an adverse opinion, depending on the materiality of the departure from the criteria against which the subject matter ... was evaluated."<sup>72/</sup> Qualification of

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<sup>71/</sup> The requirement to express an adverse opinion applies regardless of whether the material non-compliance, material weakness, or other matters preventing an unqualified opinion were identified by management or the auditor.

<sup>72/</sup> AT sec. 101.76.

the examination report is not appropriate because any instance of material non-compliance, any material weakness in internal control over compliance, or any instance in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records, is by definition material and, as such, should result in an adverse opinion. Furthermore, this requirement is consistent with SEC Proposed Rule 17a-5 which does not permit the broker or dealer to conclude in its compliance report that it is in compliance with the specified Financial Responsibility Rules if it identifies one or more instances of material non-compliance or that its internal control over compliance with the specified Financial Responsibility Rules is effective if one or more instances of material weakness in internal control over compliance exist.<sup>73/</sup>

Unlike AT sec. 101, the proposed examination standard describes specific matters that the auditor must include in the examination report when expressing an adverse opinion. For example, when expressing an adverse opinion because one or more material weaknesses exist, the auditor's examination report must include a statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in the compliance report.

The requirement to express an adverse opinion applies only to the subject matter for the respective assertion. It does not require an adverse opinion on the subject matter of all assertions in every instance. For example, if a material weakness was identified, but there were no instances of material non-compliance or instances in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the broker's or dealer's books and records, the examination report should include an adverse opinion on internal control over compliance and an unqualified opinion on the other two assertions.

In contrast to AT sec. 101, under the proposed examination standard, further modifications to the examination report are necessary if a description of all identified instances of material non-compliance and all identified material weaknesses have not been included in the broker's or dealer's compliance report. For example, if the broker or dealer concludes in its compliance report that internal controls over compliance are effective when, in fact, one or more material weaknesses in internal control over compliance exist, the proposed examination standard requires the auditor to modify his or her report to describe the material weaknesses that the auditor has identified but that are not described in the broker's or dealer's compliance report.

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See paragraph (d)(3)(i)(C) of SEC Proposed Rule 17a-5.

Under the proposed examination standard, the auditor can express an opinion on whether the assertions made by a broker or dealer in a compliance report are fairly stated, in all material respects, only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the examination engagement, the auditor should withdraw from the engagement or disclaim an opinion. This requirement is different from AT sec. 101 which states that "[r]estrictions on the scope of an engagement ... may require a practitioner to qualify the assurance provided, to disclaim any assurance, or to withdraw from the engagement."<sup>74/</sup> When a scope limitation exists, qualification of the examination report is not appropriate because the auditor does not have a reasonable basis to support the opinion.

Whereas AT sec. 101 provides only an example examination report containing a disclaimer of opinion because of a scope restriction,<sup>75/</sup> the proposed examination standard includes specific requirements so that users of the report are adequately informed. Under the proposed examination standard, when disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the examination engagement was not sufficient for the auditor to express an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer, including the procedures that were deemed necessary by the auditor that have been omitted and the reason for their omission. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an examination engagement.

Further, under the proposed examination standard, when the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that: (1) one or more instances of material non-compliance exist as of the date specified in the broker's or dealer's assertion, (2) one or more material weaknesses exist during the period specified in the broker's or dealer's assertion, or (3) one or more instances exist in which the information used to assert compliance with the specified Financial Responsibility Rules was not derived, in all material respects, from the books and records of the broker or dealer, the auditor's report also must include the applicable statement required by paragraph A3 of the proposed examination standard. In addition, unlike AT sec. 101, if the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the examination engagement, under the proposed examination standard, the auditor should

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<sup>74/</sup> AT sec. 101.73.

<sup>75/</sup> See AT sec. 101.114, Appendix A, Example 6.

communicate on a timely basis, in writing, to management and the audit committee that the examination engagement cannot be satisfactorily completed.

Under the proposed examination standard, if the broker's or dealer's compliance report contains other information in addition to the statements and assertions required by SEC Proposed Rule 17a-5,<sup>76/</sup> the auditor should disclaim an opinion on the other information. For example, if the broker's or dealer's compliance report states that an identified instance of material weakness no longer exists because controls have been implemented that address the instance of material weakness, the auditor should disclaim an opinion on this information. Furthermore, if the auditor believes that additional information in the compliance report contains a material misstatement of fact, the auditor should discuss the matter with management of the broker or dealer. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information.

Questions:

17. What changes, if any, should be made to the format or content of the report modifications described in the proposed examination standard?
18. Should the standard include examples of modified examination reports? If so, what specific examples should be provided?

**II. Proposed Attestation Standard, Review Engagements Regarding Exemption Reports of Brokers and Dealers**

The proposed review standard establishes requirements that apply when an auditor is engaged to perform a compliance review of the assertion made by a broker or dealer in an exemption report prepared pursuant to SEC Proposed Rule 17a-5.<sup>77/</sup> SEC Proposed Rule 17a-5 requires a broker's or dealer's exemption report to contain an assertion by the broker or dealer that it is exempt from the provisions of Rule 15c3-3

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<sup>76/</sup> See paragraph (d)(3) of SEC Proposed Rule 17a-5.

<sup>77/</sup> See paragraph (d)(4) of SEC Proposed Rule 17a-5. Existing Rule 17a-5(g)(2) requires that the independent public accountant engaged by the broker or dealer must "ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the independent public accountant's attention to indicate that the exemption had not been complied with during the period since the independent public accountant's last examination."

because it meets conditions set forth in paragraph (k) of Rule 15c3-3 and to identify the specified conditions.<sup>78/</sup>

#### **A. Relationship to the Interim Attestation Standards**

PCAOB standard, AT sec. 101, *Attest Engagements*, establishes requirements that apply to attestation engagements in general, including review engagements similar to those described in the SEC Proposed Rule 17a-5.<sup>79/</sup> However, the requirements in AT sec. 101 are not specific to any particular type of review engagement. The proposed review standard establishes requirements that are designed specifically for the review required by SEC Proposed Rule 17a-5.<sup>80/</sup> Accordingly, auditors should look to the requirements in this standard rather than AT sec. 101 for these engagements. In addition, the emphasis in the proposed review standard on appropriately coordinating the review engagement with the audit of the financial statements and supplemental information should avoid unnecessary redundancy in the auditor's work.

#### **B. Objective of the Auditor**

When performing a review of the assertion made by a broker or dealer in an exemption report, the auditor's objective is to state a conclusion regarding whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertion for the assertion to be fairly stated, in all material respects. To state such a conclusion, the auditor must plan and perform the review engagement to obtain appropriate evidence that is sufficient to obtain moderate assurance about whether one or more instances of non-compliance exist with respect to the conditions identified in the broker's or dealer's assertion ("exemption conditions") that, individually or in combination, would cause the broker's or dealer's assertion not to be fairly stated, in all material respects.

##### *1. Moderate Assurance*

In contrast to an examination engagement in which the auditor obtains reasonable assurance to support his or her opinion on the broker's or dealer's

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<sup>78/</sup> See paragraph (k) of Rule 15c3-3 and paragraph (d)(4) of SEC Proposed Rule 17a-5.

<sup>79/</sup> AT sec. 601, *Compliance Attestation*, does not apply to review engagements.

<sup>80/</sup> See paragraph (d)(4) of SEC Proposed Rule 17a-5.

assertions, a review engagement results in obtaining moderate assurance regarding the broker's or dealer's assertion that the broker or dealer meets the identified conditions for an exemption from Rule 15c3-3.<sup>81/</sup> Review engagements typically involve the performance of inquiries and analytical procedures,<sup>82/</sup> and the auditor's conclusions typically are expressed in the report in the form of a statement that "[b]ased on the results of the review, nothing came to [the auditor's] attention that caused [the auditor] to believe that management's assertion ... is not fairly stated, in all material respects ...."<sup>83/</sup>

In a review engagement covered by the proposed review standard, analytical procedures are not feasible for evaluating compliance with the exemption conditions, as the conditions are based on activities of the broker or dealer rather than on financial statement amounts. Thus, the proposed review standard would establish specific procedural requirements that are commensurate with the responsibility to obtain moderate assurance.<sup>84/</sup> Subsequent sections of this release discuss those procedures further.

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<sup>81/</sup> Obtaining moderate assurance in a review engagement is consistent with both existing PCAOB standards and the SEC Proposing Release. AT sec. 101.55 describes a review as an attest engagement designed to provide a moderate level of assurance. Section II.B.5. of the SEC Proposing Release states that a "moderate level of assurance [is] contemplated by the required review."

<sup>82/</sup> AT sec. 101.55 states that "[i]n an attest engagement designed to provide a moderate level of assurance (referred to as a review), the objective is to accumulate sufficient evidence to restrict attestation risk to a moderate level. To accomplish this, the types of procedures performed generally are limited to inquiries and analytical procedures (rather than also including search and verification procedures)."

<sup>83/</sup> See AT sec. 101.115, Appendix B, Example 3.

<sup>84/</sup> This approach is consistent with AT sec 101.55-.56 which states that "... there will be circumstances in which inquiry and analytical procedures ... cannot be performed... In [this] circumstance, the practitioner should perform other procedures that he or she believes can provide him or her with a level of assurance equivalent to that which inquiries and analytical procedures would have provided."



2. *Non-Compliance Requiring Material Modification*

The proposed review standard refers to non-compliance that would cause the broker's or dealer's assertion not to be fairly stated, in all material respects. The SEC's Proposing Release provides an example of a discovery by the auditor that would require a material modification of the broker's or dealer's assertion in the exemption report.<sup>85/</sup> That example is a discovery that the broker or dealer failed to promptly forward any customer securities it received.<sup>86/</sup>

Question:

19. Is the concept of non-compliance requiring material modification clear?

**C. General Requirements**

The proposed review standard requires that an auditor performing a review engagement have technical proficiency in attestation engagements, have an understanding of the exemption conditions and other rules and regulations that are relevant to the broker's or dealer's assertion, determine the auditor's compliance with independence and ethics requirements, exercise due professional care, and properly plan and supervise the review engagement.

Questions:

20. Are the general requirements included in the proposed review standard sufficiently clear?
21. Are there additional general requirements that should be included for a review engagement?

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<sup>85/</sup> See Section II.B.5. of the SEC Proposing Release.

<sup>86/</sup> See paragraph (k)(2)(ii) of Rule 15c3-3, which provides that an introducing broker or dealer is exempt from the requirements of Rule 15c3-3 if the introducing broker or dealer "promptly transmits all customer funds and securities to the clearing broker or dealer which carries all of the accounts of such customers ... ."



**D. Relationship Between the Review Engagement and the Audit of the Financial Statements and Supplemental Information**

The proposed review standard recognizes that the auditor of the financial statements of the broker or dealer generally would issue the review report covered by the proposed review standard. Accordingly, the proposed review standard includes a requirement for the auditor to coordinate the review engagement with the audit of the financial statements and supplemental information. However, the objectives of the audit and the review engagement are not the same, so the auditor must plan and perform the work to meet the objectives of both engagements.

While recognizing that the objectives of the audit and the review engagement are different, the proposed review standard includes a requirement for the auditor to take into account relevant evidence from the audit in planning and performing procedures for the review engagement and in evaluating the results of the procedures performed in the review.

For example, if the broker or dealer claims exemption under Rule 15c3-3(k)(2)(i), the auditor, among other things, needs to obtain evidence that the broker or dealer has appropriate bank accounts designated as "Special Account for the Exclusive Benefit of Customers of (name of the broker or dealer)" and that all customer transactions are effectuated through such accounts, as required by the rule.<sup>87/</sup> Audit procedures related to specially designated cash accounts, including confirming the account balance with the clearing broker and testing customer transaction activities, can provide evidence relevant to these exemption conditions.

Furthermore, if the broker or dealer claims exemption under Rule 15c3-3(k)(2)(ii), the auditor, among other things, needs to obtain evidence that the broker or dealer is operating as an introducing broker or dealer and clears all transactions with and for

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<sup>87/</sup> Paragraph (k)(2)(i) of Rule 15c3-3 states that "the provisions of [Rule 15c3-3] shall not be applicable to a broker or dealer ... who carries no margin accounts, promptly transmits all customer funds and delivers all securities received in connection with his activities as a broker or dealer, does not otherwise hold funds or securities for, or owe money or securities to, customers and effectuates all financial transactions between the broker or dealer and his customers through one or more bank accounts, each to be designated as "Special Account for the Exclusive Benefit of Customers of (name of the broker or dealer)"."

customers with clearing brokers and dealers on a fully-disclosed basis.<sup>88/</sup> Audit procedures, including reading the clearing agreement between the broker or dealer and clearing brokers and dealers when testing trade fee or commission revenues and expenses can provide evidence relevant to these exemption conditions.

Other procedures performed during the audit that are relevant to the broker's or dealer's compliance with the exemption conditions include testing of transactions related to customer trades and testing investment inventory or transactions related to the broker's or dealer's trading for its own account.

Under the proposed review standard, if the broker's or dealer's assertion is not fairly stated, in all material respects, the auditor should evaluate the effect of the matter on the audit of the financial statements and supplemental information.

If the auditor performing the review engagement does not audit the financial statements and supplemental information of the broker or dealer, the proposed review standard requires the auditor to obtain knowledge of the evidence obtained and results of procedures performed in the audit of the financial statements and supplemental information that is commensurate with that of the auditor of the financial statements and supplemental information. That level of knowledge is necessary to have an appropriate basis to perform the evaluation required by the proposed review standard.

The proposed review standard also states that the auditor's own work on the review engagement must be sufficient to support his or her conclusion on the broker's or dealer's assertion, so that the auditor who performs only the review engagement does not rely on the work of the auditor of the financial statements and supplemental information without performing the procedures required by the proposed review standard.

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<sup>88/</sup> Paragraph (k)(2)(ii) of Rule 15c3-3, states that "the provisions of [Rule 15c3-3] shall not be applicable to a broker or dealer ... who, as an introducing broker or dealer, clears all transactions with and for customers on a fully disclosed basis with a clearing broker or dealer, and who promptly transmits all customer funds and securities to the clearing broker or dealer which carries all of the accounts of such customers and maintains and preserves such books and records pertaining thereto pursuant to the requirements of Exchange Act Rules 17a-3 and 17a-4, as are customarily made and kept by a clearing broker or dealer."

Question:

22. Are there any other sources of relevant evidence obtained in the audit of the financial statements and supplemental information that the auditor should take into account when planning and performing the review engagement that should be included in the standard?

**E. Review Procedures**

The auditor's responsibility when performing a review engagement is to obtain moderate assurance about whether the broker or dealer complied with the exemption conditions cited in the broker's or dealer's assertion. Accordingly, the proposed review standard requires the auditor to plan and perform the review engagement so that the auditor obtains appropriate evidence that is sufficient for moderate assurance.

Under the proposed review standard the auditor should perform procedures including making inquiries of management and relevant personnel of the broker or dealer, reading relevant reports from internal auditors or regulatory correspondence, evaluating evidence from the audit of the financial statements and supplemental information, and performing additional procedures for identified instances of non-compliance.

*1. Nature, Timing, and Extent of Procedures*

Under the proposed review standard the nature, timing, and extent of the review procedures depend on certain risk factors and evidence about the broker's or dealer's compliance with the exemption conditions or about the effectiveness of controls over the exemption conditions obtained from the audit of the financial statements and supplemental information.

The proposed review standard states that the nature, timing, and extent of the necessary inquiries and other review procedures depend on the following risk factors:

- (1) The broker's or dealer's history of instances of non-compliance with the exemption conditions;
- (2) Changes in the broker's or dealer's procedures, controls, or the process in which the controls operate since the prior year;
- (3) Changes in the broker's or dealer's operations that are relevant to compliance with the exemption conditions;

- (4) Competence of the personnel who are responsible for compliance with the exemption conditions or who perform important controls over compliance, and whether there have been changes in those personnel during the period of the review;
- (5) The risk of fraud, including the risk of misappropriation of customer assets, relevant to the exemption conditions;
- (6) Potential non-compliance associated with related parties,<sup>89/</sup> including related parties that are investment advisors or entities with which the broker or dealer has a custodial or clearing relationship; and
- (7) The degree to which the processes that relate to the exemption conditions are performed, monitored, or controlled in a centralized or decentralized environment.

In considering the risk of fraud relevant to the exemption conditions, the auditor also considers if the broker or dealer has misrepresented its activities, e.g., the broker or dealer claims to be operating as a non-carrying broker or dealer, but based on other evidence appears to hold customer funds or securities.

In addition, knowledge of the degree to which the processes that relate to the exemption conditions are performed, monitored, or controlled in a centralized or decentralized environment might help the auditor determine which individuals within the broker or dealer the auditor should make inquiries of and what reports to request when performing review procedures.

Evidence about the broker's or dealer's compliance with the exemption conditions or about the effectiveness of controls over the exemption conditions obtained from the audit of the financial statements and supplemental information also affect the nature, timing, and extent of the necessary inquiries and other review procedures. For example, if the broker or dealer claims exemption under Rule 15c3-3(k)(1), the auditor, among other things, needs to obtain evidence that the broker's or dealer's dealer transactions are limited to those in redeemable securities of investment companies or of interests or participations in an insurance company separate account and places

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<sup>89/</sup> The auditor should look to the FASB Codification Master Glossary with respect to the term "related parties."

limitation on transaction activities outside of the allowable security types.<sup>90/</sup> Audit procedures regarding the broker's or dealer's investment inventory or investment transactions related to the broker's or dealer's trading for its own account, including confirmation of investment inventory with the custodian and testing investment transactions, can provide evidence relevant to the broker's or dealer's compliance with these exemption conditions.

As another example, if the broker or dealer claims exemption under sections (k)(1) or (k)(2) of Rule 15c3-3, the auditor needs to obtain evidence about whether the

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<sup>90/</sup> Paragraph (k)(1) of Rule 15c3-3, states that "the provisions of [Rule 15c3-3] shall not be applicable to a broker [or] dealer meeting all of the following conditions:

(i) His dealer transactions (as principal for his own account) are limited to the purchase, sale, and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company; except that a broker or dealer transacting business as a sole proprietor may also effect occasional transactions in other securities for his own account with or through another registered broker or dealer;

(ii) His transactions as broker (agent) are limited to: (a) The sale and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account, whether or not registered as an investment company; (b) the solicitation of share accounts for savings and loan associations insured by an instrumentality of the United States; and (c) the sale of securities for the account of a customer to obtain funds for immediate reinvestment in redeemable securities of registered investment companies; and

(iii) He promptly transmits all funds and delivers all securities received in connection with his activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.

(iv) Notwithstanding the foregoing, this section shall not apply to any insurance company which is a registered broker [or] dealer, and which otherwise meets all of the conditions in paragraphs (k)(1) (i), (ii), and (iii) of this section, solely by reason of its participation in transactions that are a part of the business of insurance, including the purchasing, selling, or holding of securities for or on behalf of such company's general and separate accounts."

broker or dealer promptly transmits all funds and delivers all securities received in connection with his activities as a broker or dealer, and does not otherwise hold funds or securities for, or owe money or securities to, customers.<sup>91/</sup> Audit procedures regarding customer trade and transaction activities can provide evidence relevant to these exemption conditions.

Other procedures performed during the audit that are relevant to the broker's or dealer's compliance with the exemption conditions include testing of specially designated cash accounts and reading clearing agreements between the broker or dealer and clearing brokers and dealers in connection with testing trade fee or commission revenues and expenses.<sup>92/</sup>

Question:

23. Are the factors that may increase the nature, timing, and extent of the necessary inquiries and other review procedures appropriate?

2. *Review Procedures*

The proposed review standard includes requirements for the auditor to perform inquiries of individuals at the broker or dealer and other procedures to obtain moderate assurance. The proposed review standard does not prescribe specific procedures for each of the various exemption conditions. Instead, the proposed review standard describes in general terms review procedures that should be applied regardless of the exemption claimed by the broker or dealer.

Under the proposed review standard the auditor should make inquiries of management, and, if applicable, other individuals at the broker or dealer who have relevant knowledge regarding:

- (1) Whether the broker or dealer was in compliance with the exemption conditions for the year under review,

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<sup>91/</sup> See paragraphs (k)(1)(iii), (k)(2)(i), and (k)(2)(ii) of Rule 15c3-3.

<sup>92/</sup> Refer to Section II.D., "Relationship between the Review Engagement and the Audit of the Financial Statements and Supplemental Information," of this Appendix for further discussion.



- (2) Regulatory examinations and correspondence between the SEC or the broker's or dealer's DEA and the broker or dealer that are relevant to compliance with the exemption conditions, and
- (3) Subsequent events through the date of the auditor's review report that might have a material effect on the broker's or dealer's assertion that it is exempt from the provisions of Rule 15c3-3.

In addition, if the broker or dealer has sent or received correspondence with the SEC or the broker's or dealer's DEA that is relevant to compliance with the exemption conditions, the proposed review standard includes a requirement for the auditor to read such correspondence and, when necessary in the circumstances, make inquiries of the regulatory agencies. These procedures provide the auditor with a basis for understanding whether the broker or dealer was in compliance with the exemption conditions.

Under the proposed review standard, the auditor also should make specific inquiries of individuals at the broker or dealer who have relevant knowledge of controls relevant to the broker's or dealer's compliance with the exemption conditions and individuals who are responsible for monitoring compliance with the exemption conditions or the controls over compliance.

Many brokers and dealers have internal auditors, others who perform an equivalent function, and compliance functions. Reviewing and testing internal controls over compliance with SEC rules are often important responsibilities of these functions. In addition, some brokers and dealers may engage other auditors to perform work and issue reports that are relevant to the broker's or dealer's compliance with the exemption conditions. As such, the proposed review standard includes a requirement for the auditor to read reports of internal auditors, others who perform an equivalent function, compliance functions, and other auditors that are relevant to the broker's or dealer's compliance with the exemption conditions.

SEC rules and rules of the broker's or dealer's DEA may require a broker or dealer, in certain situations, to make certain periodic regulatory filings that might be relevant to the broker's or dealer's compliance with the exemption conditions. The proposed review standard includes a requirement for the auditor to read regulatory filings of the broker or dealer that are relevant to the broker's or dealer's compliance with the exemption conditions.

Under the proposed review standard, the auditor should evaluate whether the evidence obtained and the results of the procedures performed in the audit of the



financial statements and supplemental information corroborate or contradict the broker's or dealer's assertion regarding compliance with the exemption conditions.<sup>93/</sup>

The proposed review standard also includes a requirement for the auditor to read the broker's or dealer's documentation regarding instances of non-compliance with the exemption conditions that are identified by the auditor or the broker or dealer.

Finally, the auditor should determine whether additional procedures are necessary in the circumstances for the auditor to obtain moderate assurance. These procedures may include additional inquiry procedures or other types of procedures.

Questions:

24. Are there other specific review procedures that the proposed review standard should require? If so, should the procedures be based on the various exemption conditions?
25. Are there alternative procedures that are equally or more effective than the procedures required by the proposed review standard that should replace specific procedures required by the proposed review standard?
26. Regardless of the level of assurance obtained in a review, are there other procedures that the auditor should be required to perform to enhance customer protection?

3. *Evaluating the Results of the Review Procedures*

Under the proposed review standard, the auditor should evaluate the identified instances of non-compliance with the exemption conditions to determine whether the instances of non-compliance, individually or in combination, cause the broker's or dealer's assertion not to be fairly stated, in all material respects. The SEC's Proposing Release states that "an example of a discovery that would necessitate a material modification [to the broker's or dealer's assertion] would be a discovery that the broker [or] dealer failed to promptly forward any customer securities it received."<sup>94/</sup>

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<sup>93/</sup> Refer to Section D., "Relationship between the Review Engagement and the Audit of the Financial Statements and Supplemental Information" and Section E., "Review Procedures" in this section of the release for further discussion.

<sup>94/</sup> See Section II.B.5. of the SEC Proposing Release.

The proposed review standard states that if the broker's or dealer's assertion is not fairly stated, in all material respects, the auditor should modify the review report and evaluate the effect of the matter on the audit of the financial statements and supplemental information. This requirement is intended to prompt the auditor, in the event that the broker or dealer does not meet the exemption conditions, to consider the effect on the amounts and disclosures in the financial statements, as well as the auditor's report on the financial statements and supplemental information.

Although the "moderate assurance" required for a review engagement is a lower level of assurance than the "reasonable assurance" required for an examination engagement, due professional care requires an auditor conducting a review to take appropriate actions when becoming aware of indicators of non-compliance or when substantial doubt remains. Under the proposed review standard, if information coming to the auditor's attention indicates that one or more instances of non-compliance might exist that might cause the broker's or dealer's assertion not to be fairly stated, in all material respects, or if the auditor has substantial doubt about the broker's or dealer's assertion, the auditor should perform additional procedures as necessary to address the matter. These additional procedures could include making additional inquiries, reading documents, or performing search and verification procedures, as necessary.<sup>95/</sup>

Question:

27. Are the requirements in the proposed review standard for evaluating identified instances of non-compliance sufficiently clear?

4. *Obtaining a Representation Letter*

The proposed review standard includes a requirement for the auditor to obtain written representations from management of the broker or dealer. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the review engagement. If a limitation on the scope of the review engagement exists, the auditor should withdraw from the engagement or should modify the review report.<sup>96/</sup>

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<sup>95/</sup> See AT sec. 101.56.

<sup>96/</sup> See paragraph 21 of the proposed review standard for auditor requirements when a scope limitation exists.

Question:

28. Are the representations the auditor is required to obtain from management necessary for the auditor to conclude whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker's or dealer's assertion for it to be fairly stated, in all material respects?

**F. Communication Requirements**

Under the proposed review standard, the auditor should communicate to management identified instances of non-compliance with the exemption conditions. Further, the auditor should communicate to management and to the audit committee<sup>97/</sup> identified instances of non-compliance that cause the broker's or dealer's assertion about its exemption conditions not to be fairly stated in all material respects.

Question:

29. Are there other matters related to the review that the auditor should communicate to the audit committee?

**G. Reporting on the Review Engagement**

AT sec. 101 allows the auditor to either (1) report directly on the subject matter, or (2) report on management's assertion.<sup>98/</sup> However, the proposed review standard requires the auditor to report on the broker's or dealer's assertion in the exemption report. In providing moderate assurance, reporting on the broker's or dealer's assertion in the exemption report is clearer than reporting on whether the broker or dealer did not

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<sup>97/</sup> For purposes of this standard, the term "audit committee" refers to a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of a company and audits of the financial statements of the company; if no such committee exists with respect to a company, the entire board of directors of the company. If a broker or dealer does not have an audit committee or a board of directors of the company, those responsible for the appointment, compensation, and oversight of the work of the auditor.

<sup>98/</sup> See AT sec. 101.63.

meet its exemption conditions specified in the broker-dealer's exemption report.<sup>99/</sup> Also, this is consistent with SEC Proposed Rule 17a-5 that the auditor's report be based on a review of the exemption report required to be filed by the broker or dealer.<sup>100/</sup>

Under the proposed review standard, the auditor's review report includes certain elements that are not required by AT sec. 101, but that are important for a reader of the auditor's review report to understand regarding the auditor's responsibilities. For example, under the proposed review standard, the auditor's review report must include a statement that the review was conducted in accordance with the standards of the Public Company Accounting Oversight Board, and accordingly, includes inquiries and certain other procedures to obtain evidence about the broker's or dealer's compliance with the exemption conditions.

SEC Proposed Rule 17a-5 requires the auditor's review report to comply with certain technical requirements, make certain representations, and state clearly the auditor's opinion.<sup>101/</sup> The requirements of the proposed review standard are aligned with these requirements. For example, the proposed review standard requires the auditor to manually sign the review report,<sup>102/</sup> whereas AT sec. 101 allows either a manual or printed signature of the auditor's firm.<sup>103/</sup> Furthermore, unlike AT sec. 101, the proposed review standard includes a requirement for the auditor to include the city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's review report has been issued.<sup>104/</sup>

Unlike AT sec. 101, the proposed review standard does not include provisions that allow the auditor to restrict the use of the review report to specified parties.

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<sup>99/</sup> It is not expected that an auditor would be engaged to review a broker's or dealer's assertion stating that the broker or dealer failed to meet the specified exemption conditions.

<sup>100/</sup> See paragraph (g)(2)(ii) of SEC Proposed Rule 17a-5.

<sup>101/</sup> See paragraph (i) of SEC Proposed Rule 17a-5.

<sup>102/</sup> See paragraph (i)(1)(ii) of SEC Proposed Rule 17a-5.

<sup>103/</sup> AT sec. 101.90.

<sup>104/</sup> See paragraph (i)(1)(iii) of SEC Proposed Rule 17a-5 and AT sec. 101.90.

The proposed review standard includes an example of the auditor's standard review report.

Questions:

30. Do the required elements of the auditor's review report clearly communicate the auditor's responsibilities?
31. What changes, if any, should be made to the format or content of the review report as described in the proposed review standard? Are there additional auditor representations or other information that should be included in the auditor's review report?

1. *Review Report Date*

Under the proposed review standard, the auditor should date the review report no earlier than the date on which the auditor has completed his or her review procedures. Because of the coordination between the review engagement and the audit of the financial statements and supplemental information, the date of the review report should not be earlier than the date of the auditor's report on the financial statements and supplemental information.

2. *Modifications of the Report*

If the broker's or dealer's assertion is not fairly stated, in all material respects, because of an instance or certain instances of non-compliance with the exemption conditions, the proposed review standard requires the auditor to modify the review report to describe those instances of non-compliance and state that the broker or dealer is not in compliance with the specified exemption conditions. The auditor is not required to describe all instances of non-compliance; rather, the auditor is required to describe only the instance or instances of non-compliance with the exemption conditions that cause the broker's or dealer's assertion not to be fairly stated, in all material respects.

Under the proposed review standard, if the auditor cannot perform the procedures required by the proposed review standard or other procedures that the auditor deems necessary in the circumstances, the review is incomplete because of the scope limitation. An incomplete review is not a sufficient basis for expressing a conclusion regarding the broker's or dealer's assertion. In the case of a scope limitation, the auditor should withdraw from the engagement or should modify the review report to:

- (a) Describe the scope limitation and any review procedures deemed necessary by the auditor that have been omitted, and the reason for their omission;
- (b) State that the auditor does not express any form of assurance on the broker's or dealer's assertion; and
- (c) Disclose identified instances of non-compliance, if any, that, individually or in combination, cause the broker's or dealer's assertion not to be fairly stated, in all material respects.

Question:

32. Do other conditions exist that should be included in the standard that would result in a modification of the report on the review engagement?

## **H. Effective Date and Other Considerations**

### *1. Effective Date*

The Board expects that the proposed attestation standards would be effective for fiscal years ending on or after September 15, 2012, subject to consideration of public comment, SEC rule-making,<sup>105/</sup> and approval by the SEC. This effective date is intended to coincide with the proposed end of the transition period for SEC Proposed Rule 17a-5, at which time the SEC proposed rule would require the scope of the examination engagement to encompass internal control over compliance with the specified Financial Responsibility Rules for the entire fiscal year rather a point in time as of the date of the compliance report.<sup>106/</sup> The Board will determine whether adjustments to the effective date are necessary after consideration of comments received and actions taken by the SEC regarding SEC Proposed Rule 17a-5.

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<sup>105/</sup> On June 15, 2011, the Commission proposed to amend its Rule 17a-5 regarding the annual reporting by brokers and dealers to, among other things, update the existing requirements of Rule 17a-5 and facilitate the ability of the PCAOB to implement oversight of independent public accountants of brokers and dealers as required by the Dodd-Frank Act.

<sup>106/</sup> See Section II.B.7. of the SEC Proposing Release.

Question:

33. Besides alignment with effective dates of the SEC Proposed Rule 17a-5 what other factors, if any, should the Board consider in determining the effective date for adopting final attestation standards?

2. *Agreed-Upon Procedures Engagements*

SEC Proposed Rule 17a-5, carries forward the requirement that the broker or dealer file with the Securities Investor Protection Corporation a supplemental report that includes an accountant's report on applying agreed-upon procedures based on the performance of the procedures outlined in SEC Proposed Rule 17a-5.<sup>107/</sup>

These proposed attestation standards do not affect the requirements for those agreed-upon procedures engagements. Auditors should continue to look to AT sec. 101, *Attest Engagements*, AT sec. 201, *Agreed-Upon Procedures*, and AT sec. 601, *Compliance Attestation*,<sup>108/</sup> for the requirements applicable to those engagements.

**III. Proposed Amendments**

**A. Auditing Standard No. 3**

Auditing Standard No. 3, *Audit Documentation*, establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to standards of the PCAOB, including the attestation standards of the PCAOB. The Board is proposing certain amendments to Auditing Standard No. 3 to help auditors properly apply the relevant requirements in Auditing Standard No. 3 to attestation engagements, including the attestation engagements covered by the proposed attestation standards. For example, paragraph 6 of Auditing Standard No. 3 includes a requirement for the auditor to document procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions. An amendment is proposed to footnote 2 of paragraph 6 to clarify that, with respect to an engagement conducted pursuant to the attestation standards of the PCAOB, the relevant assertions are the assertions expressed by management or the responsible party regarding the subject matter of the attestation engagement.

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<sup>107/</sup> See paragraph (e)(4)(ii) of SEC Proposed Rule 17a-5.

<sup>108/</sup> Paragraphs .16-.29 of AT sec. 601.



In addition, paragraph 12 of Auditing Standard No. 3 includes requirements regarding significant findings or issues and provides certain examples of what would be considered as significant findings or issues. An amendment is proposed to include a note regarding additional matters that would be considered as significant findings or issues in an attestation engagement performed pursuant to the standards of PCAOB. Further, paragraph 13 of Auditing Standard No. 3 requires the auditor to identify all significant findings or issues in an engagement completion document. An amendment is proposed to include an additional note to clarify that when conducting an attestation engagement in conjunction with an audit of financial statements in accordance with the standards of the PCAOB, the auditor may include the documentation of significant findings or issues related to the attestation engagement in the engagement completion document prepared in connection with the audit of financial statements.

## **B. Auditing Standard No. 7**

The Board is proposing certain amendments to Auditing Standard No. 7, *Engagement Quality Review*, to require an engagement quality review and concurring approval of issuance for each attestation engagement performed in conjunction with an audit of financial statements conducted pursuant to the standards of the PCAOB. Accordingly, under the proposed amendments, an engagement quality review and concurring approval of issuance are required for examination engagements and review engagements of brokers and dealers.<sup>109/</sup>

Amendments are proposed to include three new paragraphs regarding the engagement quality reviewer's responsibilities in an attestation engagement performed in conjunction with an audit of financial statements. Under the proposed amendments:

- The engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the attestation engagement and in preparing the engagement report. To evaluate such judgments and conclusions, the engagement quality reviewer should (1) hold discussions with the engagement partner and other members of the engagement team, (2) read the engagement report and the document containing management's assertions, and (3) review the engagement completion document and other relevant documentation.

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<sup>109/</sup> Under the proposed amendments, Auditing Standard No. 7 applies even if the firm did not audit the financial statements and supplemental information of the broker or dealer.

- The engagement quality reviewer may provide concurring approval of issuance only if, after performing with due professional care the engagement quality review, he or she is not aware of a significant engagement deficiency. A significant engagement deficiency in an attestation engagement performed in conjunction with an audit of financial statements exists when (1) the engagement team failed to perform attestation procedures necessary in the circumstances of the engagement, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.
- The firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance.

Because the proposed amendments apply only to an attestation engagement performed in conjunction with an audit of financial statements, the proposed requirements regarding the engagement quality reviewer's responsibilities in such an engagement are significantly less detailed than the existing requirements of Auditing Standard No. 7 regarding an engagement quality review for an audit. The less detailed requirements reflect the fact that the engagement quality review of the audit generally will involve a review of matters that are also important to the attestation engagement.<sup>110/</sup>

Questions:

34. Are any other proposed amendments to Auditing Standard No. 3 necessary to clearly describe the auditor's responsibilities regarding documentation when conducting attestation engagements related to brokers and dealers in accordance with the standards of the PCAOB?

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<sup>110/</sup> For example, the Board is proposing an amendment to Auditing Standard No. 3 to state that when conducting an attestation engagement in conjunction with an audit of financial statements in accordance with the standards of the PCAOB, the auditor may include the documentation of significant findings or issues related to the attestation engagement in the engagement completion document prepared in connection with the audit of financial statements.

35. Are the proposed amendments to Auditing Standard No. 7 clear? Do auditors need more extensive requirements regarding the engagement quality review of these attestation engagements?