PCAOB
Public Company Accounting Oversight Board

1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org

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

PCAOB Release No. 2017-004
August 18, 2017

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Public Company Accounting Oversight Board

Executive Summary

The Public Company Accounting Oversight Board (the "PCAOB" or the "Board") is issuing this annual report on the interim inspection program related to audits of brokers and dealers registered with the Securities and Exchange Commission (the "SEC" or the "Commission"). This report focuses on the audits and related attestation engagements covered by the inspections during 2016 and describes independence findings and audit, attestation, and other deficiencies observed from these inspections. In addition, this report provides a summary of firms and engagements inspected pursuant to the interim inspection program since its inception in 2011 and a summary of the inspection results.

Inspections of Firms During 2016

During 2016, the Board inspected 75 firms covering portions of 115 audits and related attestation engagements. The attestation engagements comprised 20 related to compliance reports and 95 related to exemption reports. This was the second inspection year in which all audits and related attestation engagements were required to be performed in accordance with PCAOB standards and amended Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5.

Inspections staff identified independence findings in 11 audits, all of which were instances in which the auditors were involved in the preparation of the financial statements or performed bookkeeping or other prohibited services, representing 10 percent of the audits covered by the inspections in 2016 compared to seven percent of the audits covered by the inspections in 2015. All audits with independence findings in 2016 were conducted by firms that did not audit issuers.

Deficiencies were observed in the audits at 73 of the 75 firms inspected during 2016, and in the related attestation engagements at 46 of the 75 firms. Deficiencies were observed in 96 of the 115 audits covered by the 2016 inspections, an increase to 83 percent from 77 percent in 2015, and in 55 of the 115 related attestation engagements, a decrease from 55 percent in 2015 to 48 percent in 2016. Further results of the inspections during 2016 and 2015 include:

Deficiencies	Percentage of Engagements with Deficiencies	
	2016	2015
Audit Engagements		
Auditing Revenue	66%	70%
Responding to the Risks of Material Misstatement Due to Fraud	57%	42%
Auditing Supplemental Information Related to the Net Capital Rule	27%	30%
Auditing Supplemental Information Related to the Customer Protection Rule	52%	53%
Engagement Quality Review	57%	57%
Attestation Engagements		
Examination Procedures of a Broker-Dealer's Compliance Report	70%	78%
Engagement Quality Review Related to Examination Engagements	20%	48%
Review Procedures of a Broker-Dealer's Exemption Report	28%	34%
Engagement Quality Review Related to Review Engagements	26%	34%

An engagement quality review was not performed for eight audits and eight review engagements in 2016 compared to seven audits and seven review engagements in 2015.

Information presented within this report cannot support a conclusion that the quality of the audits and related attestation engagements of broker-dealers has improved or deteriorated. The independence findings and the audit, attestation, and other deficiencies discussed in this report are not necessarily indicative of the full population of firms or engagements.

Summary of Inspections Since Inception of the Interim Inspection Program

Since inception of the interim inspection program in 2011 through December 31, 2016, the Board has performed 334 inspections of 264 firms that conducted audits of broker-dealers. These inspections covered portions of 514 audit engagements and 233 attestation engagements (refer to Appendix B regarding the number of audits and related attestation engagements covered by inspections since inception).

As described in this report, the independence findings and the audit, attestation, and other deficiencies discussed in the report are not necessarily indicative of the full population of firms or of all audit and attestation engagements of broker-dealers.

However, since the inception of the interim inspection program, Inspections staff has observed lower percentages of deficiencies among firms that:

- Also audit issuers; or

- Performed audits for more than 100 broker-dealers, compared to those that performed audits for 100 or fewer broker-dealers.

In addition, since the inception of the interim inspection program, Inspections staff has observed:

- Lower percentages of deficiencies in the audits of broker-dealers that reported the highest amounts of net capital; and

- The percentage of audits with deficiencies of broker-dealers that did not claim an exemption from Exchange Act Rule 15c3-3 has generally been lower compared to the audits of those that did claim an exemption.

Actions Needed by Firms

All firms that perform audits of broker-dealers should review this report and consider whether the types of audit and attestation deficiencies observed by Inspections staff could manifest themselves in their practices. In addition, firms are reminded of their obligation under the standards to address identified deficiencies in their audits and take appropriate action to assess the firm's ability to support its previously expressed audit opinions.

The Board continues to be concerned by the nature and number of deficiencies identified by the inspections. Many of these deficiencies relate to the fundamentals of audit, examination, or review procedures and are similar to those described in previous annual reports. The Board is also concerned that, to some extent, the identified deficiencies appear to indicate disregard for very specific requirements of the rules and standards. Among other things, Inspections staff continues to identify engagements in which the auditor prepared the financial statements for their audit clients, did not perform any tests of controls over compliance for examination engagements, or did not perform the required engagement quality review.

In addition to the actions needed by firms, the Board encourages audit committees (or equivalent) of broker-dealers to take steps to ensure that their auditors are independent and also consider inquiring of their auditors about how the areas described in this report are being addressed in their audits and related attestation engagements.

Next Steps of the Interim Inspection Program

The Board will continue to conduct inspections of firms that perform audits and related attestation engagements for broker-dealers under the interim inspection program until rules for a permanent inspection program take effect. The PCAOB staff will continue to work to further develop the contours of a potential rule proposal for the Board to consider for a permanent inspection program.

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

PCAOB Release No. 2017-004

August 18, 2017

Background

The PCAOB is issuing this annual report on the interim inspection program[1] related to audits of brokers and dealers[2] registered with the SEC under Section 15 of the Exchange Act. This report describes independence findings and audit, attestation, and other deficiencies identified in the audit and attestation engagements covered by the inspections performed during 2016 required to be performed in accordance with PCAOB standards.

Under the interim inspection program, the Board conducts inspections of registered public accounting firms[3] in connection with their performance of audit and attestation engagements, their issuance of reports on these engagements, and related matters involving broker-dealers registered with the Commission, to assess compliance with the professional standards, rules of the Commission and the Board, and the Sarbanes-Oxley Act of 2002.

The Board's inspections of auditors under the interim inspection program assess the auditor's compliance with the requirements that govern the conduct of audit and attestation engagements. The interim inspection program also helps to inform the Board's eventual determinations about the scope and elements of a permanent inspection program, including whether and how to differentiate among classes of broker-dealers, whether to exempt any categories of firms, and the establishment of inspection schedules.

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[1] On June 14, 2011, the Board adopted Rule 4020T to establish an interim inspection program related to the audits of broker-dealers. See PCAOB Release No. 2011-001 (June 14, 2011). The SEC approved this rule on August 18, 2011. See Exchange Act Release No. 65163 (August 18, 2011).

[2] Hereinafter, the use of the term "broker-dealer" refers to entities that are registered with the SEC as both a broker and a dealer and to entities that are registered as only one or the other.

[3] Hereinafter, the use of the terms "firm" or "firms" refers to public accounting firms registered with the PCAOB.

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The firms inspected and the audit and attestation engagements for broker-dealers covered by the inspections are not necessarily representative of the population of firms or of audit or attestation engagements of broker-dealers. Further, the populations of firms and broker-dealers are not homogeneous. Therefore, the independence findings and audit, attestation, and other deficiencies discussed in this report are not necessarily indicative of the full population of firms or of all audit and attestation engagements of broker-dealers. For these reasons, information presented within this report cannot support a conclusion that the quality of the audits and related attestation engagements of broker-dealers has improved or deteriorated.

As indicated in the Board's release related to the adoption of Rule 4020T, the inclusive scope of the interim inspection program, including decisions about which auditors to inspect, should not be construed as a decision on the likely scope of a permanent inspection program or suggest that every auditor of a broker-dealer will be inspected as part of the interim inspection program. In addition, the criteria that were considered in making selections for the interim inspection program are not necessarily representative of any decision that the Board will make in its determination of the scope or elements of a permanent inspection program.

Selection of Auditors and Broker-Dealers for Inspections During 2016

During 2016, the Board inspected 75 firms that audited broker-dealers. These inspections covered portions of 115 audits and the related attestation engagements of broker-dealers that had financial statement periods ended on June 30, 2015 through June 30, 2016 and were required to be performed in accordance with PCAOB standards. The firms inspected during 2016, and the audit and attestation engagements covered during the inspections, were generally selected based on characteristics of the firms and the broker-dealers taking into consideration the risks related to those characteristics. The firm characteristics included, among others, the number of broker-dealer audits performed, whether the firm also issued audit reports for issuers, previous inspection results, history of the firm or firm personnel in auditing broker-dealers, and existence of disciplinary actions against the firm or engagement partner by the SEC, PCAOB, or other regulatory authorities. The selection of the firms' broker-dealer engagements was based on various characteristics, including among others, financial metrics, whether the broker-dealer filed with the SEC a compliance or exemption report, whether the broker-dealer was a subsidiary of an issuer, changes in auditors, existence of disciplinary actions against the broker-dealer by the SEC, the Financial Industry Regulatory Authority ("FINRA"), or other regulatory authorities, and the engagement partner. In addition, a portion of the firms and engagements were selected randomly.

Appendix A includes information regarding firms that perform audit and attestation engagements of broker-dealers, and the selection of firms and audit and attestation engagements covered by the inspections during 2016, which provides context for this section of the report.

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Inspections of Firms During 2016

This report primarily describes the independence findings and the audit, attestation, and other deficiencies identified for the inspections during 2016 with a comparison to the results for the inspections during 2015.

Summary of Independence Findings

Inspections staff identified independence findings in 11 of 115, or 10 percent, of the audits covered by the inspections in 2016 compared to seven percent of the audits covered by the inspections in 2015. All audits with independence findings in 2016, and all but two in 2015, were conducted by firms that did not audit issuers.

In the 2016 inspections, Inspections staff observed that the firms performed bookkeeping or other services related to the broker-dealer's accounting records, or prepared, or assisted in the preparation of, the broker-dealer's financial statements, supplemental information, or exemption reports. One of these firm's independence also appeared to be impaired because the terms of the engagement letter for the audit stated that the broker-dealer would indemnify the firm from all claims, liabilities, losses, and all expenses arising in connection with the audit engagement when there was a knowing misrepresentation by the broker-dealer's management.[4]

Summary of Disciplinary Orders Related to Independence

As of the date of this report, the Board has announced settled disciplinary orders against 29 firms and six individuals for rule violations stemming from their failure to maintain independence from their broker-dealer clients and against two firms and one individual for failing to maintain independence as well as for other violations related to audits with certain fiscal years ended during 2012 through 2015. Thirty of these 31 firms were censured by the Board and agreed to pay a civil monetary penalty and undertake significant remedial actions. One firm was censured by the Board and had its registration with the PCAOB revoked due to numerous violations of PCAOB rules and standards as well as failure to maintain independence from a broker-dealer client.[5] All seven of the individuals were censured by the Board, and, of these seven, four agreed to pay a civil monetary penalty and four were barred from being an associated person of

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4 See frequently asked question 4 in the Other Matters section of the SEC's Application of the Commission's Rule on Auditor Independence available at: https://www.sec.gov/info/accountants/ocafaqaudind121304.htm.

5 The Board reminds firms that the disciplinary process carries the prospect of a range of sanctions, including significant money penalties and the possible suspension or revocation of registration.

a registered public accounting firm.[6] These settled disciplinary orders exclude disciplinary actions taken by the SEC separate from those of the Board.

Summary of Audit, Attestation, and Other Deficiencies by Area

Deficiencies that exceeded a certain level of significance were communicated to the firms in writing. This report summarizes those deficiencies that Inspections staff determined were important to convey within this report based on their nature, severity, or frequency.

Audit deficiencies are failures by firms to perform, or sufficiently perform, certain required audit procedures and do not necessarily indicate that the broker-dealer's financial statements or supporting schedules are materially misstated. Conclusions regarding these situations are often not possible for Inspections staff to reach based only on the information available from the auditors.

Attestation deficiencies are failures by firms to perform, or sufficiently perform, certain required attestation procedures and do not necessarily indicate that the broker-dealer's assertions in the compliance or exemption reports are, in any material respect, not fairly stated, that a material weakness existed during, or as of the end of, the fiscal year specified in the assertions in the compliance report, or that the broker-dealer is in violation of the Net Capital Rule[7] or the reserve requirements rule.[8] Conclusions regarding these situations are often not possible for Inspections staff to reach based only on the information available from the auditors.

Other deficiencies are failures by firms to perform, or sufficiently perform, certain procedures required by PCAOB standards that are part of the performance of audit and attestation engagements, or procedures required by PCAOB rules.

Inspection results for 2016 included the following:

- One or more audit or other deficiencies were identified at 73 of the 75 firms inspected and in 96 of the 115 audits covered by the inspections, or 83 percent;

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6 For more information on the Board's settled disciplinary orders refer to: http://pcaobus.org/News/Releases/Pages/12082014_Enforcement.aspx; http://pcaobus.org/News/Releases/Pages/07092015_Enforcement.aspx; http://pcaobus.org/Enforcement/Decisions/Pages/default.aspx (three orders effective October 15, 2015); http://pcaobus.org/News/Releases/Pages/Five-BD-independence-orders-one-cooperation-3-15-16.aspx; http://pcaobus.org/News/Releases/Pages/enforcement-three-firms-two-partners-independence-091516.aspx; http://pcaobus.org/Enforcement/Decisions/Pages/default.aspx (an order effective December 13, 2016); and http://pcaobus.org/Enforcement/Decisions/Pages/default.aspx (five orders effective March 29, 2017).

7 Exchange Act Rule 15c3-1 (also referred to as the "Net Capital Rule").

8 See Rule 15c3-3(e).

- The 19 audits with no observed audit or other deficiencies were performed by six firms, all of which also audited issuers;

- One or more attestation or other deficiencies were identified at 46 of the 75 firms and in 55 of the 115 attestation engagements covered by the inspections, or 48 percent;

- Six examination engagements with no observed attestation or other deficiencies were performed by two firms, both of which also audited issuers;

- Fifty-four review engagements with no observed attestation or other deficiencies were performed by 36 firms, of which 24 also audited issuers; and

- Two audits and related attestation engagements with no observed deficiencies were performed by two firms, both of which also audited issuers.

For three firms inspected covering portions of three audits and the related review engagements:

- For each area inspected, two firms performed no audit testing and one firm's procedures were limited to comparing receivable amounts to subsequent cash collections and the preparation of a schedule listing transactions in the broker-dealer's bank accounts for each month of the year under audit, without testing any of the transactions;

- Two of the three firms had no evidence of planning the engagements, performing procedures, or any conclusions reached; and one firm's audit methodology was not designed for audits performed under PCAOB standards;

- None performed any attestation procedures beyond reading the broker-dealers' exemption reports;

- None had engagement quality reviews performed for the audits or the review engagements; and

- All performed bookkeeping or other services related to the accounting records or the financial statements of these audit clients.

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As with independence findings, the Board brings its enforcement and disciplinary authority to bear, where appropriate, with respect to audit, attestation and other deficiencies. The Board has instituted disciplinary proceedings with respect to such matters, including proceedings that have resulted in public disciplinary orders imposing sanctions on four firms and five individuals. Among other sanctions, the Board revoked the registration of one of those firms, barred three of the individuals from association with a registered public accounting firm, and imposed civil money penalties on all four firms and two of the individuals.[9]

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[9] For more information on the Board's settled disciplinary orders:
See PCAOB Release No. 105-2017-019 (March 29, 2017).pdf (sanctioning a firm for, among other things, failing to have an engagement quality review performed);
See PCAOB Release No. 105-2017-022 (March 29, 2017).pdf (sanctioning an individual for violations of PCAOB rules and standards related to audit documentation matters);
See PCAOB Release No. 105-2017-029 (June 27, 2017).pdf (sanctioning a firm and three individuals for, among other things, violations of auditing and attestation standards in an audit and examination engagement for a broker-dealer);
See PCAOB Release No. 105-2017-035 (August 2, 2017).pdf (sanctioning a firm and one individual for failing to have engagement quality reviews performed); and
See PCAOB Release No. 105-2017-032 (August 2, 2017).pdf (sanctioning a firm for violations of auditing and attestation standards in an audit and examination engagement for a broker-dealer).

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The following tables present a summary of the audit deficiencies, attestation deficiencies, and other deficiencies in the order they are discussed:

Audit and Other Deficiencies	Exhibit	2016			2015
		Number of Audits with Deficiencies	Number of Applicable Audits[10]	Percentage of Audits with Deficiencies	Percentage of Audits with Deficiencies
Audit Deficiencies Related to the Financial Statements					
Revenue	1	76	115	66%	70%
Risks of Material Misstatement Due to Fraud	2	30	53	57%	42%
Financial Statement Presentation and Disclosures	3	45	115	39%	37%
Related Party Transactions	4	30	92	33%	32%
Fair Value Measurements	5	8	33	24%	44%
Receivables and Payables	6	16	65	25%	21%
Audit Deficiencies Related to the Supporting Schedules					
Net Capital Rule	7	31	115	27%	30%
Customer Protection Rule[11]	8	13	25	52%	53%
Other Deficiencies Related to the Audit					
Reporting on the Financial Statements and Supporting Schedules	9	15	115	13%	8%
Audit Documentation	10	32	115	28%	26%
Engagement Quality Review	11	66	115	57%	57%
Deficiencies in Independence Communications to the Audit Committee					
Independence Communications to the Audit Committee (or equivalent)[12]	-	22	115	19%	10%

[10] Some areas listed in the table were not covered by, or applicable to, all audits covered by the inspections.

[11] Exchange Act Rule 15c3-3 (also referred to as the "Customer Protection Rule").

[12] PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*, requires an auditor to have certain independence-related communications with the audit committee. As used in Rule 3526, "audit committee" means a committee (or equivalent body) established by and among the board of directors of an entity for the purpose of overseeing the accounting and financial reporting processes of the entity and audits of the financial statements of the entity, or, in the absence of such a body, the entire board of directors of the entity. For audits of non-issuers with respect to which no such committee or board of directors (or equivalent body) exists, "audit committee" means the person(s) who oversee(s) the accounting and financial reporting processes of the entity and audits of the financial statements of the entity. See PCAOB Rule 3501(a)(v).

Attestation and Other Deficiencies	Exhibit	2016			2015
		Number of Attestation Engagements with Deficiencies	Number of Applicable Attestation Engagements	Percentage of Attestation Engagements with Deficiencies	Percentage of Attestation Engagements with Deficiencies
Attestation Deficiencies					
Examination Procedures	12	14	20	70%	78%
Review Procedures	13	27	95	28%	34%
Other Deficiencies Related to Examination Engagements					
Examination Report	-	2	20	10%	11%
Examination Documentation	-	1	20	5%	11%
Engagement Quality Review	-	4	20	20%	48%
Other Deficiencies Related to Review Engagements					
Review Report	-	13	95	14%	15%
Review Documentation	-	20	95	21%	17%
Engagement Quality Review	-	25	95	26%	34%

Audit Deficiencies Related to the Financial Statements

Auditing Revenue

Inspections staff identified audit deficiencies related to auditing revenue in 76 of 115, or 66 percent, of the audits covered by the inspections, which is lower than the 70 percent of audits with deficiencies identified in 2015. In 52 of the 76 audits with deficiencies in 2016, Inspections staff identified deficiencies in more than one of the categories set forth in Exhibit 1 below:

Exhibit 1

Deficiencies Related to Auditing Revenue:	Number of Audits
Risk assessment procedures	24
Extent of testing	43
Substantive analytical procedures	9
Auditing information produced by service organizations	25
Auditing information produced by the broker-dealer	16
Other procedures to test revenue	55

Risk Assessment Procedures

AS 2110 (historically AS No. 12), *Identifying and Assessing Risks of Material Misstatement*, provides that the auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and assessing the risks of material misstatement, whether due to fraud or error, and designing further audit procedures.[13] In 24 audits, Inspections staff observed that the firms did not perform, or sufficiently perform, risk assessment procedures for revenue, which contributed to deficiencies, in these firms' revenue testing procedures, such as those discussed below. For example, in certain of these audits, Inspections staff observed that the firms did not: (a) obtain a sufficient understanding of the broker-dealer and its environment, including its key products and sources of revenue;[14] (b) obtain a sufficient understanding of aspects of the broker-dealer's internal control over financial reporting, including controls at the broker-dealer's service organization(s), such as (i) understanding how transactions are processed and the controls related to the transactions being initiated, authorized, processed, recorded, and reported; (ii) understanding management's risk assessment process; or (iii) evaluating the design of the controls intended to address significant risks, including the presumed fraud risk involving improper revenue recognition, and determining whether the controls have been implemented;[15] or (c) identify and assess the risks of material misstatement at the assertion level over material classes of revenue transactions.[16]

Extent of Testing

In 43 audits, Inspections staff observed that the extent of testing was insufficient for material classes of revenue transactions.[17] For example, Inspections staff observed instances where firms: (a) did not perform any procedures to test material classes of revenue transactions; (b) did not test, or sufficiently test, controls to support the firm's reliance on controls to reduce their substantive testing;[18] (c) did not appropriately design and perform sampling procedures to test revenue transactions in accordance with AS 2315 (historically AU sec. 350), *Audit Sampling,* because: (i) the firms did not adequately consider the relationship of the sample to the relevant audit objective, tolerable misstatement, allowable risk of incorrect acceptance, or the characteristics of the population, resulting in an insufficient sample size; or (ii) the sample items were not selected in a manner that provided a sample that was representative of the population tested (for example, firms limited their sample selections to certain time periods); or (d) limited testing to key items, or all items above a certain amount, such as planning

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[13] AS 2110.04.

[14] See AS 2110.07 through .17.

[15] See AS 2110.18 through .40.

[16] See AS 2110.59.

[17] See paragraph .08 of AS 2301 (historically AS No. 13), *The Auditor's Responses to the Risks of Material Misstatement.*

[18] See AS 2301.18.

materiality, which covered only a portion of revenue, and the firm performed no procedures to test the remaining portion of revenue that was material.[19]

Substantive Analytical Procedures

AS 2305 (historically AU sec. 329), *Substantive Analytical Procedures*, establishes requirements for the application of analytical procedures as substantive tests. In nine audits, Inspections staff observed that firms performed substantive analytical procedures that did not provide the necessary level of assurance because the firms did not: (a) develop any expectation when performing analytical procedures intended to be substantive in nature; (b) develop expectations that were sufficiently precise to identify misstatements (for example, developing an imprecise expectation that total revenue for the current year would increase over total revenue from the prior year due to the overall strength of the stock market in the current year and the broker-dealer engaging in the same lines of business as the prior year); (c) establish that there was a plausible and predictable relationship between the current year and prior year revenue balances (for example, testing 12b-1 fees by comparing total fees for the current and prior years and not considering the existence of changes that may affect the plausibility and predictability of this relationship); (d) evaluate the reliability of the data from which the auditors' expectations were developed (for example, developing an expectation based on unaudited data provided by the broker-dealer without testing the accuracy or completeness of the data); (e) determine an amount of difference from the expectation that could be accepted without further investigation; or (f) obtain corroboration of management's explanations for significant unexpected differences.

Auditing Information Produced by Service Organizations

Many broker-dealers use the services of other broker-dealers to perform trade processing and related back-office functions, primarily in the clearing and settling of customer transactions. AS 2601 (historically AU sec. 324), *Consideration of an Entity's Use of a Service Organization*, applies to audit and attestation engagements where a broker-dealer uses the services of a service organization that are part of the broker-dealer's information system, including services that affect the broker-dealer's financial reporting processes or related accounting records and specific accounts in the broker-dealer's financial statements involved in initiating, recording, processing and reporting the broker-dealer's transactions.[20]

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[19] See paragraphs .25 through .27 of AS 1105 (historically AS No. 15), *Audit Evidence*.

[20] See AS 2601.03. Also, see paragraphs .14 through .18 of AT No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, which are analogous to the auditor's requirements pursuant to AS 2601, as described in PCAOB Release No. 2013-007 (October 10, 2013).

Inspections staff identified instances in which, in auditing revenue, firms did not obtain sufficient appropriate audit evidence about the accuracy and completeness of information used in the audit that was produced by a broker-dealer's service organization. These deficiencies were observed in audits where firms used as audit evidence information provided by a service organization and relied on controls at the service organization with respect to the accuracy and completeness of that information.

In 25 audits, Inspections staff observed that firms did not perform sufficient procedures on information produced by service organizations used in the performance of audit procedures.

In 14 of the 25 audits, the firms obtained a service auditor's report, but did not sufficiently evaluate the service auditor's report or consider whether the service auditor's report provided evidence about the design and operating effectiveness of the controls being relied upon. For example, the firms did not: (a) test the operating effectiveness of necessary user organization controls at the broker-dealer specified in the service auditor's report; (b) evaluate whether the scope of the service auditor's report included testing the design and operating effectiveness of controls over the information used by the firm as audit evidence (for example, perform sufficient procedures to determine if the service auditor's report included operating effectiveness testing and results for controls over information technology ("IT")), reports produced, or information such as, customer assets under management; (c) evaluate the period covered by a service auditor's report and time elapsed since the performance of the service auditor's testing to determine if the service auditor's report provided sufficient evidence about the service organization's controls on which the firm relied; or (d) evaluate whether the services provided by sub-service organizations were relevant to the audit (for example, IT controls related to systems used by the service organization), and, if so, obtain evidence about the effectiveness of necessary controls at sub-service organizations specified in the service auditor's report.

In addition, in 11 of the 25 audits, where firms used as audit evidence statements or other information the broker-dealers obtained from their service organizations, the firms did not obtain and evaluate the service auditor's report or perform procedures to test the accuracy and completeness of the information the firms used in their audits.

Auditing Information Produced by the Broker-Dealer

Inspections staff identified 16 audits in which, in auditing revenue, firms did not test the accuracy and completeness of the information produced by the broker-dealer that was used as audit evidence.[21] Examples of such information included reports, trade blotters, order tickets, schedules, or spreadsheets prepared by broker-dealer personnel.

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21 See AS 1105.10.

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Other Procedures to Test Revenue

The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure.[22] In 55 audits, Inspections staff observed that firms did not perform sufficient procedures to test the relevant assertions for revenue. For example, firms did not: (a) evaluate whether the terms of the underlying contractual arrangements were appropriately considered in revenue recognition; (b) evaluate whether the revenue recognition criteria under ASC Topic 605, *Revenue Recognition*, were satisfied (for example, verifying that the broker-dealer completed all services required pursuant to an agreement with a customer and that the services were completed within the reporting period in which the revenue was recognized or verifying the transaction amount upon which revenue from fees was based); (c) determine whether the commission rates used to calculate commission revenue were consistent with the underlying agreements, or test the accuracy and completeness of the quantities and prices of security purchases or sales used to calculate commission revenue; (d) test whether the values used (for example, assets under management, capital commitments, or the purchase price for business mergers or acquisitions) to calculate fees were accurate or complete; (e) perform procedures to test the completeness of revenue; (f) evaluate whether revenue recognition policies were in conformity with generally accepted accounting principles ("GAAP") (for example, evaluate the appropriateness of broker-dealers recognizing revenue for certain material classes of revenue on the cash basis); or (g) evaluate the effect on the financial statements of recognizing commission revenue based on settlement date rather than trade date, as required under ASC Topic 940, *Financial Services – Broker and Dealers*.

<u>Auditing Risks of Material Misstatement Due to Fraud</u>

AS 2110, AS 2301, and AS 2401 (historically AU sec. 316), *Consideration of Fraud in a Financial Statement Audit*, describe the auditor's responsibilities for, among other things, identifying and assessing risks of material misstatement, and designing and implementing appropriate responses. The two types of misstatements that are relevant to the consideration of fraud in a financial statement audit are misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.[23] Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.[24]

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[22] AS 2301.08.

[23] AS 2401.06.

[24] AS 2401.08.

Inspections staff identified audit deficiencies related to auditing risks of material misstatement due to fraud in 30 of 53, or 57 percent, of the audits covered by the inspections where the auditor's assessment of, and response to, risks of material misstatement due to fraud was inspected, which is higher than the 42 percent of audits with deficiencies identified in 2015. In nine of the 30 audits with deficiencies in 2016, Inspections staff identified deficiencies in more than one of the categories set forth in Exhibit 2 below:

Exhibit 2

Deficiencies Related to Auditing Risks of Material Misstatement Due to Fraud:	Number of Audits
Identification and assessment of the risks of material misstatement due to fraud	13
Responses to the assessed risks of material misstatement due to fraud – management override	15
Responses to fraud risk related to improper revenue recognition	13

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

When identifying and assessing the risks of material misstatement due to fraud, the auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions may give rise to such risks.[25] If the auditor has not identified improper revenue recognition as a fraud risk, the auditor should document the reasons supporting that conclusion.[26] In 12 of the 13 audits, Inspections staff observed that the firms did not identify improper revenue recognition as a fraud risk, and there was no documentation or other persuasive evidence indicating how the firms overcame the presumption that improper revenue recognition is a fraud risk.

The auditor should inquire of the audit committee, or equivalent (or its chair), management, the internal audit function, and others within the broker-dealer who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement due to fraud.[27] In one audit, Inspections staff observed that the firm did not perform inquiries of management, or others, within the broker-dealer about potential fraud risks.

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[25] AS 2110.68.

[26] AS 2401.83.

[27] AS 2110.54.

Responses to the Assessed Risks of Material Misstatement Due to Fraud – Management Override

The auditor's identification of fraud risks should include the risk of management override of controls.[28] To specifically address the risk of management override of controls, the auditor should perform procedures that include examining journal entries recorded in the general ledger and other adjustments (for example, entries posted directly to financial statement drafts) for evidence of possible material misstatement due to fraud,[29] which consist of:

- Obtaining an understanding of the entity's financial reporting process and the controls over journal entries and other adjustments;
- Identifying and selecting journal entries and other adjustments for testing;
- Determining the timing of the testing; and
- Inquiring of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.[30]

In 15 audits, Inspections staff observed that firms did not perform sufficient procedures to test journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements because the firms did not perform one or more of the required procedures.

AS 2401 also provides that journal entry testing ordinarily should focus on journal entries made at the end of a reporting period.[31] In two audits, the firms did not test journal entries made at the end of the reporting period. In four audits, the firms did not test journal entries to address management override of controls. In six audits, the firms did not test the completeness of the population of journal entries from which they selected a sample for testing.[32]

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[28] AS 2110.69.

[29] AS 2401.58.

[30] Id.

[31] See AS 2401.62.

[32] See AS 1105.10.

Responses to Fraud Risk Related to Improper Revenue Recognition

In the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks.[33]

Inspections staff observed that in 13 audits, firms did not perform sufficient audit procedures to specifically address assessed fraud risks related to improper revenue recognition. For example, in nine audits, the firms' responses to an identified fraud risk did not include tests of details, as required by AS 2301.[34]

Auditing Financial Statement Presentation and Disclosures

The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.[35] Evaluation of the information disclosed in the financial statements includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of the reported amounts.[36] In addition, Rule 17a-5(d)(2)(i) requires the financial statements to be presented in a format that is consistent with Form X-17A-5 Part II or Part IIA.

Inspections staff identified audit deficiencies related to auditing financial statement presentation and disclosures in 45 of 115, or 39 percent, of the audits covered by the inspections, as compared to 37 percent of audits with deficiencies identified in 2015. In 16 of the 45 audits with deficiencies in 2016, Inspections staff identified deficiencies in more than one of the categories set forth in Exhibit 3 below:

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[33] AS 2301.13.

[34] See AS 2301.13.

[35] Paragraph .30 of AS 2810 (historically AS No. 14), *Evaluating Audit Results*. Also, see Rule 17a-5(d)(2)(i), which requires that the financial statements in a broker-dealer's financial report be prepared in accordance with U.S. GAAP.

[36] AS 2810.31.

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Exhibit 3

Deficiencies Related to Auditing Financial Statement Presentation and Disclosures:	Number of Audits
Identifying omission of required financial statement disclosures	29
Evaluating completeness and accuracy of disclosures	12
Evaluating fair value disclosures	6
Evaluating financial statement presentation	16

Identifying Omission of Required Financial Statement Disclosures

In 29 audits, Inspections staff observed instances in which firms did not identify the omission of required disclosures pertaining to areas such as the policy for revenue recognition, related parties, related party transactions, the correction of an accounting error related to revenue, or contingent liabilities.

Evaluating Completeness and Accuracy of Disclosures

In 12 audits, Inspections staff observed that disclosures in the financial statements appeared to be incomplete or inaccurate, but the firms either did not identify that these disclosures were incomplete or inaccurate, or perform sufficient procedures to test the disclosures included in the financial statements. For example, in four audits, firms did not identify that the broker-dealer did not disclose information related to material related party transactions that was necessary to understand the effects of the transactions on the financial statements or certain required information related to the broker-dealer's financing arrangements. In another audit, the firm did not test whether disclosures regarding revenue and expense transactions from a broker-dealer's foreign operations that were with a related party were in accordance with ASC Topic 850, *Related Party Disclosures* ("ASC 850").

Evaluating Fair Value Disclosures

In six audits, Inspections staff observed that firms did not evaluate, or sufficiently evaluate, whether the broker-dealer's fair value disclosures were in accordance with ASC Topic 820, *Fair Value Measurement* ("ASC 820"). For example, in five audits, the firms did not evaluate, or sufficiently evaluate, whether the classification of securities disclosed as Level 1 or Level 2 was appropriate based on the inputs used by the broker-dealer to measure fair value. In another audit, the firm did not identify the omission of the required disclosure of valuation techniques and inputs used to measure the fair value of securities classified as Level 3.

Evaluating Financial Statement Presentation

In 16 audits, Inspections staff observed that firms did not perform sufficient procedures regarding whether the broker-dealer's financial statements were presented fairly in conformity with GAAP. In nine audits, for example, firms did not: (a) evaluate whether the accounting for office space provided by a related party at no cost was properly accounted for and disclosed; (b) identify that the statement of cash flows did not separately present, or incorrectly presented, the cash flows of operating, financing, and investing activities; (c) identify discrepancies in amounts presented on different statements comprising the broker-dealer's financial statements (for example, the reported decrease in retained earnings on the statement of changes in retained earnings did not agree to the reported net loss for the year on the statement of income); (d) evaluate whether a related party receivable should have been presented separately from other assets in accordance with ASC 850; or (e) sufficiently evaluate the accuracy of individual revenue amounts presented as individual line items on the statement of income because the firm's procedures were limited to comparing total revenue presented to total revenue shown on the trial balance. In addition, Rule 17a-5(d)(2)(i) requires the financial statements to be presented in a format that is consistent with the statements contained in Form X-17A-5 Part II or Part IIA. In seven audits, Inspections staff observed that the firms did not identify and appropriately address instances where the broker-dealer's financial statements were inconsistent with the requirements of Form X-17A-5. Specifically, in all seven audits, the broker-dealer presented multiple significant categories of revenue as a single line item on the statement of income.

<u>Auditing Related Party Relationships and Transactions</u>

Related parties often play a significant role in the operations of broker-dealers, including, for example, through direct participation in the activities of the broker-dealers by principals or affiliates under shared service agreements. AS 2410 (historically AS No. 18), *Related Parties*, establishes requirements for the auditor with respect to obtaining sufficient appropriate audit evidence to determine whether a broker-dealer's related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in its financial statements.[37]

Inspections staff identified audit deficiencies related to auditing related party relationships and transactions in 30 of 92, or 33 percent, of the audits covered by the inspections where the auditor's procedures to test related party relationships and transactions were inspected, which is higher than the 32 percent of audits with

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[37] AS 2410 superseded AU sec. 334, *Related Parties*, and was effective for audits with fiscal years beginning on or after December 15, 2014. Seven audits covered by the inspections during 2016, for which this area was applicable, had fiscal years that began prior to the effective date for AS 2410. The deficiencies identified in two of the seven audits are included in the Responding to Risks of Material Misstatement category of deficiency.

deficiencies identified in 2015. In eight of the 30 audits with deficiencies in 2016, Inspections staff identified deficiencies in more than one of the categories set forth in Exhibit 4 below:

Exhibit 4

Deficiencies Related to Auditing Related Party Relationships and Transactions:	Number of Audits
Risk assessment procedures	9
Responding to risks of material misstatement	28
Evaluating the broker-dealer's identification of related party relationships and transactions	4

Risk Assessment Procedures

AS 2410 states that the auditor should perform procedures to obtain an understanding of the broker-dealer's relationships and transactions with its related parties that might reasonably be expected to affect the risk of material misstatement of the financial statements in conjunction with performing risk assessment procedures in accordance with AS 2110.[38] In addition, the auditor should identify and assess the risks of material misstatement at the financial statement level and the assertion level associated with related party relationships and transactions, including whether the broker-dealer has properly identified, accounted for, and disclosed its related party relationships and transactions.[39]

In nine audits, Inspections staff observed that firms failed to perform sufficient risk assessment procedures. For example, in six audits, firms did not perform procedures to identify and assess the risks of material misstatement at the financial statement and assertion level associated with related parties and relationships and transactions with related parties. Included in these six was one instance where the firm identified a fraud risk due to the broker-dealer's engagement in significant related party transactions outside the normal course of business but did not further assess these risks at the financial statement and assertion level. In another audit, the firm did not identify significant unusual transactions with a related party in its risk assessment procedures, and as a result, failed to provide communications about such transactions to the audit committee or others in accordance with AS 1301 (historically AS No. 16), *Communications with Audit Committees*.

In five of the nine audits, Inspections staff also observed that firms did not perform sufficient procedures to obtain an understanding of the broker-dealer's

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[38] AS 2410.03.

[39] AS 2410.10.

relationships and transactions with its related parties. For example, in four audits, the firms did not obtain an understanding of the business purpose of the related party relationships or transactions the broker-dealers disclosed in the financial statements and did not perform inquiries of management or others regarding the related party relationships or transactions.

Responding to Risks of Material Misstatement

In 28 audits, Inspections staff observed that firms did not perform procedures, or did not design and perform procedures, in a manner that addressed the risks of material misstatement associated with related parties and relationships and transactions with related parties.[40] For example, in one audit, the firm did not perform any procedures to test identified related party transactions. In other audits, the firms' procedures did not include: (a) reading the underlying documentation and evaluating whether the terms and other information about the transactions were consistent with explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transactions;[41] (b) determining whether the transaction was authorized and approved in accordance with the broker-dealer's established policies and procedures regarding the authorization and approval of transactions with related parties; or (c) performing other procedures necessary to address the identified and assessed risk of material misstatements.[42] In addition, in four audits, firms did not test the accuracy and completeness of information produced by the broker-dealer, such as activity reports and spreadsheets that were used as audit evidence.[43]

In 15 audits, Inspections staff observed that related party revenues and expenses were based on allocations between the broker-dealer and its parent or affiliates, but firms did not test, or sufficiently test, amounts allocated to the broker-dealers, or test the basis for the allocations and the computation of the allocated amounts. For example, in eight audits, the firms' procedures were limited to reading the allocation agreement, performing inquiries of management, or tracing the amounts disclosed in the financial statements to a list of intercompany payments or general ledger accounts, but did not include any testing of the allocated amounts to determine whether the allocated amounts were in accordance with the terms of the allocation agreement. In addition, in two audits, firms did not appropriately design and perform sampling procedures to test transactions with related parties in accordance with AS

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[40] See AS 2410.11.

[41] Two of the audits for which these deficiencies were identified were performed prior to the effective date of AS 2410. Refer to footnote 37 above.

[42] See AS 2410.12.

[43] See AS 1105.10.

2315. For example, in one of these audits, the firm's sample selections were limited to a time period other than the entire year under audit.

Evaluating the Broker-Dealer's Identification of Related Party Relationships and Transactions

The auditor should evaluate whether the company has properly identified its related parties and relationships and transactions with related parties.[44] If the auditor identifies information that indicates that related parties or relationships or transactions with related parties previously undisclosed to the auditor might exist, the auditor should perform the procedures necessary to determine whether previously undisclosed relationships or transactions with related parties exist and these procedures should extend beyond inquiry of management.[45] For example, in one of four audits, Inspections staff observed that the firm obtained a listing of related parties from the broker-dealer that identified a specific foreign bank as being under common control with the broker-dealer as well as a schedule of notes payable from the broker-dealer that identified material liabilities owed to entities similarly named as the foreign bank. However, the firm did not perform procedures to corroborate management's representation that the notes payable related to entities that were not related parties.

<u>Auditing Fair Value Measurements</u>

Broker-dealers are required to account for securities at fair value.[46] AS 2502 (historically AU sec. 328), *Auditing Fair Value Measurements and Disclosures*, describes the auditor's responsibilities relating to fair value measurements.

Inspections staff identified audit deficiencies related to auditing fair value measurements in 8 of 33, or 24 percent, of the audits covered by the inspections where the auditor's procedures to test fair value measurements were inspected, which is lower than the 44 percent of audits with deficiencies identified in 2015. In four of the eight audits with deficiencies in 2016, Inspections staff identified deficiencies in both of the categories set forth in Exhibit 5 below:

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[44] AS 2410.14.

[45] AS 2410.15.

[46] <u>See</u> ASC 820 and ASC Subtopic 940-320, *Financial Services – Brokers and Dealers – Investments – Debt and Equity Securities*.

Exhibit 5

Deficiencies Related to Auditing Fair Value Measurements:	Number of Audits
Understanding the broker-dealer's process for determining fair value measurements	5
Testing fair value measurements	7

Understanding the Broker-Dealer's Process for Determining Fair Value Measurements

The auditor should obtain an understanding of the broker-dealer's process for determining fair value measurements.[47] Inspections staff observed deficiencies in several audits involving securities with fair values based on unobservable inputs or inputs other than those from quoted prices in active markets.

In five audits, Inspections staff observed that firms did not obtain a sufficient understanding of the methods and assumptions internally developed by the broker-dealer or its specialists, or obtained from an external pricing source, that were used by the broker-dealer to determine the fair value of securities. For example, in one of these audits where the broker-dealer's securities were valued based on unobservable inputs, the firm's understanding of the methods and assumptions was limited to obtaining the broker-dealer's own estimate of fair value, as well as an external party's valuation report on which the broker-dealer based its estimate, and the firm did not perform procedures to evaluate important inputs used by the external party to estimate fair value, such as testing adjustments in the valuation report for marketability or limitations of shareholder rights.

Testing Fair Value Measurements

In seven audits, Inspections staff observed that firms did not perform, or sufficiently perform, procedures to test the fair value of securities when firms decided either to test management's process or develop an independent estimate for corroborative purposes. For example, some firms: (a) selected an insufficient sample or sampled in a manner that would not provide a sample that was representative of the population being tested; (b) did not determine whether prices obtained from external pricing sources used to develop its own estimate of fair value were independent of the external pricing source used by the broker-dealer to value its securities; (c) used a valuation report prepared by an external party as of a date other than the balance sheet date to test the fair value of securities at the balance sheet date without assessing whether the valuation report provided sufficient appropriate audit evidence for the securities as of the balance sheet date; or (d) for securities that did not appear to the

[47] See AS 2502.09 through .14.

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Inspections staff to be valued using quoted prices for identical securities in active markets, limited their procedures to comparing the broker-dealer's recorded fair value to prices on the statements from a clearing broker-dealer.

Auditing Receivables and Payables

Inspections staff identified audit deficiencies related to auditing receivables and payables in 16 of 65, or 25 percent, of the audits covered by the inspections where the auditor's procedures to test receivables and payables were inspected, which is higher than the 21 percent of audits with deficiencies identified in 2015. In three of the 16 audits with deficiencies in 2016, Inspections staff identified deficiencies in more than one of the categories set forth in Exhibit 6 below:

Exhibit 6

Deficiencies Related to Auditing Receivables and Payables:	Number of Audits
Extent of testing	9
External confirmations	1
Auditing information produced by service organizations or the broker-dealer	6
Other procedures to test receivables and payables	4

Extent of Testing

In nine audits, Inspections staff observed that the extent of testing was insufficient for a receivable or payable account balance, including commission receivables and payables to broker-dealers and clearing organizations. For example, firms: (a) did not perform sufficient procedures to test certain relevant assertions of the accounts (for example, did not perform procedures to obtain evidence regarding the underlying agreements or the related transactions that resulted in the balance); (b) limited procedures to inquiry alone to evaluate the collectability of receivables; (c) selected an insufficient sample or sampled in a manner that would not provide a sample that was representative of the population being tested; or (d) did not perform sufficient procedures to provide a reasonable basis for extending the audit conclusions from the interim date to year end (for example, only inquiring of management about differences between balances at the interim date and year end).

External Confirmations

PCAOB standards provide that there is a presumption that the auditor will request the confirmation of accounts receivable during an audit unless certain conditions apply.[48] The auditor should direct the confirmation request to a third party who the auditor believes is knowledgeable about the information to be confirmed.[49] In one audit, Inspections staff identified deficiencies related to external confirmation procedures in which the firm did not perform procedures to determine whether the individual to whom the confirmation was directed was knowledgeable about the information to be confirmed.

Auditing Information Produced by Service Organizations or the Broker-Dealer

In six audits, Inspections staff observed deficiencies related to the testing of receivables and payables that were the result of auditors not obtaining sufficient appropriate audit evidence about the accuracy and completeness of information the auditor used in its audit that was produced by the broker-dealer or the broker-dealer's service organization (for example, failing to perform, or sufficiently perform, procedures to test the accuracy and completeness of, or obtain evidence about the effectiveness of controls over, schedules and reports produced by the broker-dealer or the broker-dealer's service organization that were used in the performance of substantive testing).[50]

Other Procedures to Test Receivables and Payables

In four audits, Inspections staff observed other deficiencies related to the testing of receivables and payables. For example, in one audit, the firm did not evaluate whether the broker-dealer's practice of only reporting receivables (and the related revenues) at year end when cash had been collected after year end and prior to the issuance of the financial statements, resulted in a complete and accurate receivables balance reported at year end. In another audit, the firm did not sufficiently test the broker-dealer's estimate of commissions receivable at year end because its testing of the estimate was limited to recalculation without either testing the process used by management to develop the estimate, developing its own independent estimate to corroborate the broker-dealer's estimate, or reviewing subsequent events after year end that could have been important to evaluating the reasonableness of the estimate.[51]

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[48] See paragraph .34 of AS 2310 (historically AU sec. 330), *The Confirmation Process*.

[49] AS 2310.26.

[50] Refer to the Auditing Revenue section of this report for discussion regarding auditing information produced by service organizations and by the broker-dealer related to AS 2601 and AS 1105, respectively.

[51] See paragraph .10 of AS 2501 (historically AU sec. 342), *Auditing Accounting Estimates*.

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Audit Deficiencies Related to the Supporting Schedules

Net Capital Rule

AS 2701 (historically AS No. 17), *Auditing Supplemental Information Accompanying Audited Financial Statements*, addresses the auditor's responsibilities when engaged to report on whether supplemental information, such as the supporting schedules required by Rule 17a-5, is fairly stated, in all material respects, in relation to the financial statements as a whole. Rule 17a-5(d)(2)(ii) provides that the financial report of a broker-dealer shall include, among other things, a supporting schedule that presents a computation of net capital under Rule 15c3-1. Net capital is also generally disclosed in the notes to the financial statements. Among other things, the auditor's responsibilities under AS 2701 include performing procedures to test the completeness and accuracy of the information presented in the supplemental information to the extent that it was not tested as part of the audit of financial statements and evaluating whether the supplemental information, including its form and content, complies with the relevant regulatory requirements or other applicable criteria, if any.[52]

Inspections staff identified audit deficiencies regarding the auditor's testing and evaluation of the supporting schedule regarding the Net Capital Rule in 31 of 115, or 27 percent, of the audits covered by the inspections, which is lower than the 30 percent of audits with deficiencies identified in 2015. In 16 of the 31 audits with deficiencies in 2016, Inspections staff identified deficiencies in more than one of the categories set forth in Exhibit 7 below:

Exhibit 7

Deficiencies Related to the Net Capital Rule:	Number of Audits
Minimum net capital requirements	9
Adjustments to net worth	6
Allowable assets	19
Haircuts	4
Operational charges and other deductions	13
Other procedures	6

Minimum Net Capital Requirements

Generally, a broker-dealer's required minimum net capital is the greater of (1) one of a number of fixed-dollar amounts prescribed in Rule 15c3-1 applicable to the broker-dealer relative to its line(s) of business,[53] or (2) an amount computed using one

52 See AS 2701.04(e) and (f).

53 See Rule 15c3-1(a)(2).

of two financial ratios.[54] In nine audits, Inspections staff observed that firms did not test whether the broker-dealer's required minimum net capital reported in the supporting schedule was determined by the broker-dealer in accordance with Rule 15c3-1(a)(2).

Adjustments to Net Worth

Under Rule 15c3-1, net worth should be adjusted by certain items, such as discretionary liabilities, certain capital contributions, and certain deferred taxes, in the determination of net capital.[55] In six audits, Inspections staff observed that firms did not evaluate, or sufficiently evaluate, the completeness and accuracy of the adjustments to net worth that the broker-dealer reported in the supporting schedule. For example, in two audits, the firms did not evaluate, or sufficiently evaluate, whether the amounts of subordinated loans that were reported by the broker-dealer as additions to net worth met the requirements of Rule 15c3-1.[56] In another audit, the firm was aware that the broker-dealer had obligations for services rendered to the broker-dealer that were assumed by a broker-dealer's owner, but did not evaluate whether the broker-dealer should have reported an adjustment to net worth for these obligations in accordance with Rule 15c3-1.[57]

Allowable Assets

Rule 15c3-1 requires that assets not readily convertible into cash ("non-allowable assets") be deducted from equity when computing net capital.[58] In 19 audits, Inspections staff observed that firms did not perform sufficient procedures to test the broker-dealer's classification of allowable and non-allowable assets as reported in its supporting schedule. For example, some firms limited their procedures to tracing reported amounts, such as receivables from clearing broker-dealers and commissions receivable, to the Financial and Operational Combined Uniform Single reports (SEC Form X-17A-5, commonly referred to as FOCUS reports), general ledger, or the statement of financial condition, but did not evaluate whether the reported assets were classified appropriately in accordance with Rule 15c3-1. In two audits, the firms did not

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[54] See Rule 15c3-1(a)(1).

[55] See Rule 15c3-1(c)(2).

[56] See Appendix D of Rule 15c3-1.

[57] See Rule 15c3-1(c)(2)(i)(F). In addition, FINRA Notice to Members 03-63, *Expense-Sharing Agreements*, provides guidance to broker-dealers regarding the net capital computation when liabilities associated with business expenses have been assumed by another party.

[58] See Rule 15c3-1(c)(2)(iv).

test the aging of commissions receivables to determine whether the amount reported as allowable assets met the requirements of this rule.[59]

Haircuts

When computing net capital, Rule 15c3-1 generally requires broker-dealers to apply percentage reductions (referred to as "haircuts") to the values of securities owned by the broker-dealer.[60] The valuation of the securities and the haircut percentages can be significant components of the net capital computation reported on the supporting schedule.

In four audits, Inspections staff observed that firms did not perform sufficient procedures to evaluate whether the appropriate haircuts were applied by the broker-dealer to reported securities, including evaluating the relevant characteristics of the securities (for example, maturity dates and security ratings) in accordance with Rule 15c3-1(c)(2)(vi). In one of these audits, the firm did not test the accuracy and completeness of the securities designated as hedges included in the haircut calculation pursuant to Rule 15c3-1(c)(2)(vi)(F). In another audit, the firm used security values produced by the broker-dealer's service organization without obtaining sufficient appropriate audit evidence regarding the completeness and accuracy of these security values.

Operational Charges and Other Deductions

In computing net capital, Rule 15c3-1 requires broker-dealers to deduct amounts related to excess deductible amounts related to fidelity bond coverage[61] and operational charges, such as securities borrowed deficits.[62] In 13 audits, Inspections staff observed that firms did not evaluate, or sufficiently evaluate, the completeness and accuracy of the amounts of operational charges and other deductions reported by the broker-dealer on its supporting schedule.

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[59] Rule 15c3-1(c)(2)(iv)(C) provides that commissions receivable from other broker-dealers that are outstanding longer than 30 days from the date they arise are non-allowable assets.

[60] See Rule 15c3-1(c)(2)(vi).

[61] See Rule 15c3-1(c)(2)(xiv).

[62] See FINRA Interpretations of Financial and Operational Rules, Interpretation 15c3-1(c)(2)(iv)(B)/09.

Other Procedures

Inspections staff also observed deficiencies related to net capital in six other audits. For example, in four audits, the firms did not obtain written representations from management required by AS 2701,[63] and in two audits, the firms did not perform procedures to determine whether the supporting schedule reconciled to the underlying accounting and other records or to the broker-dealer's financial statements.[64] In one of the six audits, the firm did not obtain an understanding of the methods of preparing the supplemental information and evaluate the appropriateness of those methods.[65]

Customer Protection Rule

Similar to the procedures regarding the computation of net capital noted above, AS 2701 is applicable to audit procedures required to be applied to the other supplemental information required by Rule 17a-5(d)(2)(ii) that consists of supporting schedules that present the reserve requirements computation under Exhibit A of Rule 15c3-3, which include the customer reserve computation and the proprietary securities account of a broker-dealer ("PAB account") reserve computation, and information relating to requirements for possession or control of securities under Rule 15c3-3.

Inspections staff identified audit deficiencies regarding the auditor's testing and evaluation of supporting schedules related to Rule 15c3-3 in 13 of 25, or 52 percent, of the audits covered by the inspections where the auditor's procedures to test supplemental information related to Rule 15c3-3 were inspected, which is lower than the 53 percent of audits with deficiencies identified in 2015. In five of the 13 audits with deficiencies in 2016, Inspections staff identified deficiencies in more than one of the categories set forth in Exhibit 8 below:

Exhibit 8

Deficiencies Related to the Customer Protection Rule:	Number of Audits
Customer and broker-dealer debits or credits	12
Possession or control requirements	5
Other procedures	2

[63] See AS 2701.05.

[64] See AS 2701.04(d).

[65] See AS 2701.04(b).

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Customer and Broker-Dealer Debits or Credits

In 12 audits, Inspections staff observed that firms did not test, or sufficiently test, the completeness and accuracy of debits or credits included in the customer and PAB account reserve computations reported on the supporting schedules. In five audits, the firms limited their procedures to inquiry, or used as audit evidence, information produced by the broker-dealer, or the broker-dealer's service organization, without obtaining sufficient appropriate audit evidence about the completeness and accuracy of the reported amounts (for example, inappropriately relying on controls over the accuracy and completeness of a report produced by a service organization that was used in substantive testing when neither the firm nor the service auditor tested controls over the report).[66]

Possession or Control Requirements

Rule 15c3-3(b)(1) requires a broker-dealer to promptly obtain and maintain the physical possession or control[67] of all fully-paid securities[68] and excess margin securities[69] carried by the broker-dealer for the accounts of customers. In five audits, Inspections staff observed that firms did not perform sufficient procedures to test the information related to the broker-dealer's possession or control requirements as reported on the supporting schedule. In one audit, the firm did not obtain an understanding of the purpose of the possession or control schedule because its procedure to test the possession or control schedule consisted of tracing amounts from the customer reserve schedule to the general ledger and recalculating amounts on the customer reserve schedule. In another audit, the firm did not obtain an understanding of the methods used by the broker-dealer to prepare the schedule, evaluate the appropriateness of those methods, and determine whether those methods had changed from the methods used in the prior period.

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[66] Refer to the Auditing Revenue section of this report for discussion regarding auditing information produced by service organizations related to AS 2601.

[67] Generally, "possession" of securities means the securities are physically located at the broker-dealer and "control" of securities means the securities are located at an approved "control" location, such as a clearing corporation or depository.

[68] Generally, fully-paid securities are securities that are purchased in transactions for which the customer has made full payment. See Rule 15c3-3(a)(3).

[69] Generally, excess margin securities in a customer account are those securities with a market value greater than 140 percent of the customer's debit balance. See Rule 15c3-3(a)(5).

In three audits, the firms did not perform necessary procedures over the completeness and accuracy of information produced by the broker-dealer, or the broker-dealer's service organization, that was included in the supporting schedule, test whether deficits existed for margin securities in excess of 140 percent of customer debits, test the customer securities held, or evaluate whether control locations were good control locations pursuant to Rule 15c3-3(c).

Other Procedures

Inspections staff observed deficiencies in two audits regarding other procedures performed on the supporting schedules related to compliance with Rule 15c3-3. In one of these two audits, the firm appeared to the Inspections staff to be aware that the balance in the broker-dealer's special reserve bank account[70] was less than the balance the broker-dealer reported in its customer reserve schedule and less than the required deposit reported by the broker-dealer. The misstatement appeared to the Inspections staff to be material, due to the effect of the misstatement in light of its relationship to the broker-dealer's reporting concerning its compliance with the reserve requirement, and the firm appeared to the Inspections staff to have failed to identify and address that fact. In another audit, the firm failed to obtain any of the required written representations from management.

Other Deficiencies Related to the Audit

Auditor's Reporting on the Financial Statements and Supporting Schedules

Generally, broker-dealers are required under Rule 17a-5(c)(2) to annually file with the SEC, among other things, a financial report containing financial statements and supporting schedules along with an auditor's report on the financial statements and supporting schedules.

Under PCAOB standards, the auditor's report on the supporting schedules should include an opinion on whether the supplemental information is fairly stated, in all material respects, in relation to the financial statements taken as a whole.[71] In addition, the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the auditor's opinion on the

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[70] See Rule 15c3-3(e)(1). Broker-dealers that do not claim exemption from Rule 15c3-3 are generally required to maintain a bank account for the exclusive benefit of customers that is referred to in this report as a "special reserve bank account."

[71] See AS 2701.03.

financial statements and on the supplemental information in relation to the financial statements as a whole.[72]

Inspections staff identified deficiencies related to the auditor's reporting on the financial statements and supporting schedules in 15 of 115, or 13 percent, of the audits covered by the inspections, which is higher than the eight percent of audits with deficiencies identified in 2015. In three of the 15 audits with deficiencies in 2016, Inspections staff identified deficiencies in more than one of the categories set forth in Exhibit 9 below:

Exhibit 9

Deficiencies Related to Auditor's Reporting on the Financial Statements and Supporting Schedules:	Number of Audits
Inaccurate auditor's report	13
Dating of the auditor's report	5

Inaccurate Auditor's Report

In 12 of the 13 audits, Inspections staff observed that the auditor's report on the supplemental information did not include, or include properly, one or more of the elements required by AS 2701.[73] For example, firms: (1) did not identify a supporting schedule that the firm had audited and that the broker-dealer filed with its financial statements; (2) incorrectly identified the broker-dealer's exemption report as supplemental information; (3) identified supporting schedules that the broker-dealer did not file with its financial statements; (4) did not include a required statement that the audit procedures performed included performing procedures to test the completeness and accuracy of the information presented in the supplemental information; (5) did not include a required statement that in forming its opinion, the firm evaluated whether the supplemental information, including its form and content, complied, in all material respects, with the specified regulatory requirements; (6) stated that the firm conducted its audit in accordance with generally accepted auditing standards ("GAAS") rather than in accordance with PCAOB standards, as required by Rule 17a-5(g)(1); or (7) referenced the incorrect regulatory requirement with which the supplemental information was to comply.

Further, in two of the 13 audits, the auditor's report on the financial statements (1) did not include the word independent in the title of the report; or (2) did not identify

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[72] See paragraph .01 of AS 3110 (historically AU sec. 530), *Dating of the Independent Auditor's Report,* and AS 2701.12.

[73] See AS 2701.10.

statements that the firm had audited and that the broker-dealer filed with its financial statements.[74]

Dating of the Auditor's Report

In five audits, Inspections staff observed that the auditor's report was dated prior to the date on which the auditor concluded that it had obtained sufficient, appropriate evidence. For example, firms reached conclusions regarding matters necessary to support their auditor's opinion after the date of the auditor's report, such as in one instance in which a firm completed procedures related to a broker-dealer's reported revenue after the date of the auditor's report.

Audit Documentation

AS 1215 (historically AS No. 3), *Audit Documentation*, establishes the general requirements for documentation that the auditor should prepare and retain in connection with an audit performed under PCAOB standards.[75] Audit documentation is the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation also facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor.[76]

Inspections staff identified deficiencies in 32 of 115, or 28 percent, of the audits covered by the inspections related to audit documentation, which is higher than the 26 percent of audits with deficiencies identified in 2015. In one of the 32 audits with deficiencies, Inspections staff identified deficiencies in more than one of the categories set forth in Exhibit 10 below:

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[74] See paragraphs .08 of AS 3101 (historically AU sec. 508), *Reports on Audited Financial Statements.*

[75] See AS 1215.04 through .09.

[76] AS 1215.02.

Exhibit 10

Deficiencies Related to Audit Documentation:	Number of Audits
Engagement completion document	9
Documentation of significant findings or issues	21
Other audit documentation matters	3

Engagement Completion Document

The auditor must identify all significant findings or issues in an engagement completion document.[77] In nine audits, Inspections staff observed that firms did not complete an engagement completion document. In these audits, the firms also did not complete an engagement completion document in the related review engagements (see Other Deficiencies Related to Review Engagements below). These nine audits were performed by firms that did not audit issuers.

Documentation of Significant Findings or Issues

In 21 audits, Inspections staff observed that firms prepared an engagement completion document, but did not include one or more relevant required items, such as significant findings or issues, including the results of auditing procedures performed in response to significant risks or the identification and evaluation of uncorrected misstatements.[78]

Other Audit Documentation Matters

In three audits, Inspections staff observed deficiencies related to other audit documentation matters. AS 1215 requires that a complete and final set of audit documentation be assembled for retention as of a date not more than 45 days after the release date of the auditor's report (documentation completion date).[79] In two of the three audits, the firms did not assemble a complete and final set of audit documentation by the documentation completion date. AS 1215 further requires that any documentation added after the documentation completion date indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it.[80] In two of the three audits, the firms

[77] AS 1215.13.

[78] See AS 1215.12.

[79] AS 1215.15.

[80] AS 1215.16.

added documentation to the audit file after the documentation completion date but did not document the date the information was added, the name of the person who prepared the additional documentation, or the reasons for adding it.

The Board has settled disciplinary orders with respect to audit documentation matters related to audits of broker-dealers for fiscal years ended during 2014 that imposed sanctions on three individuals.[81]

Engagement Quality Review

AS 1220 (historically AS No. 7), *Engagement Quality Review*, requires an engagement quality review to be performed for audits performed under PCAOB standards. The objective of the engagement quality reviewer is to perform an evaluation of the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report, if a report is to be issued, in order to determine whether to provide concurring approval of issuance.[82]

Inspections staff identified deficiencies related to the engagement quality review performed in 66 of 115, or 57 percent, of the audits covered by the inspections, which is the same as the percentage of audits with deficiencies identified in 2015. In three of the 66 audits with deficiencies in 2016, Inspections staff identified deficiencies in more than one of the categories set forth in Exhibit 11 below:

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[81] In March 2017, the Board found that a partner at a registered public accounting firm made and directed additions and alterations to work papers in 15 broker-dealer audits after the documentation completion dates and after learning of an upcoming PCAOB inspection, without following the requirements described above. Based on that conduct, the Board imposed disciplinary sanctions for violations of both AS 1215.16 and PCAOB Rule 4006, *Duty to Cooperate with Inspectors* ("Rule 4006"), including a censure, a bar on association with any registered public accounting firm, and a civil money penalty. See PCAOB Release No. 105-2017-022 (March 29, 2017).pdf.

In addition, in June 2017, the Board found that two individuals at another registered public accounting firm made and directed additions and alterations to work papers in one broker-dealer audit after the documentation completion date and after learning of an upcoming PCAOB inspection. The Board imposed disciplinary sanctions for violations of both AS 1215.16 and Rule 4006 (as well as for other violations by those individuals), including censures, bars on association with any registered public accounting firm, and for one of the individuals a civil money penalty. See PCAOB Release No. 105-2017-029 (June 27, 2017).pdf.

[82] AS 1220.02.

Exhibit 11

Deficiencies Related to Engagement Quality Review:	Number of Audits
Performance of an engagement quality review	8
Insufficient review by the engagement quality reviewer	57
Engagement quality reviewer qualifications	4

Performance of an Engagement Quality Review

In eight audits, Inspections staff observed that firms did not have an engagement quality review performed for the audit prior to issuance of the engagement report, which compares to seven audits identified in 2015. All of these audits in 2016, and all but one in 2015, were conducted by firms that did not audit issuers. These firms also did not have an engagement quality review performed for the related review attestation engagement (see Other Deficiencies Related to Review Engagements below).

Insufficient Review by the Engagement Quality Reviewer

In 57 audits, Inspections staff observed that the engagement quality review performed was not sufficient. For example, through inspection of the documentation relating to the engagement quality review performed, the engagement quality reviewer did not, or did not sufficiently: (a) evaluate the engagement team's assessment of, and audit responses to, significant risks identified by the engagement team, including fraud risks; (b) review the engagement team's evaluation of the firm's independence in relation to the engagement; (c) review the engagement completion document and confirm with the engagement partner that there were no significant unresolved matters; or (d) review the financial statements and the related engagement report.[83]

Engagement Quality Reviewer Qualifications

In four audits, Inspections staff observed that the engagement quality reviewer did not meet the required qualifications. For example, in one audit, the engagement quality reviewer was from the firm that issued the engagement report, but was not a partner at the firm, or another individual in an equivalent position.[84] In three audits, the

[83] See AS 1220.10.

[84] See AS 1220.03. In addition, because the engagement quality review is intended to be an objective second look at work performed by the engagement team, the reviewer should be able to withstand pressure from the engagement partner or other firm personnel, such as members of the firm's national office. When considering an outside individual for the role of engagement quality reviewer, the firm will likely need to make additional inquiries to obtain necessary information about the individual's qualifications. See PCAOB Release No. 2009-004 (July 28, 2009).

reviewer did not appear to possess the level of knowledge and competence related to accounting, auditing, and financial reporting required in order to serve as the engagement partner on the engagement under review,[85] given that the engagement quality reviewer had very limited experience, no recent experience, or no experience with broker-dealer engagements.

Deficiencies in Independence Communications to the Audit Committee

PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence* ("Rule 3526"), requires auditors to communicate to the audit committee (or equivalent body)[86] of their broker-dealer audit clients certain matters prior to accepting an initial engagement and on at least an annual basis.

Inspections staff observed that firms did not comply with Rule 3526 in 22 of 115, or 19 percent, of the audits covered by the inspections, which is an increase from 10 percent identified in 2015. In 11 of those audits, the firm failed to make any written communication to the broker-dealer's audit committee, including failing to affirm in writing that the firm was independent of the broker-dealer in compliance with PCAOB Rule 3520, *Auditor Independence*.[87] These audits were performed by nine firms, of which five did not audit issuers. In 11 other audits, the firm's independence was impaired because of certain non-audit service relationships (including bookkeeping services and preparation of financial statements), but the firm failed to describe those relationships in writing to the audit committee (or equivalent) as relationships that may reasonably be thought to bear on independence.[88] These audits were performed by 11 firms that did not audit issuers.

Attestation Deficiencies

Rule 17a-5(d) requires that annual reports filed by SEC-registered broker-dealers include, among other things, a compliance report or an exemption report.[89]

Rule 17a-5(d)(1)(C) also generally requires the annual reports to contain reports by an independent public accountant covering the financial report and the compliance

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85 See AS 1220.05.

86 Refer to the meaning of the term "audit committee" described earlier in this report.

87 See Rule 3526(b)(3).

88 See Rule 3526(b)(1).

89 See Rule 17a-5(d)(3) and (4).

report or exemption report. The auditor must, as part of the engagement, undertake, as applicable: (1) to prepare a report based on an examination of certain statements of the broker-dealer in the compliance report; or (2) to prepare a report based on a review of the statements of the broker-dealer in the exemption report. In each case, the examination or review performed by the auditor must be conducted in accordance with PCAOB standards.[90]

Examination Procedures

Rule 17a-5(d) provides that broker-dealers that did not claim exemption from Rule 15c3-3 throughout the most recent fiscal year must file with the Commission a compliance report which must include certain statements.[91]

AT No. 1 provides that the objective of the auditor's examination is to express an opinion regarding whether the statements (also referred to as "assertions") made by the broker-dealer in its compliance report are fairly stated, in all material respects.[92] These assertions concern: (a) the effectiveness of the broker-dealer's internal control over compliance ("ICOC") with the financial responsibility rules[93] during, and as of the end of, the most recent fiscal year; (b) the broker-dealer's compliance with the Net Capital Rule and with the reserve requirements rule[94] as of the end of the most recent fiscal year; and (c) whether the information the broker-dealer used to state whether it was in compliance with the Net Capital Rule and the reserve requirements rule was derived from the books and records of the broker-dealer.[95]

Inspections staff identified attestation deficiencies in 14 of 20, or 70 percent, of the attestation engagements covered by the inspections related to examination procedures, which is lower than the 78 percent of attestation engagements with

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[90] See Rule 17a-5 (g)(2)(i) and (ii). The auditor must also undertake to prepare a report based on an examination of the financial report in accordance with PCAOB standards. See Rule 17a-5(g)(1).

[91] See Rule 17a-5(d)(1)(i)(B)(1) and Rule 17a-5(d)(3).

[92] AT No. 1.03.

[93] As in the SEC release adopting amendments to Rule 17a-5, the term "financial responsibility rules" is used in this report to refer to the Net Capital Rule, the Customer Protection Rule, Exchange Act Rule 17a-13, and any rule of a designated examining authority that requires the broker-dealer to periodically send account statements to customers.

[94] See Rule 15c3-3(e).

[95] See Rule 17a-5(d)(3)(i)(A)(2) through (5).

deficiencies identified in 2015. In eight of the 14 examinations with deficiencies in 2016, Inspections staff identified deficiencies in more than one of the categories set forth in Exhibit 12 below:

Exhibit 12

Deficiencies Related to Examination Procedures:	Number of Examinations
Planning the examination	5
Testing controls over compliance	12
Performing compliance tests	9
Evaluation of results	1
Other examination procedures	1

Planning the Examination

In five examinations, Inspections staff observed instances where firms did not sufficiently plan the examination procedures over certain of the financial responsibility rules, because the firms did not: (a) obtain an understanding, or a sufficient understanding, of the broker-dealer's processes, including relevant controls, regarding compliance with the financial responsibility rules; (b) assess the risk of fraud, including the risk of misappropriation of customer assets, relevant to compliance with the Net Capital Rule and the reserve requirements rule and the effectiveness of ICOC; (c) assess the risks associated with related parties that were relevant to compliance and controls over compliance; (d) inquire of management, or other individuals at the broker-dealer, who have relevant knowledge regarding regulatory examinations and correspondence between the broker-dealer and regulatory agencies that are relevant to the broker-dealer's assertions; or (e) obtain an understanding of the nature and frequency of customer complaints that were relevant to compliance with the financial responsibility rules.[96]

Testing Controls Over Compliance

In 12 examinations, Inspections staff observed that firms did not test, or sufficiently test, controls over compliance with the financial responsibility rules. For example, in one examination, the firm did not test any controls over compliance related to any of the financial responsibility rules. In four other examinations, when the firms tested review controls, the firms did not obtain an understanding of the nature and extent of management's review, including understanding and evaluating the expectation and criteria used by management to identify matters for investigation, and the nature and resolution of the investigation procedures performed. In addition, in one of the four examinations, the firm also did not sufficiently test the effectiveness of IT controls, such

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[96] See AT No. 1.09 and .10.

as logical access, change management, and computer operations controls, over a proprietary application used extensively in the broker-dealer's ICOC, as aspects of the controls were not tested, or the sample sizes were insufficient. As a result, the four firms' tests of controls were not sufficient to determine whether the identified controls were designed and operating effectively to prevent or detect instances of non-compliance.

Inspections staff also observed in six of the 12 examinations that firms did not test controls, or sufficiently test controls, over the accuracy and completeness of underlying information, produced by either the broker-dealer or the broker-dealer's service organizations, upon which the design and operating effectiveness of ICOC depended.[97] For example, in two examinations, the firms did not sufficiently test controls over the calculation of deficits or excesses because the testing did not provide evidence that the calculation correctly included important items such as identification of customer or PAB accounts subject to inclusion in the calculation and identification of all fully paid securities in non-margin accounts. In addition, in seven of the 12 examinations, Inspections staff observed that firms did not sufficiently test controls over customer account statements.[98] Specifically, these firms did not test, or sufficiently test, controls designed to ensure all customers received account statements either electronically or by mail or controls designed to ensure the account statements included complete and accurate information.

Performing Compliance Tests

In nine examinations, Inspections staff observed deficiencies in the firms' performance of compliance tests to support their conclusions regarding whether the broker-dealer was in compliance with the Net Capital Rule or the reserve requirements rule as of the end of its fiscal year. For example, in three examinations, the firms did not perform sufficient procedures on the schedules the broker-dealer used to determine compliance in accordance with AT No. 1.21, because the firms did not test, or sufficiently test, the accuracy and completeness of the underlying information produced by the broker-dealer or the broker-dealer's service organizations and used by the broker-dealer to prepare its schedules. In another examination, the firm did not perform any compliance tests required by AT No. 1.21.

Inspections staff also observed in two examinations that firms' procedures were deficient concerning whether the broker-dealer maintained a special reserve bank account for the exclusive benefit of its customers in accordance with the requirements of the Customer Protection Rule. For example, in one examination, the firm was aware

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97 Refer to the Auditing Revenue section of this report for discussion regarding auditing information produced by service organizations and by the broker-dealer related to AS 2601 and AS 1105, respectively.

98 See FINRA Rule 2340.

that the broker-dealer's written bank notification letter regarding the account that the broker-dealer used to hold its customer reserve funds contained provisions that indicated that the account may not qualify to be a special reserve bank account.[99] However, the firm did not perform procedures to further evaluate these provisions to determine whether the account qualified as a special reserve bank account.

Evaluation of Results

As noted earlier, in one instance the firm appeared to the Inspections staff to be aware that the broker-dealer's amount on deposit in the broker-dealer's special reserve bank account at year end was less than the required deposit as reported in its customer reserve schedule, but that the broker-dealer's compliance report included an assertion that the broker-dealer was in compliance with the reserve requirements rule at year end. The firm did not modify its examination report to indicate that the broker-dealer was not in compliance with the reserve requirements rule as of the end of its fiscal year.[100] In addition, the firm appeared to the Inspections staff to not have evaluated whether a material weakness in ICOC with the reserve requirements rule existed related to this matter.

Other Examination Procedures

In one examination, Inspections staff observed that the firm did not obtain written representations from management of the broker-dealer required by AT No. 1.[101]

Review Procedures

Rule 17a-5(d) provides that broker-dealers that claimed an exemption from Rule 15c3-3 throughout the most recent fiscal year must file an exemption report which must include certain statements.[102]

AT No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, provides that the objective of the auditor's review of the broker-dealer's exemption report is to state whether, based upon the results of the review procedures, the auditor is aware of any material modifications that should be made to the broker-dealer's assertions for the assertions to be fairy stated, in all material respects.[103]

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[99] See Rule 15c3-3(f).

[100] See AT No. 1.C1.

[101] See AT No. 1.32.

[102] See Rule 17a-5(d)(1)(i)(B)(2) and Rule 17a-5(d)(4).

[103] AT No. 2.03.

Further, AT No. 2 provides that the auditor must plan and perform the review to obtain appropriate evidence that is sufficient to obtain moderate assurance about whether one or more conditions exist that would cause one or more of the broker-dealer's assertions not to be fairly stated, in all material respects.[104] Such conditions include:

- The broker-dealer's assertion that identifies the provisions in Rule 15c3-3(k) under which the broker-dealer claimed an exemption from Rule 15c3-3 is inaccurate;

- The broker-dealer asserts that it met the identified exemption provisions in Rule 15c3-3(k) without exception when the auditor is aware of exceptions in meeting the exemption provisions; or

- The broker-dealer's assertion that identifies and describes each exception during the most recent fiscal year in meeting the identified exemption provisions in Rule 15c3-3(k) is inaccurate or incomplete.[105]

Inspections staff identified attestation deficiencies in 27 of 95, or 28 percent, of the attestation engagements covered by the inspections related to review procedures, which is lower than the 34 percent of attestation engagements with deficiencies identified in 2015. In 11 of the 27 reviews with deficiencies in 2016, Inspections staff identified deficiencies in more than one of the categories set forth in Exhibit 13 below:

Exhibit 13

Deficiencies Related to Review Procedures:	Number of Reviews
Gaining an understanding of exemption conditions and consideration of risk factors	6
Making required inquiries and performing other review procedures	25
Evaluation of results	1
Other required review procedures	7

Gaining an Understanding of Exemption Conditions and Consideration of Risk Factors

In six reviews, Inspections staff observed that firms did not gain an understanding of the broker-dealer's exemption conditions and did not consider certain

[104] AT No. 2.04.

[105] Id.

risk factors in performing necessary inquiries and other review procedures.[106] For example, in five reviews, firms did not obtain a sufficient understanding of the provision of the Customer Protection Rule that was relevant to the broker-dealer's exemption asserted in the exemption report because the broker-dealer engaged in activities that generated material revenues that were handled directly with entities that were not clearing broker-dealers, and, therefore, did not meet the requirements of the exemption provision claimed. In one review, the firm's procedures did not include consideration of the following risk factors that appeared to be relevant in order to determine the nature, timing, and extent of its inquiries and other review procedures: (a) changes in the broker-dealer's procedures, controls, or the environment in which the controls operated since the prior year; (b) competence of the personnel who were responsible for compliance with the exemption provisions or who performed important controls over compliance; and (c) the degree to which the broker-dealer's processes related to the identified exemption provisions were performed, monitored, or controlled in a centralized or decentralized environment.

Making Required Inquiries and Performing Other Review Procedures

In 25 reviews, Inspections staff observed that the firms' inquiries and other review procedures were insufficient.

In 19 of these reviews, the firms did not perform all required inquiries,[107] including those which involve obtaining an understanding of management's controls and monitoring activities in place to comply with the claimed exemption provisions.

In 14 of these reviews, the firms did not perform other procedures necessary to assess whether a material modification was necessary for the broker-dealer's assertions to be fairly stated.[108] For example, in seven reviews, the firms did not perform or sufficiently perform other procedures to determine whether customer checks received by the broker-dealer were promptly transmitted, given its knowledge that the broker-dealer received customer checks during the year. In four other reviews, the firms were aware of the broker-dealer's past history of non-compliance with the exemption provisions, but did not appropriately consider this factor in determining whether to adjust the nature, timing, or extent of their inquiries and other review procedures responsive to the risks that non-compliance in the prior year may have had on the broker-dealer's assertions.

[106] See AT No. 2.05(b) and .09(a).

[107] See AT No. 2.10(b) through .10(d).

[108] See AT No. 2.10(h).

Evaluation of Results

The auditor should evaluate whether information has come to the auditor's attention that causes the auditor to believe that one or more of the broker-dealer's assertions are not fairly stated, in all material respects.[109] In one review, Inspections staff observed an instance where the auditor's evaluation of the results of its review procedures was insufficient. Although information came to the auditor's attention indicating that one or more exceptions to the exemption provisions occurred during the year or might have existed at year-end, that were not disclosed in the exemption report and that might have caused one or more of the broker-dealer's assertions not to be fairly stated in all material respects, the auditor failed to perform additional procedures to address the matter.

Other Required Review Procedures

In seven reviews, Inspections staff observed that firms did not obtain written representations from management of the broker-dealer required by AT No. 2.[110]

Other Deficiencies Related to Examination Engagements

Examination Report

The auditor's examination report should include specific elements[111] with respect to the auditor's examination of the assertions made by a broker-dealer in its compliance report such as a statement that management of the broker-dealer is responsible for establishing and maintaining a system of internal control that has the objective of providing the broker-dealer with reasonable assurance that any instances of non-compliance with the financial responsibility rules will be prevented or detected on a timely basis and the auditor's opinion on whether the assertions made by the broker-dealer in the compliance report regarding the effectiveness of ICOC are fairly stated in all material respects.

Inspections staff identified deficiencies in 2 of 20, or 10 percent, of the examinations covered by the inspections related to the auditor's examination report, which is lower than the 11 percent of examinations with deficiencies identified in 2015. In one examination, Inspections staff observed that the firm stated in its examination report that the broker-dealer's responsibility for maintaining ICOC with respect to Rule 15c3-3 was limited to Rule 15c3-3(e), which is inconsistent with the definition of ICOC in AT No. 1. In another examination, the firm did not express an adverse opinion in its

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[109] See AT No. 2.11 and .12.

[110] See AT No. 2.13 and .14.

[111] See AT No. 1.36.

examination report, even though it identified a material weakness in ICOC in its examination, and also did not include a statement in its examination report that one or more material weaknesses in ICOC had been identified during, and as of the end of, the fiscal year.

Examination Documentation

AS 1215 establishes general requirements for documentation that the auditor should prepare and retain in connection with an attestation engagement performed under PCAOB standards.[112]

Inspections staff identified deficiencies in 1 of 20, or five percent, of the examinations covered by the inspections related to documentation, which is lower than the 11 percent of examinations with deficiencies identified in 2015. In this one examination, Inspections staff observed that the firm did not complete an engagement completion document for the examination or include required documentation related to the examination in an engagement completion document prepared in connection with the corresponding audit. In addition, the firm did not assemble a complete and final set of audit documentation by the documentation completion date.

Engagement Quality Review in an Examination Engagement

AS 1220 requires an engagement quality review to be performed by a qualified reviewer for attestation engagements performed pursuant to AT No. 1.[113]

Inspections staff identified deficiencies related to the engagement quality review performed in 4 of 20, or 20 percent, of the examinations covered by the inspections, which is lower than the 48 percent of examinations with deficiencies identified in 2015.

In four examinations, Inspections staff observed that the engagement quality reviewer did not perform a sufficient review, including instances in which the engagement quality reviewer did not review the engagement report, failed to detect one or more errors in the engagement report, or failed to identify the absence of an engagement completion document.[114] In addition, in one instance, it appeared to the Inspections staff that the engagement quality reviewer's concurring approval of issuance of the examination report was provided despite the engagement quality reviewer being aware that (1) the broker-dealer's amount on deposit in the broker-dealer's special reserve bank account at year end was less than the required deposit as reported in its

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[112] See AT No. 1.06 and AT No. 2.05.

[113] See AS 1220.01 and .03 through .08.

[114] See AS 1220.18A and .18B.

customer reserve schedule, (2) the broker-dealer's compliance report included an assertion that the broker-dealer was in compliance with the reserve requirements rule at year end, and (3) the engagement team had not evaluated whether a material weakness in ICOC with the reserve requirements rule existed related to this matter. In one of the four examinations, the reviewer also did not appear to possess the level of knowledge and competence related to attestation procedures required in order to serve as the engagement partner on the engagement under review,[115] given that the engagement quality reviewer had no experience with broker-dealer engagements.

Other Deficiencies Related to Review Engagements

Review Report

The auditor's review report should include specific elements[116] with respect to the auditor's review of the assertions made by a broker-dealer in its exemption report such as a statement that management of the broker-dealer is responsible for compliance with the identified exemption provisions throughout the fiscal year and for its assertions and a statement about whether the auditor is aware of any material modifications that should be made to the assertions made by the broker-dealer for them to be fairly stated, in all material respects. AT No. 2 also establishes that the review report should be dated no earlier than the date on which the auditor has completed his or her review procedures and also no earlier than the date of the auditor's report on the financial statements and supplemental information.[117]

Inspections staff identified deficiencies in 13 of 95, or 14 percent, of the reviews covered by the inspections related to the auditor's review report, which is lower than the 15 percent of reviews with deficiencies identified in 2015.

In 13 reviews, Inspections staff observed that the auditor's review report did not comply with the requirements of AT No. 2. For example, these review reports either: (1) omitted the independent reference in the report title; (2) identified a different exemption than the exemption the broker-dealer operated under and specified in its exemption report; (3) omitted any reference to the provision(s) of Rule 15c3-3 under which the broker-dealer claimed an exemption in its exemption report; (4) inaccurately stated that the broker-dealer met the identified exemption provision without exception when the broker-dealer's exemption report either indicated there were exceptions or the exemption report contained no such statement; (5) incorrectly made reference to the broker-dealer's assertions included within a supporting schedule of the broker-dealer,

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[115] See AS 1220.05.

[116] See AT No. 2.16.

[117] See AT No. 2.18.

which was not an exemption report; or (6) covered a different period than the period covered by the broker-dealer's exemption report. In three of the 13 reviews, the firm's review report was dated prior to the date of the broker-dealer's exemption report.

Review Documentation

Inspections staff identified deficiencies in 20 of 95, or 21 percent, of the reviews covered by the inspections related to documentation, which is higher than the 17 percent of reviews with deficiencies identified in 2015.

In nine reviews, Inspections staff observed that firms did not complete an engagement completion document for the review or include required documentation related to the review in an engagement completion document prepared in connection with the corresponding audit. In one of these nine reviews, the firm did not assemble a complete and final set of audit documentation by the documentation completion date and did not document the date and explain the reasons for adding documentation after the documentation completion date. These nine reviews were performed by firms that did not audit issuers.

In 11 reviews, Inspections staff observed that firms prepared an engagement completion document, but did not include in it one or more required items related to the review, such as actions taken to address significant findings or issues, including risks requiring special consideration.

Engagement Quality Review in a Review Engagement

AS 1220 requires an engagement quality review to be performed by a qualified reviewer for attestation engagements performed pursuant to AT No. 2.[118]

Inspections staff identified deficiencies related to the engagement quality review performed in 25 of 95, or 26 percent, of the reviews covered by the inspections, which is lower than the 34 percent of reviews with deficiencies identified in 2015.

In eight reviews, Inspections staff observed that firms did not have an engagement quality review performed for the review engagement.[119] In another 15 reviews, Inspections staff observed that the engagement quality reviewer did not perform a sufficient review, including instances in which the engagement quality reviewer did not review the engagement report, failed to detect one or more errors in the engagement report, failed to identify the absence of an engagement completion

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118 See AS 1220.01 and .03 through .08.

119 In 2015, Inspections staff observed that firms did not have an engagement quality review performed for seven reviews.

document, or failed to review the engagement team's evaluation of the firm's independence.[120]

In three of the 25 reviews, Inspections staff observed that the engagement quality reviewer did not meet the required qualifications. For example, in one review, Inspections staff noted that the engagement quality reviewer was from the firm that issued the engagement report, but was not a partner or individual in an equivalent position at the firm.[121] In another two reviews, the reviewer did not appear to possess the level of knowledge and competence related to attestation procedures required in order to serve as the engagement partner on the engagement under review,[122] given that the engagement quality reviewer had little experience, or no recent experience, with broker-dealer engagements.

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[120] See AS 1220.18A and .18B.

[121] See AS 1220.03.

[122] See AS 1220.05.

Comparative Summary of Deficiencies by Certain Firm Characteristics

The following tables present a comparative summary of audits and attestation engagements with deficiencies by certain firm characteristics:

Exhibit 14: Firms that Audited Broker-Dealers that Filed Compliance Reports and Firms that Only Audited Broker-Dealers that Filed Exemption Reports[123]

	Percentage of Audits with Audit and Other Deficiencies		Percentage of Areas with Audit and Other Deficiencies[124]		Percentage of Examinations with Attestation and Other Deficiencies		Percentage of Reviews with Attestation and Other Deficiencies	
	2016	2015	2016	2015	2016	2015	2016	2015
Firms that audited broker-dealers that filed compliance reports	70%	64%	22%	25%	70%	77%	25%	26%
Firms that only audited broker-dealers that filed exemption reports	97%	95%	51%	47%	N/A	N/A	54%	63%

In 2016, Inspections staff identified a high percentage of audits, areas, and attestation engagements with deficiencies across firms covered by the inspections but noted that deficiencies were significantly higher at firms that only audited broker-dealers that filed exemption reports. The 2016 results are consistent with 2015.

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[123] Included in the 2015 results in Exhibits 14 – 16 are inspections performed during 2014 of five firms covering portions of five audit and attestation engagements that were required to be performed under PCAOB standards.

[124] Not all areas were included for, or applicable to, each broker-dealer audit included in the inspections.

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Exhibit 15: Firms That Also Audited Issuers and Firms That Did Not Audit Issuers[125]

	Percentage of Audits with Audit and Other Deficiencies		Percentage of Areas with Audit and Other Deficiencies		Percentage of Attestations with Attestation and Other Deficiencies	
	2016	2015	2016	2015	2016	2015
Firms That Also Audited Issuers:						
Broker-dealers that filed a compliance report	74%	79%	22%	25%	68%	71%
Broker-dealers that filed an exemption report	75%	62%	25%	23%	28%	32%
Firms That Did Not Audit Issuers:						
Broker-dealers that filed a compliance report	100%	100%	70%	71%	100%	100%
Broker-dealers that filed an exemption report	100%	95%	60%	51%	66%	71%

In 2016, Inspections staff identified a high percentage of audits, areas, and attestation engagements with deficiencies across firms covered by the inspections but noted that deficiencies were significantly higher at firms that did not audit issuers. The 2016 results are consistent with 2015.

In addition, Inspections staff identified that the percentage of attestation and other deficiencies was higher for examinations of broker-dealers that filed a compliance report compared to reviews of broker-dealers that filed an exemption report at both firms that also audited issuers and those that did not.

[125] The 2015 results in this Exhibit are for 118 audits and related attestation engagements, as two broker-dealers did not did not file either a compliance or an exemption report.

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Comparative Summary of Deficiencies for Firms Inspected in 2016 and in 2015

There were eight firms inspected during 2016 that were also inspected during 2015. The following table presents a comparative summary of deficiencies for these firms by year:

Exhibit 16: Results for Firms Inspected in 2016 and 2015

Inspection Year	Percentage of Audits with Audit and Other Deficiencies	Percentage of Areas with Audit and Other Deficiencies	Percentage of Examinations with Attestation and Other Deficiencies	Percentage of Reviews with Attestation and Other Deficiencies
2016	62%	14%	60%	20%
2015	49%	12%	46%	27%

Inspections staff has identified that the percentage of audits, areas, and examination engagements with deficiencies for firms inspected in 2016 and 2015 increased in 2016 compared to 2015. The percentage of review engagements with deficiencies decreased in 2016 compared to 2015. The individual firm results were generally consistent with the aggregate results for these eight firms.

Firms and Broker-Dealers Selected for Inspection on a Random Basis

During 2016, certain firms inspected, and audits and attestation engagements covered by the inspections, were selected on a random basis.[126] The random selections were made after the selection of firms and broker-dealers that were based on certain risk characteristics. Further, the random firm and random broker-dealer selections were made from a population of broker-dealers that claimed exemption from Rule 15c3-3.

Specifically, 11 audits and related attestation engagements performed by 11 firms were selected randomly from the population of firms and broker-dealer audits that had not previously been selected for inspection under the interim inspection program. Inspections staff identified independence findings in 27 percent of these selections; and deficiencies in 100 percent, 56 percent, and 82 percent of audits, areas, and review engagements, respectively.

In addition, for seven firms where one or more of the firms' audits were covered by the 2016 inspections, one additional audit and related review engagement was selected on a random basis from the population of broker-dealer engagements that had not previously been inspected under the interim inspection program. Inspections staff identified no independence findings in these selections; and deficiencies in 43 percent

[126] The number of random selections are not sufficient to generalize the results to the related populations of firms or engagements.

and 15 percent of audits and areas, respectively. There were no deficiencies identified in the review engagements.

Future Inspections

The Board will continue to conduct inspections of firms that perform audit and attestation engagements for broker-dealers under the interim inspection program until rules for a permanent inspection program take effect. There were 478 firms that issued audit reports on the financial statements of 3,728 broker-dealers[127] that were filed for fiscal periods ended during 2016.

Exhibit 17

Number of Broker-Dealer Audits per Firm	Number of Firms[128]	Percentage of Firms
1	155	32%
2 to 20	286	60%
21 to 50	23	5%
51 to 100	9	2%
More than 100	5	1%
Total	478	100%

During 2017, the Board plans to perform inspections of 75 firms covering portions of approximately 115 audits and the related attestation engagements. The firms to be inspected and the audit and attestation engagements to be covered during the inspections are being selected based on characteristics of the firms and the broker-dealers taking into consideration the related risks. In addition, a portion of the firms and audits are being selected randomly.

Permanent Inspection Program

The Board is continuing to take a careful and informed approach in establishing a permanent inspection program recognizing the complexity and diversity of the broker-dealers. The Board continues to consider the risk of loss to customers and whether this risk can be assessed from attributes that characterize broker-dealers in an effort to

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[127] This information is based on the number of broker-dealers who filed financial statements through May 15, 2017, for fiscal years ended during 2016, that included audit reports issued by firms registered with the PCAOB.

[128] Information about the number of firms that audited broker-dealers and their broker-dealer audits is based on financial statements filed through May 15, 2017, for fiscal years ended during 2016. These firms were registered with the PCAOB at the time the audit reports were issued.

provide for differentiation of a class of broker-dealers. The Board is also considering the high number of independence findings and audit, attestation, and other deficiencies that have been identified during the inspections under the interim inspection program. The PCAOB staff will continue to work to further develop the contours of a potential rule proposal for the Board to consider for a permanent inspection program.

Actions Needed by Firms

In light of the nature and number of independence findings and audit, attestation, and other deficiencies across the firms and the audit and attestation engagements covered by the inspections, all firms that perform audit and attestation engagements for broker-dealers should:

- Ensure they have taken measures to comply with independence requirements for the audit and attestation engagements they perform;[129]
- Undertake only those broker-dealer audit and attestation engagements that the firm can reasonably expect to complete with professional competence;
- Consider whether the audit, attestation, and other deficiencies described in this report might be present in their current audit and attestation engagements and take appropriate preventative or corrective action;[130]
- Maintain policies and procedures that provide reasonable assurance that the work performed by engagement personnel meets applicable PCAOB standards and regulatory requirements when conducting broker-dealer audit and attestation engagements;

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[129] Firms should review the SEC's independence requirements and consider if the services performed for broker-dealer audit and attestation clients violate the applicable requirements. Firms should also make certain to have in place a system of quality control that is designed to provide reasonable assurance of compliance with the requirements and provide guidance and training to firm personnel. When necessary, firms should seek guidance and clarification from the SEC. The SEC encourages auditors to consult with its Office of the Chief Accountant (the "OCA"). Guidance on consulting with the OCA is available at: http://www.sec.gov/info/accountants/ocasubguidance.htm.

[130] When deficiencies related to an audit are identified, firms should take appropriate action to assess the importance of the deficiencies to the firm's present ability to support its previously expressed audit opinions. See AS 2901 (historically AU sec. 390), *Consideration of Omitted Procedures After the Report Date*, and AS 2905 (historically AU sec. 561), *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.*

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- Ensure that all audits and the related attestation engagements have an engagement quality review performed, that the review is performed by a qualified individual at the firm or outside the firm, and that the review is performed in accordance with AS 1220;

- Give attention to the importance of effective practice monitoring, including performing effective analyses of the root causes of these matters;[131] and

- Provide appropriate guidance and training to firm personnel and evaluate the appropriateness of the firm's policies on supervision, including review, so that partners and supervisory personnel are placing appropriate attention on these matters.[132]

Firms should be aware that information obtained through the interim inspection program may lead the Board to commence an investigation or disciplinary proceeding concerning the conduct of a firm or associated persons of such firms, and the Board has done so in some instances.[133] In addition, when it comes to the Board's attention that the financial statements of a broker-dealer appear not to present fairly, in all material respects, the financial position, results of operations, or cash flows of the broker-dealer in conformity with GAAP, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting over the financial statements of broker-dealers. Similarly, information related to possible violations of laws or rules, including independence rules, by broker-dealers may be, and have been, reported to the SEC and to FINRA when the broker-dealer is a member of FINRA.

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[131] PCAOB Quality Control Standards can be found at: http://pcaobus.org/Standards/QC/Pages/default.aspx.

[132] Firms are encouraged to review the *Staff Guidance for Auditors of SEC-Registered Brokers and Dealers* issued on June 26, 2014, as well as the practice alerts issued by the PCAOB staff related to areas such as auditing revenue and maintaining and applying professional skepticism. Firms are also encouraged to attend the Board's periodic Forums for Auditors of Broker-Dealers and PCAOB staff webinars or review the materials from these events archived on the Board's website. Firms should direct any inquiries regarding the standards to the PCAOB at: http://pcaobus.org/About/Pages/ContactUsWebForm.aspx.

[133] The disciplinary process carries the prospect of a range of sanctions, including significant money penalties and the possible suspension or revocation of registration.

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Appendix A

Firms That Perform Audit and Attestation Engagements and the Selection of Firms and Audit and Attestation Engagements for Inspection

Firms that Perform Audit and Attestation Engagements of Broker-Dealers

For fiscal periods ended during the period from July 1, 2015 through June 30, 2016, there were 531 firms that issued audit reports on the financial statements and other information required by Rule 17a-5 of broker-dealers that were filed with the SEC. Many of the firms performed audits for as few as one broker-dealer, while several firms performed audits for more than 100 broker-dealers.

Number of Broker-Dealer Audits per Firm	Number of Firms[134]	Percentage of Firms
1	188	35%
2 to 20	306	58%
21 to 50	23	4%
51 to 100	9	2%
More than 100	5	1%
Total	531	100%

[134] Information about the number of firms that performed audit and attestation engagements for broker-dealers and their engagements is based on financial statements filed through May 15, 2017, for fiscal years ended during the period from July 1, 2015 through June 30, 2016. These firms were registered with the PCAOB at the time their audit and attestation reports were issued.

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There were 3,933 broker-dealers that filed audited annual financial statements with the SEC for fiscal years ended during the period from July 1, 2015 through June 30, 2016. The following table expands on the information above to provide further information on which firms also audited issuers and the number of their broker-dealer audits:[135]

Number of Broker-Dealer Audits per Firm	Also Audited Issuers		Did Not Audit Issuers	
	Number of Firms	Number of Broker-Dealers	Number of Firms	Number of Broker-Dealers
1	51	51	137	137
2 to 20	135	766	171	825
21 to 50	13	412	10	341
51 to 100	4	311	5	342
More than 100	4	627	1	121
Total	207	2,167	324	1,766

<u>Selection of Firms and Audit and Attestation Engagements During 2016</u>

The following tables present the number of firms inspected and the number of audits covered by the inspections by the number of broker-dealer audits per firm as determined at the time of the inspection, whether or not the firms also audited issuers, and whether the firms audited broker-dealers that filed a compliance report or only audited broker-dealers that filed an exemption report:

Number of Broker-Dealer Audits per Firm	Number of Firms Inspected	Number of Audits Covered
1	15	15
2 to 20	43	43
21 to 50	7	9
51 to 100	5	10
More than 100	5	38
Total	75	115

[135] Information about the firms that audited issuers is derived from data on audit reports issued from April 1, 2015 through March 31, 2016 obtained from the firms' annual reports on Form 2. PCAOB Rule 2201 requires each firm to file an annual report on Form 2 by June 30 of each year. The report covers the twelve-month period ending March 31. Information about the number of firms that performed audit and attestation engagements for broker-dealers and the number of these engagements is based on financial statements filed through May 15, 2017, for fiscal years ended during the period from July 1, 2015 through June 30, 2016. These firms were registered with the PCAOB at the time their audit and attestation reports were issued.

Firms	Number of Firms Inspected	Number of Audits Covered
Also audited issuers	38	76
Did not audit issuers	37	39
Total	75	115

Firms	Number of Firms Inspected	Number of Audits Covered
Audited broker-dealers that filed compliance reports	18	56
Only audited broker-dealers that filed exemption reports	57	59
Total	75	115

At the time of the inspections, 38 of the 75 firms also audited issuers. Of these 38, four firms selected for inspection audited more than 100 issuers and 34 firms selected for inspection audited 100 or fewer issuers. The remaining 37 firms did not audit issuers and were not subject to inspection other than under the interim inspection program.

The following tables present the amounts or ranges of minimum net capital requirements and actual net capital reported for the broker-dealers that filed either a compliance report or an exemption report, stratified by the type of report filed and whether the broker-dealer did or did not claim exemption from Rule 15c3-3:

Broker-Dealer Filed	Number of Attestations	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End[136]
Compliance Report	20	$100,000 - $1,500,000,000	$300,000 - $8,000,000,000
Exemption Report	95[137]	$5,000 - $2,400,000	$6,000 - $300,000,000

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136 Excluded from the range of actual net capital reported at fiscal year-end in this table and the following table is one instance of reported negative net capital.

137 The number of audits includes the audit of one broker-dealer that did not claim exemption from Rule 15c3-3 but filed an exemption report. See footnote 74 to SEC Release 34-70073 (July 30, 2013).

Broker-Dealer	Number of Audits	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End
Did not claim exemption	21[138]	$100,000 - $1,500,000,000	$300,000 - $8,000,000,000
Claimed exemption	94	$5,000 - $2,400,000	$6,000 - $300,000,000

<u>Selection of Firms and Audit and Attestation Engagements Since Inception</u>

The following tables present the number of firms inspected, the number of audits covered by the inspections, and the number of attestation engagements covered by the inspections by the number of broker-dealer audits per firm as determined at the time of the inspection, whether or not the firms also audited issuers, and whether the firms audited broker-dealers that filed a compliance report or only audited broker-dealers that filed an exemption report since the inception of the interim inspection program:

Number of Broker-Dealer Audits per Firm	Number of Firms Inspected	Number of Audits	Number of Examinations	Number of Reviews
1	51	51	2	22
2 to 20	174	203	16	81
21 to 50	28	82	3	19
51 to 100	13	37	2	17
More than 100	7	141	27	44
Total	264[139]	514	50	183

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[138] <u>Id</u>.

[139] The sum of the number of firms inspected does not add to 273 because nine firms that were inspected more than once are reported in multiple stratifications due to a change in the number of broker-dealer audits performed by the firms.

Firms	Number of Firms Inspected	Number of Audits	Number of Examinations	Number of Reviews
Also audited issuers	100	310	43	107
Did not audit issuers	164	204	7	76
Total	264	514	50	183

The following table presents the number of firms inspected during 2016 and 2015 and five firms inspected during 2014, the number of audits covered by the inspections, and the number of attestation engagements covered by the inspections by whether the firms audited broker-dealers that filed compliance reports or only audited broker-dealers that filed exemption reports:

Firms	Number of Firms Inspected	Number of Audits	Number of Examinations	Number of Reviews
Audited broker-dealers that filed compliance reports	37	120	50	70
Only audited broker-dealers that filed exemption reports	109	114	N/A	113
Total[140]	145[141]	234	50	183

140 One of the firms inspected only audited one broker-dealer and that broker-dealer did not file either a compliance report or an exemption report. The firm and the audit are not included in this table. In addition, another broker-dealer did not file either a compliance or an exemption report.

141 The number of firms inspected does not add to 146 because one firm that was inspected more than once is included in both stratifications.

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The following tables present the amounts or ranges of minimum net capital requirements and actual net capital reported for the broker-dealers that filed either a compliance report or an exemption report, stratified by the type of report filed and whether the broker-dealer did or did not claim exemption from Rule 15c3-3:

Broker-Dealer Filed[142]	Number of Attestation Engagements	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End[143]
Compliance Report	50	$100,000 - $1,500,000,000	$300,000 - $11,000,000,000
Exemption Report	183	$5,000 - $4,000,000	$6,000 - $300,000,000

Broker-Dealer	Number of Audits	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End
Did not claim exemption	118	$100,000 - $2,050,000,000	$300,000 - $16,000,000,000
Claimed exemption[144]	396	$5,000 - $10,000,000	$6,000 - $2,250,000,000

[142] For two of the 235 audits covered by the inspections, the broker-dealers did not file either a compliance report or an exemption report. These two broker-dealers had minimum net capital requirements of $5,000 and $250,000, respectively, and actual net capital reported at year end of approximately $50,000 and $600,000, respectively.

[143] Excluded from the range of actual net capital reported at fiscal year-end in this table and the table that follows are one and two instances of reported negative net capital, respectively.

[144] The number of audits includes the audits of three broker-dealers that claimed exemption from Rule 15c3-3 for certain portions of their business and did not claim exemption for other portions of their business.

Appendix B

Summary of Inspections of Firms Since Inception of the Interim Inspection Program

Since inception of the interim inspection program through December 31, 2016, the Board has performed 334 inspections of 264 firms that conducted audits of broker-dealers.[145] The 334 inspections covered portions of 514 audits, of which 235 were required to be performed in accordance with PCAOB standards and 279 were required to be performed in accordance with GAAS, and 233[146] attestation engagements that were required to be performed in accordance with PCAOB standards. The 514 audits and the 233 attestation engagements had financial statement periods ended December 31, 2010 through June 30, 2016 and June 30, 2014 through June 30, 2016, respectively.

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[145] Thirty-eight of the 264 firms have been inspected more than once. The 334 inspections include the inspection of 10 firms reported in the first annual report, 43 firms reported in the second annual report, 60 firms reported in the third annual report, 66 firms reported in the fourth annual report, five firms reported in the January 28, 2015 supplemental report, 75 firms reported in the fifth annual report, and 75 firms inspected in 2016.

[146] For two of the 235 audits covered by the inspections, the broker-dealers did not file either a compliance report or an exemption report.

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The following tables summarize the independence findings, audit, attestation, and other deficiencies identified from inspections under the interim inspection program through December 31, 2016:

Comparative Summary of Findings and Deficiencies Since Inception

Inspection Year	Percentage of Audits with Independence Findings	Percentage of Audits with Audit and Other Deficiencies[147]	Percentage of Areas with Audit and Other Deficiencies[148]	Percentage of Examinations with Attestation and Other Deficiencies	Percentage of Reviews with Attestation and Other Deficiencies
2016	10%	83%	36%	70%	43%
2015[149]	7%	78%	35%	77%	49%
2014 and prior[150]	25%	87%	37%	N/A	N/A

[147] Audit and other deficiencies presented in this appendix represent the total audit and other deficiencies for the selected areas reported in the body of this report and those audit deficiencies reported within Part I of previous annual reports, under the auditing standards that were applicable at the time of inspection.

[148] Not all areas were included for, or applicable to, each broker-dealer audit included in the inspections.

[149] Included in the 2015 results discussed in this appendix are inspections performed during 2014, of five firms covering portions of five audit and attestation engagements that were required to be performed under PCAOB standards. The results from the inspections of these five firms are not included in the 2015 results presented in this report unless otherwise specified.

[150] All references to "2014 and prior" included in this appendix refer to the cumulative results for 2011, 2012, 2013, and 2014.

Comparison of Audit and Other Deficiencies Related to the Audit Since Inception

Deficiencies	Percentage of Applicable Audits with Deficiencies		
	2016	2015	2014 and Prior
Audit Deficiencies Related to the Financial Statements			
Revenue	66%	71%	67%
Financial Statement Presentation and Disclosures	39%	38%	39%
Related Party Transactions	33%	32%	26%
Risks of Material Misstatement Due to Fraud	57%	44%	47%
Fair Value Measurements	24%	44%	36%
Receivables and Payables	25%	23%	19%
Audit Deficiencies Related to the Supporting Schedules			
Net Capital Rule	27%	29%	37%
Customer Protection Rule	52%	52%	33%
Other Deficiencies Related to the Audit			
Reporting on the Financial Statements and Supporting Schedules	13%	8%	14%
Audit Documentation	28%	27%	N/A
Engagement Quality Review	57%	58%	N/A
Deficiencies in Independence Communications to the Audit Committee			
Independence Communications to the Audit Committee (or equivalent)	19%	10%	N/A

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Comparison of Attestation and Other Deficiencies Related to the Attestation Engagement Since Inception

Deficiencies	Percentage of Applicable Attestation Engagements with Deficiencies		
	2016	2015	2014 and Prior
Attestation Deficiencies			
Examination Procedures	70%	77%	N/A
Review Procedures	28%	34%	N/A
Other Deficiencies Related to Examination Engagements			
Examination Report	10%	13%	N/A
Examination Documentation	5%	13%	N/A
Engagement Quality Review	20%	50%	N/A
Other Deficiencies Related to Review Engagements			
Review Report	14%	16%	N/A
Review Documentation	21%	18%	N/A
Engagement Quality Review	26%	35%	N/A

The remainder of this section presents cumulative audit, attestation, and other deficiencies from inspections since inception of the interim inspection program stratified by certain firm or broker-dealer characteristics.

Number of Broker-Dealer Audits per Firm

Number of Broker-Dealer Audits per Firm	Percentage of Audits with Audit and Other Deficiencies	Percentage of Areas with Audit and Other Deficiencies	Percentage of Examinations with Attestation and Other Deficiencies	Percentage of Reviews with Attestation and Other Deficiencies
1	98%	53%	100%	77%
2 to 20	95%	45%	100%	56%
21 to 50	87%	40%	100%	37%
51 to 100	92%	41%	100%	24%
More than 100	60%	16%	52%	25%

Firms that Also Audited Issuers and Firms that Did Not Audit Issuers

Firms	Percentage of Audits with Audit and Other Deficiencies	Percentage of Areas with Audit and Other Deficiencies	Percentage of Examinations with Attestation and Other Deficiencies	Percentage of Reviews with Attestation and Other Deficiencies
Also audited issuers	75%	27%	70%	30%
Did not audit issuers	97%	51%	100%	68%

Percentage of Audits with Audit, Attestation, and Other Deficiencies Stratified by whether the Broker-Dealer Claimed or Did Not Claim Exemption from Rule 15c3-3

Broker-Dealer	Percentage of Audits with Audit and Other Deficiencies	Percentage of Areas with Audit and Other Deficiencies	Percentage of Examinations with Attestation and Other Deficiencies	Percentage of Reviews with Attestation and Other Deficiencies
Did not claim exemption	78%	30%	74%	50%[151]
Claimed exemption	86%	39%	N/A	46%

151 Four broker-dealers that did not claim exemption from Rule 15c3-3 filed an exemption report.

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Percentage of Audits with Audit, Attestation, and Other Deficiencies Stratified by Reported Actual Net Capital by Broker-Dealers

Reported Actual Net Capital	Number of Broker-Dealers	Percentage of Audits with Audit and Other Deficiencies			Number of Broker-Dealers	Percentage of Attestations with Attestation and Other Deficiencies		
		2016	2015	2014 and Prior		2016	2015	2014 and Prior
Less than $100,000	61	87%	83%	90%	20	73%	60%	N/A
$100,000 to $2,000,000	187	90%	94%	93%	90	46%	71%	N/A
$2,000,001 to $15,000,000	140	78%	69%	92%	62	33%	43%	N/A
$15,000,001 to $100,000,000	79	75%	68%	81%	42	40%	45%	N/A
$100,000,001 to $16,000,000,000	47	83%	43%	54%	19	67%	43%	N/A

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Percentage of Audits with Audit, Attestation, and Other Deficiencies Stratified by Reported Revenues by Broker-Dealers

Reported Revenues	Number of Broker-Dealers	Percentage of Audits with Audit and Other Deficiencies			Number of Broker-Dealers	Percentage of Attestations with Attestation and Other Deficiencies		
		2016	2015	2014 and Prior		2016	2015	2014 and Prior
Less than $1,000,000	82	88%	80%	91%	38	50%	71%	N/A
$1,000,000 to $5,000,000	96	94%	96%	92%	46	56%	68%	N/A
$5,000,001 to $15,000,000	105	100%	83%	91%	47	50%	55%	N/A
$15,000,001 to $50,000,000	101	77%	63%	93%	41	41%	53%	N/A
$50,000,001 to $125,000,000	53	73%	69%	79%	24	45%	46%	N/A
$125,000,001 to $500,000,000	52	72%	56%	72%	27	39%	33%	N/A
Greater than $500 Million	25	50%	67%	53%	10	75%	33%	N/A

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Percentage of Audits with Audit, Attestation, and Other Deficiencies Stratified by Reported Assets by Broker-Dealers

Reported Assets	Number of Broker-Dealers	Percentage of Audits with Audit and Other Deficiencies			Number of Broker-Dealers	Percentage of Attestations with Attestation and Other Deficiencies		
		2016	2015	2014 and Prior		2016	2015	2014 and Prior
Less than $250,000	56	88%	80%	91%	20	56%	50%	N/A
$250,000 to $1,000,000	67	100%	100%	89%	31	63%	93%	N/A
$1,000,001 to $5,000,000	111	85%	87%	92%	57	44%	60%	N/A
$5,000,001 to $15,000,000	77	90%	90%	96%	31	30%	57%	N/A
$15,000,001 to $50,000,000	75	75%	57%	93%	33	42%	38%	N/A
$50,000,001 to $500,000,000	79	78%	60%	76%	38	39%	40%	N/A
Greater than $500 Million	49	64%	67%	58%	23	64%	50%	N/A

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Appendix C

References to Certain Releases for Standards and Rules Related to Broker-Dealers and Their Auditors

Audits and attestation engagements of broker-dealers with fiscal years ended on or after June 1, 2014 are required to be performed in accordance with PCAOB standards. The following table provides a list of PCAOB releases and guidance that describe requirements applicable to audits of broker-dealers.

Title or Reference	Release Date	Release and Link
Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards	October 10, 2013	See PCAOB Release No. 2013-007 http://pcaobus.org/Rules/Rulemaking/Pages/Docket035.aspx
Auditing Standard No. 17 Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards	October 10, 2013	See PCAOB Release No. 2013-008 http://pcaobus.org/Rules/Rulemaking/Pages/Docket036.aspx
Amendments to Conform PCAOB Rules and Forms to the Dodd-Frank Act and Make Certain Updates and Clarifications	December 4, 2013	See PCAOB Release No. 2013-010 http://pcaobus.org/Rules/Rulemaking/Pages/Docket039.aspx
Staff Guidance for Auditors of SEC-Registered Brokers and Dealers	June 26, 2014	http://pcaobus.org/News/Releases/Pages/06262014_Staff_Guidance.aspx
PCAOB Staff Inspection Brief Vol. 2017/1	June 28, 2017	http://pcaobus.org/News/Releases/Pages/inspection-brief-2016-broker-dealer-preview-6-28-17.aspx
PCAOB Staff Inspection Brief Vol. 2017/2	June 29, 2017	http://pcaobus.org/News/Releases/Pages/inspection-brief-2017-broker-dealer-scope-6-29-17.aspx

RELEASE

Staff Audit Practice Alerts Staff Questions and Answers Auditing Interpretations	N/A	http://pcaobus.org/Standards/Pages/Guidance.aspx
Materials from the Board's Forums for Auditors of Broker-Dealers	N/A	http://pcaobus.org/Featured/Pages/ForumArchive.aspx
Materials from PCAOB Staff Webinars	N/A	http://pcaobus.org/News/Pages/forums-public-outreach.aspx

The following table lists SEC releases and staff guidance that describe the amendments to the reporting requirements for broker-dealers under Rule 17a-5 and the SEC's financial responsibility rules, including Rules 15c3-1 and 15c3-3.

Title	Release Date	Release and Link
Broker-Dealer Reports	July 30, 2013	See Exchange Act Release No. 34-70073 http://www.sec.gov/rules/final/finalarchive/finalarchive2013.shtml
Financial Responsibility Rules for Broker-Dealers	July 30, 2013	See Exchange Act Release No. 34-70072 http://www.sec.gov/rules/final/finalarchive/finalarchive2013.shtml
Frequently Asked Questions Concerning the Amendments to Certain Broker-Dealer Financial Responsibility Rules	March 6, 2014	http://www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-financial-responsibility-rule-faq.htm
Frequently Asked Questions Concerning the July 30, 2013 Amendments to the Broker-Dealer Financial Reporting Rule	April 4, 2014	http://www.sec.gov/divisions/marketreg/amendments-to-broker-dealer-reporting-rule-faq.htm