PCAOB
Public Company Accounting Oversight Board

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

PCAOB Release No. 2016-004
August 18, 2016

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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 its interim inspection program for auditors of brokers and dealers registered with the Securities and Exchange Commission ("SEC" or the "Commission").

This report:

- Provides information about registered public accounting firms and the audits and the related attestation engagements covered by the inspections during 2015 and describes independence findings and deficiencies observed from these inspections;

- Provides a summary of firms and engagements inspected pursuant to the interim inspection program since its inception in 2011 through December 31, 2015, and a summary of the inspection results; and

- Describes actions needed by firms and next steps of the interim inspection program.

Inspections of Firms During 2015

During 2015, the Board inspected 75 firms covering portions of 115 audits and 114 related attestation engagements, as one broker did not file either a compliance or exemption report. The attestation engagements comprised 27 related to compliance reports and 87 related to exemption reports. This was the first annual cycle in which all audits and related attestation engagements were required to be performed in accordance with PCAOB standards and amended Exchange Act Rule 17a-5 and the first annual cycle in which the new attestation engagements were included in the inspections.

Independence findings were identified in eight audits representing seven percent of the audits covered by the inspections in 2015 compared to 25 percent of the audits covered by the inspections in this area in 2014. Inspections staff continued to observe instances in which auditors were involved in the preparation of the financial statements or performed bookkeeping or other prohibited services. Of the eight audits with independence findings in 2015, six were conducted by firms that did not audit issuers.

The percentage of deficiencies in the audits covered by the inspections in 2015 continued to occur at a high level – 77 percent, although this was lower than the 87 percent in 2014. In addition, deficiencies were identified in 55 percent of the attestation engagements in 2015. Further results of the inspections during 2015 include:

<u>Deficiencies at the firms inspected:</u>

- In the audits at 72 of the 75 firms; and
- In the attestation engagements at 54 of the 74 applicable firms.

<u>Deficiencies in the audits:</u>

- Auditing revenue in 70 percent of the audits;
- Auditing related party transactions in 32 percent of the applicable audits in 2015 compared to 21 percent in 2014;
- Auditing related to the Net Capital Rule in 30 percent of the audits in 2015, including a high number of deficiencies related to auditing the securities haircuts component of the net capital computation; and
- Auditing related to the Customer Protection Rule in 53 percent of the applicable audits in 2015 compared to 43 percent in 2014.

<u>Deficiencies in the attestation engagements:</u>

- In 78 percent of the examinations of a broker's or dealer's compliance report; and
- In 34 percent of the reviews of a broker's or dealer's exemption report.

<u>Deficiencies in the required engagement quality reviews:</u>

- In 57 percent of the audits;
- In 48 percent and 34 percent of the attestation engagements related to the compliance and exemption reports, respectively; and
- For seven audits and seven attestation engagements, no engagement quality review was performed.

Many deficiencies were observed in financial statement audit areas similar to prior years. In addition, many deficiencies also related to new standards or standards that were new for the auditor.

Summary of Inspections Since Inception of the Interim Inspection Program

Since inception of the interim inspection program in 2011 through December 31, 2015, the Board has performed 259 inspections of 210 firms that conducted audits of brokers and dealers. These inspections covered portions of 399 audit engagements and 118 attestation engagements.

For reasons discussed later in this report, the independence findings and deficiencies discussed in this report are not necessarily indicative of the full population of audit firms or the audits and related attestation engagements of brokers and 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 brokers and dealers, compared to those that performed audits for 100 or fewer brokers and dealers.

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

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

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

Actions Needed by Firms

The Board continues to be concerned by the nature and consistently high number of deficiencies across the firms and the audits covered by the inspections. Many of these deficiencies continue to be similar in nature to those described in previous reports and relate to the fundamentals of auditing that are not necessarily dependent on whether the audit was performed under generally accepted auditing standards ("GAAS") or PCAOB standards. Many of the inspected firms need to significantly improve their audit work to meet the requirements of the professional standards and SEC and PCAOB rules. The Board is also concerned by the nature and number of deficiencies in the attestation engagements across the firms inspected.

All firms that perform audits for brokers and dealers should read this report in its entirety and consider whether the independence findings and deficiencies in the audits and the related attestation engagements described in this report might be present in the engagements they currently perform, and take the appropriate preventive or corrective actions. The Board urges firms that perform audit and attestation engagements for brokers and dealers to give careful consideration to their approaches to these engagements.

The Board encourages firms that audit brokers and dealers 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. The Board also encourages partners and staff of firms to attend the Board's Forums for Auditors of Broker-Dealers and PCAOB staff webinars or review the materials from these events archived on the Board's website. Information, including links to more information or the full documents, can be found in Appendix C.

In addition to the actions needed by firms, management and audit committees (or equivalent) of brokers and dealers may want to consider inquiring of their auditor about how the areas described in this report are being addressed in their audits and related attestation engagements and also take steps to ensure that independence violations are avoided.

Next Steps of the Interim Inspection Program

The Board will continue to conduct inspections of firms that perform audits and related attestation engagements for brokers and dealers under the interim inspection program until rules for a permanent inspection program take effect. During 2016, Inspections staff will focus on, among other matters, independence, financial statement audit areas where deficiencies have been identified in past inspections, attestation engagements, and audit procedures related to newly applicable PCAOB standards.

The PCAOB staff is currently working to develop a rule proposal for the Board to consider during 2016 to establish a permanent inspection program, which will address, among other things, the scope of such a program, including whether to exempt any category of firm from any such inspection program.

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Background

The PCAOB is issuing this annual report on the progress of its interim inspection program[1] for auditors of brokers and dealers[2] registered with the SEC.[3] This report describes independence findings and deficiencies in the audit and attestation engagements identified in inspections performed during 2015 that covered audit and attestation engagements required to be performed under PCAOB standards.[4]

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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 brokers and 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 terms "broker(s) and dealer(s)" or "broker(s) or dealer(s)" refers to brokers and dealers registered with the SEC.

[3] The Board issued annual reports on its interim inspection program on August 20, 2012, August 19, 2013, August 18, 2014, and August 18, 2015, as well as a report on January 28, 2015 regarding inspections during 2014 of five firms and five audit and attestation engagements that were required to be conducted in accordance with PCAOB standards, all of which are available on the PCAOB website at: http://pcaobus.org/Inspections/Pages/PublicReports.aspx.

[4] On July 30, 2013, the SEC adopted amendments to its net capital, customer protection, books and records, and notification rules for brokers and dealers under the Securities Exchange Act of 1934 ("Exchange Act"), see Exchange Act Release No. 70072 (July 30, 2013), and adopted amendments to Rule 17a-5 (see Rule 17a-5) and Exchange Act Rule 17a-11 (see Rule 17a-11), see Exchange Act Release No. 70073 (July 30, 2013). Among other things, the amendments to Rule 17a-5 require that audits of brokers and dealers be performed in accordance with PCAOB standards, effective beginning with audits for fiscal years ended on or after June 1, 2014. Refer to Appendix C for references to certain releases issued by the SEC or PCAOB related to standards and rules for brokers and dealers and their auditors. Refer also to Appendix D for references from certain PCAOB standards to previously applicable GAAS.

RELEASE

Under the interim inspection program, the Board conducts inspections of registered public accounting firms[5] in connection with their performance of audit and attestation engagements, their issuance of reports on these engagements, and related matters involving brokers and 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 "Act").

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 brokers and dealers, whether to exempt any categories of firms, and the establishment of inspection schedules.

This report contains three parts:

- Part I provides information about the audit and attestation engagements covered by the inspections during 2015 and describes independence findings and audit, attestation, and other deficiencies observed from the inspections of 75 firms covering portions of 115 audits and the related attestation engagements;[6]

- Part II provides a summary of firms and engagements inspected pursuant to the interim inspection program since its inception in 2011 through December 31, 2015, and a summary of the inspection results; and

- Part III describes actions needed by firms and the next steps of the interim inspection program.

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 selection of firms for inspection took into consideration the number of broker or dealer audits performed by the firms, whether they also issued audit reports for issuers, risk characteristics based on previous inspection results, as well as other risk characteristics, to obtain a cross section of firms that perform audit and attestation engagements of brokers and dealers and of the brokers and dealers.

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

[6] The registered independent public accountant engaged by a broker or dealer to perform the audit of the broker's or dealer's financial statements must also perform attestation procedures on the compliance or exemption report filed by the broker or dealer. See Rule 17a-5(f)(2)(ii)(E) and Rule 17a-5(g).

RELEASE

The selection of firms for inspection and the audit and attestation engagements for brokers and dealers covered by the inspections is not necessarily representative of the population of firms or of audit and attestation engagements of brokers and dealers. Further, the populations of firms and brokers and 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 brokers and dealers. For these reasons, information presented within this report cannot support a conclusion that audit quality has improved or deteriorated.

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

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Part I: Inspections of Firms During 2015

For the audit and attestation engagements covered by the inspections discussed in this report, Rule 17a-5 generally required brokers and dealers to file with the SEC and other regulators, among other things: (1) annual financial statements; (2) supporting schedules related to the computation of net capital and the customer reserve requirement; and (3) either a compliance report containing statements concerning compliance and internal control over compliance with the financial responsibility rules,[7] or an exemption report containing, among others, a statement that the broker or dealer was exempt from the Customer Protection Rule throughout its fiscal year.[8]

This section of the report primarily describes the independence findings and deficiencies identified from inspections during 2015 of 75 firms and portions of 115 audits and the related attestation engagements that had financial statement periods ended on September 30, 2014 through June 30, 2015 and were required to be performed in accordance with PCAOB standards.

Appendix A includes information regarding firms that perform audit and attestation engagements of brokers and dealers, and the selection of firms and audit and attestation engagements covered by the inspections during 2015, which provides context for this section of the report.

The inspections performed during 2015 focused on portions of 115 audits and the related attestation engagements performed pursuant to Rule 17a-5 with respect to independence, audit procedures on portions of the financial statements and related supporting schedules, and attestation procedures pursuant to PCAOB standards. These inspections assessed firms' compliance with PCAOB standards, including Auditing Standard ("AS") 1220 (currently AS No. 7), *Engagement Quality Review,*[9] AS 2701 (currently AS No. 17), *Auditing Supplemental Information Accompanying Audited Financial Statements,* Attestation Standard No. 1, *Examination Engagements*

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[7] As in the SEC release adopting amendments to Rule 17a-5, the term "financial responsibility rules" is used in this report to refer to Exchange Act Rule 15c3-1 (also referred to as the “Net Capital Rule”), Exchange Act Rule 15c3-3 (also referred to as the “Customer Protection Rule”), and Exchange Act Rule 17a-13, and any rule of a designated examining authority that requires the broker or dealer to periodically send account statements to customers.

[8] See Rule 17a-5(d).

[9] On March 31, 2015, the PCAOB adopted amendments that reorganize and renumber its auditing standards, effective December 31, 2016. (See PCAOB Release No. 2015-002.) The new numbering may also be used in advance of that date. This report uses the prospective numbering with the current number indicated parenthetically the first time a standard is cited.

Regarding Compliance Reports of Brokers and Dealers ("AT No. 1"), and Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers* ("AT No. 2").

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

Independence Findings	2015			2014
	Number of Audits with Findings	Number of Applicable Audits	Percentage of Audits with Findings	Percentage of Audits with Findings
Failure to Satisfy Auditor Independence Requirements	8	115	7%	25%

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Audit and Other Deficiencies	Exhibit	2015			2014
		Number of Audits with Deficiencies	Number of Applicable Audits[10]	Percentage of Audits with Deficiencies	Percentage of Audits with Deficiencies[11]
Audit Deficiencies Related to the Financial Statements					
Revenue	1	80	115	70%	72%
Financial Statement Presentation and Disclosures	2	43	115	37%	44%
Related Party Transactions	3	27	85	32%	21%
Risks of Material Misstatement Due to Fraud	4	24	57	42%	42%
Fair Value Measurements	5	19	43	44%	44%
Receivables and Payables	6	14	67	21%	19%
Audit Deficiencies Related to the Supporting Schedules					
Net Capital Rule	7	34	115	30%	39%
Customer Protection Rule	8	16	30	53%	43%
Other Deficiencies Related to the Audit					
Reporting on the Financial Statements and Supporting Schedules	9	9	115	8%	8%
Audit Documentation	10	30	115	26%	N/A
Engagement Quality Review	11	66	115	57%	N/A
Deficiencies in Audit Committee Communications					
Independence Communications to the Audit Committee (or equivalent)[12]	N/A	12	115	10%	N/A

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

[11] Certain areas are not applicable for 2014 due to the fact that the requirements of the auditors under PCAOB standards and rules were new or not a focus of the inspections in 2014.

[12] The term "audit committee" is defined in AS 1301 (currently AS No. 16), *Communications with Audit Committees*, as "a committee (or equivalent body) established by and among the board of directors of a company for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company; if no such committee exists with respect to the company, the entire board of directors of the company." If no such committee or board of directors (or equivalent body) exists with respect to the company, then the term applies to the person(s) who oversee the accounting and financial reporting process of the company and audits of the financial statements of the company.

Attestation and Other Deficiencies	Exhibit	2015		
		Number of Attestation Engagements with Deficiencies	Number of Applicable Attestation Engagements	Percentage with Deficiencies
Attestation Deficiencies				
Examination Procedures	12	21	27	78%
Review Procedures	13	30	87	34%
Other Deficiencies Related to Examination Engagements				
Examination Report	N/A	3	27	11%
Examination Documentation	14	3	27	11%
Engagement Quality Review	15	13	27	48%
Other Deficiencies Related to Review Engagements				
Review Report	16	13	87	15%
Review Documentation	17	15	87	17%
Engagement Quality Review	18	30	87	34%

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's or dealer's financial statements or supporting schedules are materially misstated or that there are undisclosed material weaknesses in internal control. Conclusions regarding these situations are often not possible for Inspections staff to reach based only on the information available from the auditors.[13]

Attestation deficiencies are failures by firms to perform, or sufficiently perform, certain required attestation procedures and do not necessarily indicate that the broker's or 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 or dealer is in violation of the Net Capital Rule or the reserve requirements rule.[14] Conclusions regarding these situations are often not possible for Inspections staff to reach based only on the information available from the auditors.

[13] Refer to Part III of this report for additional information regarding an auditor's responsibilities when audit deficiencies are identified.

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

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 2015 included the following:

- One or more audit or other deficiencies were identified at 72 of the 75 firms inspected and in 89 of the 115 audits covered by the inspections, or 77 percent;

- The 26 audits with no observed audit or other deficiencies were performed by 11 firms, of which nine also audited issuers. For eight of these 11 firms, more than one of the firms' audits were covered in the inspection and Inspections staff identified audit or other deficiencies in the other audits;

- One or more attestation or other deficiencies were identified at 54 of the 74 firms where the brokers or dealers for the selected engagements filed a compliance or an exemption report and in 63 of the 114 attestation engagements covered by the inspections, or 55 percent;

- The 51 attestation engagements with no observed attestation or other deficiencies were performed by 29 firms, of which 18 also audited issuers. For 11 of these 29 firms, more than one of the firms' other attestation engagements were covered in the inspection and Inspections staff identified attestation or other deficiencies in the other attestation engagements for nine of these 11 firms; and

- Two firms were inspected that did not have any deficiency identified in either the audit or attestation engagement inspected, for all of the firms' audit and attestation engagements covered by the inspections. One of these firms also audited issuers and the other firm did not audit issuers.

In addition, for one firm inspected, which did not audit issuers, Inspections staff found that the firm did not perform any substantive or control tests related to the broker's accounting records, or any attestation procedures, but issued unqualified reports on the broker's financial statements and the broker's exemption report. In addition, the firm did not prepare or maintain audit documentation for these engagements. The resulting deficiencies are reflected in the applicable categories shown in the table above and in the information presented for the applicable categories throughout this report.

Failure to Satisfy Auditor Independence Requirements

SEC rules require auditors of brokers and dealers to comply with SEC independence requirements.[15] SEC rules provide, among other things, that an accountant is not independent if the accountant provides bookkeeping or other services related to the accounting records or financial statements of the audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures performed by the accountant during an audit of the client's financial statements.[16]

Inspections staff identified independence findings in eight of 115, or seven percent, of the audits covered by the inspections. The 2015 results represent a decrease from the 25 percent of audits with independence findings in 2014.

The eight audits with independence findings in 2015 were performed by eight firms, of which six did not audit issuers and two firms that audited 100 or fewer issuers. Inspections staff observed in these eight audits that the firms performed bookkeeping or other services related to the accounting records or financial statements of the broker or dealer, including, in some instances, the preparation of journal entries or source data underlying the financial statements, each of which is prohibited under the SEC independence rules (refer to Part III of this report for information regarding the Board's settled disciplinary orders against firms for violating these rules). Inspections staff also observed in two of the eight attestation engagements that firms assisted the brokers or dealers in the preparation of their exemption reports.

Audit Deficiencies Related to the Financial Statements

Auditing Revenue

Brokers and dealers may generate revenue from a variety of securities-related lines of business. When testing revenue, the auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion.[17]

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[15] Rule 17a-5(f)(1) provides that the auditor must be independent in accordance with Rule 2-01 of SEC Regulation S-X. This requirement has been articulated in Rule 17a-5(f) since 1972.

[16] Rule 2-01(c)(4)(i) of Regulation S-X.

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

Inspections staff identified audit deficiencies related to auditing revenue in 80 of 115, or 70 percent, of the audits covered by the inspections, which is slightly lower than the 72 percent of audits with deficiencies identified in this area in 2014. In 56 of the 80 audits with deficiencies in 2015, Inspections staff identified deficiencies in more than one of the categories set forth in the exhibit below:

Exhibit 1: Deficiencies Related to Auditing Revenue

Deficiencies Related to Auditing Revenue:	Number of Audits
Risk assessment	11
Extent of testing	42
Substantive analytical procedures	20
Auditing information produced by service organizations	45
Auditing information produced by the broker or dealer	17
Other procedures to test revenue	52

Risk Assessment

AS 2110 (currently 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.[18]

Inspections staff observed in 11 audits that firms did not perform, or sufficiently perform, risk assessment procedures for revenue, which contributed to deficiencies, such as those discussed below, in these firms' revenue testing procedures. For example, in certain of these audits, Inspections staff observed that the firms did not obtain a sufficient understanding of the aspects of internal control over financial reporting relevant to revenue, including evaluating the design of the controls intended to address fraud risks.[19]

Extent of Testing

Inspections staff observed that in 42 audits, the extent of testing was insufficient for material classes of revenue transactions, including commission revenue, trading gains and losses, and advisory fees. For example, Inspections staff observed instances where firms: (a) did not perform any procedures to test material classes of revenue transactions; (b) did not sufficiently test controls to support their reliance on controls to

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[18] AS 2110.04.

[19] See AS 2110.18 through .40.

reduce their substantive testing;[20] or (c) did not appropriately design and perform sampling procedures to test revenue transactions in accordance with AS 2315 (currently 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 would provide a sample that was representative of the population being tested (for example, firms limited their sample selections to certain time periods or transaction amounts).

Substantive Analytical Procedures

AS 2305 (currently AU sec. 329), *Substantive Analytical Procedures*, establishes requirements for the application of analytical procedures as substantive tests, and provides that the degree of assurance to be obtained from the procedures depends on, among other things: (a) the nature of the assertion; (b) the plausibility and predictability of the relationship; (c) the availability and reliability of the data used to develop the expectation; and (d) the precision of the expectation.[21] Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the accuracy and completeness of the underlying information.[22] In addition, the auditor should evaluate significant unexpected differences. Management responses to such differences should ordinarily be corroborated with other evidential matter.[23] In those cases when an explanation for the difference cannot be obtained, the auditor should obtain sufficient evidence about the assertion by performing other audit procedures to determine whether the difference is a misstatement.[24]

Inspections staff observed in 20 audits that firms performed substantive analytical procedures that did not provide the necessary level of assurance because the firms did not: (a) develop expectations that were sufficiently precise to identify misstatements (for example, comparing total revenue for the current year to the prior year as a primary test of significant revenue accounts); (b) establish that there was a plausible and predictable relationship between the current year and prior year balances

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[20] See AS 2301.18.

[21] AS 2305.11.

[22] AS 2305.16.

[23] See AS 2305.21.

[24] Id.

(for example, testing interest income by comparing monthly interest income recorded in current year to the monthly interest income recorded in the prior year without establishing the plausibility and predictability of the relationship between current and prior year interest income); (c) evaluate the reliability of the data from which the auditors' expectations were developed (for example, developing an expectation based on unaudited data provided by a broker without testing the accuracy or completeness of the data); or (d) determine an amount of difference from the expectation that could be accepted without further investigation.

Auditing Information Produced by Service Organizations

Many brokers and dealers use the services of other brokers and dealers to perform trade processing and related back-office functions, primarily in the clearing and settling of customer transactions. AS 2601 (currently AU sec. 324), *Consideration of an Entity's Use of a Service Organization*, applies to audit and attestation engagements where a broker or dealer uses the services of a service organization that affect the broker's or dealer's information system, including business processes that affect the broker's or dealer's accounting records and financial reporting processes.[25]

Inspections staff identified instances in which, in auditing revenue, auditors did not obtain sufficient appropriate audit evidence about the accuracy and completeness of information the auditor used in its audit that was produced by a broker's or dealer's service organization. These deficiencies were observed in audits where auditors 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.

Inspections staff observed that in 45 audits, auditors did not perform sufficient procedures on information produced by service organizations used in the performance of audit procedures. For example, some auditors used information produced by a service organization (such as trade blotters, various customer or broker or dealer statements, or population data) and limited their procedures to agreeing the information in these reports and statements to amounts recorded in the general ledger or received as cash.

Inspections staff observed that in 36 of the 45 audits, auditors 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, Inspections staff observed instances where auditors did not: (a) test the operating effectiveness of necessary user organization controls at the broker or dealer as specified in the service auditor's report;

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[25] See AS 2601.03.

(b) obtain evidence about the effectiveness of necessary controls at sub-service organizations as specified in the service auditor's report; (c) 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 auditor as audit evidence; or (d) 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 controls on which the auditor relied.

In addition, Inspections staff observed that in 9 of the 45 audits, where auditors used as audit evidence statements and other information the broker or dealer obtained from its service organization, the auditors did not obtain and evaluate the service auditor's report or perform their own procedures related to the accuracy and completeness of the information the auditors used in their audits.

Auditing Information Produced by the Broker or Dealer

Inspections staff identified 17 audits in which, in auditing revenue, auditors did not test the accuracy and completeness of the information produced by the broker or dealer that was used as audit evidence.[26] Examples of such information included trade blotters, account statements, and schedules or spreadsheets prepared by broker or dealer personnel.

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.[27] Inspections staff observed in 52 audits, 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 recognizing revenue; (b) test whether the values used for assets under management to calculate fees were accurate or complete; (c) determine whether the commission rates used to calculate commission revenue were consistent with the underlying agreements; (d) evaluate whether revenue recognition policies were in conformity with generally accepted accounting principles ("GAAP"); or (e) evaluate the effect on the financial statements of recognizing commission revenue on a settlement date rather than on a trade date basis, as required under FASB ASC Topic 940, *Financial Services – Broker and Dealers*.

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[26] See Paragraph .10 of AS 1105 (currently AS No. 15), *Audit Evidence*.

[27] AS 2301.08.

Auditing Financial Statement Presentation and Disclosures

The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with GAAP.[28] 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.[29]

Inspections staff reviewed the audit work performed related to financial statement disclosures for those areas included in the inspection. Inspections staff identified audit deficiencies related to auditing financial statement presentation and disclosures in 43 of 115, or 37 percent, of the audits covered by the inspections, which is lower than the 44 percent of audits with deficiencies identified in this area in 2014. In 24 of the 43 audits with deficiencies in 2015, Inspections staff identified deficiencies in more than one of the categories set forth in the exhibit below:

Exhibit 2: Deficiencies Related to Auditing Financial Statement Presentation and Disclosures

Deficiencies Related to Auditing Financial Statement Presentation and Disclosures:	Number of Audits
Identifying omission of required financial statement disclosures	28
Evaluating completeness and accuracy of disclosures	12
Evaluating fair value disclosures	16
Evaluating financial statement presentation	8
Compliance with Rule 17a-5	10

Identifying Omission of Required Financial Statement Disclosures

In 28 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, or related party transactions.

Evaluating Completeness and Accuracy of Disclosures

Inspections staff observed in 12 audits 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 respond to evidence that was inconsistent

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28 See Paragraph .30 of AS 2810 (currently AS No. 14), *Evaluating Audit Results*.

29 AS 2810.31.

with disclosures included in the financial statements including the notes to the financial statements. For example, in two audits, firms failed to identify a material difference between the amounts presented on the statement of operations or the statement of financial condition and the amounts disclosed in the notes to the financial statements. In other instances, firms did not identify that the brokers or dealers did not disclose material related party information that was necessary to understand the effects of the related party transactions on the financial statements as required by GAAP.

Evaluating Fair Value Disclosures

In 16 audits, Inspections staff observed that firms did not evaluate the broker's or dealer's classification of fair value measurements of certain assets and liabilities within the hierarchy required by FASB ASC Topic 820, *Fair Value Measurement* ("ASC 820"). For example, in 10 of the 16 audits, Inspections staff observed that the firms did not evaluate whether the classification of securities disclosed as Level 1 or Level 2 was appropriate based on the inputs used by the broker or dealer to measure fair value.

Evaluating Financial Statement Presentation

Inspections staff observed in eight audits that firms did not perform sufficient procedures regarding whether the broker's or dealer's financial statements were presented fairly in conformity with GAAP. For example, in two audits, Inspections staff observed that firms failed to identify and appropriately address errors in amounts presented on the statement of cash flows that appeared to the inspection team to be material. In other audits, Inspections staff observed that firms failed to identify and appropriately address incorrect financial statement line item descriptions. For example, in one audit, the firm did not identify that the broker and dealer reported a receivable from broker as securities sold short on its statement of financial condition.

Compliance with Rule 17a-5

In addition to the requirement for the broker or dealer to present financial statements in accordance with GAAP, Rule 17a-5(d)(2)(i) requires the financial statements to also be presented in a format that is consistent with Form X-17A-5 Part II or Part IIA. In 10 audits, Inspections staff observed that firms did not identify and appropriately address instances where the broker's or dealer's financial statements were inconsistent with the requirements of Form X-17A-5, including eight audits in which the broker or dealer presented multiple significant categories of revenue as a single line item on the statement of operations.

Auditing Related Party Transactions

Related parties often play a significant role in the operations of brokers and dealers, including, for example, through direct participation in the activities of the brokers and dealers by principals or affiliates under shared service agreements. AU sec. 334, *Related Parties*, establishes requirements with respect to identifying and testing related party relationships and transactions, and evaluating the related accounting and financial statement disclosure.[30]

Inspections staff identified audit deficiencies related to auditing related party transactions in 27 of 85, or 32 percent, of the audits covered by the inspections where the auditor's procedures to test related party transactions were inspected, which is higher than the 21 percent of audits with deficiencies identified in this area in 2014. The 2015 deficiencies were identified in the categories set forth in the exhibit below:

Exhibit 3: Deficiencies Related to Auditing Related Party Transactions

Deficiencies Related to Auditing Related Party Transactions:	Number of Audits
Examining identified related party transactions	26
Identification of related party transactions	1

Examining Identified Related Party Transactions

In 26 audits, Inspections staff observed that firms identified related parties or material related party transactions, including service agreements, fee arrangements, or intercompany balances, yet the firms did not perform procedures, or sufficient procedures, to test the transactions.[31]

In three of the 26 audits, Inspections staff observed that firms identified related parties or material related party transactions, but did not perform any procedures to test those transactions.

In 15 of the 26 audits, Inspections staff observed that related party revenue and expenses were based on allocations between the broker or dealer and its parent or affiliates, but firms did not test amounts allocated to the brokers or dealers, or test the basis for the allocations and the computation of the allocated amounts. For example, in one audit, Inspections staff observed that the firm's procedures were limited to reading the allocation agreement and tracing the amounts disclosed in the financial statements to a list of intercompany payments, but did not include any testing of the reasonableness of the allocated expenses or whether the allocated expenses were in accordance with the terms of the allocation agreement.

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[30] AS 2410 (currently AS No. 18), *Related Parties*, superseded AU sec. 334 and is effective for audits with fiscal years beginning on or after December 15, 2014. All of the audits covered by the inspections during 2015 had fiscal years beginning prior to December 15, 2014. As such, all deficiencies identified in this section are in relation to the requirements of AU sec. 334.

[31] See AU sec. 334.09 and .10.

Identification of Related Party Transactions

Inspections staff observed in one audit that the firm was aware of the broker and dealer's related entities and that it had examined certain of the broker and dealer's transactions with these entities that were disclosed in the financial statements. The firm, however, did not perform sufficient procedures to identify and evaluate all material transactions with these related entities. Specifically, although the firm was aware of a material class of revenue transactions with the same related entities, the firm did not consider the revenue transactions in the performance of its related party evaluation.

Auditing Risks of Material Misstatement Due to Fraud

AS 2110, AS 2301, and AS 2401 (currently 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.[32] Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.[33]

Inspections staff identified audit deficiencies related to auditing risks of material misstatement due to fraud in 24 of 57, or 42 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 the same as the percentage of audits with deficiencies identified in this area in 2014. In 11 of the 24 audits with deficiencies in 2015, Inspections staff identified more than one deficiency in the categories set forth in the exhibit below:

Exhibit 4: Deficiencies Related to Auditing Risks of Material Misstatement Due to Fraud

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	8
Responses to the assessed risks of material misstatement due to fraud – management override	16
Responses to fraud risk related to improper revenue recognition	12

[32] AS 2401.06.

[33] AS 2401.08.

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.[34] If the auditor has not identified improper revenue recognition as a fraud risk, the auditor should document the reasons supporting that conclusion.[35] In five 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 company who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement.[36] In five audits,[37] Inspections staff observed that auditors failed to perform inquiries of the audit committee, or equivalent (or its chair), management, or others within the company about the risks of material misstatement.

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.[38] 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.[39]

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34 AS 2110.68.

35 AS 2401.83.

36 AS 2110.54.

37 Two audits were included in the example of five audits in the paragraph above.

38 AS 2110.69.

39 AS 2401.58.

Inspections staff observed that in 16 audits, firms did not perform sufficient procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. Specifically, firms failed to perform one or more of the following procedures required by AS 2401:

- Obtain an understanding of the entity's financial reporting process and the controls over journal entries and other adjustments;

- Identify and select journal entries and other adjustments for testing;

- Determine the timing of the testing; or

- Inquire of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.[40]

AS 2401 also provides that journal entry testing ordinarily should focus on journal entries made at the end of a reporting period.[41] In four of the 16 audits, Inspections staff observed that firms failed to test journal entries made at the end of the reporting period. In addition, in 13 of the 16 audits, Inspections staff observed that firms did not test the completeness of the population of journal entries from which they selected a sample for journal entry testing.[42]

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.[43]

Inspections staff observed that in 12 audits, firms did not perform sufficient audit procedures to specifically address assessed fraud risks related to improper revenue recognition.[44] For example, Inspections staff noted instances where the firm's approach to address the identified fraud risk did not include tests of details as required by AS 2301.[45]

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[40] Id.

[41] See AS 2401.62.

[42] See AS 1105.10.

[43] AS 2301.13.

[44] See AS 2301.14.

[45] See AS 2301.13.

Auditing Fair Value Measurements

Brokers and dealers are required to account for securities at fair value.[46] AS 2502 (currently 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 19 of 43, or 44 percent, of the audits covered by the inspections where the auditor's procedures to test fair value measurements was inspected, which is the same as the percentage of audits with deficiencies identified in this area in 2014. In 11 of the 19 audits with deficiencies in 2015, Inspections staff identified deficiencies in more than one of the categories set forth in the exhibit below:

Exhibit 5: Deficiencies Related to Auditing Fair Value Measurements

Deficiencies Related to Auditing Fair Value Measurements:	Number of Audits
Understanding the broker's or dealer's process for fair value measurement	13
Testing fair value measurements	17

Understanding the Broker's or Dealer's Process for Fair Value Measurement

The auditor should obtain an understanding of the broker's or dealer's process for determining fair value measurements.[47] In 13 audits, Inspections staff observed that firms did not obtain a sufficient understanding of the broker's or dealer's process for determining fair values. For example, in several audits involving securities with fair values based on unobservable inputs or inputs other than those from quoted prices in active markets, firms did not obtain an understanding of the methods and assumptions internally developed or obtained from third parties that were used by the broker or dealer to determine the fair value of securities. For example, in one audit, Inspections staff observed that the firm's understanding of the methods and assumptions used by the broker and dealer to determine the fair value of securities was limited to obtaining a description of the broker and dealer's valuation methodology and the firm did not further consider the inputs used by the broker and dealer to determine the fair value of securities that were described by the broker and dealer as being illiquid and infrequently traded.

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46 See FASB ASC 820 and FASB ASC Subtopic 940-320, *Financial Services – Brokers and Dealers – Investments - Debt and Equity Securities*.

47 See AS 2502.09 through .14.

Testing Fair Value Measurements

The auditor's tests of the broker's or dealer's fair value measurements should be based on the auditor's assessment of the risk of material misstatement.[48] In 17 audits, Inspections staff observed that firms did not perform sufficient procedures to test the valuation of securities. For example, Inspections staff observed that some firms limited their procedures to obtaining a confirmation from a clearing broker or dealer or an account statement from a custodian and performed no additional procedures to test the valuation of securities. Other firms failed to perform sufficient procedures to evaluate whether security valuations internally produced by the brokers or dealers or obtained by the brokers or dealers from third parties were representative of fair value given the lack of observable inputs, recent trades, or low trade volume prior to year end. In other instances firms used in their testing the same valuation source as the one used by the broker or dealer and did not perform procedures to evaluate whether the valuation source provided values indicative of fair value at year end. In addition, in one of the 17 audits, Inspections staff observed that for selected securities with inputs other than quoted prices, the firm obtained prices from a third-party pricing source and, for securities with significant differences between the prices from the third-party pricing source and the recorded prices, the firm obtained additional prices from an alternate source that were not significantly different from the recorded prices and, based on that alternate pricing evidence, accepted the recorded prices. The firm did not, however, perform procedures to evaluate whether the price from the alternate source was more indicative of the securities' fair values at year end.

Auditing Receivables and Payables

Brokers and dealers may report receivables and payables resulting from their transactions with various counterparties, customers, and clearing depositories, or securities-related financing transactions such as repurchase or reverse repurchase agreements.

Inspections staff identified audit deficiencies related to auditing receivables and payables in 14 of 67, or 21 percent, of the audits covered by the inspections where the auditor's procedures to test receivables and payables were inspected, which is slightly higher than the 19 percent of audits with deficiencies identified in this area in 2014. In three of the 14 audits with deficiencies in 2015, Inspections staff identified more than one deficiency in the categories set forth in the exhibit below:

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[48] See AS 2502.23 through .42.

Exhibit 6: Deficiencies Related to Auditing Receivables and Payables

Deficiencies Related to Auditing Receivables and Payables:	Number of Audits
Extent of testing	10
External confirmations	3
Auditing information produced by service organizations or the broker or dealer	5

Extent of Testing

Inspections staff observed that in 10 audits, the extent of testing was insufficient for a receivable or payable account balance, including commission receivables and payables to brokers and dealers and clearing organizations. For example, Inspections staff observed instances where firms: (a) did not perform any procedures to test certain relevant assertions of the accounts; (b) limited their procedures to inquiry alone or performed no procedures to evaluate the collectability of receivables; or (c) did not select a sufficient sample because, for example, the sample size was determined assuming reliance on controls but the firm did not test controls.[49]

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.[50] The auditor should perform alternative audit procedures if responses to confirmation requests are not received.[51] In three audits, Inspections staff identified deficiencies related to external confirmation procedures in which firms did not: (a) perform procedures to confirm accounts receivable or establish an appropriate basis for not performing confirmation procedures; or (b) perform alternative procedures on nonresponses to address the assessed risks of material misstatement.

Auditing Information Produced by Service Organizations or the Broker or Dealer

Inspections staff observed deficiencies in five audits 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 or dealer or the broker's or

[49] See AS 2301.33.

[50] See Paragraph .34 of AS 2310 (currently AU sec. 330), *The Confirmation Process*.

[51] See AS 2310.31.

dealer's service organization. Refer to the Auditing Revenue section in Part I of this report for further discussion of these types of deficiencies.

Audit Deficiencies Related to Supporting Schedules

Net Capital Rule

Rule 17a-5(d)(2)(ii) provides that the financial report of a broker or 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. AS 2701 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. The auditor's responsibilities include, evaluating whether the supplemental information, including its form and content, complies with the relevant regulatory requirements or other applicable criteria, if any. Inspections staff identified deficiencies, as described below, involving noncompliance with certain requirements in AS 2701[52] regarding the computation of net capital.

Inspections staff identified audit deficiencies related to the Net Capital Rule in 34 of 115, or 30 percent, of the audits covered by the inspections, which is lower than the 39 percent of audits with deficiencies identified in this area in 2014. Although the percentage of audits with deficiencies was 30 percent in 2015 and 39 percent in 2014, there continued to be a high number of deficiencies related to securities haircuts. In 16 of the 34 audits with deficiencies in 2015, Inspections staff identified more than one deficiency in the categories set forth in the exhibit below:

Exhibit 7: Deficiencies Related to the Net Capital Rule

Deficiencies Related to the Net Capital Rule:	Number of Audits
Minimum net capital requirements	7
Adjustments to net worth	6
Allowable assets	18
Haircuts	18
Operational charges and other deductions	9
Omitted disclosures	3

Minimum Net Capital Requirements

Generally, a broker's or dealer's required minimum net capital is the greater of (1) one of a number of fixed-dollar amounts prescribed in Rule 15c3-1 applicable to the

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

broker or dealer relative to its line(s) of business,[53] or (2) an amount computed using one of two financial ratios.[54] In seven audits, Inspections staff found that firms did not test whether the broker's or dealer's reported required minimum net capital was determined by the broker or 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 found that firms did not sufficiently evaluate whether these adjustments were made in accordance with the requirements of Rule 15c3-1. For example, in two audits, Inspections staff found that firms did not evaluate whether the amounts of the subordinated loans that were added to net worth in the determination of net capital were approved by the Financial Industry Regulatory Authority ("FINRA") in accordance with paragraph (d) and Appendix D of Rule 15c3-1.

Allowable Assets

Rule 15c3-1 requires that assets not readily convertible into cash ("non-allowable assets") be deducted from equity when computing net capital.[56] Inspections staff observed 18 audits where firms did not perform sufficient procedures to test the broker's or dealer's classification of allowable and non-allowable assets when computing net capital.

Under Rule 15c3-1, brokers and dealers are permitted to offset certain receivables and payables when specific conditions are met. In four of the 18 audits, Inspections staff observed that firms did not perform sufficient procedures to evaluate whether commissions receivable pursuant to the Investment Company Act of 1940 Rule 12b-1 were allowable assets under Rule 15c3-1. For example, Rule 12b-1 commissions receivable can be classified as an allowable asset only to the extent the receivables are offset by Rule 12b-1 commissions payable to sales representatives, and there is a signed written agreement between the sales representatives and the broker or dealer waiving payment of their commissions payout until the broker or dealer is in receipt of its

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

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

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

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

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Rule 12b-1 commissions revenue.[57] Among other things, the firms did not perform procedures to obtain and inspect the signed written agreements.

Rule 15c3-1(c)(2)(iv)(C) provides that commissions receivable from other brokers or dealers that are outstanding longer than 30 days from the date they arise are non-allowable assets. In five of the 18 audits, Inspections staff observed that firms did not evaluate the aging of commissions receivable to determine whether the amount reported as an allowable asset met the requirements of Rule 15c3-1(c)(2)(iv)(C).

Haircuts

When computing net capital, Rule 15c3-1 generally requires brokers and dealers to apply percentage reductions (referred to as "haircuts") to the values of securities owned by the broker or dealer.[58] The valuation of the securities and the haircut percentages can be significant components of the net capital computation.

Inspections staff observed 18 audits where firms did not perform sufficient procedures related to haircuts on securities. In all 18 audits, Inspections staff found that firms did not perform procedures to evaluate whether the appropriate haircut percentages were applied by the broker or dealer to its securities, including evaluating the relevant characteristics of the securities. For example, firms did not evaluate whether haircuts on securities were based on the percentages applicable to the categories of securities and marketability, if applicable, pursuant to Rule 15c3-1(c)(2)(vi) and Rule 15c3-1(c)(2)(vii). In two of the audits, the firms did not perform any procedure to evaluate whether haircuts should have been taken on equity securities and cash in a money market sweep account, respectively. In four audits, Inspections staff found that the firms used as audit evidence information produced by the brokers or dealers but did not test the accuracy and completeness of the reported securities positions upon which haircuts were applied.

Operational Charges and Other Deductions

In computing net capital, Rule 15c3-1 requires brokers and dealers to deduct amounts related to operational charges, such as aged fail to deliver balances,[59] and other deductions, such as excess fidelity bond coverage.[60] In nine audits, Inspections

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

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

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

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

staff observed that firms did not evaluate the completeness of the reported amounts of operational charges and other deductions from the broker's or dealer's net capital.

Omitted Disclosures

In three audits, Inspections staff found that firms did not identify the omission of certain required disclosures. In two of these audits, firms did not identify the omission of the disclosure of minimum net capital and excess net capital in the broker's or dealer's computation of net capital that was included as supplemental information accompanying the audited financial statements filed with the SEC pursuant to the instructions to Part II of Form X-17A-5 in accordance with Rule 17a-5(d)(2)(ii). In another audit, the firm did not identify differences between the computation of net capital included as supplemental information accompanying the financial statements and the computation included in the Financial and Operational Combined Uniform Single ("FOCUS") report that appeared to the Inspections staff to be material, and did not identify that the supplemental information did not include the reconciliation required by Rule 17a-5(d)(2)(iii) of these differences.

<u>Customer Protection Rule</u>

Rule 17a-5(d)(2)(ii) provides that the financial report of a broker or dealer shall include a supporting schedule that presents the customer reserve computation and information relating to requirements for possession or control of securities under Rule 15c3-3. Similar to the procedures regarding compliance with the Net Capital Rule noted above, AS 2701 is applicable to audits described in this section.

Inspections staff identified audit deficiencies related to the Customer Protection Rule in 16 of 30, or 53 percent, of the audits covered by the inspections where the brokers or dealers did not claim exemption from Rule 15c3-3, which is higher than the 43 percent of audits with deficiencies identified in this area in 2014. Among firms that also audited issuers, the percentage of audits with these deficiencies was 46 percent in 2015 and 43 percent in 2014. All audits that were covered by the inspections in 2014, for which this area was applicable, were performed by firms that also audited issuers. The percentage of audits with deficiencies in this area, performed by firms that did not audit issuers, was 83 percent in 2015. In eight of the 16 audits with deficiencies in 2015, Inspections staff identified more than one deficiency in the categories set forth in the exhibit below:

Exhibit 8: Deficiencies Related to the Customer Protection Rule

Deficiencies Related to the Customer Protection Rule:	Number of Audits
Customer debits or credits	10
Possession or control requirements	12
Omitted disclosures	2
Other procedures	2

Customer Debits or Credits

In 10 audits, Inspections staff noted that firms did not test, or sufficiently test, the completeness and accuracy of customer debits or credits included in the customer reserve supporting schedule. For example, Inspections staff observed that some firms performed no procedures over customer debits or credits or did not perform testing to ensure the completeness of credits reported. Other firms limited their procedures to inquiry, or used as audit evidence, information produced by the broker or dealer, or the broker's or dealer's service organization, without obtaining sufficient appropriate audit evidence about the accuracy and completeness of this information. Refer to the Auditing Revenue section in Part I of this report for further discussion of these types of deficiencies.

Possession or Control Requirements

Rule 15c3-3(b)(1) requires a broker or dealer to promptly obtain and maintain the physical possession or control[61] of all fully-paid securities[62] and excess margin securities[63] carried by the broker or dealer for the accounts of customers.

Inspections staff observed in 12 audits that firms did not perform sufficient procedures to test the broker's or dealer's possession or control supporting schedules. For example, in one audit, the broker reported no items in its possession or control supporting schedule and the firm did not test the completeness of this supporting schedule because it did not perform a test to determine whether fully-paid customer

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

[62] 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).

[63] 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).

mutual fund shares, carried in accounts held at mutual fund companies in the broker's name, were under the control of the broker. In another audit, the broker reported no items in its possession or control supporting schedule and the firm did not test the completeness of this supporting schedule because it did not perform a test to determine whether customer fully-paid and excess margin securities were segregated from those pledged by the broker as collateral for a bank loan or at other non-control locations.

Omitted Disclosures

In two audits, Inspections staff found that firms did not identify the omission of certain required supporting disclosures. For example, in one audit, the firm did not identify the omission of a disclosure within a filed supporting schedule that stated there were no material differences between the reserve computation included in the supporting schedule and the broker's most recently filed FOCUS report.

Other Procedures

Inspections staff also observed deficiencies related to customer protection in two other audits. For example, in one audit, Inspections staff found a deficiency in the firm's testing of the broker and dealer's customer reserve supporting schedule because the firm did not identify and appropriately address that the broker and dealer's reported customer reserve included cash that was deposited with an affiliated bank, contrary to the requirements of Rule15c3-3(e)(5).

Other Deficiencies Related to the Audit

Auditor's Reporting on the Financial Statements and Supporting Schedules

Generally, brokers and dealers are required under Rule 17a-5 to file with the SEC 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.[64] 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 financial statements and on the supplemental information in relation to the financial statements as a whole.[65]

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64 See AS 2701.03.

65 See paragraph .01 of AS 3110 (currently AU sec. 530), *Dating of the Independent Auditor's Report,* and 2701.12.

Inspections staff identified deficiencies related to the auditor's reporting on the financial statements and supporting schedules in nine of 115, or eight percent, of the audits covered by the inspections, which is the same as the percentage of audits with deficiencies identified in this area in 2014. The following exhibit presents a summary of the deficiencies identified during 2015:

Exhibit 9: Deficiencies Related to Auditor's Reporting on the Financial Statements and Supporting Schedules

Deficiencies Related to Auditor's Reporting on the Financial Statements and Supporting Schedules:	Number of Audits
Inaccurate auditor's report	7
Incorrect dating of the auditor's report	2

Inaccurate Auditor's Report

Inspections staff observed in one of the seven audits that the auditor's report stated that the firm conducted its audit in accordance with GAAS rather than in accordance with PCAOB standards, as required by Rule 17a-5. Inspections staff also found that in these seven audits, the portion of the auditor's report on the supplemental information did not include, or include properly, one or more of the elements required by AS 2701.[66] For example, it was observed that the auditor's report: (1) did not identify a supporting schedule that the firm had audited and that the broker or dealer filed with its financial statements; (2) identified a schedule that the broker or dealer did not file with its financial statements; (3) did not include a statement that the audit procedures performed included performing procedures to test the accuracy and completeness of the information presented in the supplemental information; or (4) did not include a statement that in forming the auditor's opinion, the auditor evaluated whether the supplemental information, including its form and content, complied, in all material respects, with the specified regulatory requirements.

Incorrect Dating of the Auditor's Report

Inspections staff observed in two audits that the auditor's report was incorrectly dated prior to the date on which the auditor obtained sufficient appropriate evidence. For example, in one audit, the auditor's report was dated prior to the date through which management evaluated subsequent events, as disclosed in the notes to the financial statements. In another audit, the firm reached conclusions regarding matters necessary to support its auditor's report after the date of the auditor's report.

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[66] See AS 2701.10.

Audit Documentation

The 2015 inspection cycle was the first in which all audits of brokers and dealers were required to be conducted in accordance with PCAOB standards, including AS 1215 (currently AS No. 3), *Audit Documentation*, which establishes the general requirements for documentation that the auditor should prepare and retain in connection with an audit performed under PCAOB standards.

Inspections staff identified deficiencies in 30 of the 115 audits covered by the inspections related to audit documentation. In four of the 30 audits with deficiencies, Inspections staff identified deficiencies in more than one of the categories set forth in the exhibit below:

Exhibit 10: Deficiencies Related to Audit Documentation

Deficiencies Related to Audit Documentation:	Number of Audits
Engagement completion document	11
Documentation of significant findings or issues	19
Other audit documentation matters	4

Engagement Completion Document

The auditor must identify all significant findings or issues in an engagement completion document.[67] Inspections staff observed in 11 audits that firms did not complete an engagement completion document. These 11 audits were performed by firms that did not audit issuers. In 10 of these 11 audits, firms also did not complete an engagement completion document in the related examination or review engagements (see Other Deficiencies Related to Examination Engagements and Other Deficiencies Related to Review Engagements below). For one of the 11 audits, the broker did not file either a compliance report or an exemption report.

Documentation of Significant Findings or Issues

Inspections staff also observed 19 audits where firms prepared an engagement completion document, but did not include one or more relevant required items such as the results of auditing procedures performed in response to significant risks, or the identification and evaluation of uncorrected misstatements.[68]

[67] AS 1215.13.

[68] See AS 1215.12.

Other Audit Documentation Matters

Inspections staff observed deficiencies in four audits related to audit documentation matters. PCAOB standards require 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).[69] In three of the four audits, firms did not complete a final set of audit documentation within 45 days of the report release date. PCAOB standards further require 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.[70] In two of the three audits, Inspections staff observed that firms added documentation more than 45 days after the report release date but failed to document the date added or the reasons for adding audit documentation.

Engagement Quality Review

The 2015 inspection cycle was the first in which all audits of brokers and dealers were required to be conducted in accordance with PCAOB standards, including AS 1220, which requires an engagement quality review for audits performed under PCAOB standards.

Inspections staff identified deficiencies related to the engagement quality review in 66 of the 115 audits covered by the inspections. In five of the 66 audits, Inspections staff identified deficiencies in more than one of the categories set forth in the exhibit below:

Exhibit 11: Deficiencies Related to Engagement Quality Review

Deficiencies Related to Engagement Quality Review:	Number of Audits
Performance of an engagement quality review	7
Insufficient review by the engagement quality reviewer	59
Engagement quality reviewer qualifications	5

Performance of an Engagement Quality Review

Inspections staff observed seven audits where firms did not have an engagement quality review performed for the audit prior to issuance of the engagement report. One of these seven firms also audited issuers and six firms did not audit issuers. Three of these seven firms audited more than ten brokers or dealers and did not perform engagement quality reviews on any broker or dealer audit performed for which an

69 AS 1215.15.

70 AS 1215.16.

engagement quality review was required. In addition, for all seven of these audits, the 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

Inspections staff identified 59 audits where the engagement quality review was not sufficient. For example, Inspections staff observed through inspection of the documentation relating to the engagement quality review, that the engagement quality reviewer did not: (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 engagement report.[71]

Engagement Quality Reviewer Qualifications

In five audits, Inspections staff observed that the engagement quality reviewer did not meet the required qualifications. For example, in two audits, Inspections staff noted that the engagement quality reviewer was not a partner or individual in an equivalent position at the firm.[72] In another two audits, Inspections staff observed that the 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 quality reviewer for a broker or dealer audit given the frequency and nature of other audit deficiencies identified by Inspections staff from the inspection of the respective audit. In one audit, Inspections staff observed that the reviewer served as the engagement partner for the preceding audit and the firm did not qualify to be exempt from the two-year cooling off period.[73]

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[71] See AS 1220.10.

[72] See AS 1220.03.

[73] AS 1220.08 states that the person who served as the engagement partner during either of the two audits preceding the audit subject to the engagement quality review may not be the engagement quality reviewer unless the firm qualifies for the exemption, set out in Rule 2-01(c)(6)(ii) of Regulation S-X, from the Commission's partner rotation rules.

Deficiencies in Audit Committee Communications

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)[74] of their broker or 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 12 of the 115 audits covered by the inspections. Specifically, in these 12 audits, Inspections staff observed that the firms did not affirm in writing to the broker's or dealer's audit committee that they were independent of the brokers or dealers in compliance with PCAOB Rule 3520, *Auditor Independence*. All 12 of these firms did not audit issuers.

Attestation Deficiencies

Rule 17a-5(d) requires that annual reports filed by SEC-registered brokers and dealers include, among other things, a compliance report or an exemption report.[75]

Rule 17a-5 also requires the annual reports to contain a report by an independent public accountant based on, as applicable: (1) an examination of certain statements of the broker or dealer in the compliance report; or (2) a review of the statements of the broker or dealer in the exemption report.[76] In each case, the examination or review performed by the auditor must be conducted in accordance with PCAOB standards.[77]

The PCAOB adopted two attestation standards effective for engagements of brokers and dealers with fiscal years ended on or after June 1, 2014, to establish requirements aligned with the auditor's responsibilities under the amendments made to Rule 17a-5. The attestation standards cover the auditor's examination of a broker's or dealer's compliance report or the auditor's review of a broker's or dealer's exemption report. The 2015 inspection cycle was the first in which all attestation engagements of brokers and dealers were required to be conducted in accordance with PCAOB attestation standards.

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[74] Refer to the meaning of the term "audit committee" in footnote 12 in Part I of this report.

[75] See Rule 17a-5(d)(3) and (4).

[76] See Rule 17a-5(f)(1) and (g)(2)(i) and (ii).

[77] See Rule 17a-5(g)(2)(i) and (ii).

Examination Procedures

Rule 17a-5(d) provides that brokers and 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.[78]

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 or dealer in its compliance report are fairly stated, in all material respects.[79] These assertions concern: (a) the effectiveness of the broker's or dealer's internal control over compliance ("ICOC") with the financial responsibility rules during, and as of the end of, the most recent fiscal year; (b) the broker's or dealer's compliance with the Net Capital Rule and with the reserve requirements rule[80] as of the end of the most recent fiscal year; and (c) the information the broker or 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 or dealer.[81]

AT No. 1 provides that for an auditor to be able to express an opinion on the assertions made by a broker or dealer in a compliance report, the auditor must plan and perform the examination to obtain appropriate evidence that is sufficient to obtain reasonable assurance about whether: (a) one or more material weaknesses in ICOC existed during the most recent fiscal year specified in the broker's or dealer's assertion; (b) one or more material weaknesses in ICOC existed as of the end of the most recent fiscal year specified in the broker's or dealer's assertion; and (c) one or more instances of non-compliance with the Net Capital Rule or the reserve requirements rule existed as of the end of the most recent fiscal year specified in the broker's or dealer's assertion.[82] The auditor's procedures to determine compliance with the Net Capital Rule and with the reserve requirements rule must include procedures on the schedules the broker or dealer used to determine compliance with the Net Capital Rule and the reserve requirements as of its fiscal year end, including a determination of whether the information in the schedules was derived from the books and records of the broker or dealer.[83]

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[78] Rule 17a-5(d)(1)(i)(B)(1).

[79] AT No. 1.03.

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

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

[82] See AT No. 1.04.

[83] See AT No. 1.21.

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Inspections staff identified deficiencies in 21 of the 27 attestation engagements covered by the inspections related to the examination procedures of a broker or dealer that filed a compliance report. In 12 of the 21 examinations, Inspections staff identified more than one deficiency in the categories set forth below:

Exhibit 12: Deficiencies Related to Examination Procedures

Deficiencies Related to Examination Procedures:	Number of Examinations
Planning the examination	10
Testing controls over compliance	20
Performing compliance tests	7

Planning the Examination

In 10 examinations, Inspections staff observed instances where firms did not sufficiently plan the examination, because firms did not: (a) identify and evaluate the design and implementation of relevant controls over compliance; (b) assess the risks associated with related parties that were relevant to compliance and controls over compliance; (c) obtain an understanding of the nature and frequency of customer complaints; or (d) assess the risk of fraud, including the risk of misappropriation of customer assets.[84]

Testing Controls Over Compliance

In 20 examinations, Inspections staff observed that firms did not perform or sufficiently perform tests of controls over compliance. For example, in five of the 20 examinations, firms did not identify and test the operating effectiveness of any controls over compliance. In six other examinations, Inspections staff observed that when firms tested review controls, the firms failed to obtain an understanding of the nature of the review controls, including understanding and evaluating management's expectations and criteria used to identify matters for investigation, and the nature and resolution of the investigation procedures performed. As a result, the firms' tests were not sufficient to determine whether the identified controls were designed to prevent and detect instances of non-compliance. In addition, in 11 of the 20 examinations, firms did not test controls over the accuracy and completeness of underlying information upon which the design and operating effectiveness of ICOC depended.

Performing Compliance Tests

In seven examinations, Inspections staff observed that firms did not perform sufficient procedures to support their conclusions regarding whether the broker or dealer was in compliance with Rule 15c3-1 and Rule 15c3-3(e) as of the end of its fiscal

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

year. Specifically, the firms did not perform the procedures required on the schedules the broker or dealer used to determine compliance in accordance with AT No. 1.21. For example, Inspections staff observed that firms did not: (a) evaluate, or evaluate sufficiently, whether the amounts in the schedules were determined in accordance with Rule 15c3-1 or Rule 15c3-3(e), as applicable; (b) test the accuracy and completeness of the information in the schedules (for example, the accuracy and completeness of customer debits and credits included in the reserve computation schedule); or (c) determine whether the broker or dealer maintained a Special Reserve Bank Account[85] for the exclusive benefit of customers and deposited funds in at least the required amount in accordance with Rule 15c3-3(e).

<u>Review Procedures</u>

Rule 17a-5(d) provides that brokers and dealers that claimed exemption from Rule 15c3-3 throughout the most recent fiscal year must file an exemption report which must include certain statements.[86]

AT No. 2 provides that the objective of the auditor's review of the broker's or 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's or dealer's assertions for the assertions to be fairy stated, in all material respects.[87] Further, AT No. 2 provides that an 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's or dealer's assertions not to be fairly stated, in all material respects.[88] Such conditions include:

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

- The broker or 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

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[85] Brokers and 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."

[86] Rule 17a-5(d)(1)(i)(B)(2).

[87] AT No. 2.03.

[88] AT No. 2.04.

- The broker's or 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.[89]

Inspections staff identified deficiencies in 30 of the 87 attestation engagements covered by the inspections related to the review procedures of a broker or dealer that filed an exemption report. In nine of the 30 reviews, Inspections staff identified more than one deficiency in the categories set forth below:

Exhibit 13: Deficiencies Related to Review Procedures

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	27
Evaluation of results	3
Other required review procedures	3

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's or dealer's exemption conditions and consider certain risk factors in performing necessary inquiries and other review procedures.[90] For example, in one review, the firm's review procedures addressed the provisions of a different exemption than the actual exemption claimed by the broker. In other reviews, Inspections staff observed that the firms' procedures did not include consideration of the following risk factors when determining the nature, timing and extent of their inquiries and other review procedures: (a) the broker's or dealer's history of instances of non-compliance with the identified exemption provisions; (b) changes in the broker's or dealer's procedures, controls, or the environment in which the controls operate since the prior year; (c) changes in the broker's or dealer's operations that are relevant to compliance with the exemption provisions; (d) the risk of fraud, including the risk of misappropriation of customer assets, relevant to the identified exemption provisions; (e) the degree to which the broker's or dealer's processes that relate to the identified exemption provisions are performed, monitored, or controlled in a centralized or decentralized environment; (f) evidence about the broker's or dealer's compliance with

[89] Id.

[90] See AT No. 2.5(b) and .9(a).

the identified exemption provisions; or (g) evidence about the effectiveness of controls over compliance with the identified exemption provisions.

Making Required Inquiries and Performing Other Review Procedures

In 27 reviews, Inspections staff observed that the firms' inquiries and other review procedures were insufficient. For example, in 19 of the 27 reviews, firms did not perform all required inquiries,[91] including those which involve obtaining an understanding of management's controls and monitoring activities in place to comply with the claimed exemption provisions. In 12 of the 27 reviews, firms did not perform additional procedures necessary to assess whether a material modification was necessary for the broker’s or dealer’s assertions to be fairly stated.[92] For example, in two of the 12 reviews, the firms did not perform additional procedures to understand why the exemption provision identified in the broker’s or dealer’s FINRA membership agreement differed from the one identified in its exemption report. In one of the 12 reviews, the firm reviewed work performed by the broker and dealer's internal audit function that indicated a likelihood that exceptions related to prompt transmittal may have existed for the days not tested by internal audit. In another of the 12 reviews, the firm obtained a disposition letter from a recent examination conducted by FINRA that indicated FINRA elected to take no further action with regards to an exception noted in its exam. However, the firm did not perform additional procedures necessary to understand the nature of the exception FINRA identified and if the exception identified had any bearing on the broker's assertions.

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's or dealer's assertions are not fairly stated, in all material respects.[93] In three reviews, Inspections staff observed that firms had information that indicated that the broker or dealer had exceptions that were not disclosed and the firms did not address these situations in their reports. For example, Inspections staff observed in two reviews that the firms were aware that the brokers and dealers had instances during the year of not promptly transmitting customer funds to the clearing brokers and stated in their exemption reports that the exemption provisions were met without exception.

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

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

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

Other Required Review Procedures

In three reviews, Inspections staff observed that firms did not perform all required review procedures. Specifically, in one review, Inspections staff observed that the firm did not identify and appropriately address an instance in which the broker and dealer's exemption report was dated prior to the end of the period in which the broker and dealer stated that it complied with the identified exemption provisions. In addition, in two other reviews, Inspections staff observed that firms did not obtain written representations from management of the brokers or dealers.[94]

Other Deficiencies Related to Examination Engagements

Examination Report

The auditor's examination report should include specific elements[95] with respect to the auditor's examination of the assertions made by a broker or dealer in its compliance report such as a statement that management of the broker or dealer is responsible for establishing and maintaining a system of internal control that has the objective of providing the broker or 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 or dealer in the compliance report regarding the effectiveness of ICOC are fairly stated in all material respects.

Inspections staff identified deficiencies in three of the 27 examinations inspected related to the auditor's examination report. For example, Inspections staff observed that two firms omitted from their reports a reference to the account statement rule applicable to the broker or dealer. In another examination, Inspections staff observed that the broker's or dealer's compliance report did not include a statement as to whether the ICOC of the broker or dealer was effective as of the end of the fiscal year,[96] yet the firm's examination report stated that it had examined the broker's or dealer's statement that ICOC was effective 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.[97]

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

[95] See AT No. 1.36.

[96] See Rule 17a-5(d)(3)(i)(A)(3).

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

Inspections staff identified deficiencies in three of the 27 examinations inspected related to documentation as shown in the following exhibit:

Exhibit 14: Deficiencies Related to Examination Documentation

Deficiencies Related to Examination Documentation:	Number of Examinations
Engagement completion document	2
Documentation of significant findings or issues	1

Engagement Completion Document

The auditor must identify all significant findings or issues from an attestation engagement in an engagement completion document. The auditor may include the documentation of significant findings or issues related to an attestation engagement in the engagement completion document prepared in connection with the corresponding audit of the financial statements of the broker or dealer.[98] Inspections staff observed in two examinations that the firms 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. These examinations were performed by firms that did not audit issuers.

Documentation of Significant Findings or Issues

Inspections staff also observed in one examination that the firm prepared an engagement completion document, but did not include in it the actions taken to address significant findings or issues, including risks requiring special consideration by the auditor.

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 PCAOB attestation standards AT No. 1 or AT No. 2.[99]

Inspections staff identified deficiencies related to the engagement quality review performed in 13 of the 27 examinations inspected. In two of the 13 examinations, Inspections staff identified deficiencies in more than one of the categories set forth in the exhibit below:

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98 See AS 1215.13.

99 See AS 1220.01.

Exhibit 15: Deficiencies Related to Engagement Quality Review in an Examination Engagement

Deficiencies Related to Engagement Quality Review in an Examination Engagement:	Number of Examinations
Insufficient review by the engagement quality reviewer	13
Engagement quality reviewer qualifications	2

Insufficient Review by the Engagement Quality Reviewer

Inspections staff identified 13 examinations where the engagement quality reviewer did not perform a sufficient review. For example, Inspections staff observed, through inspection of the documentation relating to the engagement quality review, that the engagement quality reviewer did not: (a) identify that the engagement team did not perform some of the examination procedures necessary in the circumstances of the engagement, such as identify and test controls that were important to the engagement team's conclusion as to whether or not the broker or dealer maintained effective ICOC; (b) review the engagement team's evaluation of the firm's independence in relation to the engagement; or (c) review the engagement completion document.[100]

Engagement Quality Reviewer Qualifications

In one examination, Inspections staff observed that the reviewer served as the engagement partner for the preceding audit and the firm did not qualify to be exempt from the two-year cooling off period. In another examination, Inspections staff noted that the engagement quality reviewer was not a partner or individual in an equivalent position to a partner of the firm.

Other Deficiencies Related to Review Engagements

Review Report

Inspections staff identified deficiencies in 13 of the 87 reviews inspected related to the auditor's review report. In two of the 13 reviews, Inspections staff identified deficiencies in both of the categories set forth in the exhibit below:

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

Exhibit 16: Deficiencies Related to the Review Report

Deficiencies Related to the Review Report:	Number of Reviews
Inaccurate review report	11
Incorrect dating of the review report	4

Inaccurate Review Report

In 11 reviews, Inspections staff observed that the review report did not comply with the requirements of AT No. 2. For example, in five reviews, Inspections staff observed that the auditor's review report covered a different period than the period covered by the broker's or dealer's exemption report. In other reviews, Inspections staff also observed that the firm's review report either: (1) omitted the independent reference in the title of its review report; (2) identified a different exemption than the exemption the broker or dealer operated under and specified in its exemption report; (3) identified that the broker or dealer specified an exemption in its exemption report when in fact that broker's or dealer's exemption report omitted any reference to the provision(s) of Rule 15c3-3 under which the broker or dealer claimed an exemption; (4) omitted the exception identified in the broker's or dealer's exemption report; or (5) incorrectly made reference to the broker's or dealer's assertions included within a supporting schedule of the broker or dealer, which was not an exemption report.

Incorrect Dating of the Review Report

AT No. 2 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.[101] Inspections staff observed in four reviews that the review report was dated prior to the date of the broker's or dealer's exemption report or dated prior to the date the auditor obtained the broker's or dealer's management representation letter.

<u>Review Documentation</u>

Inspections staff identified deficiencies in 15 of the 87 reviews inspected related to documentation. In one of the 15 reviews, Inspections staff identified deficiencies in more than one of the categories set forth in the exhibit below:

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[101] <u>See</u> AT No. 2.18.

Exhibit 17: Deficiencies Related to Review Documentation

Deficiencies Related to Review Documentation:	Number of Reviews
Engagement completion document	8
Documentation of significant findings or issues	5
Other review documentation matters	3

Engagement Completion Document

Inspections staff observed in eight reviews 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. These eight reviews were performed by firms that did not audit issuers.

Documentation of Significant Findings or Issues

Inspections staff also observed in five reviews 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 risks identified by the firm related to a broker's or dealer's compliance with the applicable exemption provisions.

Other Review Documentation Matters

Inspections staff observed deficiencies in three other review engagements related to documentation matters. For example, in two of the three engagements, firms did not complete a final set of audit documentation within 45 days of the report release date. In one of the two engagements, Inspections staff observed that the firm added documentation more than 45 days after the report release date but failed to document the date added or the reasons for adding the documentation.[102]

Engagement Quality Review in a Review Engagement

Inspections staff identified deficiencies related to the engagement quality review performed in 30 of the 87 reviews inspected. In three of the 30 reviews, Inspections staff identified deficiencies in more than one of the categories set forth in the exhibit below:

[102] See AS 1215.15 and .16.

Exhibit 18: Deficiencies Related to Engagement Quality Review in a Review Engagement

Deficiencies Related to Engagement Quality Review in a Review Engagement:	Number of Reviews
Performance of an engagement quality review	7
Insufficient review by the engagement quality reviewer	23
Engagement quality reviewer qualifications	3

Performance of an Engagement Quality Review

Inspections staff observed seven reviews where firms did not have an engagement quality review performed for the review. In addition, Inspections staff observed that four of these seven firms did not have an engagement quality review performed for any of their broker or dealer reviews during the period covered by the inspections.

Insufficient Review by the Engagement Quality Reviewer

Inspections staff identified 23 reviews where the engagement quality reviewer did not perform a sufficient review. For example, Inspections staff observed that the engagement quality reviewer did not: (a) identify that the engagement team did not perform some of the review procedures necessary in the circumstances of the engagement, such as making necessary inquiries of management and evaluating whether the evidence obtained indicated that one or more of the broker's or dealer's assertions were not fairly stated; (b) review the engagement team’s evaluation of the firm's independence in relation to the engagement; or (c) review the engagement completion document.

Engagement Quality Reviewer Qualifications

In three 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 not a partner or individual in an equivalent position at the firm.

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Part II: Summary of Inspections of Firms Since Inception of the Interim Inspection Program

Since inception of the interim inspection program through December 31, 2015, the Board has performed 259 inspections of 210 firms that conducted audits of brokers and dealers.[103] The 259 inspections covered portions of 399 audits, of which 120 were required to be performed in accordance with PCAOB standards and 279 were required to be performed in accordance with GAAS, and 118 attestation engagements that were required to be performed in accordance with PCAOB standards. The 399 audits and the 118 attestation engagements had financial statement periods ended December 31, 2010 through June 30, 2015 and June 30, 2014 through June 30, 2015, respectively.

Appendix A includes information regarding firms that perform audit and attestation engagements of brokers and dealers, and the selection of firms and audit and attestation engagements covered by the inspections since inception of the interim inspection program, which provides context for this section of the report.

The following discussion summarizes the independence findings, audit, attestation, and other deficiencies identified from inspections under the interim inspection program through December 31, 2015. The continued occurrence and high percentage of audits with deficiencies that relate to the fundamentals of auditing, whether the audits were performed under PCAOB standards or GAAS, as applicable, observed during the interim inspection program, are significant and provide a necessary point of reference for discussions about areas for improvement when performing audits of brokers and dealers.

Independence Findings, Audit, Attestation, and Other Deficiencies from Inspections

On a cumulative basis, independence findings were identified in 79, or approximately 20 percent, of the 399 audits covered by the inspections. These 79 audits were performed by 74 firms, of which 63 did not audit issuers. In addition, on a cumulative basis, audit and other deficiencies were identified in 336, or approximately 84 percent, of the 399 audits covered by the inspections.[104] The 63 audits where

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[103] Twenty-five of the 210 firms have been inspected more than once. The 259 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, and 75 firms covered in Part I of this report.

[104] Audit and other deficiencies presented in Part II of this report represent the total audit and other deficiencies for the selected areas reported in Part I 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.

Inspections staff did not identify audit and other deficiencies were performed by 21 firms, of which 15 also audited issuers. The following exhibit presents a comparative summary of the percentage of audits with independence findings, as well as audits and areas with audit and other deficiencies, for inspections performed during 2015, 2014, and 2013 and prior:

Exhibit 19: Comparative Summary of Audits

	Percentage of Audits with Independence Findings	Percentage of Audits with Audit and Other Deficiencies	Percentage of Areas[105] with Audit and Other Deficiencies
2015[106]	7%	78%	35%
2014	25%	87%	35%
2013 and prior[107]	26%	87%	38%

For inspections performed during 2015, the overall percentage of audits with independence findings was lower compared to 2014. The percentage of audits with independence findings was lower for firms that also audited issuers and those that did not. In addition, the percentage of audits with independence findings for brokers and dealers that claimed exemption from Rule 15c3-3 was lower in 2015 compared to 2014. The following exhibits present the percentage of audits covered by the inspections during the interim inspection program with independence findings:

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[105] Areas include all areas that were both applicable in the respective inspection year and reported within Part I of the respective annual reports, and excludes those related to independence.

[106] Included in the 2015 results discussed in Part II of this report 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 Part I of this report.

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

Exhibit 20: Comparison of Independence Findings by Firm Characteristic

Firm:	Percentage of Audits with Independence Findings		
	2015	2014	2013 and Prior
Firms that also audited issuers	3%	9%	5%
Firms that did not audit issuers	13%	48%	51%
Total	7%	25%	26%

Exhibit 21: Comparison of Independence Findings by Broker or Dealer Characteristic

Broker or Dealer:	Percentage of Audits with Independence Findings		
	2015	2014	2013 and Prior
Did not claim exemption	6%	0%	14%
Claimed exemption	7%	31%	30%
Total	7%	25%	26%

Attestation and other deficiencies were identified in 66, or approximately 56 percent, of the 118 attestation engagements related to brokers or dealers that filed a compliance or an exemption report during 2015 and 2014. The 52 attestation engagements where Inspections staff did not identify any attestation or other deficiencies were performed by 29 firms, of which 18 also audited issuers.

The following exhibit presents a comparison of the percentage of applicable audits with audit and other deficiencies for certain areas for the 399 audits covered by the inspections during the interim inspection program:[108]

[108] Audit deficiencies that were reported in prior annual reports but not Part I of this report were not included in this exhibit, such as audit deficiencies related to the report on material inadequacies, reliance on records and reports, and evaluation of internal control deficiencies.

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Exhibit 22: Comparison of Audit and Other Deficiencies Related to the Audit

Deficiencies	Percentage of Applicable Audits with Deficiencies		
	2015	2014	2013 and Prior
Audit Deficiencies Related to the Financial Statements			
Revenue	71%	72%	64%
Financial Statement	38%	44%	36%
Related Party Transactions	32%	21%	29%
Risks of Material Misstatement Due to Fraud	44%	42%	50%
Fair Value Measurements	44%	44%	32%
Receivables and Payables	23%	19%	N/A
Audit Deficiencies Related to the Supporting Schedules			
Net Capital Rule	29%	39%	37%
Customer Protection Rule	52%	43%	28%
Other Deficiencies Related to the Audit			
Reporting on the Financial Statements and Supporting Schedules	8%	8%	17%

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 and dealer characteristics. Refer to Appendix B for the audit, attestation, and other deficiencies from the inspections of 75 firms and 115 audits and the related attestation engagements during 2015 stratified by certain firm characteristics.

Audit, Attestation, and Other Deficiencies Stratified By Certain Firm Characteristics

Number of Broker or Dealer Audits per Firm

Inspections staff has identified a high percentage of audits, areas, and attestation engagements covered by the inspections with deficiencies. As the following exhibit presents, the highest percentages of deficiencies were identified in the audit and attestation engagements covered by the inspections for firms that audited only one broker or dealer client while the lowest percentages of deficiencies were identified for firms that audited more than 100 broker or dealer clients.

Exhibit 23: Number of Broker or Dealer Audits per Firm

Number of Broker or 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	97%	48%	100%	75%
2 to 20	95%	45%	100%	59%
21 to 50	85%	40%	100%	36%
51 to 100	89%	44%	100%	50%
More than 100	61%	17%	46%	25%

The 2015 results are consistent with the cumulative results shown above and are presented in Appendix B, Exhibit 1.

Firms that Also Audited Issuers Compared to Firms that Did Not Audit Issuers

As the following exhibit presents, Inspections staff has identified that the percentage of audits, areas, and attestation engagements covered by the inspections with deficiencies was significantly lower at firms that also audited issuers.

Exhibit 24: Firms that Also Audited Issuers and Firms that Did Not Audit Issuers

	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
Firms that also audited issuers	76%	28%	71%	32%
Firms that did not audit issuers	96%	49%	100%	71%

The 2015 results are consistent with the cumulative results shown above and are presented in Appendix B, Exhibit 2.

Firms that Audited Brokers or Dealers that Filed Compliance Reports Compared to Firms that Only Audited Brokers or Dealers that Filed Exemption Reports

The following exhibit presents the percentage of audits, areas, and type of attestation engagements with deficiencies stratified by firms that audited brokers or dealers that filed compliance reports and firms that only audited brokers or dealers that filed exemption reports:

Exhibit 25: Firms that Audited Brokers or Dealers that Filed Compliance Reports and Firms that Only Audited Brokers or Dealers that Filed Exemption Reports

	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
Firms that audited brokers or dealers that filed compliance reports	64%	25%	77%	26%
Firms that only audited brokers or dealers that filed exemption reports	95%	47%	N/A	63%

Audit, Attestation, and Other Deficiencies Stratified by Certain Broker and Dealer Characteristics

Reported Actual Net Capital, Revenues, and Assets

Inspections staff has identified a high percentage of audits and areas with deficiencies across the spectrum of audits covered by the inspections in terms of broker or dealer characteristics, such as reported actual net capital, revenues, and assets. For illustrative purposes, the following exhibit presents a comparison of the percentage of audits and areas with deficiencies identified in 2015, 2014, and 2013 and prior, stratified by the reported actual net capital of the brokers and dealers at the time of the audit:

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Exhibit 26: Percentage of Audits with Audit and Other Deficiencies Stratified by Reported Actual Net Capital by Brokers and Dealers

	Number of Brokers and Dealers	Percentage of Audits with Audit and Other Deficiencies			Percentage of Areas with Audit and Other Deficiencies		
		2015	2014	2013 and Prior	2015	2014	2013 and Prior
Less than $100,000	46	83%	92%	89%	36%	40%	40%
$100,000 to $2,000,000	146	94%	90%	95%	47%	40%	46%
$2,000,001 to $15,000,000	113	69%	96%	90%	33%	35%	39%
$15,000,001 to $100,000,000	59	68%	90%	78%	22%	46%	29%
$100,000,001 to $16,000,000,000	35	43%	56%	50%	8%	17%	18%

Inspections staff has also observed for this stratification a significantly lower percentage of audits and areas with deficiencies in 35 audits of brokers and dealers with reported actual net capital greater than $100,000,000 compared to the audits of brokers and dealers with lower amounts of reported actual net capital (these 35 audits were performed by 34 firms that also audited issuers and for 17 of these 34 firms, Inspections staff did not identify any audit or other deficiencies related to the audit).

In addition, Inspections staff has identified a high percentage of attestation engagements with deficiencies across the spectrum of attestation engagements covered by the inspections in terms of broker or dealer characteristics, such as reported actual net capital, revenues, and assets. For illustrative purposes, the following exhibit presents the percentage of attestation engagements with deficiencies identified in the 118 attestation engagements covered by the inspections, stratified by the reported actual net capital of the brokers and dealers at the time of the audit:

Exhibit 27: Reported Actual Net Capital by Brokers and Dealers

	Percentage of Examinations with Attestation and Other Deficiencies	Percentage of Reviews with Attestation and Other Deficiencies
Less than $100,000	N/A	60%
$100,000 to $2,000,000	100%	65%
$2,000,001 to $15,000,000	83%	34%
$15,000,001 to $100,000,000	67%	31%
$100,000,001 to $16,000,000,000	50%	0%

In addition, since the inception of the interim inspection program, Inspections staff has observed that the percentage of audits with deficiencies of brokers or dealers that did not claim exemption from Rule 15c3-3 has been lower compared to the audits of those that did claim exemption (although the percentage of audits with deficiencies of those that did not claim exemption was slightly higher in 2015 compared to those that claimed exemption).

Exhibit 28: Percentage of Audits with Audit and Other Deficiencies Stratified by Whether or Not the Broker or Dealer Claimed Exemption from Rule 15c3-3

Broker or Dealer:	Percentage of Audits with Audit and Other Deficiencies			Percentage of Areas with Audit and Other Deficiencies		
	2015	2014	2013 and Prior	2015	2014	2013 and Prior
Did not claim exemption	79%	76%	79%	32%	27%	33%
Claimed exemption	78%	89%	89%	36%	38%	40%

<u>Compliance Report or Exemption Report</u>

As the following exhibit presents, Inspections staff noted a high percentage of audits, areas, and attestation engagements covered by the inspections with deficiencies, regardless of whether the broker or dealer filed a compliance report or an exemption report. In addition, the percentage of deficiencies in the audits, areas, and attestation engagements covered by the inspections was lower for the firms that also audited issuers.

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Exhibit 29: Brokers or Dealers That Filed a Compliance Report or an Exemption Report[109]

	Percentage of Audits with Audit and Other Deficiencies	Percentage of Areas with Audit and Other Deficiencies	Percentage of Attestations with Attestation and Other Deficiencies
Filed a Compliance Report:			
Firms that also audited issuers	79%	25%	71%
Firms that did not audit issuers	100%	71%	100%
Filed an Exemption Report:			
Firms that also audited issuers	62%	23%	32%
Firms that did not audit issuers	95%	51%	71%

[109] The results in this exhibit are for 118 audit engagements, 88 attestation engagements for brokers or dealers that filed an exemption report, and 30 attestation engagements for brokers or dealers that filed a compliance report. For two of the 120 audits included in Part II of this report, the broker or dealer did not file either a compliance or an exemption report.

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Part III: Actions Needed by Firms and Next Steps of the Interim Inspection Program

The Board continues to be concerned by 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.

Independence findings in 2015 were identified with less frequency compared to the past, but Inspections staff continued to observe some instances in which independence appeared to be impaired because the auditors were involved in the preparation of the financial statements or performed bookkeeping or other prohibited services. Independence findings have been emphasized in the previous annual reports, at the Board's Forums for Auditors of Broker-Dealers, and through other outreach by the Board and Board staff. In addition, as discussed below, the Board has settled disciplinary orders against firms for rule violations stemming from the firms' failures to maintain independence from their audit and attest clients. Most of the violations relate to long-standing SEC independence rules that prohibit auditors from maintaining or preparing the audit client's accounting records; preparing the audit client's financial statements that are filed with the SEC, or that form the basis for the financial statements filed with the SEC; and preparing or originating source data underlying the audit client's financial statements.

The Board continues to be concerned by the nature and consistently high number of audit and other deficiencies across the firms and the audits covered by the inspections. Of particular note are the audit areas with percentages of deficiencies that increased or remained consistent when comparing 2015 to 2014, such as revenue, related party transactions, and the Customer Protection Rule. Many of these deficiencies continue to be similar in nature to those described in previous reports and relate to the fundamentals of auditing that are not dependent on whether the audit was performed under GAAS or PCAOB standards. In addition, the Board is concerned by the high percentage of deficiencies identified in 2015 related to engagement quality reviews and audit documentation. Many of the inspected firms need to significantly improve their audit work to meet the requirements of the professional standards and SEC rules.

The Board is also concerned by the nature and number of attestation and other deficiencies identified across the firms and the attestation engagements covered by the inspections, especially in light of the fact that the auditor's requirements have been emphasized in PCAOB staff guidance for brokers and dealers, at the Board's Forums for Auditors of Broker-Dealers, and through other outreach by the Board and Board staff.

The Board reminds firms 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. In addition, when it comes to the Board's attention that the financial statements of a broker or dealer appear not to present fairly, in all material respects, the financial position, results of operations, or cash flows of the broker or dealer in conformity with GAAP, the Board's practice is to report that information to the SEC, which has jurisdiction to determine proper accounting of the financial statements of brokers and dealers. Similarly, information related to possible violations of laws or rules, including independence rules, by brokers and dealers may be, and has been, reported to the SEC as well as, with respect to any broker or dealer under the jurisdiction of FINRA, to FINRA.

As of the date of this report, the Board has announced settled disciplinary orders against 22 firms for rule violations stemming from their failure to maintain independence from their broker or dealer clients.[110] The Board found that each of these 22 firms prepared the financial statements of their audit clients, or portions of the financial statements, by drafting them outright or by some combination of aggregating, revising, classifying, or supplementing financial information obtained from their audit clients. Under the SEC's rules, the auditor's preparation of financial statements, including preparation based on client-provided information, such as schedules or reports, impairs the auditor's independence. In addition to censure by the Board, each of these 22 firms agreed to pay a civil monetary penalty and undertake significant remedial actions.[111]

Actions Needed by Firms

In light of the independence findings and audit, attestation, and other deficiencies that continue to be identified by Inspections staff, combined with the need to adapt to amended SEC rules and to follow PCAOB standards, the Board urges firms that perform audit and attestation engagements for brokers and dealers to give careful consideration to their approaches to these engagements.

All firms that perform audit and attestation engagements for brokers or dealers should consider whether the audit, attestation, and other deficiencies described in this report might be present in the audit and attestation engagements they currently perform, and should take appropriate preventative or corrective action. In addition, firms should give consideration to the independence findings described in this report and ensure they have taken measures to comply with independence requirements for the audit and attestation engagements they perform.

[110] For more information on the settled disciplinary orders refer to:
https://pcaobus.org/News/Releases/Pages/12082014_Enforcement.aspx
https://pcaobus.org/News/Releases/Pages/07092015_Enforcement.aspx
https://pcaobus.org/Enforcement/Decisions/Pages/default.aspx (three orders effective October 15, 2015), and
https://pcaobus.org/News/Releases/Pages/Five-BD-independence-orders-one-cooperation-3-15-16.aspx

[111] 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.

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When deficiencies related to an audit are identified, the Board expects firms to take appropriate action. Under PCAOB standards, when these deficiencies are discovered after the date of the audit report, a firm must take appropriate action to assess the importance of the deficiencies to the firm's present ability to support its previously expressed audit opinions.[112] Depending upon the circumstances, the firm may do one or more of the following: (1) perform additional audit procedures; (2) inform a client of the need for changes to its financial statements or supporting schedules; or (3) take steps to prevent reliance on previously expressed audit opinions.

The Board continues to urge firms to be proactive in considering how to prevent similar deficiencies from occurring and seeking ways to better anticipate and address risks that might arise in specific broker or dealer audit and attestation engagements. The Board encourages firms to continually stress to their personnel the critical need to conduct audit and attestation engagements with due professional care, including professional skepticism. In addition, the Board strongly encourages firms to take action now regarding the independence findings and audit, attestation, and other deficiencies identified in this report. The Board also emphasizes the importance of having effective procedures for practice monitoring, including performing effective analyses of the root causes of these matters.[113]

Specifically, with respect to independence, firms should review the SEC's independence requirements and consider if the services performed for broker and 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.

The Board urges firms to give appropriate attention to the independence findings and audit, attestation, and other deficiencies identified in this report, including providing appropriate guidance and training to firm personnel and evaluating the appropriateness of the firm's policies on supervision, including review, so that partners and supervisory personnel are placing appropriate attention on these areas.

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[112] See AS 2901 (currently AU sec. 390), *Consideration of Omitted Procedures After the Report Date*, and AS 2905 (currently AU sec. 561), *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.*

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

The Board encourages firms 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. The Board also encourages firms 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.[114]

In addition to the actions needed by firms, management and audit committees (or equivalent) of brokers and dealers may want to consider inquiring of their auditor about how the areas described in this report are being addressed in their audits and take steps to ensure that independence violations are avoided.

Next Steps of the Interim Inspection Program

Future Inspections

The Board will continue to conduct inspections of firms that perform audit and attestation engagements for brokers and dealers under the interim inspection program until rules for a permanent inspection program take effect. There were 541 firms that issued audit reports on the financial statements of 3,958 brokers and dealers[115] that were filed for fiscal periods ended during 2015.

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[114] Contact information can be found at: http://pcaobus.org/About/Pages/ContactUsWebForm.aspx.

[115] This information is based on the number of brokers and dealers who filed financial statements through May 15, 2016, for fiscal years ended during 2015, that included audit reports issued by firms registered with the PCAOB.

Exhibit 30: Number of Broker or Dealer Audits Stratified by Broker or Dealer Audits per Firm

Number of Broker or Dealer Audits per Firm	Number of Firms[116]	Percentage of Firms
1	199	37%
2 to 20	307	57%
21 to 50	22	4%
51 to 100	8	1%
More than 100	5	1%
Total	541	100%

During 2016, the Board plans to perform inspections of 75 firms covering portions of approximately 115 audits and the related attestation engagements of brokers and dealers to assess compliance with PCAOB standards, rules of the SEC and the Board, and the Act. 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 brokers and dealers taking into consideration the related risks. In addition, a portion of the firms and audits are being selected randomly. Inspections staff will focus on areas unique to audit and attestation engagements conducted pursuant to existing or newly applicable PCAOB standards. Inspections staff will also continue to focus on areas with deficiencies noted from past inspections, as described in the various annual reports.

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 brokers and dealers, as well as working through the challenges in obtaining relevant information for these non-public companies. The Board continues to consider the risk of loss to customers and whether this risk can be assessed from attributes that characterize brokers and dealers in an effort to provide for differentiation of a class of brokers and dealers. The Board will also consider the high number of independence findings and audit, attestation, and other deficiencies that have been identified during the inspections under the interim inspection program.

[116] Information about the number of firms that audited brokers and dealers and their broker or dealer audits is based on financial statements filed through May 15, 2016, for fiscal years ended during 2015. These firms were registered with the PCAOB at the time the audit reports were issued.

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The PCAOB staff is currently working to develop a rule proposal for the Board to consider during 2016 to establish a permanent inspection program, which will address whether to exempt any category of firms from any such inspection program.

Other Board Initiatives

In its efforts and initiatives to protect the interests of investors and further the public interest in informative, accurate, and independent audit and attestation reports for brokers and dealers, the Board will continue to, among other things:

- Conduct forums for auditors of brokers and dealers that provide information about the Board, the interim inspection program, findings from the interim inspection program, audit and attestation engagements of brokers and dealers under PCAOB standards, and updates from the SEC and FINRA;

- Participate in various outreach initiatives, including conferences and other events to inform firms that issue audit and attestation reports for brokers and dealers about findings from the interim inspection program, and developments in the Board's standards-setting initiatives;

- Issue guidance for audit and attestation engagements of brokers and dealers, if needed, to assist with the implementation of PCAOB auditing and attestation standards; and

- Continue utilizing communication tools such as webinars, stored media presentations, and staff inspection briefs to effectively deliver guidance and information to auditors of brokers and dealers.

The Board will issue future annual reports that will describe deficiencies from inspections of audit and attestation engagements required to be performed in accordance with PCAOB standards, the publication of which may be appropriate to protect the interests of investors or to further the public interest. In addition, the Board will use information obtained from the interim inspection program and other research and outreach efforts to inform its future standards-setting activities relevant to audit and attestation engagements of brokers and dealers.

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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 Brokers and Dealers

For fiscal periods ended during the period from July 1, 2014 through June 30, 2015, there were 614 firms that issued audit reports on the financial statements and other information required by Rule 17a-5 of brokers and dealers that were filed with the SEC. Many of the firms performed audits for as few as one broker or dealer, while several firms performed audits for more than 100 brokers and dealers.

Number of Broker or Dealer Audits per Firm	Number of Firms[117]	Percentage of Firms
1	239	39%
2 to 20	339	55%
21 to 50	22	4%
51 to 100	9	1%
More than 100	5	1%
Total	614	100%

There were 4,079 brokers and dealers that filed audited annual financial statements with the SEC for fiscal years ended during the period from July 1, 2014 through June 30, 2015. The following table expands on the information above to provide further information on which firms also audited issuers and the number of their broker and dealer audits:[118]

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[117] Information about the number of firms that performed audit and attestation engagements for brokers and dealers and their engagements is based on financial statements filed through May 15, 2016, for fiscal years ended during the period from July 1, 2014 through June 30, 2015. These firms were registered with the PCAOB at the time their audit and attestation reports were issued.

[118] Information about the firms that audited issuers is derived from data on audit reports issued from April 1, 2014 through March 31, 2015 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 brokers and dealers and the number of these engagements is based on financial statements filed through May 15, 2016, for fiscal years ended during the period from July 1, 2014 through June 30, 2015. These firms were registered with the PCAOB at the time their audit and attestation reports were issued.

Number of Broker or Dealer Audits per Firm	Also Audited Issuers		Did Not Audit Issuers	
	Number of Firms	Number of Brokers and Dealers	Number of Firms	Number of Brokers and Dealers
1	67	67	172	172
2 to 20	144	812	195	890
21 to 50	12	400	10	306
51 to 100	4	299	5	341
More than 100	4	687	1	105
Total	231	2,265	383	1,814

Selection of Firms and Audit and Attestation Engagements During 2015

The selection of firms for inspection during 2015 took into consideration the number of broker or dealer audit and attestation engagements performed by the firms, whether they also audited issuers, risk characteristics based on previous inspection results, as well as other risk characteristics, to obtain a cross section of firms and level of coverage, including all firms that audit more than 100 brokers and dealers and approximately one third of the firms that audit 21 to 100 brokers and dealers. The Board did not exclude any firms that audit brokers or dealers from being eligible for selection. This approach for the selection of firms has generally been consistent since the inception of the interim inspection program.

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

Number of Broker or Dealer Audits per Firm	Number of Firms Inspected	Number of Audits Covered
1	10	10
2 to 20	49	53
21 to 50	8	13
51 to 100	4	7
More than 100	4	32
Total	75	115

Firms	Number of Firms Inspected	Number of Audits Covered
Also audited issuers	34	72
Did not audit issuers	41	43
Total	75	115

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Firms	Number of Firms Inspected	Number of Audits Covered
Firms that audited brokers or dealers that filed compliance reports	23	60
Firms that only audited brokers or dealers that filed exemption reports	51	54
Total[119]	74	114

At the time of the inspections, 34 of the 75 firms also audited issuers. Of these 34, four firms selected for inspection audited more than 100 issuers and 30 firms selected for inspection audited 100 or fewer issuers. The remaining 41 firms did not audit issuers and were not subject to inspection other than under the interim inspection program.

The selection of audits of brokers and dealers covered by the inspections considered various characteristics of brokers and dealers, such as the broker's or dealer's minimum net capital requirement and reported actual net capital under the Net Capital Rule, whether or not the broker or dealer claimed exemption from Rule 15c3-3, and whether or not the broker or dealer filed with the Commission a compliance report or an exemption report pursuant to Rule 17a-5. The Board did not exclude any audits of brokers or dealers from being eligible for selection.

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

[119] This exhibit presents 74 firms and 114 audits. One of the 75 firms inspected during 2015 only audited one broker and that broker did not file either a compliance or an exemption report.

Broker or Dealer Filed:[120]	Number of Attestations	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End
Compliance Report	27	$250,000 - $750,000,000	$300,000 - $11,000,000,000
Exemption Report	87	$5,000 - $4,000,000	$6,000 - $195,000,000

Broker or Dealer:	Number of Audits	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End
Did not claim exemption	30	$250,000 - $750,000,000	$300,000 - $11,000,000,000
Claimed exemption	85	$5,000 - $4,000,000	$6,000 - $195,000,000

Selection of Firms and Audit and Attestation Engagements Since Inception

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 or dealer audits per firm as determined at the time of the inspection, whether or not the firm also audited issuers, and whether the firms audited brokers or dealers that filed a compliance report or only audited brokers and dealers that filed an exemption report:[121]

[120] One broker with a minimum net capital requirement of $5,000 and actual net capital reported at fiscal year-end of approximately $50,000 did not file either a compliance or an exemption report.

[121] The 118 attestation engagements discussed in Part II of this report correspond to 118 of the 120 audits required to be performed under PCAOB standards. For two of the 120 audits covered by the inspections, the brokers or dealers did not file either a compliance report or an exemption report. These two brokers or 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.

Number of Broker or Dealer Audits per Firm	Number of Firms Inspected	Number of Audits	Number of Examinations	Number of Reviews
1	36	36	1	8
2 to 20	136	160	13	41
21 to 50	27	73	2	11
51 to 100	11	27	1	8
More than 100	6	103	13	20
Total	210[122]	399	30	88

Firms	Number of Firms Inspected	Number of Audits	Number of Examinations	Number of Reviews
Also audited issuers	75	234	24	50
Did not audit issuers	135	165	6	38
Total	210	399	30	88

Firms	Number of Firms Inspected	Number of Audits	Number of Examinations	Number of Reviews
Firms that audited brokers or dealers that filed compliance reports	26	64	30	34
Firms that only audited brokers or dealers that filed exemption reports	52	55	N/A	54
Total[123]	78	119	30	88

The following tables present the amount or ranges of minimum net capital requirements and actual net capital reported for the brokers and dealers that filed either

[122] The sum of the number of firms inspected does not add to 210 because six firms that were inspected more than once are reported in multiple stratifications due to a change in the number of broker or dealer audits performed by the firms.

[123] This exhibit presents 78 firms, 119 audits, 30 examination engagements, and 88 review engagements. One of the firms inspected only audited one broker and that broker did not file either a compliance or an exemption report. In addition, another broker and dealer did not file either a compliance or an exemption report.

a compliance report or an exemption report, stratified by the type of report filed and whether the broker or dealer did or did not claim exemption from Rule 15c3-3:

Broker or Dealer Filed:	Number of Attestation Engagements	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End
Compliance Report	30	\$250,000 - \$750,000,000	\$300,000 - \$11,000,000,000
Exemption Report	88	\$5,000 - \$4,000,000	\$6,000 - \$195,000,000

Broker or Dealer:	Number of Audits	Range of Minimum Net Capital Requirements	Range of Actual Net Capital Reported at Fiscal Year End
Did not claim exemption	97	\$250,000 - \$2,050,000,000	\$300,000 - \$16,000,000,000
Claimed exemption[124]	302	\$5,000 - \$10,000,000	\$6,000[125] - \$2,250,000,000

[124] The number of audits includes the audits of three brokers or 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.

[125] Excluded from the range of actual net capital reported at fiscal year end is one instance of reported negative net capital.

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Appendix B

2015 Audit, Attestation, and Other Deficiencies Stratified By Certain Firm Characteristics

Exhibit 1: Number of Broker or Dealer Audits per Firm

	Percentage of Audits with Audit and Other Deficiencies	Percentage of Audit Areas with Audit and Other Deficiencies	Percentage of Examinations with Attestation and Other Deficiencies	Percentage of Reviews with Attestation and Other Deficiencies
1	100%	49%	100%	75%
2 to 20	94%	49%	100%	59%
21 to 50	62%	22%	100%	36%
51 to 100	71%	42%	N/A	43%
More than 100	50%	11%	50%	25%

Exhibit 2: Firms that Audited Issuers and Firms that Did Not Audit Issuers

	Percentage of Audits with Audit and Other Deficiencies	Percentage of Audit Areas with Audit and Other Deficiencies	Percentage of Examinations with Attestation and Other Deficiencies	Percentage of Reviews with Attestation and Other Deficiencies
Firms that audited issuers	67%	24%	73%	32%
Firms that did not audit issuers	95%	52%	100%	70%

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Appendix C

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

Audits of brokers and dealers with fiscal years ended on or after June 1, 2014 are required to follow PCAOB standards. The following table provides a list of PCAOB releases and guidance that describe requirements applicable to audits of brokers and 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. 2016/4	July 14, 2016	https://pcaobus.org/News/Releases/Pages/Staff-Inspection-Brief-2016-scope-broker-dealers.aspx

Staff Audit Practice Alerts	N/A	https://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 brokers and 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

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Appendix D

References from Certain PCAOB Standards to Previously Applicable GAAS

The table below presents the reorganized PCAOB auditing standards discussed in this report with reference to the corresponding interim PCAOB auditing standards and the clarified generally accepted auditing standards.

PCAOB Reference (AS Reference)	**Title**	**PCAOB Reference** (AU sec. or AS No.)	**AICPA Clarified Standards** (AU-C)
1105	Audit Evidence	AS No. 15	500
1215	Audit Documentation	AS No. 3	230
1220	Engagement Quality Review	AS No. 7	220
1301	Communications with Audit Committees	AS No. 16	210, 260
2110	Identifying and Assessing Risks of Material Misstatement	AS No. 12	315
2301	The Auditor's Responses to the Risks of Material Misstatement	AS No. 13	330
2305	Substantive Analytical Procedures	AU sec. 329	520
2310	The Confirmation Process	AU sec. 330	505
2315	Audit Sampling	AU sec. 350	530
2401	Consideration of Fraud in a Financial Statement Audit	AU sec. 316	240
2410	Related Parties	AS No. 18	550
2502	Auditing Fair Value Measurements and Disclosures	AU sec. 328	540
2601	Consideration of an Entity's Use of a Service Organization	AU sec. 324	402
2701	Auditing Supplemental Information Accompanying Audited Financial Statements	AS No. 17	725
2810	Evaluating Audit Results	AS No. 14	240, 330, 450, 500, 520
2901	Consideration of Omitted Procedures After the Report Date	AU sec. 390	585
2905	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report	AU sec. 561	560
3110	Dating of the Independent Auditor's Report	AU sec. 530	560, 700