
Broker/Dealer Alert

Auditors Play a Critical Role Within the Securities Industry



THE NONPERFORMANCE OF AN AUDITOR CAN HAVE SERIOUS CONSEQUENCES TO A BROKER- DEALER. SUB STANDARD AUDITS MAY RESULT IN REPERFORMANCE, RECALL OF REPORTS AND REFERRALS TO REGULATORS, SUCH AS FINRA AND THE SEC.

“Regulator’s Watchful Eyes”

The Public Company Accounting Oversight Board (the “PCAOB”) which is overseen by the Securities and Exchange Commission (the “SEC”) continues to scrutinize accounting firms that perform audits for broker-dealers.

The PCAOB provides auditors substantial feedback on their performance through their Annual Interim Inspection Reports (2012-2015), Staff Inspection Briefs, various industry forums, staff guidance and other communications. Numerous areas of improvement have been outlined for auditors in performing their audits. This feedback enables auditors to improve and design audits to meet auditing requirements under PCAOB standards (in effect since June 2014). The consequences, as noted above, to the broker-dealer can be dire if an audit is not performed adequately.

Annual Report on the Interim Inspection Program

Four annual reports have been issued since the inception of the inspection program in 2012. The fourth interim inspection report that was issued in August of 2015, noted recurring deficiencies. What is particularly troublesome is the reoccurrence of many of the same deficiencies. As noted in the report, “observations continue to occur at unacceptably high levels.... Particularly concerning is an apparent lack of due professional care of these audits by some firms.”

As defined in the release, “audit deficiencies are failures by firms to perform, or perform sufficiently, certain required audit procedures and do not necessarily indicate that the broker's or dealer's financial statements or supporting schedules are misstated, that there are undisclosed material inadequacies or material weaknesses, or that the broker or dealer has violated Exchange Act Rules 15c3-3 (“Rule 15c3-3” or the “Customer Protection Rule”) or 15c3-1 (“Rule 15c3-1” or the “Net Capital Rule”).”



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The fourth interim inspection report reported on the results of the inspection of 75 firms and 115 audit engagements. Through December 31, 2014 the statistics show that of the 155 firms and 279 engagements that were inspected since the beginning of the inspection program in 2012, 87% of them had identified deficiencies.

Key deficiencies noted in the fourth interim inspection report are detailed below (which were noted in previous interim inspections). We have also included some considerations for broker dealers in these areas.

- **Revenue recognition** – The PCAOB noted the auditor’s inadequate procedures to evaluate incomplete or omitted disclosures and their inadequate presentation of revenue in the financial statements.
Has the auditor considered all material revenue streams, and sufficiently audited those streams?

Considerations for Broker-dealers:

- Have you documented procedures to ensure that the revenue cycle is adequately disclosed and that proper signoffs are evidenced?
- Are contracts reviewed and evidenced for proper recording and accounting treatment?
- Note that merely recording transactions from the clearing statement is not substantive audit evidence to provide the auditor comfort regarding revenue.

- **Use of information produced or used by brokers or dealers** – The PCAOB noted that the audit procedures performed to evaluate the accuracy, completeness and sufficiency of information produced by a service organization and used by the broker of dealer in maintaining its books or records was deficient.

Considerations for Broker-dealers:

- Does your system document what was transmitted to the clearing broker?
- Do you reconcile to the clearing broker’s records, and is the resulting output accurately reflected in your accounting records?
 - An example of a proper control would be an internal trade ticket or equivalent reconciled to the clearing broker’s records. This reconciliation should be formally documented to evidence review by management. This process should be performed prior to recording the activity.
- How do you ensure the completeness of the population of your trades; how do you ensure proper cut-off procedures and completeness of transactions?

- **Fair value Accounting Estimates**-The PCAOB noted the auditor’s inadequate review of management’s estimates and procedures.

Considerations for Broker-dealers:

- **Are there documented procedures and support for your fair value estimates? Are the methodology and the basis for classifying financial instruments into the fair value hierarchy evidenced appropriately?**
- **For Level 3 investments, do you perform “benchmarking” analyses to ensure that fair values (and the methodology utilized) are appropriate?**

- **Financial Statement Presentation and Disclosure**- The PCAOB found that some audits failed to note all required disclosures and the financial statement presentation. Additionally, there were instances where the financial statement presentation did not adhere to generally accepted accounting principles.

Considerations for Broker-dealers:

- Are your procedures adequate to determine required disclosures in your financial statements?
- Have you considered using financial statement disclosure checklists to assist with the preparation of your financial statements?

- **Customer protection rule-** Deficiencies by auditors were found with regard to those firms subject to the Customer Protection Rule, and those claiming the exemption. For those exempt from the rule, the auditor did not perform sufficient procedures to verify whether the conditions of the exemption were complied with as of the examination date, and whether facts came to the auditor's attention to indicate that the broker or dealer was not in compliance with the exemption. The PCAOB noted deficiencies concerning the audit of fully computing firms including computation of the reserve formula and possession and control requirements.

Considerations for Broker-dealers:

- Can you demonstrate the particular exemption claimed?
- Are procedures in place to ensure that the broker-dealer promptly transmits funds and securities?
- Are there controls in place to identify instances of non-compliance? What documentation is maintained relating to instances of non-compliance?

Industry Commentary

The number of auditing firms that audit broker-dealers has dramatically decreased during the last several years. There is no doubt, regulatory oversight has caused many firms to opt out of performing the audits of broker and dealers and thus reduced their risk associated with auditing under PCAOB standards.

For the fiscal period June 1, 2013 through May 31, 2014, there were 758 registered public accounting firms that issued audit reports on 4,164 broker-dealers. A significant number of the registered public accounting firms audited as few as one broker or dealer, while several firms audited more than 100 brokers and dealers.

Number of Broker or Dealer Audits per Firm	Number of Firms	Percentage of Firms
1	348	46%
2 to 20	374	49%
21 to 50	22	3%
51 to 100	8	1%
More than 100	6	1%
Total	758	100%

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	99	99	249	249
2 to 20	147	810	227	924
21 to 50	11	333	11	344
51 to 100	3	197	5	346
More than 100	6	862	-	-
Total	266	2,301	492	1,863

The above tables were taken from PCAOB Release 2015-006, the fourth interim inspection report, and reflect some interesting facts.

Of the 758 firms that audit broker-dealers, a significant number of accounting firms, 348, perform audits of only one broker dealer, with 95% (722 of 758) of accounting firms performing audits of 20 or less broker-dealers. This raises concerns, namely:

- How demanding is it on a practice to acquire industry specific expertise and is it cost effective to the accounting firm and ultimately to broker-dealers?
- Does lack of volume of engagements by an accounting firm effect audit quality? The percentage of deficiencies goes down considerably from those who perform one audit (100%) to those who audit 100 or more broker dealers (66%).

In January of 2015, the PCAOB published “Observations from PCAOB Inspections Covering Five Audits of Brokers and Dealers Required to be Conducted in Accordance with PCAOB Standards.” This initial inspection of audits under the new standards which were effective for years ending after June 1, 2014 disclosed many of the same deficiencies that were disclosed in the interim inspection reports, under the standards of the AICPA. In addition to the usual areas, including revenue recognition, the new standards required an engagement quality reviewer (“EQR”). The PCAOB cited in four out of five engagements reviewed, there were deficiencies in the EQR process. In these instances, either a sufficient review was not conducted, or the EQR did not possess the required qualifications.

PCAOB Staff Inspection Briefs (August 2015 and April 2016)

The PCAOB issued communications to highlight their objectives, plans, and the scope of their inspection program. While the staff inspection brief is primarily for broker-dealer auditors, it does offer insight to broker-dealers regarding where the PCAOB will be focusing their efforts.

The areas of focus continues to be revenue recognition, the examination of compliance reports for carrying firms, exemption reports for introducing firms, and support for supplemental schedules. The PCAOB will continue to focus on how an auditing firm performs an engagement quality review, maintains a system of quality control, and ensures auditor independence.

In April 2016, the PCAOB issued its Staff Inspection Brief and a preview of observations from its 2015 Inspections. Many of the observations were similar to those previously reported and will be covered in more detail in their next Annual Report on the Interim Inspection Program.

AUDITORS NEED TO BE INDEPENDENT IN FACT AND IN APPEARANCE

PCAOB Chairman James Doty announced the violations of auditor independence in December 2014 and noted that, “The bedrock of audit quality is independence. When an auditor’s independence is impaired, the auditor’s responsibility to exercise professional skepticism, and to serve the public trust, is also put at risk.”

Despite being well publicized, independence violations continue to be significant and reoccurring. 25 out of 106 engagements reviewed in the fourth interim inspection report were noted by the PCAOB violated independent rules.

SEC Rule 17a-5 requires that an auditor must be independent in accordance with Rule 2-01 of SEC Regulation S-X. Currently, certain carve outs exist under PCAOB standards for non-issuer broker-dealers. Their carve outs include partner rotation and the ability to perform tax compliance services for those in financial reporting roles. Future legislation could change the landscape.

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Nature of Violations

Violations of independence encompassed several areas where the auditor in fact took over management functions including the preparation of financial information which was later audited. As recent as March 2016, 5 audit firms were sanctioned by the PCAOB. One firm not only prepared the financial statements for the broker-dealer they audited, but also maintained and prepared the client's accounting records.

Violations that were noted by the PCAOB include:

- The auditor's preparation of the financial statements, including footnotes.
- Usage of auditor's word processing systems including typing.
- The regrouping of line items on financial statements as the auditor made the determination to disclosure of particular accounts.
- Preparation of tax accruals by the auditor.

So what can the auditors do?

Independence is not impaired in the case where the auditor proposes adjustments or provides the client with comments relating to the financial statement. Clients should consider a proposed adjustment by the auditor, but the ultimate decision to record a journal entry resides with the broker-dealer.

Clients need to prepare and understand any journal entry that is recorded in the books and records including tax accruals. The client should consider utilizing the services of an external accounting professional in order to record or review certain areas if it cannot be completed in-house.

ACCOUNTING FIRMS MUST HAVE A "SYSTEM OF QUALITY CONTROL"

According to AICPA professional standards, an accounting firm must establish and maintain a system of quality control. The firm's system of quality control should include policies and procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm (the "tone at the top")
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

The elements of quality control are interrelated. For example, a firm continually assesses client relationships to comply with relevant ethical requirements, including independence, integrity, and objectivity, along with policies and procedures related to the acceptance and continuance of client relationships and specific engagements. Similarly, the human resources element of quality control encompasses criteria related to professional development, hiring, advancement, and assignment of firm personnel to engagements, all of which affect policies and procedures related to engagement performance. In addition, policies and procedures related to the monitoring element of quality control enable a firm to evaluate whether its policies and procedures for each of the other five elements of quality control are suitably designed and effectively applied.

SEC Sanctioning Firms For Non-Compliance with Not Only Independence Violations

An example recently of a firm lacking a sufficient system of quality control is illustrated below.

In one recent notable case, the SEC found that an accounting firm registered with the PCAOB was unable to locate audit documentation for six of its audit engagements for the years 2009 through 2013. The affected clients were registered broker-dealers who were required to file annual financial reports that are audited by an independent public accountant pursuant to Generally Accepted Auditing Standards (“GAAS”). The firm did not have written policies and procedures outlining the practices followed for retention of audit documentation. GAAS requires that audit documentation for such annual audits be retained for a period of at least five years from the report release date. The firm’s failure to retain audit documentation in accordance with GAAS for six audits for the years 2009 through 2013 of registered broker-dealers constituted improper professional conduct. As a result, this firm was required to engage an independent consultant to review and evaluate whether the firm’s audit documentation retention policies and procedures are designed and implemented in a manner reasonably sufficient under PCAOB standards and applicable SEC rules to retain all audit documentation in accordance with applicable professional standards. However, the broker dealer’s audits for those years were not affected.

WHAT LIES AHEAD?

The PCAOB is working on several SEC projects to improve audit quality.

One project is the formalizing of their interim inspection program to a permanent inspection program. During this interim program, the PCAOB will continue to provide public reports annually on its progress and identify significant issues. The PCAOB’s permanent inspection program is anticipated to be put in place in 2016.

A number of PCAOB proposals and discussions could impact the audit of broker-dealers.

The staff of the PCAOB's Office of the Chief Auditor is considering ways to improve the standards that apply to the auditor's use of the work of a specialist. PCAOB standards describe a specialist as "a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing." The use and importance of specialists has increased in recent years, in part due to the increasing complexity of business transactions and the resulting complexity of information needed to account for those transactions. This complexity may contribute to increased risks of material misstatement in financial statements. Auditors of many companies now use the work of specialists, such as valuation specialists, appraisers, and actuaries, to bring necessary expertise for financial reporting.

In 2015, the PCAOB also issued a concept release on audit quality indicators (“AQIs”). The PCAOB detailed 28 different AQIs, which were divided into three areas; (a) audit professionals, (b) audit process, and (c) audit results. As the PCAOB concept release No. 2015-005 states, the AQIs are meant to provide an “effective practical picture of audit quality to inform discussions that may produce improvements in quality.” Currently, the use of AQIs is not mandatory, and the impact and use of AQIs in PCAOB auditing still remains to be seen.

CONCLUSIONS

The PCAOB will continue its oversight in order to protect the interests of investors and further public interest in the preparation of informative, accurate and independent audit reports.

Of utmost importance is that broker-dealers engage an accounting firm that demonstrates knowledge and competence of auditing under PCAOB standards, has a system of quality control that insures a high level of quality performance and ensures independence standards are adhered to. Auditors that have expert industry knowledge and a high level of competency are able to perform an examination in a reasonable amount of time and can navigate difficult audit issues so audits are not disruptive and costly to the broker-dealer's business. Quality audits provide comfort to the broker-dealer and prevent additional regulatory scrutiny.

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Due to financial constraints, many broker-dealers are not in a position to hire a full time financial and operations principal ("FINOP") with the experience and expertise to carry out the ever growing responsibilities that FINRA expects of them. The solution of outsourcing has worked well in most instances and there are many benefits. Speaking to broker-dealer firms and part time FINOPs, I want to remind you to review the Notice to Members 06-23. In that notice, FINRA outlines the FINOP's obligations under Rule 1022 and issues guidance for those of us who work part-time, off-site or hold multiple registrations. As WeiserMazars LLP has pointed out, the regulators have raised the bar when it comes to compliance and FINOPs are no exception. Being "part-time" is not an excuse for failing to fulfill duties and can result in disciplinary actions including bars, fines, and suspensions.

The Securities and Exchange Commission ("SEC") and FINRA look to the FINOP to be fully responsible for among other things, the complete and accurate presentation of the firm's financial statements, computation of net capital, and filing of FOCUS reports. A FINOP colleague recently provided a correct journal entry to the CFO of a broker-dealer. The CFO inadvertently recorded the entry in reverse and timely filed the incorrect FOCUS report. When FINRA noticed the error, it was the FINOP and not the CFO who was held responsible and accordingly fined \$15,000 and subsequently suspended 20 days.

Many of the SEC and FINRA recent examinations have revealed that over 50% of the broker-dealer firms have books and records violations including net capital computation inaccuracies. Based on these findings additional guidance was provided to FINOPs as follows:

1. Make on-site visits to the firms and inspect books and records. Document the visit
2. Gain complete access to the broker-dealer firm's books and records. Especially the allowable assets to assure cash and securities counted on for the firm's net capital compliance are not withdrawn mid-month.
3. Establish and update procedures of the FINOPs responsibilities.
4. Stay current on Notice to Members and other regulatory publications as well as Continuing Education programs.
5. Continue to assess requirements and capabilities.

In closing, before agreeing to become a FINOP for a broker-dealer I would strongly urge to make sure that the prospective firm is well capitalized, has reputable management, and is within your area of expertise. In addition, triple check everything!

The license, reputation, and money you save may be your own!

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