Changes to Broker-Dealer Reporting & Auditing

Background

The Sarbanes-Oxley Act of 2002 created the Public Company Accounting Oversight Board (PCAOB) and required that auditors of U.S. public companies be subject to external, independent oversight for the first time in history. In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act amended Sarbanes-Oxley to give the PCAOB oversight of the audits of broker-dealers registered with the Securities and Exchange Commission (SEC). Since then, the PCAOB has established a registration process for broker-dealer auditors, an interim inspection program, and developed standards on audits of broker-dealers.

In June 2011, the SEC issued proposed amendments on annual reporting, audit and notification requirements for broker-dealers in response to several high-profile broker-dealer collapses, most notably Bernard Madoff’s firm. The SEC adopted these rules on July 30, 2013. PCAOB proposed three auditing and attestation standards to address the SEC’s new rules. This article highlights those changes to broker-dealer reporting requirements and changes in auditors’ testing and reporting requirements.

Overview of SEC Amendments

The SEC amendments will require broker-dealers to submit new reports to the SEC concerning customer funds and securities. Annually, a compliance report or an exemption report now must be filed in addition to audited financial statements and supplemental information. An independent registered public accountant will be required to examine the compliance report or review the claim of exemption and issue a report. Clearing or carrying broker-dealers also will be required to permit their accountant to discuss with and make audit workpapers available to the SEC or their designated enforcement agency (DEA).1

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1 A broker-dealer that is a member of more than one securities self-regulatory organization may be assigned a “designated examining authority” that is responsible for examining the broker-dealer’s compliance with SEC financial responsibility rules. Examples of DEAs include the National Association of Securities Dealers (NASD), Chicago Board Options Exchange (CBOE) and Financial Industry Regulatory Authority (FINRA).
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The amendments require audits of broker-dealers’ financial statements and supplemental information, as well as the examination or reviews of newly required compliance and exemption reports to be conducted by firms registered with the PCAOB in accordance with PCAOB standards. Prior to this, the American Institute of Certified Public Accountants (AICPA) established the generally accepted auditing standards (GAAS) to be followed by broker-dealer auditors.

Compliance Report

SEC’s amendments will require broker-dealers to report on their internal controls in compliance with certain financial responsibility rules (FRRs), including net capital requirements (Rule 15c3-1), customer protection, reserves and custody of securities (Rule 15c3-c), quarterly security counts (Rule 17a-13) and compliance with the entities’ DEA rules on customer statements.

Registered broker-dealers would be required to prepare a compliance report that includes a statement that the broker-dealer has established and maintained a system of internal control to provide the broker-dealer with reasonable assurance that any instance of noncompliance with net capital and reserve rules would be prevented or detected on a timely basis. Broker-dealers will not be required to assess the effectiveness of internal controls over financial reporting as issuers are required to do in connection with Sarbanes-Oxley.

Exemption Report

Many broker-dealers are introducing firms that do not clear transaction or carry customer assets. Some clearing broker-dealers clear only their own transactions and do not hold customer securities or cash. If broker-dealers meet certain criteria, they could be exempt from SEC’s Rule 15c3-3, Customer Protection – Reserves and Custody of Securities. Such broker-dealers would file an annual exemption report, which would be reviewed by an independent registered public accountant.

Notification Requirements

An auditor must immediately notify the CFO of the broker-dealer of any instances of noncompliance with the financial responsibility rules and the nature of the noncompliance or existence of a material weakness. When the broker-dealer is required to notify the SEC, a copy also must be provided to the auditor. Auditors who do not receive the notice within one business day or disagree with the notice are required to notify the SEC.

Form Custody

Broker-dealers will be required to file a new quarterly Form Custody report with their DEA, containing information on how custody is maintained on customer and noncustomer assets and relationships with other custodians. This requirement begins as of the quarter ended December 31, 2013, and is due within 17 business days of calendar quarter ends; therefore, the initial form is due January 27, 2014.

SIPC

The Securities Investor Protection Corporation (SIPC) is a not-for-profit corporation responsible for providing financial protection to customers of failed broker-dealers. The SEC previously only required limited information to be filed with SIPC. SEC’s amendments require SIPC member broker-dealers to file their full annual reports with SIPC—including the independent registered public accountant’s reports covering the financial statements and the compliance or exemption report. This requirement is effective December 31, 2013.
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Effective Date

Compliance with the amended FRRs was effective October 21, 2013. The new quarterly form custody report and requirements to file with SIPC are effective as of December 31, 2013. The requirements related to annual reports take effect for all broker-dealers with fiscal years ending on or after June 1, 2014.

Overview of PCOAB’s New Standards

PCAOB’s three new auditing and attestation standards establish guidance for the auditor’s responsibility related to the new broker-dealer compliance reports and audits of supplemental information. The overall objective is to increase investor protection. According to Daniel Goelzer of PCAOB, “Unlike public company auditing, the protections investors derive from the auditor’s broker-dealer work results primarily from the auditor’s association with compliance related information outside of the financial statements. The examination and review engagements that are the basis for auditor reporting on these matters provide the SEC, Financial Industry Regulatory Authority (FINRA), and investors with independent assurance that customer assets are not improperly exposed to misappropriation or similar risks.”

The new standards support the SEC’s focus on broker-dealer practices and internal controls over compliance with the financial responsibility rules, particularly the safeguarding of customer securities and funds. The standards require risk assessment procedures specifically related to the risks of fraud, including the risk of misappropriation of customer assets. The standard requires performing procedures to obtain evidence about the existence of customer funds and securities held for customers.

All broker-dealers generally must file either a Compliance Report or Exemption Report depending on whether they can claim an exemption from the Customer Protection Rule. The new accountant report replaces the material inadequacy report required previously. The attestation standards are based on existing concepts and principals but are tailored to the requirements for broker-dealers under the new SEC rules.

Scope

The attestation standards will be applicable to all registered accounting firms conducting attestation engagements related to broker-dealer compliance or exemption reports. The standards do not extend to the audit work performed in connection with the client asset custody arrangements of investment advisors, which are governed by other SEC rules. Currently, auditors of nonissuer broker-dealers are not required to audit under PCAOB standards, but the new proposal would require all broker-dealers to be audited under the PCAOB standards beginning with years ending on or after June 1, 2014.

Attestation Standard No. 1, Examination Engagements Regarding Compliance Reports of Brokers & Dealers

Attestation Standard No. 1 establishes the auditor’s requirements for examining the new SEC compliance reports. Auditor judgment is required to identify and focus on the matters most important to the customer-protection objectives of the engagement. The standard is risk-based and scaled to the size and complexity of a broker-dealer’s business. The standard requires auditors to obtain sufficient, appropriate evidence to provide reasonable assurance on the following statements in the compliance report:

- The broker-dealer was in compliance with the net capital rule and the reserve requirement rule at fiscal year-end
- The broker-dealer had effective internal control over compliance during the year and at year-end
- The broker-dealer based its assertions on information from its books and records

A single instance of noncompliance or one material weakness in internal controls over compliance during a fiscal year requires the auditor to issue an adverse opinion, even if the entity has undertaken remediation efforts. An
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An adverse opinion is required even if the material weakness or noncompliance was identified by management. The compliance report would reflect both the identification of the material weakness and that its internal control over compliance was effective as of the end of the fiscal year, indicating the material weakness had been adequately remediated.

Attestation Standard No. 2, Review Engagements Regarding Exemption Reports of Brokers & Dealers

PCAOB’s standards for performing reviews of exemption reports take into account the size and complexity of the broker-dealer. Exempt broker-dealers are deemed less risky to investors, so the review standard mandates fewer and less burdensome procedures and requires the auditor to provide moderate (versus reasonable) assurance on the entity’s assertions in the exemption report.

The review standard requires auditors to obtain moderate assurance whether conditions exist that would cause one or more of the following assertions not to be fairly stated:

- The provision under which the broker-dealer claimed an exemption
- A statement that the broker-dealer either:
  - Met the identified exemption provisions throughout the most recent fiscal year without exception
  - Met the identified exemption provisions throughout the most recent fiscal year, with some exceptions; a broker-dealer would need to identify each exception with a brief explanation and the date(s) when the exceptions existed

Previously, the auditor had to ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to the auditor’s attention to indicate the exemption had not been complied with. The SEC considered, but rejected, a more limited “agreed-upon procedures” engagement for the exemption report, which would not require an opinion or negative assurance. The SEC concluded that the importance of safeguarding customer securities and cash required a conclusion on the broker-dealer’s exemption report.

Material Inadequacy Is Split into Two Components

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<th>Current</th>
<th>New</th>
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<td>Material inadequacy – The scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of examination in accounting systems, internal accounting control or procedures for safeguarding securities would be disclosed.</td>
<td>Noncompliance – A failure by the broker-dealer to comply with any of the financial responsibility rules in all material aspects; Applies to all broker-dealers</td>
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<td>Applied to all broker-dealers</td>
<td>Material weakness – A deficiency in internal controls over compliance resulting in a reasonable possibility that noncompliance will not be prevented or detected on a timely basis; Applies only to carrying broker-dealers</td>
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Auditing Standard No. 17: Supplemental Information

Along with their financial statements, broker-dealers also file certain supplemental information including the calculation of their net capital and reserve requirements and information related to possession and control of customer assets. The firm’s auditor is required to review and report on this supplemental information. Auditing Standard No. 17 requires the performance of audit procedures to test the supplemental information to support the auditor’s report on the supplemental information. The objective of the standard is to provide the SEC and
other regulators with greater confidence in the quality and consistency of supplemental information filed with financial statements.

All audited supplemental information is covered for financial statements prepared under PCAOB standards, whether required by regulatory bodies or submitted voluntarily, e.g., schedules required by the U.S. Department of Labor relating to the annual reports of employee stock purchase, savings and similar plans. Unaudited supplemental information would not be covered, such as oil and gas production activity required by SEC regulations S-K. The standard does not apply if the auditor who is engaged to audit and report on supplemental information did not audit the financial statements.

Testing would be based on the extent of the risk of material misstatement of the information. If supplemental information was tested as part of the financial statement audit, no additional testing is required. The auditor would opine on whether the supplemental information is fairly stated, in all material respects in relation to the financial statements as a whole. It requires auditors to perform procedures to determine that the supplemental information reconciles to the entities books and records, to test the completeness and accuracy of the supplemental information and to evaluate whether the supplemental information complies with relevant regulatory requirements. The auditor’s report on supplemental information may be included in the auditor’s report on the financial statement or a separate report may be issued.

PCAOB considered but rejected an approach that would have required a standalone audit of the supplemental information. PCAOB concluded that an “in relation to” approach was the most cost-effective approach to meet the objective of promoting investor protection and improving the effectiveness of regulatory oversight.

PCAOB Effective Date

PCAOB’s new standards are subject to SEC approval. The standards are proposed to be effective for fiscal years ending on or after June 1, 2014, which coincides with the effective date for the SEC broker-dealer rules.

Contributors

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com

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