

Client Alert

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PCAOB's Report on Broker-Dealer Audit Deficiencies Points the Way for BDs to Improve Their Financial Reporting and Compliance

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PCAOB'S MISSION

For two years, the Public Company Accounting Oversight Board (PCAOB) has been reviewing the work of auditors of broker-dealers, with a view to assessing their work and enabling the PCAOB to develop a permanent program for inspection of broker-dealer audits. Last week, the PCAOB issued its second progress report on this interim inspection program. For broker-dealers, PCAOB's report provides a useful preview of the issues on which their auditors will be increasing their focus in future audits; PCAOB's criticisms of the auditors that it regulates will most likely cause the auditors to beef up their audits in the areas criticized, and broker-dealers are bound to feel the effects in future audits.

Broker-dealers should review the second report, the most significant findings of which are summarized below. The PCAOB found deficiencies in audit procedures related to customer protection and net capital, certain financial statement areas, and auditor independence.

The Dodd-Frank Wall Street Reform and Consumer Protection Act amendments to the Sarbanes-Oxley Act provided the PCAOB with oversight authority with respect to audits of brokers and dealers registered with the Securities and Exchange Commission. A June 2011 rule adopted by the PCAOB and approved by the SEC established an interim inspection program related to broker-dealer audits with the dual purpose of assessing compliance of registered public accounting firms with the applicable statutes, regulations, and professional standards in connection with their performance of broker-dealer audits, and informing the Board's decisions about the scope and elements of a permanent inspection program to be announced in 2014 or later.

SEC Rule 17a-5¹ requires broker-dealers to file with the SEC and other regulators, among other things: (1) annual financial statements, (2) supporting schedules relating to the computation of net capital and customer reserve, and (3) an accountant's supplemental report on material inadequacies. Rule 17a-5(f)(3) requires auditors of broker-dealers to comply with SEC independence requirements, which provide that an accountant is not independent if it provides bookkeeping or other services related to the accounting record or financial statements of a client unless it is reasonable to conclude that the results of the services will not be subject to audit procedures performed by the accountant during an audit of the client's financial statement.

¹ For a discussion of recent revisions to Rule 17a-5 which expanded auditor responsibilities in connection with broker-dealer audits, increased reporting by broker-dealers, and subjected broker-dealer audits to PCAOB standards, review our Client Alert.

Client Alert

PCAOB'S FINDINGS

The PCAOB found a high level of audit deficiencies: in every one of the audit firms inspected and in 95% (57 of 60) of the audits selected for inspection. Some of the deficiencies identified relate to fundamental concepts of auditing, and the PCAOB characterized the audit deficiencies and independence findings as troubling.

Specifically, the PCAOB concluded that audits, as they related to customer protection and the net capital, were deficient as a result of:

- Insufficient testing of controls related to the broker-dealer's procedures for safeguarding securities, and periodic computations of aggregate indebtedness, net capital, or customer reserves;
- Inadequate inquiries or procedures for determining whether the broker-dealer properly claimed an exemption from the requirement to maintain a special reserve bank account under the customer protection rule;
- Failing to evaluate whether a material inadequacy existed when the broker-dealer reported a net capital deficiency in its financial statements;
- Failing to assess whether a net capital rule computation error indicated the existence of a material inadequacy;
- Failing to notify the SEC or FINRA of material inadequacies related to the customer reserve computation within the required time frame after the broker-dealer failed to provide notification;
- Failing to sufficiently test the completeness and accuracy of customer credit or debits included in the customer reserve computation;
- Failing to perform sufficient procedures to test the broker-dealer's classification of allowable and non-allowable assets when computing net capital; and
- Failing to perform sufficient procedures for haircuts on securities in the net capital computation, including by failing to test the completeness and accuracy of supporting records received from the broker-dealer or third parties.

Auditors were also found to have failed to follow applicable standards in the financial statement area by:

- Failing to perform audit procedures to respond to the identified risk of fraud for revenue recognition, or failing to identify such fraud risk altogether;
- Failing to perform sufficient journal entry testing;
- Failing to perform sufficient procedures to test for related parties or related parties transactions;
- Performing insufficient testing for material classes of revenue transactions, including trading gains and losses, commission revenue, and principal transaction revenue;

Client Alert

- Performing insufficient procedures to test the valuation of securities, including the reasonableness of the fair value estimates;
- Performing insufficient assessment as to whether the control deficiencies identified represented significant deficiencies or material weaknesses, or would affect a financial statement audit;
- Failing to identify and address omission of disclosures regarding related parties and transactions, fair value of securities, or revenue recognition policies, despite the fact that they exceeded materiality thresholds;
- Failing to identify incomplete disclosures or address evidence that was inconsistent with the disclosures made in financial statements;
- Failing to obtain an understanding of the entity and its environment, including its internal control before designing the nature, timing, and extent of audit procedures; and
- Applying incorrect definitions of “significant deficiency” and “material weakness” in the evaluation of identified control deficiencies.

These detailed deficiency findings illustrate the level of scrutiny which the PCAOB will apply to audit reports in its permanent inspection program, and auditors are likely to apply in their future audits of broker-dealers’ financial records.

PCAOB’S EXPECTATIONS

The Board stated that it expects audit firms to consider whether the audit deficiencies and independence findings in the report might be present in the audits they are performing, and should correct such deficiencies.

In connection with the audits analyzed in the report, auditors may need to assess their ability to support previously expressed audit opinions, which may entail performing additional audit procedures, informing the broker-dealer of the need to make changes to its statements, schedules, or the audit report on material inadequacies, or take steps to prevent reliance on previously expressed audit opinions. If the financial statements of a broker-dealer appear not to present fairly, in all material respects, the financial position, result of operations, or cash flows of the broker-dealer in conformity with GAAP, the Board reports that information to the SEC. The Board may report information suggesting violations of law and rules, including independence rules, by broker-dealers to the SEC and other regulators.

PCAOB counseled audit firms to stress to their personnel the need to conduct audits with professional care, including professional skepticism. Audit firms should also heed independence rules, and review policies for supervision and review to ensure that their partners and supervisory personnel are paying attention to various broker-dealer audit aspects.

MORE SCRUTINY AND OVERSIGHT TO COME

For a permanent inspection program, the Board is particularly focused on how the auditor’s role contributes to the protection of assets of broker-dealer customers. To make the audit as useful as possible in promoting customer protection, PCAOB is evaluating whether the risk of loss to customers can be assessed based on certain

Client Alert

attributes of broker-dealers. For example, PCAOB is considering differentiating among firms based on whether the broker-dealer: (a) receives, handles or holds securities or cash from the purchase or sale of securities by customers; (b) carries customer accounts; (c) engages in lines of business transacting with customers; (d) reports financial measurements of net capital, revenues, or assets that represent a differentiation of risk of loss to customers; (e) has features in its business model potentially indicating heightened fraud risk or has been the subject of regulatory sanctions; and (f) is a member of the Securities Investor Protection Corporation. The Board anticipates presenting a rule proposal for a permanent inspection program in 2014 or later.

PCAOB advised audit firms to stress to their personnel the need to conduct audits with professional care, including professional skepticism. Broker-dealers should pay attention to the deficiency areas identified in the PCAOB's report, so that they can be prepared for the Board's expectations once it establishes its permanent inspection program.

WHAT BROKER-DEALERS SHOULD DO NEXT

In preparation for future audits, broker-dealers should review their procedures for financial reporting and net capital and customer protection calculations with an eye towards the specific deficiencies identified in the PCAOB's report. Additionally, although abiding by independence rules remains an auditor's responsibility, broker-dealers should be at least familiar with the governing independence rules, and stay clear of arrangements with their accountants that might taint the auditors' independence.

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