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Presenting a live 110-minute teleconference with interactive Q&A

Broker Dealer Auditing: Mastering New SEC and PCAOB Rules and Standards

Complying with Changed Regulatory Framework for
Conducting Audits and Attesting to Internal Controls

TUESDAY, DECEMBER 10, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Kevin Breard, Managing Partner, **Breard & Associates**, Northridge, Calif.

John T. Hague, Partner & National Director of Financial Services, **McGladrey & Pullen**, Chicago

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Broker Dealer Auditing: Mastering New SEC and PCAOB Rules and Standards

Dec. 10, 2013

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Today's Program

Overview

[Kevin Breard]

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Access to Accountant and Audit Documentation

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Kevin Breard, Breard & Associates

OVERVIEW

Overview

- How many broker/dealers are registered with the SEC as of December 31, 2011?*
- A. 4,700
- B. 5,500
- C. 6,500
- D. 8,900

▫ *Based on FOCUS reports filed for December 31, 2011

Overview

- How many of the 4,700 SEC registered firms are carrying broker/dealers?
 - A. 900
 - B. 700
 - C. 300

Overview

BROKER-DEALER CAPITAL AT CALENDAR YEAR END 2011⁷⁴⁴
[\$ millions]

Capital	Number of firms	Aggregate total capital
Less than \$500,000	2,506	\$347
Greater than or equal to \$500,000 and less than \$5 million	1,320	2,212
Greater than or equal to \$5 million and less than \$50 million	608	10,520
Greater than or equal to \$50 million and less than \$100 million	80	5,672
Greater than or equal to \$100 million and less than \$500 million	125	26,655
Greater than or equal to \$500 million and less than \$1 billion	28	19,248
Greater than or equal to \$1 billion and less than \$5 billion	27	61,284
Greater than or equal to \$5 billion and less than \$10 billion	6	41,175
Greater than or equal to \$10 billion	9	175,585
Total	4,709	342,698

Source: Federal Registers/Vol. 78 No. 162/ Wednesday, August 21, 2013
Rules and Regulations

Overview

Number of Audits per Firm	Number of Firms	Percentage of Firms
1	363	46%
2 to 5	293	37%
6 to 50	113	15%
51 to 100	8	1%
More than 100	6	1%
Total	783	100%

Source: PCAOB Release No 2013-006
August 19, 2013

Kevin Breard, Breard & Associates

EXEMPTION REPORTS

New SEC report

“Form Custody” for Broker/Dealers

- **Who** Applies to all B/Ds
- **When** 4th quarter 2013
- **Due** 17th business day after quarter
- **Filed** With FOCUS DEA
- **Have to audit?** No

Form Custody

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

**FORM CUSTODY
For Broker-Dealers**

(Please read instructions before preparing Form.)

Name of Broker/Dealer

As of (Month/Day/Year)

8-
SEC File No.

CRD No.

Address of Principal Place of Business

(No. and Street)

(City)

(State)

(Zip Code)

- **Beginning December 31, 2013, what entity will require a copy of your audited financial statements?**
 - A. **Affordable Care Act Insurance Exchange (Online)**
 - B. **Vatican (Rome, Italy)**
 - C. **United Nations (New York, NY)**
 - D. **Securities Investor Protections Corporation (Washington, DC)**

New SEC Rule Issued August 2013

- Net capital rules
- Rule 15c3-1
 - Requirement to deduct from net worth certain liabilities or expenses assumed by third parties
 - New paragraph (c)(2)(i)(F)
 - If B/D shifts (offloads) expenses/liabilities to a third party that lacks the resources to pay, then B/D must take a charge to net capital

Final Hot Topics

- **Expense sharing agreement**
 - Parent – sub (B/D)
 - Reasonable allocation
- **All expenses on books to run B/D?**
- **Parent's books**
 - Not audited
 - Not made available to FINRA
 - Solvent/liquid/creditworthy
 - Regulator frustration

New SEC Rule August 2013

- Requirement to subtract from net worth certain non-permanent capital contributions.
 - (c) (2) (i) (G) (2)
 - Capital contribution with intent of withdrawal within a year
 - Then must be subtracted from net capital.

New SEC Rule August 2013

- **Amendment to 15c3-1 Restricting Withdrawal of Capital.**
 - 15c3-1(e)(3)(i) and 15c3-1(e)(3)(i)(A) and (B)
 - Restrictions on withdrawal of capital
 - Old rule 30% limit of excess capital
 - New rule prohibits withdrawal of any excess capital
 - Applies to withdrawal, advances, loans

New SEC Rule August 2013

- **Broker/dealers Solvency Requirements**
 - Amends (a) of 15c3-1
 - Broker/dealers cease conducting business if insolvent
 - If insolvent, notices to SEC, DEA, CFTC

New Rules

Effective June 1, 2014

Carrying B/D

- Compliance report addresses compliance with 15c3-1, 15c3-3
- Report material weakness internal control over compliance
- Report any instances of non-compliance

Non-carrying B/D

- **Exemption report.**
Did claim exempt under 15c3-3

Review Rule 15c3-3 Exemptive Provision

- **(k)1: Limited business (mutual fund and/or variable annuities)**
- **(k)(2)(1): “Special account” for the exclusive benefit for customers maintained**
- **(k)(2)(ii): All customer transactions cleared through another broker/dealer on a fully disclosed basis**
- **(k)(3): Exemption by order of the SEC**

Two new PCAOB attestation standards

1. Examination Engagements Regarding Compliance Reports of Brokers and Dealers
“Compliance Report”
2. Review engagements Regarding Exemption Reports of Brokers and Dealers
“Exemption Report”



PCAOB Attestation Standard #2

- **Review Engagements Regarding Exemption Reports for Broker/Dealers**
 - **“Exempt Report”**
 - **Applies to majority of FINRA members**
 - **Fully disclosed; no customers; nickel broker/dealer**

Assertion 2 - "Exemption Report"

- **Broker/dealer statement (assertion) operates under particular exemption (k)1, k(i), k(ii), etc)**
- **Auditor objective: State whether any material modification to the assertions should be made for the assertions to be fairly stated in all material respects**
- **Auditors report**
 - **Broker/dealer met exemption provision without exception, OR**
 - **Exceptions - discuss nature and occurrence**

- Review engagement should be coordinated with audit financial statements.
- Auditor needs to perform inquiries, i.e. management and those with relevant knowledge.
- Review regulatory examination regarding compliance with exemption provision
- Review controls relevant to compliance with exemption provision
- Review monitoring activity
- Review any known exceptions to exemption provision.

Representation Letter

- **Must obtain**
- **Failure to obtain – limit on scope of review engagement**

Report of Independent Registered Public Accounting Firm

Introductory paragraph with no exceptions:

We have reviewed management's statements, included in the accompanying Surebet, Inc. Exemption Report, in which (1) Surebet, Inc. identified the following provisions of 17 C.F.R. § 15c3-3(k) under which Surebet, Inc. claimed an exemption from 17 C.F.R. § 240.15c3-3: (2) (ii) (the "exemption provision") and (2) Surebet, Inc. stated that Surebet, Inc. met the identified exemption provision throughout the most recent fiscal year without exception. Surebet, Inc.'s management is responsible for compliance with the exemption provision and its statements.

Introductory paragraph with exceptions:

We have reviewed management's statements, included in the accompanying Surebet, Inc. Exemption Report, in which (1) Surebet, Inc. identified the following provisions of 17 C.F.R. § 15c3-3(k) under which Surebet, Inc. claimed an exemption from 17 C.F.R. § 240.15c3-3: (2)(ii) (the "exemption provision") and (2) Surebet, Inc. stated that Surebet, Inc. met the identified exemption provision throughout the most recent fiscal year except as described in its exemption report. Surebet, Inc.'s management is responsible for compliance with the exemption provision and its statements.

Report of Independent Registered Public Accounting Firm (cont.)

Our review was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) and accordingly, included inquiries and other required procedures to obtain evidence about Surebet, Inc.'s compliance with the exemption provision. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's statements. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to management's statements referred to above for them to be fairly stated, in all material respects, based on the provisions set forth in paragraph (k)(2)(ii) of Rule 15c3-3 under the Securities and Exchange Act of 1934.

Breard & Associates, Inc.
Los Angeles, California

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John Hague, McGladrey

COMPLIANCE REPORTS

Compliance Report – Descriptions

- The Compliance Report also includes two (2) descriptions, if applicable
 - 1) Each identified material weakness in the *Internal Control Over Compliance* during and as of the end of the fiscal year
 - 2) Any instances of non-compliance with the Net Capital and the Customer Reserve Requirement of the Customer Protection Rules as of the end of the fiscal year

Compliance Report – Definitions

- *Internal Control Over Compliance*
 - Internal controls that have the objective of providing the broker-dealer with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis

- *Material Weakness*
 - **A deficiency, or a combination of deficiencies,** in the broker-dealer's *Internal Control Over Compliance* such
 - that there is a reasonable possibility that non-compliance with the Net Capital and the Customer Reserve Requirement of the Customer Protection Rules will not be prevented or detected on a timely basis **or**
 - that non-compliance to a material extent with Rule 15c3-3, except for paragraph (e), or any Account Statement Rule will not be prevented or detected on a timely basis

Important Thought

- An identified material weakness in the internal control over compliance does not automatically result in a reportable instance of non-compliance with the financial responsibility rules.

Compliance Report – Changes from Proposed Rules

- The final rules reflect two (2) changes from the proposal:
 - 1) Elimination of the concept of material non-compliance and compliance in all material respects
 - 2) A narrowing of these statements and requirements from compliance with all of the financial responsibility rules to compliance the Net Capital and the Customer Reserve Requirement of the Customer Protection Rules

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Independent Public Accountant's Responsibility

Independence

- Follow SEC independence rules (Regulation S-X)
 - Auditors cannot provide
 - Bookkeeping or other services related to accounting records or financial statements preparation
 - Financial information systems design and implementation
 - Management functions or human resources
 - Certain Regulation S-X rules do not apply
 - Partner rotation
 - Audit committee pre-approval
 - Review of the exemption report or perform an examination of the compliance report
 - The exemption and compliance reports **MUST BE** prepared by the broker-dealer

PCAOB independence rules pending (stay tuned)

Engagement of the Accountant

- Current Requirements, applicable to audits of year ends through May 31, 2014
 - Audits of broker dealers reports filed with SEC made in accordance with generally accepted auditing standards (GAAS)
 - Report on Internal Control Report prepared by the accountant
- New Rules, applicable to audits of year ends on and after June 1, 2014
 - Audits and attestation of broker dealers reports filed with SEC will be made in accordance with PCAOB standards
 - Auditor's Report on Internal Control previously required by SEC Rule 17a-5(g)(1) is replaced by the auditor's Examination Report or Review Report, as appropriate
 - The PCAOB is working to finalize the permanent inspection program of audits of broker-dealers. The interim inspection program is anticipated to continue through 2014.

PCAOB Standards

- SEC amended Rule 17a-5 to state that examination of Compliance Reports and review of Exemption Reports will be in accordance with PCAOB Standards
- PCAOB in 2011:
 - Proposed Auditing Standard on Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards
 - Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports
- These standards are to align attestation standards more closely with the auditor's responsibility under the amendments to Rule 17a-5

PCAOB Standards *(continued)*

- On October 10, 2013, the PCAOB adopted the Attestation Standards and Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements
 - Effective for fiscal years ending on or after June 1, 2014 (subject to SEC approval)

- PCAOB also proposed an update to certain rules to conform to the Dodd-Frank amendments to the Sarbanes-Oxley Act, which includes
 - Rules requiring that registered firms comply with the PCAOB standards
 - Ethics and independence requirements
 - These are pending final approval

PCAOB – Attestation Standards

- Two attestation standards that cover the auditor's examination regarding compliance reports and the auditor's review regarding exemption reports of broker-dealers were adopted
 - **Examination Standard:** Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*
 - **Review Standard:** Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*

PCAOB – Examination Standard

- Provides requirements for the auditor that include the following:
 - Obtaining sufficient appropriate evidence to opine on the Compliance Report
 - Focusing on matters that are most important to the auditor's conclusion regarding the statements of the broker-dealer
 - Consideration of fraud risk, including the risk of misappropriation of customer assets
 - Coordination of the examination engagement with the audit of the financial statements and audit procedures performed on supplemental information
 - Description of how to report on an examination engagement, in connection with the requirements of SEC Rule 17a-5

PCAOB – Review Standard

- Requires the auditor to obtain moderate assurance about the following statements in the exemption report:
 - A statement that identifies the exemptive provisions claimed by the broker-dealer
 - A statement that the broker-dealer
 - 1) Met the identified exemption provisions throughout the fiscal year without exception **OR**
 - 2) Met the identified exemption provisions throughout the fiscal year, except as described in exemption report
 - 3) If applicable, identification of each exception with descriptions (nature and approximate date(s))

PCAOB – Supplemental Information

- Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Auditing Financial Statements*
 - A new standard
 - Establishes the auditor's responsibilities when performing audit procedures and reporting on supplemental information that accompanies the audited financial statements of broker-dealers and others
 - Intended to give the SEC and other users greater confidence in the quality and consistency of supplemental information

PCAOB – Supplemental Information (continued)

- Requirement of the auditor:
 - To determine that the supplemental information reconciles to the underlying accounting and other records or to the financial statements
 - To test the completeness and accuracy of the supplemental information
 - To evaluate whether or not the supplemental information, including form and content, complies with the relevant regulatory requirements

PCAOB – Supplemental Information (continued)

- Supplemental Information means:
 - Supporting schedules required to be filed pursuant to Rule 17a-5
 - Supplemental information
 - Required to be presented pursuant to the rules and regulations of a regulatory authority
 - Covered by an auditor’s report on that information related to financial statements that are audited in accordance with PCAOB standards
 - Information that is
 - Ancillary to the audited financial statements;
 - Derived from the company’s accounting books and records; and
 - Covered by an auditor’s report on that information related to financial statements that are audited in accordance with PCAOB standards

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Best Practices with Exemption Report

- **Example 1**

- \$5,000 B/D can effectuate 10 (ten) proprietary trades a year.
- Broker/dealer has 100 trades. Exemption not met.
- FINRA asserts \$100K B/D and assesses penalties for being below net capital.

- **Example 2**

- What could go wrong? B/D has client that walks in with stock certificate.
- Audit evidence – working supervisory procedures (W/S/P) promptly refuse to accept certificate or forward to a clearing firm.

Best Practices

Example 3

- Old
 - SEC two (2) copies
- New
 - SEC one (1) copy, SIPC one (1)

Best Practices

Related parties (AU Sec 334)

- **Is inquiry of management sufficient for evaluating related party transactions?**
 - **Yes**
 - **No**

Best Practices

Related parties (AU Sec 334)

- After identifying related party transactions, the auditor should apply the procedures he considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect in the financial statements. **The procedures should be directed toward obtaining and evaluating sufficient appropriate evidential matter and should extend beyond inquiry of management.**
- Procedures that should be considered include the following:
 - A. Obtain an understanding of the business purpose of the transaction

Best Practices

Related parties (AU Sec 334)

- **Procedures that should be considered include the following:**
 - B. Examine invoices, executed copies of agreements, contracts and other pertinent documents, such as receiving reports and shipping documents
 - C. Determine whether the transaction has been approved by the board of directors or other appropriate officials.

Best Practices

Related parties (AU Sec 334)

- **Procedures that should be considered include the following:**
 - D. **Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosures, in the financial statements.**
 - E. **Arrange for the audit of intercompany account balances to be performed as of concurrent dates even if the fiscal years differ, and for the examination of specified, important and representative related party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.**
 - F. **Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral**

Technical side

Prior Rule 17a-5

- Rule 17a-5(d) “Annual filing of audited financial statements”
- (d)(2) List of financial reports
- (d)(3) Support schedules, net capital computations, reserve requirement, possession/control
- (d)(4) Reconciliation of FOCUS to the audited net capital

New June 1, 2014

- New (d)2 to combined (d)2-(d)4
- (d)(3) Compliance Report
- (d)(4) Exemption Report
- (d)(5) “Annual Reports” new term to replace Audit Report
- (d)(6) SIPC filing

Annual Reports

1. Audit Financial Statement with support schedule, et al
2. Exemption or Compliance report

Access to Accountant and Audit Documentation

Access to Accountant and Audit Documentation

- SEC amended Rule 17a-5 to require that each clearing broker-dealer agrees to allow SEC and its DEA examination staff
 - to review the audit documentation associated with its annual audit reports
 - allow its independent public accountant to discuss findings relating to the audit reports with the SEC and DEA
- Access to information and discussions with a clearing broker-dealer's independent public accountant would enhance the efficiency and effectiveness of Commission and DEA examinations
- This requirement is limited to clearing broker-dealers, which generally have more complex business operations than non-carrying firms
- Request to a broker-dealer's independent public accountant for the accountant to discuss audit findings or for access to audit documentation must be made in writing
- SEC anticipates that it will accord confidential treatment to such documents to the extent permitted by law