

Broker-Dealer Audits: Overcoming Costly Deficiencies in PCAOB Examinations and Avoiding Sanctions

TUESDAY, APRIL 28, 2020, 1:00-2:50 pm Eastern

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**Broker-Dealer Audits:
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OBJECTIVES

- Provide audit professionals and advisers with practical guidance for conducting broker-dealer audits, offering tools to avoid the most common and costly risk areas in broker-dealer audits as identified in PCAOB annual inspections.
- Understanding the areas of highest risk in broker-dealer audits.
- Identifying and avoiding the most common mistakes in broker-dealer audits.
- Establishing a system of quality control to ensure compliance with PCAOB standards.
- Addressing auditor independence.



ASSURANCEDIMENSIONS

- Assurance Dimensions is a licensed CPA firm. Our professional staff demographics comprises a diverse group of individuals including both men and women who originate from numerous backgrounds.
- Assurance Dimensions has significant experience in the industries of broker-dealers, construction, manufacturing, medical, technology, retail, not for profit, retirement plans, and many more. We staff our engagements with knowledgeable personnel so that we can provide quality service.
- Our two differentiating factors are related to the use of only staffing experienced professional and fixed fee pricing. Experienced professionals make the audit process much more smooth and effective for our clients. We add more value to senior management from a consultative perspective. The fixed fee pricing allows our clients to feel comfortable calling us anytime during the year with no risk of additional billing. This factor creates an environment where significant accounting issues and questions are addressed early in their life cycle, which allows for the most efficient resolution.

LOCATIONS:



TAMPA BAY

JACKSONVILLE

ORLANDO

SOUTH FLORIDA



Harley Aronoff, CPA

**Blue Diamond Audit Consulting
Managing Partner**





Blue Diamond Audit Consulting is a boutique audit consulting firm, founded by former PCAOB Inspectors, that specializes in consulting public accounting firms on PCAOB audits of broker-dealers and regulatory compliance.



Our Panelists



Matthew C. McNamara, CPA, CISA
Assurance Practice Leader (Partner)



Batul Abdulali
Senior Audit Manager



Harley Aronoff, CPA
Blue Diamond Audit Consulting
Managing Partner



Agenda

1. BROKER-DEALER AUDIT INSPECTION OVERVIEW

- Relevant Regulations
- PCAOB Inspection Findings
- Small Business Audit Correction Act
- Broker- dealer audit issues

2. BEST PRACTICES FOR AUDIT PREPARATION / EFFECTIVE PRE-PLANNING

- Look-back: what worked / did not work from past season
- Effective pre-planning
- Problem areas
- Preparing areas of audit focus (revenue, adopting new standards, financial reporting)

3. CHALLENGES TO ANTICIPATE / PRACTICAL SOLUTIONS

- Contractual support (discuss each type of revenue stream)
- Reconciled schedules
- Use of experienced FINOP
- Security of support
- Common errors and potential fixes for errors

4. OTHER UPDATES

Broker-dealer audit inspection overview

Relevant Regulations

- **PCAOB audit requirements**
 - Increased Documentation Requirements
 - Lower Materiality Requirements
 - Results in higher sample sizes
 - Increased costs of training
 - Increased insurance costs
- **FINRA**
 - SEA Rule 17a-5
 - SEA Rule 15c3-1
 - SEA Rule 15c3-3
- **Securities Exchange Commission (SEC)**
 - Rules and regulations to follow

PCAOB Inspection Findings

- **Engagement performance**
 - Inadequate materiality levels
 - Inadequate sample sizes
 - Engagement Quality Review
 - Audit documentation
- **Testing of Internal Controls**
 - Management review controls
 - Controls over SOC reports
- **Exemption reviews**
 - Understanding the exemptions
 - Inquiries with management
 - Assessing compliance with exemption
- **Net Capital**
 - Understanding minimum requirements
 - Testing completeness
 - Allowable vs non-allowable

PCAOB Inspection Findings *(continued)*

➤ Areas of the Financial Statement Audit with Deficiencies

- Revenue
- Risks of Material Misstatement Due To Fraud
- Related Party Relationships and Transactions
- Financial Statement Presentation and Disclosures
- Receivables and Payables
- Fair Value Measurements

Small Business Audit Correction Act

Senator Tom Cotton (R-Arkansas) along with Senators Thom Tillis (R-North Carolina), Doug Jones (D-Alabama), and Kyrsten Sinema (D-Arizona) yesterday introduced the Small Business Audit Correction Act to provide much-needed regulatory relief to small investment brokers by exempting them from certain audit requirements and reinstating previous regulations. The bill was first introduced in the 115th Congress. Last year a similar version passed the House Financial Services Committee in bipartisan fashion.

"Requiring our small non-custodial broker-dealers to get the same audits required of public companies only results in higher costs and fewer small firms, and all because of a provision that wasn't even supposed to be aimed at non-custodial firms. This bill will return audit requirements to the former standard, one appropriate for these kinds of firms and which will allow our small broker-dealers to expand and help create more jobs," said Cotton.

Broker-dealer audit issues

➤ Revenue

- sample sizes
- understanding their process and control environment;
- Reliance on SOC 1 reports
- Cut off issues

➤ Receivables

- Confirmations not sent (AS 2310)
- Undue reliance on reports
- Insufficient sampling

➤ Net Capital

- Not performing/performing insufficient procedures to test certain elements of the net capital computation such as:
- Deductions/Additions to Net Worth
- Classification of assets
- Haircuts on securities
- Minimum net capital requirements
- Ratios

Broker-dealer audit issues *(continued)*

➤ **Review of Exemption Report**

- Claiming the wrong exemption (SEC rule 15c3-3)
- Not claiming all applicable exemptions (SEC rule 15c3-3)
- Reporting errors noted
- Insufficient inquiries (AT2, par 10c and 10d)
- Not performing other procedures as necessary (10h)
- Rep Letter omissions (AT2)

➤ **Related-party transactions**

- Legitimate transactions
- Arm's length
- Supported and properly disclosed

Broker-dealer audit issues *(continued)*

➤ Responses to Fraud Risks

- Testing journal entries
- Assumed revenue fraud risk

➤ Fair Value Measurements

- Valuation
- Proper disclosures



Best practices for audit preparation/effective pre-planning

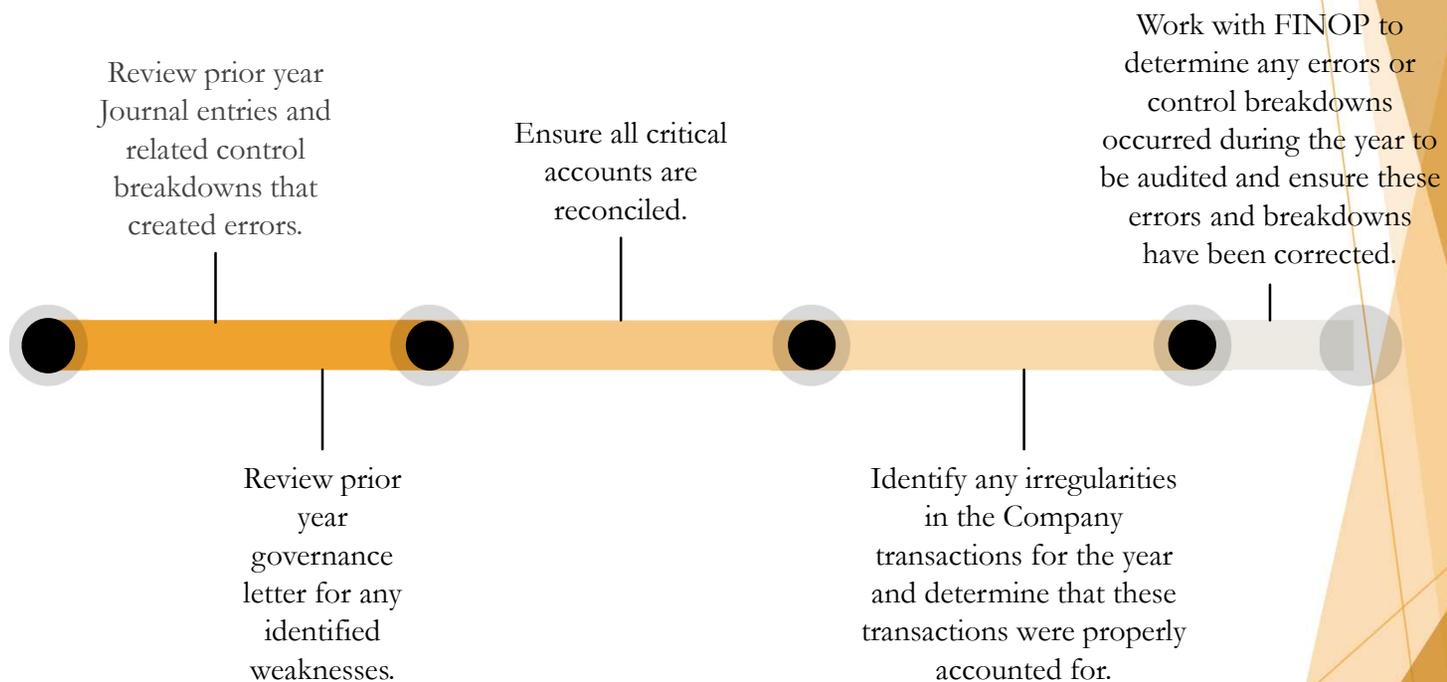
Look-Back: what worked / did not work from past season

- Effective pre-planning
- Understanding the clients business processes upfront
- Interim testing
- Use of experienced / non-experienced FINOP
- Communication

Effective pre-planning

- Planning and interim work at least 2 days prior to year end
- Internal controls- having process narrative/ memo's; flow of revenue all documented (if don't have request from auditor)
- Have a clear understanding of controls in place
 - Auditors taking a controls approach around revenue
 - PCAOB expert; means less sample sizes if controls in place effective
- Having all regulatory documents and correspondence ready; any issues are made known in advance
- Confirmations pre-prepared
- SOC reports from clearing broker are obtained
- Addressing the effects of any new standards early on
- Commitment of resources (both client and audit firm)
- Same audit team
- Who is preparing the financial statements? Have this done early - does not need to be at the end of fieldwork
- Each broker-dealer has specific nuances- having same team critical
- Any major transactions/issues discussed beforehand and not last minute

Problem areas



Preparing Areas of Audit Focus

➤ Revenue

- Commissions- documenting the controls in place to reconcile information from the clearing broker; PCAOB not allowing us to rely directly on clearing broker statements; understanding the controls environment and what specifically is done to reconcile the information; reconciling the trades etc.; results in less sample sizes; typical broker-dealer with approx. \$2 million in revenue- can create a sample size of up to 130 items; reduce to approx. 30/40
- Investment banking/underwriting- have contracts in place; has revenue recognition criteria been met; not applying on cash basis; have the documentation for deals closed and a recalculation of the revenue earned
- Proprietary trading- control environment; key controls in place to reconcile the information from clearing broker; understanding and documenting fair value of securities owned; what fair method / sources being used; critical for level 2 / level 3
- Revenue controls allow Company to re-compute revenue and ensure completeness not just rely on third parties

Preparing Areas of Audit Focus *(continued)*

➤ **Adopting New Standards**

- Understanding upfront which ones will affect the broker-dealer
- Discussing with the auditor
- Reviewing disclosures beforehand

➤ **Financial Reporting**

- Who is preparing the financials
- Experience
- Auditor independence

Challenges to anticipate/practical solutions

Practical Solutions

➤ Contractual Support

- Signed by management
- Signed by customer
- In writing

➤ Reconciled Schedules

➤ Use of Experienced FINOP

- Financial statement preparation
- Organized and tied out to audit request

➤ Security of Support

- Use of secure web portal
- Dropbox
- Secure email

➤ Common errors and potential fixes for errors

- Underestimation of audit process

OTHER UPDATES

Other updates

ASU 2018-13 Fair Value Measurement (Topic 820), Disclosure Framework

- Changes to the Disclosure Requirements for Fair Value Measurement Effective for fiscal years beginning after 15 December 2020, and interim periods within those fiscal years:
 - Objective to provide users of financial statements with information about assets and liabilities measured at fair value in the statement of financial position or disclosed in the notes to financial statements:
 - a. The valuation techniques and inputs that a reporting entity uses to arrive at its measures of fair value, including judgments and assumptions that the entity makes
 - b. The uncertainty in the fair value measurements as of the reporting date
 - c. How changes in fair value measurements affect an entity's performance and cash flows

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PCAOB release 2017-001

- Inclusion of Critical Audit Matters (CAM's) in audit report; not required for broker-dealers but auditors may voluntarily include CAM's if they choose; effective for fiscal years ending on or after December 15, 2020

Q&A

QUESTIONS?

ANSWERS

Contact Information

Contact Information



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Matt McNamara has been practicing as a Certified Public Accountant for 19 years. He began his career at two of the world's largest accounting firms, Arthur Andersen and Grant Thornton, before moving over to the industry sector as corporate controller for Anchor Glass and director of internal audit for MarineMax Corporation. He returned to Grant Thornton as a senior manager to oversee a client list in the following industries: not-for-profit, technology, manufacturing, construction, and transportation. Matt led both private equity and venture capital engagements and managed key relationships for the firm's portfolio companies. He currently serves as the audit practice leader at Assurance Dimensions.

Matt graduated from the University of Florida in 1998 with a Masters Degree of Accounting. He holds licenses as a Certified Public Accountant (CPA) in the State of Florida and nationally, as a Certified Information Systems Auditor (CISA).

He is a graduate of Leadership Tampa Bay, a member of the Florida Institute of Certified Public Accountants, the American Institute of Certified Public Accountants, Community Association Institute and works with Junior Achievement and the Leukemia Lymphoma to support their causes.

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Batul has worked with Assurance Dimensions and over the past five years has effectively managed audits for public reporting companies in the beverage, IT, telecommunications, oil and gas and waste management industries. In addition she has experience in specialized audits such as factoring companies and broker-dealers. She has also managed private company audits in various industries including pharmaceutical, medical equipment and sustainable energy. She began her auditing career with KPMG, UK and became a Qualified Chartered Accountant and is a member of the Institute of Chartered Accountants in England and Wales in 2010. Batul moved to Florida and worked with KPMG, Miami and was responsible for managing audits in various industries including aviation, not for profit and health.

Batul graduated from the University of Manchester, UK, with a Bachelor Honors degree in Accounting, Business and Computer Science.

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Harley Aronoff

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Former PCAOB inspector and broker-dealer industry technical expert, Harley Aronoff, co-founded Blue Diamond Audit Consulting LLC after recognizing the need for auditors of broker-dealers to have a trusted, expert broker-dealer industry consultant with PCAOB experience. During his career, Harley has earned the reputation, both in public accounting, and in the broker-dealer industry, as an expert in broker-dealer audits, regulations, and operations. Harley has the unique background and experience as a CPA who audited broker-dealer financial statements for a globally-networked public accounting firm and as a former Series 24 FINRA licensed Principal for a regional broker-dealer.

During his 7+ years as an inspector in the Broker-Dealer Inspection Group at the PCAOB, Harley inspected audits of broker-dealers of all types and sizes, although he primarily inspected the regulatory areas of audits for the largest and most complex broker-dealer audits. Harley also served as a broker-dealer technical expert on the Broker-Dealer Inspection Group's technical review committee.

During his 15 years in the broker-dealer industry, Harley worked as a Branch Operations Specialist at Edward Jones & Co. and was the Financial Reporting Manager at Citi Hedge Fund Services where he was responsible for the preparation and filing of regulatory computations and FOCUS Reports for over 50 broker-dealers.