

PEER REVIEW ALERT 11-02 (March 2011)

Enhanced Peer Review Guidance for Reviews of Firms That Audit Broker-Dealers

Background

The Sarbanes-Oxley Act originally gave the Public Company Accounting Oversight Board (PCAOB) authority and responsibility to inspect registered public accounting firms with respect to their auditing of Securities and Exchange Commission (SEC) issuers. As of July 21, 2010, Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act expanded that inspection authority to include audits of registered securities brokers and dealers (BDs). On December 14, 2010, the PCAOB announced a proposal for an interim broker-dealer inspection program. Under the proposal, the PCAOB will inspect, over the next two years, all types of BDs to determine what auditing standards are needed and what the scope should be for the permanent inspection program. They will be following the AICPA audit guide and there will be no public release of the interim inspection results unless the BD type is ultimately included in the permanent inspection program. Although the PCAOB does not expect to issue firm-specific inspection reports before the scope of a permanent program is set, the PCAOB will identify and address with the inspected firm any significant issues in its audit work and, where appropriate, refer information about potential violations to the SEC and the Financial Industry Regulatory Authority (FINRA), or take disciplinary action against the auditor. Approximately 100 firms will be inspected the first year – selection will be partially risk based but primarily focused on gaining a representative sample.

For more information on the PCAOB interim inspection Program, refer to the following link: [Docket 032: Proposed Temporary Rule for an Interim Inspection Program for the Audits of Brokers and Dealers.](#)

Enhanced Peer Review

As noted in the [11-01 Peer Review Alert](#) released in February 2011, to address the current risks of peer review and public interest in regards to the audits of broker-dealers, the Peer Review Board (PRB) has made the changes below which are effective for peer reviews commencing on or after April 1, 2011.

Carrying vs. Non-Carrying Broker-Dealers

For purposes of the Peer Review Program, broker-dealer audit engagements were categorized as either carrying or non-carrying based on systemic risk. The definitions of carrying and non-carrying broker-dealers will be included in Interpretation 63-2 as follows:

63-2 *Question*—For purposes of the AICPA Peer Review Program, what is the difference between a carrying broker-dealer and a non-carrying broker-dealer?

Interpretation—Carrying broker-dealers include all broker-dealers that clear customer transactions, carry customer accounts or hold custody of customer cash or securities. Examples of carrying broker-dealers include (a) clearing broker-dealers who receive and execute customer instructions, prepare trade confirmations, settle the money related to customer trades and arrange for the book entry (or physical movement) of the securities and (b) carrying broker-dealers that hold customer accounts or clear customer trades for introducing broker-dealers. Non-carrying broker-dealers are those broker-dealers that do not clear customer transactions, carry customer accounts, or hold custody of customer cash or securities. Examples of non-carrying broker-dealers are (a) introducing broker-dealers that introduce transactions and accounts of customers or other broker-dealers to another registered broker-dealer that carries such accounts on a fully disclosed basis, and who does not receive or hold customer or other broker-dealers securities and (b) a broker-dealer whose business does not involve customer accounts, such as proprietary trading firms, investment banking firms, and firm's that sell interest in mutual funds or insurance products.

Risk Assessment and Engagement Selection

The PRB has determined that if a firm performs the audit of one or more carrying broker-dealers, at least one such audit should be selected for review. It is also expected that if a firm's audits of broker-dealers include only non-carrying broker-dealers, the team captain should be aware of and give special consideration to the risks associated with such broker-dealer audits in making engagement selections.

Inclusion of carrying BDs as a "must select" engagement elevates these audits to the same prominence as others with a significant public interest, including engagements subject to *Government Auditing Standards*, compliance audit requirements of engagements subject to Single Audit Act/OMB Circular A-133, engagements conducted pursuant to ERISA, and audits of federally insured depository institutions subject to FDICIA. In complying with the engagement selection guidance in the Standards, peer reviewers should ensure that engagements selected include a reasonable cross section of the firm's accounting and auditing engagements, appropriately weighted considering risk. Thus, the peer reviewer may need to select greater than the minimum of one engagement from these industries in order to attain this risk weighted cross section. A reasonable cross section of a firm's accounting and auditing practice not only includes consideration of the specific industries that are required to be selected, but other industries that have a significant public interest.

If a firm audits non-carrying BDs, the team captain's risk assessment is expected to address the risks associated with those BDs (e.g., if the BD has some form of custody and control that may create risk and require additional internal controls). For all broker-dealer engagements, the team captain should take into consideration the experience of the partners conducting the BD audit, relative CPE of the partner and staff on the engagement, and communications from regulatory agencies and the size of the BD's business (e.g., does the BD serve one or more non-carrying BDs). Refer to Interpretation 59-2 for other examples of factors to consider when assessing peer review risk at the engagement level.

Reviews Selected for the PCAOB Interim Inspection Program

If a firm performs the audit of multiple carrying broker-dealers and the PCAOB selects one of them, a different BD may be selected for the Peer Review Program. The team captain is still expected to understand the findings on that engagement and the impact to peer review. This understanding should be documented in the Summary Review Memorandum (SRM) in question II D and the risk assessment.

If a firm only performs the audit of one carrying broker-dealer and that audit has been inspected by the PCAOB, the team captain will need to determine if it should be reviewed as part of the firm's peer review. In order to make such a determination, the team captain will need to understand the scope of the inspection, where the PCAOB had findings and where they did not, the nature of any remediation, and the effect on the peer review/system of quality control. If the PCAOB inspection only focuses on a particular area (e.g., 15c3-3 compliance), the team captain should address the risk associated with that area and consider other peer review risks (e.g., net capital computation) that were not addressed.

In both instances described above, as the PCAOB may not be issuing written comment forms, it could result in extra time and effort from the team captain to document information discussed about the PCAOB review. Team captains should reference Interpretation 40-1 for further guidance on discussing and documenting the PCAOB Inspection. It is not the intention of the PRB for the reviewer to hold up the planning, performance, or completion of a peer review waiting on the results of the PCAOB inspection. The team captain should perform the review based on the knowledge they have of the inspection through the exit conference date. If the firm only has one carrying BD and it was selected by the PCAOB but the firm has not been informed of their conclusions, it is expected that carrying BD will be selected for the peer review.

Revised Peer Review Documents

There are additional forthcoming changes to the documents provided by the Peer Review Program. The SRM and Engagement Statistics Data Sheets will be revised to allow peer reviewers, technical reviewers, and peer review committees to identify and track when a firm performs audits of broker-dealers, if those audits were selected for review, and if the audit was deemed to be not performed in accordance with

professional standards. Further, revisions are being made to the peer reviewer's resume form and the reviewed firm's background form to properly align firms that perform audits of carrying and non-carrying broker-dealers with peer reviewers with appropriate experience. A broker-dealer supplemental checklist focusing on the risks associated with both carrying and non-carrying broker-dealers will also be released later this year. In the meantime, reviewers of broker-dealer audit engagements should continue to use the general audit checklist.

Report Modification

The appendices to Section 1000 with examples of peer review reports will also be revised to include carrying broker-dealers in the paragraph regarding engagements selected for review. If a team captain reviewed any of the must-select engagements in a review, the system review report should include the following paragraph: "As required by the standards, engagements selected for review included (engagements performed under *Government Auditing Standards*; audits of employee benefit plans, audits performed under FDICIA and audits of carrying broker-dealers."

Guidance for Administering Entities and Technical Reviewers

Due to the lead time required to program these changes in PRISM, administrators and technical reviewers will need to perform additional inquiries to ensure peer review teams have adequate experience and that broker-dealers have been appropriately considered by the review team. PRISM is expected to be programmed to reflect the BD changes later in 2011.

Review Administration

Under current guidance, a firm is required to have its peer review administered by the National PRC if it is required to be registered and inspected by the PCAOB, and/or it performs audits of non-SEC issuers pursuant to the standards of the PCAOB. Until a permanent scope is identified for the PCAOB inspection program of BDs, firms that are only required to be inspected by the PCAOB due to the performance of audits of BDs, may have their peer reviews administered by a state CPA society, group of state CPA societies, or other entity approved by the PRB to administer peer reviews. They do NOT have to be administered by the National PRC but may choose to do so.

At least one member of the RAB considering a peer review that includes audits of carrying broker-dealers must have current experience in such engagements. A national list of experienced RAB members will be maintained so that the administering entity has an available pool of RAB members with carrying broker-dealer experience.

Administering Entities (AEs)

In order to properly align firms that perform audits of BDs with reviewers with appropriate experience, the AE should contact both the firm and the team member with BD experience for reviews anticipated to commence on or after April 1, 2011.

Currently, the firm background form and reviewer resume form have two BD industry codes: 135 Brokers and Dealers in Securities and 140 Brokers and Dealers in Commodities. If a firm submits a background form to the AE that indicates that the firm performs an audit in either of these industry codes, the AE should contact the firm to determine if they perform audits of carrying or non-carrying BDs. A reviewer that has experience with carrying BDs may review a firm with non-carrying BDs. However, a reviewer with only non-carrying BD experience does NOT have the appropriate experience needed to perform a review of a carrying BD. Therefore, if the reviewed firm indicates that they perform audits of carrying BDs, the AE should contact the team member with BD experience to determine if such experience is with carrying or non-carrying BDs. If the reviewed firm indicates that they only perform audits of non-carrying BDs, it is not necessary for the AE to contact the team member unless the AE feels the team member will benefit from knowing the types of BD engagements that should be considered in his/her risk assessment. The reviewers in the national RAB pool with current carrying BD experience have also agreed to serve as team members for reviewing firms that cannot find a qualified team member.

The review should not be approved for scheduling until a team member with the requisite BD experience is added to the team. The AE should document this verification of the type of BDs audited by the firm and

the reviewer's experience for later reference by the technical reviewer and others. If the review has already been scheduled, the AE must contact the reviewed firm and peer reviewer to ensure the reviewer is appropriately qualified.

A separate administrator's alert will be released with additional guidance for the AEs.

Technical Reviewers

To ensure that BDs have been appropriately considered by the review team, the technical reviewer should review the Summary Review Memorandum (SRM) for indication of audits of entities subject to SEC Independence Rules. If the SRM includes audits of entities subject to SEC Independence Rules, the technical reviewer should 1) determine if the audits of entities subject to SEC Independence Rules were audits of BDs, 2) ensure that BDs were addressed in the team captain's risk assessment, 3) ensure a carrying BD was appropriately selected as a must-select or if the firm only performs one audit of carrying BDs and such was previously inspected by PCAOB, sufficient documentation regarding the PCAOB inspection results as to justify why it was appropriate not to review the carrying BD during the peer review, and 4) ensure that question II D of the SRM addresses the PCAOB inspection, if applicable. Technical reviewers should also ensure the paragraph in the peer review report regarding engagements selected for review also includes carrying broker-dealers. Further, for reviews that include carrying broker-dealers, the technical reviewer should confirm with the AE that the team member reviewing the carrying BD was contacted to verify that he/she has current carrying BD experience.