PCAOB Oversight of Broker-Dealer Auditors

By Billy Bob Messer, CPA, CGMA

Two years after the world learned Bernie Madoff had orchestrated the largest Ponzi scheme in history, the Dodd-Frank Act in 2010 gave the Public Company Accounting Oversight Board (PCAOB) oversight authority over auditors of broker-dealers (BDs). The purpose of this article is to help BD audit firms improve the quality of their audits and minimize PCAOB deficiencies in those audits. To do so, firms should understand the background of this regulation, analyze the differences between the PCAOB standards and the BD audit standards of the American Institute of CPAs (AICPA) and review the specific results of PCAOB's interim inspection progress reports.

Lastly, BDs and their auditors should understand PCAOB's plans for the future, so they can prepare for further changes as they arise. Although expansion of PCAOB oversight to include BD auditors may bring some painful changes in the beginning, these measures should ultimately result in higher-quality audits in the long run.

Background

Since its inception, PCAOB has transformed the auditing profession. Many of the changes within the last seven years can be at least partially attributed to the Madoff scandal. Understanding the audit quality breakdowns that contributed to this scandal can help auditors comply with these changes. First, Madoff's auditor was not adhering to professional standards, which could have been discovered by a thorough peer review. However, not only was Madoff's auditor not subject to PCAOB inspection, he was able to avoid peer review by telling AICPA that he did not conduct audits.[1] The large firms auditing investment funds holding Madoff investments were also guilty of performing insufficient procedures to assess the validity of the statements provided by Madoff,[2] and thus share some of the blame.

Two key lessons were gleaned from this scandal. First, a sufficient level of auditor oversight is necessary, as there are members of the profession who intentionally disregard the profession's standards. Second, auditors should thoroughly assess the reliability of third-party evidence, including evidence from other accounting firms. The government responded to the lack of auditor supervision by granting PCAOB oversight authority over the audits of BDs.[3] PCAOB addressed the second lesson by highlighting the reliability of third-party evidence in their inspection process.

In 2011, PCAOB implemented an interim inspection program designed to gather information for use in developing a permanent program. The first progress report was released in August 2012, noting deficiencies in each of the 23 BD audits inspected. The audits inspected within this report were performed under AICPA standards rather than those of PCAOB.[4] It is important to understand that PCAOB defines a deficiency as "the failure to perform, or perform sufficiently, certain required audit procedures." This does not mean that the Board concluded the firm lacked sufficient evidence to support its opinion, unless the Board specifically stated that fact.

However, it is particularly alarming to note that these inspection reports revealed that none of the audits, performed under existing standards, were performed satisfactorily.

Almost one year after the release of the first report, the SEC amended Rule 17a-5 to require that audits of BDs be conducted in accordance with PCAOB, rather than AICPA, standards.[5] Given the poor results in the first inspection, this expansion of control was practical and it would be difficult for the Board to continue to conduct inspections on audits performed in accordance with standards that it did not promulgate. Moreover, the deficiency rates noted in subsequent inspection reports showed little improvement,[6,7,8] making it difficult to argue against the need for stronger oversight.

Many of the findings in the reports relate to basic audit procedures, indicating a pervasive lack of audit quality. These reports collectively demonstrate the need for improvement. Firms conducting BD audits in the future should carefully read them so they can take appropriate action before the inspection team arrives.

PCAOB Standards vs. GAAS

The first major difference between generally accepted auditing standards and PCAOB standards is the very nature of the standards themselves. The phrase *Generally Accepted Auditing Standards (GAAS)* means that the standards derive their authority from the fact that they are generally accepted practice among auditors. In contrast, PCAOB standards are regulatory requirements promulgated by a regulatory body for a regulatory purpose.

The second major difference between these standards lies in the nature of the respective processes that assure compliance. The AICPA peer review process ensures that audit teams perform the right procedures. In contrast, the PCAOB inspection process ensures that teams perform not only the right procedures but that they are performed the *right way*. For example, while the documentation standards of the two groups appear to be similar, PCAOB's inspection process takes the position that not fully documenting a procedure is just as bad as *not performing* the procedure. The AICPA peer review process is less rigorous in this area. The rigor of documentation supporting auditor judgment is especially important in a PCAOB audit. Auditors should assume that PCAOB will question every decision they make and their documentation should sufficiently support their judgment.

As of this writing, PCAOB has released two new attestation standards specifically applicable to BDs. Attestation (AT) Standard 1 establishes the standards firms should follow when performing an examination of the BD's compliance report[9] and therefore only applies to "carrying" BDs. AT Standard 2 includes the standards that a firm should follow when performing a review of the exemption report,[10] and therefore only applies to "non-carrying" BDs. The importance of obtaining and documenting specific evidence supporting each BD assertion is the underlying message in both standards. Engagement teams need to carefully consider the statements their clients make in these reports.

Auditing Standard (AS) 17 establishes the standards governing audit procedures over supplemental information.[11] Although released the same day as the two attestation standards, it is not specific to BDs. It does, however, specifically apply to the net capital computation included in BD reports and materiality considerations are vital. For example, a misstatement that does not meet the documented audit materiality threshold may be considered material if it changes the outcome of the "net capital" test. The Board considers these standards to be key audit areas and they will continue to be areas of focus during PCAOB inspections. Although these standards are new, compliance is relatively simple if firms can show that they are professionally skeptical, that they do the right things the right way and that they fully document the procedures performed and the resulting conclusions.

Inspection Results – Common Findings

To date, the BD audit inspection reports reveal repeated deficiencies in the same audit areas. For example, inspectors have consistently found firms violating the SEC's independence requirements by preparing the client's financial statements. The SEC considers any form of preparation to be a violation, including word processing and printing assistance. For small BDs who currently use their auditing firm as a one-stop shop, appropriate adherence to independence will require a paradigm shift for both auditors and their clients. PCAOB Rule 3526 states that audit teams are required to communicate that the firm is independent in writing to the audit committee or those charged with governance. The letter should also discuss any threats to independence and explain how the firm has addressed these risks.[12]

Another common finding in the inspection results pertains to the engagement quality review partner requirement established in Auditing Standard 7.[13] A partner, other than the engagement partner, is required to be appointed to perform additional review of the financial statements and key audit work papers. This partner is required to be independent, and teams should carefully consider the applicable cooling off requirements if the partner has previously served as the lead engagement partner. Also, the quality review partner should perform a thorough review, particularly in light of the fact that their review can be considered insufficient by default if other deficiencies are found. For example, BD auditors who fail to update the wording in their opinion to reference PCAOB Standards instead of US GAAS, a common inspection finding, will have a deficiency related to the ineffectiveness of the quality review.

The BD inspection reports also contain deficiencies pervasive to the overall profession. For example, the testing and consideration of an entity's internal controls is a common deficiency. Proper testing of internal controls can be difficult and require complex considerations. However, the majority of BDs are exempt from the internal control reporting requirements. Therefore, the internal control deficiencies likely occur when teams fail to connect identified misstatements (especially misstatements below their documented materiality) to the underlying control deficiency, a requirement even for non-carrying BDs.

Teams fail to properly assess the information provided to them by their client or their client's service provider. When the client provides the engagement team with any report from any source, the team is responsible for assessing the completeness and accuracy of the data. Additionally, teams commonly fail to consider all classes of

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revenue transactions in both their risk assessment and in performing substantive testing.

Lastly, PCAOB standards require auditors to perform testing of details to address any significant risk, whereas auditors commonly rely solely on substantive analytics to test the risk of fraud in revenue recognition. The deficiencies described in the inspection report will continue to be target areas during subsequent inspections until the profession shows improvement. In the most recent inspection report this summer, PCAOB staff said they are still seeing signs of impaired auditor independence. They found problems with revenue recognition, financial statement presentation and disclosures, and the assessment of risks of material misstatement due to fraud.

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What's Next?

PCAOB's next step is to establish a permanent inspection program. There are a couple of inherent difficulties in scoping the permanent program. First, it is difficult to draw a line that would not have excluded Bernie Madoff's auditor, and the Board is unwilling to implement a program that would not have solved the problem that gave rise to their oversight. Second, deficiency data points within the recent inspection results make it difficult to narrow the scope of the permanent program. Specifically, limiting the scope based on the characteristics of the BDs under audit is difficult. Whereas larger BDs present the greatest risk to investors, there have been fewer deficiencies in their audits than those of smaller BDs. Also, excluding BDs who claim an exemption from customer protection rules presents problems because this population of BDs contributes to a higher number of deficiencies than the firms not claiming an exemption.[14] It is illogical to expect the Board to remove the audits with the highest deficiency rates from the scope of their review.

Additionally, although exempt BDs do not hold customer funds and thus pose little risk to the investors, auditors are the primary source of assurance over the accuracy of the assertions made in BD reports, and the Board views the procedures performed over these assertions to be key. Scoping based on firm characteristics is also challenging. The Board notes in its 2015 progress report that 83 percent of firms auditing BDs audit fewer than five each. Thirty-three percent of these firms only audit one BD, and that BD is the only audit subject to PCAOB standards.[15] Firms not auditing public companies also have higher deficiency rates than registered firms that audit public companies.[16] The majority of these firms are small, with limited exposure to PCAOB. Carving out small firms with few PCAOB audits not only eliminates the majority of the population, it eliminates the portion of the population showing the most difficulty with compliance.

The Board is considering all of its options. They have indicated that even if they do not scope out specific types of BDs or specific types of firms, they may modify how often they inspect smaller firms, and they may narrow the scope of the actual inspection. For example, instead of inspecting an entire audit, they may only inspect the audit procedures supporting the review report. Currently, the Board plans to increase the number of inspections and gather more data. Although the Board indicates they hope to gather enough information to properly scope the permanent inspection program, they will likely see similar results. BD audit firms, especially those with little PCAOB experience, should operate with the expectation that each of their audits will be subject to inspection every year. Although that will likely not be the case, operating in such a manner should increase the likelihood of compliance.

A Necessary Inconvenience

Firms auditing BDs should take advantage of the resources found on PCAOB's website, which includes a page dedicated to BD auditors and provides the inspection reports, FAQs and all related standards. The Board also hosts forums for BD auditors throughout the year at multiple locations. These forums include input from the Financial Industry Regulatory Authority (FINRA) as well as the SEC. They highlight and summarize key items in the standards, and provide a forum for asking questions.

The Bernie Madoff scandal has had a lasting impact on the auditing profession as a whole, and it directly resulted in the oversight of BD audits by PCAOB. The inspection results to date have revealed poor quality audits, and they highlight the growing chasm between the standards of PCAOB and the standards generally accepted by the rest of the profession. Few of these differences lie in the written standards; therefore, in order to improve audit quality and achieve compliance, audit firms should carefully consider PCAOB's unwritten expectations and read the available inspection reports in order to avoid similar mistakes. Auditors should understand that PCAOB oversight, while potentially inconvenient, will help ensure the auditing profession fulfills its responsibilities and maintains its relevance in this vital industry.

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Footnotes

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