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Audits of brokers and dealers in securities; Statement of position 1976 December;

American Institute of Certified Public Accountants. Auditing Standards Division

Statement of Position

Audits of Brokers and Dealers in Securities

December 1976

Issued by the Auditing Standards Division
American Institute of Certified Public Accountants

NOTICE TO READERS

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of these guides, AICPA subcommittees may from time to time conclude that it is desirable to change a guide. A Statement of Position is used to revise or clarify certain of the recommendations in the guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA subcommittee.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the subcommittee.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the subcommittee are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the subcommittee believes would be in the public interest.

Stockbrokerage Auditing Subcommittee

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Audits of Brokers and Dealers in Securities

1. In 1973, the AICPA issued the industry audit guide, *Audits of Brokers and Dealers in Securities.* Recent actions by the Securities and Exchange Commission (SEC) will require the AICPA Stockbrokerage Auditing Subcommittee to revise portions of that guide. Because the SEC continually reviews its rules and issues revisions or interpretations of existing rules, independent auditors should be aware of current actions of the SEC and their effects, if any, on financial statements being examined. The purpose of this Statement of Position is to provide guidance to independent auditors during the period prior to the issuance of the revised audit guide.

Adoption of the Financial and Operational Combined Uniform Single Report

2. The SEC recently announced the adoption of a new financial and operational reporting system for brokers and dealers in securities. The new reporting system, Financial and Operational Combined Uniform Single Report (FOCUS) is designed to eliminate duplicate reporting of information to the SEC and self-regulatory organizations. The FOCUS Report supersedes the previous Form X-17A-5[1], Form X-17A-11, the Joint Regulatory Report, Forms "M" and "Q," the income and expense reports, and various other financial and operational forms and reports required by self-regulatory organizations.[2] It allows brokers and dealers to file one series of reports monthly and quarterly or quarterly, depending on the type of business of the broker or dealer; the form and content of the reports to be filed are explained in SEC Release No. 34-11935.

[1] It should be noted that the new report is also designated "Form X-17A-5."

[2] While certain information previously required by Form X-17A-10 is now covered by Form X-17A-5, brokers and dealers must continue to file the revised Form X-17A-10 annually.

Changes in Annual Audit Requirements

3. The adoption of FOCUS has resulted in the elimination of the "minimum audit requirements" formerly prescribed in Form X-17A-5. The nature, timing, and extent of certain procedures previously mandated by regulation are now determined by the independent auditor based on his study and evaluation of existing internal controls and other procedures performed in accordance with generally accepted auditing standards.

4. In reporting on the financial statements and required supplemental schedules, the independent auditor performs certain procedures on data now produced and maintained by the broker or dealer, as required by Rule 17a-4. Previously, the independent auditor was required to prepare the financial statements and supplemental schedules.

5. The SEC has specified the statements and schedules on which the independent auditor is to report:

Financial Statements

- Statement of Financial Condition
- Statement of Income (Loss)
- Statement of Changes in Financial Position
- Statement of Changes in Stockholders' Equity or Partners' or Sole Proprietor's Capital
- Statement of Changes in Liabilities Subordinated to Claims of General Creditors

Schedules

- Computation of Net Capital Pursuant to Rule 15c3-1
- Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3
- Information Relating to the Possession or Control Requirements Pursuant to Rule 15c3-3
- A Reconciliation (or statement that one is not necessary) Pursuant to Rule 17a-5(d)(4)

The form and content of the financial statements are described in *Audits of Brokers and Dealers in Securities.*

Changes in Reporting Requirements

6. The major changes required by FOCUS that affect the independent auditor include:

a. The "Answers to Financial Questionnaire" and the Part III

Interim Report by the independent auditor have been eliminated.

b. Annual audited financial statements are required to be consolidated in conformity with generally accepted accounting principles. The audited Statement of Financial Condition must be in a format and on a basis consistent with the totals reported on the Statement of Financial Condition contained in Form X-17A-5, Part II or Part IIA as filed by the broker or dealer. If the Statement of Financial Condition filed on Form X-17A-5, Part II or Part IIA, is not on a consolidated basis, there may be differences between it and the statement reported on by the auditor; the SEC requires that such differences be disclosed in a note to the audited Statement of Financial Condition.

c. The following supplemental schedules are to be included in the information required as part of the annual audit:
   1. Computation of Net Capital Pursuant to Rule 15c3-1.
   2. Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3.
   3. Information Relating to the Possession or Control Requirements Pursuant to Rule 15c3-3.
   4. A reconciliation pursuant to Rule 17a-5(d)(4) of the audited computations under (1) and (2) above to the unaudited computations submitted by the broker or dealer if, in the opinion of the independent auditor, the computations differ materially. The Rule provides that, "If no material differences exist, a statement so indicating shall be filed."[3]

d. A Statement of Financial Condition, a Statement of Income (Loss), Statement of Changes in Financial Position, Statement of Changes in Stockholders' Equity or Partners' or Sole Proprietor's Capital, and Statement of Changes in Liabilities Subordinated to Claims of General Creditors all should be included in the annual audited reports of all brokers and dealers, including those who were previously permitted to file only the "Answers to Financial Questionnaire."

e. Audited financial statements must be filed within sixty (60) days of the broker's or dealer's fiscal year end, as defined in Rule 17a-5.

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[3] Securities and Exchange Commission, Securities Exchange Act of 1934, Release No. 11935, paragraph (d)(4).

f. A Supplementary Report on Internal Accounting Control must be submitted by the independent auditor. In this connection, the SEC has stated:

> If, during the course of the audit or interim work, the independent public accountant determines that any material inadequacies exist in the accounting system, internal accounting control, procedures for safeguarding securities, or as otherwise defined in subparagraph (g) (3), then he shall call it to the attention of the chief financial officer of the broker or dealer, who shall have a responsibility to inform the Commission and the designated examining authority by telegraphic notice within 24 hours thereafter as set forth in paragraphs (d) and (f) of Rule 17a-11. The broker or dealer shall also furnish the accountant with a copy of said notice to the Commission by telegraphic communication within said 24 hour period. If the accountant fails to receive such notice from the broker or dealer within said 24 hour period, or if he disagrees with the statements contained in the notice of the broker or dealer, the accountant shall have a responsibility to inform the Commission and the designated examining authority by report of material inadequacy within 24 hours thereafter as set forth in paragraph (f) of Rule 17a-11. Such report from the accountant shall, if the broker or dealer failed to file a notice, describe any material inadequacies found to exist. If the broker or dealer filed a notice, the accountant shall file a report detailing the aspects, if any, of the broker's or dealer's notice with which the accountant does not agree.[4]

The SEC has also stated:

> A determination of a material inadequacy may, in many instances, require completed audit procedures in a particular area, appropriate review at the decision making level by management and the independent accountant, and possible consultation with counsel. While it is expected that a determination in this context involves a contemplative process, the length and complexity of the deliberations should depend on the circumstances and be completed in the shortest time possible.[5]

The report shown as Exhibit A, page 13, is appropriate only if the independent auditor has completed his examination of the financial statements. The report shown as Exhibit B, page 16, should be used if an examination has not been completed and the independent auditor disagrees with the noti-

[4] Ibid., paragraph (h)(2).
[5] Ibid., p. 14.

fication made by the broker or dealer or the broker or dealer has failed to make the required notification. Consideration should be given to the possible need to consult with legal counsel and to modify the report based on the particular circumstances.

g. The auditor must also issue a report indicating whether the assessments, for purposes of the Securities Investor Protection Corporation, were determined fairly in accordance with applicable instructions and forms, or that a claim for exclusion from membership was consistent with income reported.

Auditor's Report

7. The auditor's standard report (Exhibit C, page 19) should include reference to the supplemental schedules discussed in paragraph 6 (c).

Objectives of an Examination

8. The SEC has stated in the FOCUS Report the objectives of an examination:

> The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. The audit shall include all procedures necessary under the circumstances to enable the independent public accountant to express an opinion on the statement of financial condition, results of operations, changes in financial position, and the Computation of Net Capital Under Rule 15c3-1, the Computation for Determination of Reserve Requirements for Brokers or Dealers Under Exhibit A of Rule 15c3-3, and Information Relating to the Possession or Control Requirements Under Rule 15c3-3.[6] The scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in (a) the accounting system; (b) the internal accounting controls; (c) procedures for safeguarding securities and (d) the practices and procedures whose review

[6] The forms for the Computation of Net Capital Under Rule 15c3-1 and Information Relating to the Possession or Control Requirements Under Rule 15c3-3 are contained in Securities Exchange Act of 1934, Release No. 11935.

is specified in (i), (ii), (iii) and (iv) of this paragraph would be disclosed. Additionally, as specific objectives, the audit shall include reviews of the practices and procedures followed by the client:

(i) in making the periodic computations of aggregate indebtedness and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e);

(ii) in making the quarterly securities examinations, counts, verifications and comparisons and the recordation of differences required by Rule 17a-13;

(iii) in complying with the requirement for prompt payment for securities of Section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System; and

(iv) in obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.[7]

Extent and Timing of Auditing Procedures

9. In determining the extent of procedures to be performed, the auditor should consider the materiality of the item in question and the possible effect of a misstatement in the financial statements and related schedules.

10. The auditor's determination of the timing of auditing procedures is based on his evaluation of existing internal control. Only adequate internal control and appropriate consideration of the related factors discussed in the preceding paragraphs warrant the performance of certain procedures at other than the broker's or dealer's fiscal year end, as defined in Rule 17a-5. Also, Rule 17a-5 paragraph (h) (1) states:

> The performance of auditing procedures involves the proper synchronization of their application and thus comprehends the need to consider simultaneous performance of procedures in certain areas such as, for example, securities counts, transfer verification and customer and broker confirmation in connection with verification of securities positions.

Nature of Auditing Procedures

11. Certain procedures unique to an examination of a broker or dealer are discussed in the following paragraphs. Procedures that are similar to those for examinations of industrial and other

[7] Securities Exchange Act of 1934, Release No. 11935, paragraph (g)(1).

commercial enterprises are not described in this statement. Nothing herein should be construed as limiting the independent auditor's examination or permitting the omission of any additional procedures he deems necessary in the circumstances.

12. *Objective.* To determine, by appropriate procedures, that positions on the stock record, including securities, debt instruments, options, and commodities, are balanced and accounted for.

13. *Procedures.* Evidential matter for stock record positions may be obtained by physical inspection, or confirmation, or by a combination of physical inspection and confirmation.

a. The following would normally be accounted for by physical inspection:
   - Securities, options, and debt instruments held by the broker or dealer, including those in segregation and safekeeping.
   - Warehouse receipts.
   - Spot commodities.
   - Other significant amounts of liquid assets in the physical possession of the broker or dealer.

b. The following would normally be accounted for by confirmation:
   - Securities, options, and commodity positions carried or held by foreign and domestic depositories, clearing corporations, and associations.
   - Securities and commodity positions carried or held for the broker or dealer by other banking or brokerage houses or others.
   - Securities and commodity positions, options, and significant open contractual commitments and other money market instruments (other than uncleared "regular way" purchases and sales of securities) in accounts carried by the broker or dealer for customers, partners, officers, directors, or subordinated lenders.
   - Details of securities and commodities in trading and investment accounts of the broker or dealer (from individuals with responsibility for such accounts).
   - Details of—
     1. Securities borrowed and loaned.
     2. Securities "fail to deliver" and "fail to receive."
     3. Material open contractual commitments with other brokers or clearing corporations and associations.

- Significant open contractual commitments or positions in joint trading and underwriting accounts of the broker or dealer carried by others.
- Guarantees required to satisfy significant deficits in accounts at the audit date.

c. The following would normally be accounted for by a combination of physical inspection and confirmation:
- Positions held by agents for transfer, exchange, or redemption.
- Positions in transit between offices of the broker or dealer.
- Bank loan collateral.

Independent Auditor's Supplementary Report on Internal Accounting Control

To the Board of Directors
Standard Stockbrokerage Co., Inc.

We have examined the consolidated financial statements of Standard Stockbrokerage Co., Inc., and Subsidiaries for the period ended December 31, 19XX, and have issued our report thereon dated February 15, 19XX. As part of our examination, we made a study and evaluation of the system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards and Rule 17a-5 of the Securities and Exchange Commission. This study and evaluation included the accounting system, the procedures for safeguarding securities, and the practices and procedures followed by the client[1] (i) in making the periodic computations of aggregate indebtedness and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e); (ii) in making the quarterly securities examinations, counts, verifications and comparisons, and the recordation of differences required by Rule 17a-13;[2] (iii) in complying with the requirements for prompt payment for securities of Section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System;[3] and (iv) in obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.[4] Rule 17a-5 states that the scope of the study and evaluation should be sufficient to provide

[1] If the broker or dealer is exempt from compliance with Rule 15c3-3, the independent auditor should include a statement indicating that the broker or dealer was in compliance with the conditions of the exemption, and that no facts came to the attention of the independent auditor indicating that such conditions had not been complied with during the period.

[2] If the broker or dealer does not maintain customer accounts or does not handle securities, he may not be required to undertake quarterly securities examinations, counts, verifications and comparisons and the recordation of differences required by Rule 17a-13, however, the independent auditor should indicate that he has reviewed the broker's or dealer's practices and procedures for safeguarding securities that may be received by the broker or dealer for transmittal to a clearing organization.

[3] See Note 2.

[4] See Note 2.

reasonable assurance that any material weakness existing at the date of our examination would be disclosed. Under generally accepted auditing standards and Rule 17a-5, the purposes of such study and evaluation are to establish a basis for reliance thereon in determining the nature, timing, and extent of other auditing procedures necessary for expressing an opinion on the financial statements and to provide a basis for reporting material weaknesses in internal accounting control.

The objective of internal accounting control is to provide reasonable, but not absolute, assurance concerning the safeguarding of assets against loss from unauthorized use or disposition and concerning the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management. However, for the purposes of this report under Rule 17a-5, the determination of weaknesses to be reported was made without considering the practicability of corrective action by management within the framework of a cost/benefit relationship.[5]

There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends on segregation of duties can be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management either with respect to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements. Further, projection of any evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation of the system of internal accounting control for the (period) ended December 31, 19XX, which was made for the purposes set forth in the first paragraph above

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[5] This sentence makes it clear that the independent auditor is not permitted, in reporting on internal control under Rule 17a-5, to use the option indicated in Section 640.13 of SAS No. 1, which states in part, "In some cases, the auditor may conclude that for certain weaknesses corrective action by management is not practicable in the circumstances, and he may decide to exclude such weaknesses from his report."

and would not necessarily disclose all weaknesses in the system that may have existed during the period, disclosed (certain) (no) weaknesses that we believe to be material. Such weaknesses, with an indication of (the) (any) corrective action taken or proposed, were as follows.

Accounting Firm

New York, New York
February 15, 19XX

Exhibit B

Independent Auditor's Supplementary Report on Internal Accounting Control

(Appropriate when the broker or dealer has not made the required notification or when the auditor does not agree with the statements therein. Modification of this letter may be required based on the facts and circumstances of the particular situation. (See Paragraph 6f.))

September 10, 19X7

Securities and Exchange Commission
(Washington) and Appropriate
Regional Office
Designated Examining Authority

Dear Sirs:

Our most recent examination of the financial statements of Standard Stockbrokerage Co., Inc., and Subsidiaries was as of September 30, 19X6, and for the twelve-month period then ended, which we reported on under date of November 4, 19X6. We have not examined any financial statements of the company as of any date or for any period subsequent to September 30, 19X6. Although we are presently performing certain procedures as part of our examination of the financial statements of the company as of September 30, 19X7, and for the twelve-month period then ended, these procedures do not constitute all the procedures necessary in an examination made in accordance with generally accepted auditing standards or all the procedures necessary to evaluate the system of internal accounting control as required by generally accepted auditing standards and Rule 17a-5 of the Securities and Exchange Commission.

The objective of internal accounting control is to provide reasonable, but not absolute, assurance concerning the safeguarding of assets against loss from unauthorized use or disposition and concerning the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management. However, for the purposes of this report under Rule 17a-5, the determination of weaknesses to be reported was made without considering the practicability of corrective action by management within the framework of a cost/benefit relationship.[1]

There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends on segregation of duties can be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management either with respect to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements. Further, projection of any evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the company's financial statements. It must be understood that the procedures performed are not designed, and cannot be relied on, to provide reasonable assurance that all material weaknesses in the system of internal accounting control and procedures for safeguarding securities would be disclosed.

However, pursuant to the requirements of Rule 17a-5(h)(2), we are to call to the attention of the chief financial officer any weaknesses that we believe to be material and that were disclosed during the course of interim work. (We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc., and we believe the following additional information is required pursuant to the requirements of Rule 17a-11(f).) Or (We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc., who has failed to make the

[1] This sentence makes it clear that the independent auditor is not permitted, in reporting on internal control under Rule 17a-5, to use the option indicated in Section 640.13 of SAS No. 1, which states in part, "In some cases, the auditor may conclude that for certain weaknesses corrective action by management is not practicable in the circumstances, and he may decide to exclude such weaknesses from his report."

required notification to the Securities and Exchange Commission. We believe the following information is required pursuant to the requirements of Rule 17a-11(f).)

(List and describe all items concerning which the independent auditor did not agree with the notification of the broker or dealer or concerning which the required notification was not made.)

Accounting Firm

Exhibit C

Independent Auditor's Report on Examination of Corporate Financial Statements

To the Board of Directors
Standard Stockbrokerage Co., Inc.:

We have examined the consolidated statement of financial condition of Standard Stockbrokerage Co., Inc., and Subsidiaries as of December 31, 19XX, and the related consolidated statements of income, changes in stockholders' equity, changes in subordinated liabilities, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the consolidated financial position of Standard Stockbrokerage Co., Inc., and Subsidiaries at December 31, 19XX, and the results of their operations and changes in financial position for the year then ended in conformity with generally accepted accounting principles on a basis consistent with that of the preceding year.

Also, we have examined the supplementary schedules on pages 00 to 00 and, in our opinion, they present fairly the information included therein in conformity with the rules of the Securities and Exchange Commission.

Accounting Firm

New York, New York
February 15, 19XX