

Broker's and Dealer's Use of a Service Organization

Introduction

The Center for Audit Quality (CAQ) is pleased to release Alert 2018-04, *Broker's and Dealer's Use of a Service Organization* (the Alert). The Alert includes a decision tree (found on [page 3](#)) and associated information designed to assist auditors of Securities and Exchange Commission (SEC)-registered brokers and dealers in developing their audit approach on audit and attestation engagements of a broker or dealer that uses a service organization.

Brokers and dealers may use service organizations to perform certain transactions as part of their financial reporting process, such as trade processing and other back-office functions. Introducing brokers and dealers may use a carrying broker or dealer to maintain custody of customer securities, and oftentimes that carrying broker or dealer may be considered a service organization. Public Company Accounting Oversight Board (PCAOB) [Auditing Standard 2601, Consideration of an Entity's Use of a Service Organization \(AS 2601\)](#),¹ establishes the auditing requirements for when a company uses the services of a service organization to process certain transactions that affect the broker's or dealer's financial statements and supplemental information. This Alert focuses on the use of service organizations as this is an area that can require significant auditor judgment when planning and performing broker and dealer audit engagements.

There is no one-size-fits-all approach to auditing a broker's or dealer's use of a service organization. Auditors should carefully design and execute their audit approach based upon their understanding of the broker's or dealer's transactions, related risks, the relevant controls at the broker or dealer, and the controls performed at the service organization that are part of the broker's or dealer's information system. This Alert should not be relied upon as all-inclusive or authoritative and should be read in conjunction with the relevant PCAOB auditing and attestation standards.

Key Terms

The following terms are defined in the PCAOB auditing standards to assist in determining if the broker or dealer uses a service organization.²

- ▶ **User Organization** – The entity that has engaged a service organization and whose financial statements are being audited.
- ▶ **User Auditor** – The auditor who reports on the financial statements of the user organization.
- ▶ **Service Organization** – The entity (or segment of an entity) that provides services to a user organization that are part of the user organization's information system.

¹ Also see *Staff Guidance for Auditors of SEC-Registered Brokers and Dealers*, published by the PCAOB June 26, 2014. Pages 17-18 provide auditors of brokers and dealers with considerations of the broker or dealer's use of third parties and service organizations.

² See PCAOB AS 2601.02.



- ▶ **Service Auditor** – The auditor who reports on controls of a service organization that may be relevant to a user organization’s internal control as it relates to an audit of financial statements.
- ▶ **Report on Controls Placed in Operation** – A service auditor’s report on a service organization’s description of its controls that may be relevant to a user organization’s internal control as it relates to an audit of financial statements, on whether such controls were suitably designed to achieve specified control objectives, and on whether they had been placed in operation as of a specific date.
- ▶ **Report on Controls Placed in Operation and Tests of Operating Effectiveness** – A service auditor’s report on a service organization’s description of its controls that may be relevant to a user organization’s internal control as it relates to an audit of financial statements, on whether such controls were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

The following is a key term used within the Alert:

- ▶ **Key Reports Produced by the Service Organization** – Reports or information produced by the service organization that is part of the broker’s or dealer’s information system (“key reports”). Key reports may be used by the broker or dealer in the execution of a control and/or may be used by the auditor in substantive testing and/or control testing.

The following terms are defined by the American Institute of CPAs (AICPA):³

- ▶ **System and Organization Controls (SOC)** is a suite of service offerings CPAs may provide in connection with system-level controls of a service organization or entity-level controls of other organizations.
- ▶ **SOC for Service Organizations: ICFR** is a report on controls at a service organization relevant to a user entities’ internal control over financial reporting (ICFR), and are commonly referred to as SOC 1 reports. These reports are prepared in accordance with clarified attestation standard (AT-C) section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities’ Internal Control Over Financial Reporting*, are specifically intended to meet the needs of entities that use service organizations (user entities) and the CPAs that audit user entities’ financial statements (user auditors), in evaluating the effect of the controls at the service organization on the user entities’ financial statements.
- ▶ **Subservice Organization**⁴ – A service organization used by another service organization to perform some of the services provided to user entities that are likely to be relevant to those user entities’ ICFR.

Use of SOC 1 reports is restricted to the management of the service organization, user entities, and user auditors.

PCAOB Attestation Standard 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers (AT 1)*, establishes the requirements that apply when an auditor is engaged to perform an examination of certain statements made by a broker or dealer in a compliance report prepared pursuant to SEC Rule 17a-5. Such requirements may include obtaining an understanding of internal control over compliance (ICOC). If the broker or dealer uses a service organization, the auditor may consider obtaining from the broker or dealer a SOC 1 report from the service organization. For example, carrying or clearing brokers and dealers may use a service organization for customer statement production and/or printing and mailing customer statements, which may be part of the broker’s or dealer’s ICOC.

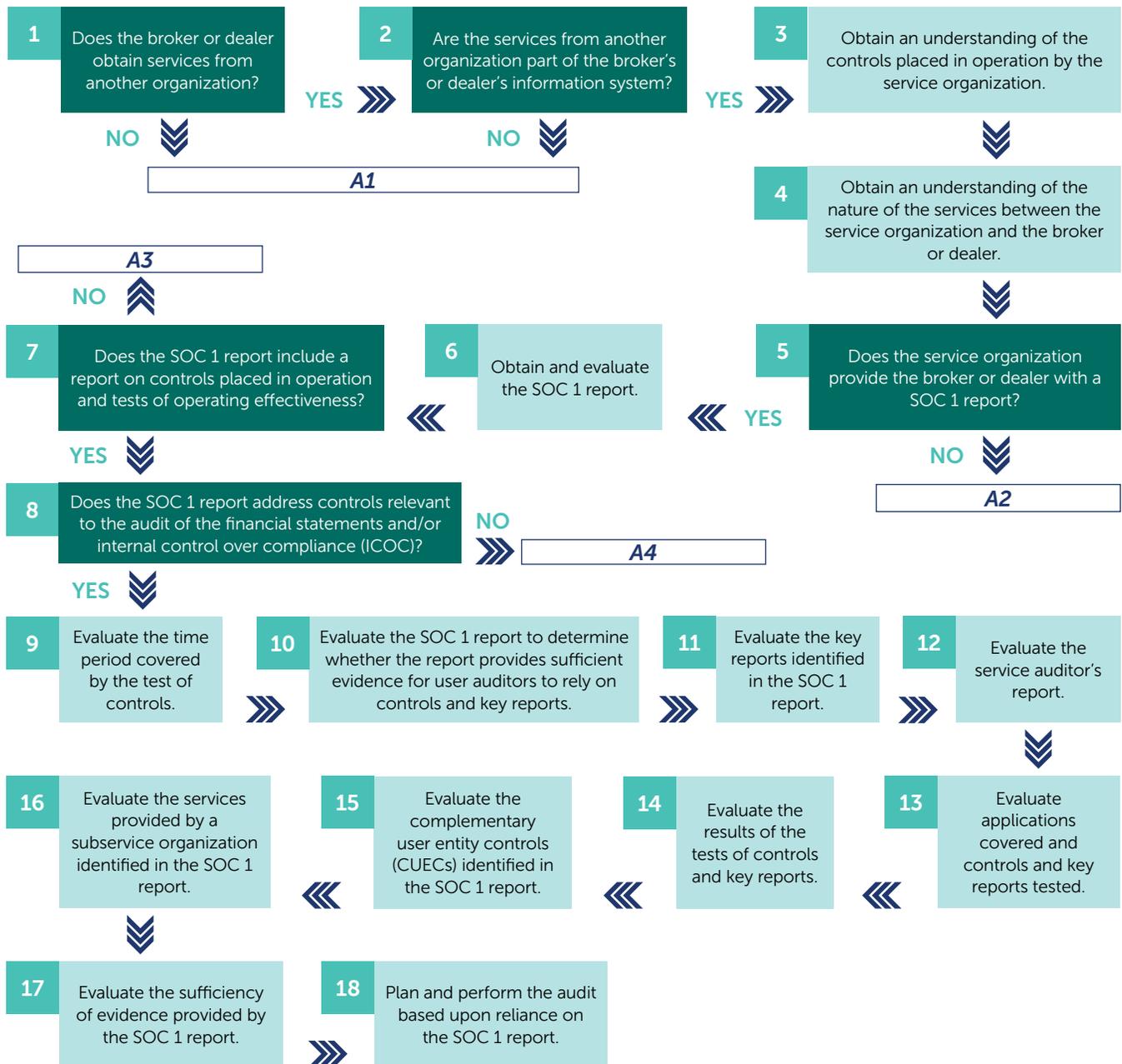
³ While PCAOB standards are applicable to the audits of SEC registered brokers and dealers, AICPA standards are the attestation standards followed by the service auditors when performing SOC engagements.

⁴ AT-C Section 320.08, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities’ Internal Control Over Financial Reporting*.

Use of a Service Organization Decision Tree

The decision tree has been prepared to assist user auditors in applying the professional standards when obtaining a sufficient understanding of the broker’s or dealer’s use of a service organization, as well as designing auditing and attestation procedures that address the broker’s or dealer’s use of a service organization. The decision points are grounded in the PCAOB auditing standards. The decision tree notes should be read in conjunction with the decision tree and relevant auditing and attestation standards.

Decision Tree



Decision Tree Notes

We have highlighted certain relevant PCAOB auditing requirements related to each of the decision points in the decision tree.

1 Does the broker or dealer obtain services from another organization? – As noted above, AS 2601.02 defines the term *service organization* as an entity (or segment of an entity) that provides services to a user organization that are part of the user organization’s information system.

2 Are the services from another organization part of the broker’s or dealer’s information system? – AS 2601.03 states that, a service organization’s services are part of an entity’s information system if they affect any of the following:

- ▶ The classes of transactions in the entity’s operations that are significant to the entity’s financial statements
- ▶ The procedures, both automated and manual, by which the entity’s transactions are initiated, recorded, processed, and reported from their occurrence to their inclusion in the financial statements
- ▶ The related accounting records, whether electronic or manual, supporting information, and specific accounts in the entity’s financial statements involved in initiating, recording, processing and reporting the entity’s transactions
- ▶ How the entity’s information system captures other events and conditions that are significant to the financial statements
- ▶ The financial reporting process used to prepare the entity’s financial statements, including significant accounting estimates and disclosures

A1 *The broker or dealer does not obtain services from another organization, and/or the broker or dealer does not obtain services from another organization that are part of the broker or dealer’s information system. As a result, this decision tree would not be applicable. The rest of the decision tree would not apply.*

3 Obtain an understanding of the controls placed in operation by the service organization. – PCAOB Auditing Standard 2110, *Identifying and Assessing Risks of Material Misstatement* (AS 2110), states that an auditor should obtain an understanding of each of the five components of the entity’s internal control sufficient to plan the audit. AS 2601.07 also states that this understanding may encompass controls placed in operation by the entity and by service organizations whose services are part of the entity’s information system. See AS 2601.06-.10 when obtaining an understanding of the controls placed in operation by the service organization.

4 Obtain an understanding of the nature of the services between the service organization and the broker or dealer. – AS 2601.09 states that information about the nature of the services provided by a service organization that are part of the user organization’s information system— and the service organization’s controls over those services— may be available from a wide variety of sources, such as user manuals, system overviews, technical manuals, the contract between the user organization and the service organization, and reports by service auditors, internal auditors, or regulatory authorities on the service organization’s controls. AS 2601.38 provides a sample report on controls placed in operation at a service organization. The sample report illustrates that the report is restricted to only be used by management of the service organization, its customers, and the independent auditors of its customers. As part of obtaining an understanding of the relationship between the service organization and the broker or dealer, the auditor should consider if they are an intended user of the report.

5 Does the service organization provide the broker or dealer with a SOC 1 Report? – AS 2601.12 states that a service auditor’s report on controls placed in operation at the service organization should be helpful in providing a sufficient understanding to the user auditor to plan the audit of the user organization. Such a report, however, is not intended to provide any evidence of the operating effectiveness of the relevant controls.

A2 *The service organization does not provide the broker or dealer with a SOC 1 report or the broker-dealer is not an intended user. Additional considerations not contemplated in this decision tree will be necessary. The user auditor*

should determine how they will obtain a sufficient understanding of the controls occurring at the service organization as part of planning and performing their audit and attestation engagement.

6 Obtain and evaluate the SOC 1 report. – AS 2601.18-.21 provides considerations in using a service auditor’s report. One such consideration, among others, is that the user auditor should make inquiries concerning the service auditor’s professional reputation. Paragraph .10a of Auditing Standard 1205, *Part of the Audit Performed by Other Independent Auditors* (AS 1205), provides appropriate sources of information concerning the professional reputation of the service auditor.

7 Does the SOC 1 report include a report on controls placed in operation and tests of operating effectiveness? – A SOC 1 type 2 report is a report on the fairness of the presentation of management’s description of the service organization’s system and the suitability of the design and operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period. Such a report may be useful in providing the user auditor with an understanding of the controls necessary to plan the audit and may also provide the user auditor with a basis for reducing his or her assessments of control risk below the maximum. See AS 2601.24b.

A3 *Additional considerations not contemplated in this decision tree will be necessary. A Type 1, SOC 1 report does not provide evidence of the effectiveness of controls and therefore can only be used to assist in performing risk assessment and planning procedures.*

8 Does the SOC 1 report address controls relevant to the audit of the financial statements and/or internal control over compliance (ICOC)? – AS 2601.14 states that the user auditor may find that controls relevant to assessing control risk below the maximum for particular assertions are applied only at the service organization. If the user auditor plans to assess control risk below the maximum for those assertions, he or she should evaluate the operating effectiveness of those controls by obtaining a service auditor’s report that describes the results of the service auditor’s tests of those controls⁵ or by performing tests of controls at the service organization. If the user auditor decides to use a service auditor’s report, the user auditor should consider the extent of the evidence provided by the report about the effectiveness of controls intended to prevent or detect material misstatements in the particular assertions. The user auditor remains responsible for evaluating the evidence presented by the service auditor and determining its effect on the assessment of control risk at the user organization.

A4 *Additional considerations not contemplated in this decision tree will be necessary. If the SOC 1 report does not address controls relevant to the audit of the financial statements and supplemental information and/or internal control over compliance (ICOC) then the SOC 1 should only be used to assist in performing risk assessment and planning procedures.*

9 Evaluate the time period covered by the test of controls. – AS 2601.16 states that for those tests of controls and results that are relevant, a user auditor should consider whether the nature, timing, and extent of such tests of controls and results provide appropriate evidence about the effectiveness of the controls to support the user auditor’s assessed level of control risk. In evaluating these factors, user auditors should also keep in mind that, for certain assumptions, the shorter the period covered by a specific test and the longer the time elapsed since the performance of the test, the less support for control risk reduction the test may provide. While Auditing Standard 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS 2201) applies to audits of internal control over financial reporting, there are concepts described in this standard that may be helpful when auditors of brokers or dealers plan and perform tests of internal control for brokers or dealers financial statement audits and attestation engagements. Paragraph B21 of AS 2201 provides that if a service auditor’s report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. The auditor should assess, among other factors, the time period covered by the tests of controls. Paragraph B24 describes what auditors are required to do when a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor’s report and the period under audit.

⁵ That is, a report on controls placed in operation and tests of operating effectiveness, or an agreed-upon procedures report.

10 Evaluate the SOC 1 report to determine whether the report provides sufficient evidence for the user auditors to rely on controls and key reports. – AS 2601.16 notes that because the service auditor’s report may be intended to satisfy the needs of several different user auditors, a user auditor should determine whether the specific tests of controls and results in the service auditor’s report are relevant to the assertions that are significant in the user organization’s financial statements. For those tests of controls and results that are relevant, a user auditor should consider whether the nature, timing, and extent of such tests of controls and results provide appropriate evidence about the effectiveness of the controls to support the auditor’s assessed level of control risk.

11 Evaluate the key reports identified in the SOC 1 report. – When using key reports, Auditing Standard 1105, *Audit Evidence* (AS 1105) requires the auditor to, among other things, evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to: test the accuracy and completeness of the information,⁶ or test controls over the accuracy and completeness of that information. Key reports that are used by the auditor in either controls, substantive test work, or as part of ICOC testing should be specifically identified in the SOC 1 report in order for the auditor to be able to rely on the completeness and accuracy of information in those key reports. There are times where the key reports are not specifically listed in the SOC 1 report and this can be problematic from an auditor reliance perspective. If the auditor plans to use the SOC 1 report of a service auditor rather than perform his or her own procedures regarding information or controls of the service organization, the auditor should comply with the applicable requirements in PCAOB standards for using service auditor’s reports.⁷ In the absence of a service auditor’s report, the auditor should perform his or her own procedures to obtain the necessary evidence.⁸

12 Evaluate the service auditor’s report. – User auditors should evaluate the SOC 1 report to determine if the service auditor’s report contains a qualification. To the extent the service auditor’s report contains a qualification, the user auditor should consider the impact of the qualification on applications and controls relevant to the auditor’s assessed level of control risk. See AS 2601.16.

13 Evaluate applications covered and controls and key reports tested. – User auditors should evaluate the SOC 1 report to determine if the applications and controls covered by the SOC 1 report are relevant to assessing control risk below the maximum. See AS 2601.14-.16 and AS 2201.B21.

14 Evaluate the results of the tests of controls and key reports. – User auditors should evaluate the SOC 1 report to consider the extent of evidence provided by the service auditor’s report about the effectiveness of controls intended to prevent or detect material misstatements in the financial statements (or non-compliance with respect to specific financial responsibility rules) in particular assertions. See AS 2601.14-.16 and AS 2201.B21.

15 Evaluate Complementary User Entity Controls (CUECs) identified in the SOC 1 report. – If the user auditor determines that it will use the SOC 1 report as audit evidence, the user auditor should evaluate the SOC 1 report to determine if the service auditor has identified CUECs that the service organization assumes in the design of its service are implemented by user entities, and which are necessary to achieve control objectives identified in the SOC 1 report. For those CUECs that are necessary to achieve the control objectives identified in the SOC 1 report that the user auditor deems relevant to the audit of the financial statements and/or ICOC, the user auditor should consider whether the broker or dealer has designed and implemented controls that address the CUECs and, if relying on these controls, that they were operating effectively throughout the period.

16 Evaluate services provided by a subservice organization identified in the SOC 1 report. – User auditors should evaluate the SOC 1 report to determine if there are services provided by a subservice organization that are relevant and significant to the audit of the broker’s or dealer’s financial statements. If there are controls relevant and significant to the audit of the broker’s or dealer’s financial statements occurring at the subservice organization, the user auditor

⁶ Note when a key report produced by the service organization is used in the execution of a control that is part of ICOC, the auditor can only test controls to obtain sufficient appropriate audit evidence over the completeness and accuracy of the key reports.

⁷ See *Staff Guidance for Auditors of SEC-Registered Brokers and Dealers*, page 18, published by the PCAOB June 26, 2014. Also see PCAOB AS 2601.11-20.

⁸ See *Staff Guidance for Auditors of SEC-Registered Brokers and Dealers*, page 18, published by the PCAOB June 26, 2014. Also see PCAOB AS 2601.14-15.

should determine how they will obtain sufficient appropriate audit evidence that those controls are operating effectively. See PCAOB Auditing Interpretation 18, *Consideration of an Entity's Uses of a Service Organization: Auditing Interpretations of AS 2601* (AI 18) paragraphs .04-.13 and AS 2601.06-.17.

17 Evaluate the sufficiency of evidence provided by the SOC 1 report. – Based upon the evaluation of the SOC 1 report in boxes 6 through 16, the user auditor should determine the sufficiency of the audit evidence provided by the SOC 1 report.

18 Plan and perform audit based upon reliance on SOC 1 report. – Once the user auditor has obtained and evaluated the SOC 1 report, they should document their evaluation of the SOC 1 report and its impact on the control risk assessment and plan and perform substantive procedures based upon the determined controls reliance strategy.

Additional Resources

We encourage auditors of brokers and dealers also to reference the CAQ's dedicated resource page, thecaq.org/brokerdealers. This page provides additional resources including a series of alerts on additional topical areas of relevance to planning and performing audit and attestation engagements of brokers and dealers.

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