1993

Securities industry developments - 1993; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Securities Industry Developments—1993

Complement to AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*

AICPA

American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of the financial statements of brokers and dealers in securities with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Albert F. Goll
Technical Manager, Accounting Standards Division

Gerard L. Yarnall
Director, Audit and Accounting Guides

The staff of the AICPA is grateful to the members of the AICPA Stockbrokerage and Investment Banking Committee for their contribution to this document.

1 2 3 4 5 6 7 8 9 0 AAG 9 9 8 7 6 5 4 3

Table of Contents

Securities Industry Developments—1993

Industry and Economic Developments

The securities industry appears to be continuing its record of strong growth. For the year ended December 31, 1992, New York Stock Exchange (NYSE) member firms dealing with the public set records with revenues of $62.8 billion, profits before income taxes of $6.2 billion, an average pretax return on equity of 22.8 percent, and an average daily volume of over 202 million shares. Current trends portend new records for year-end 1993. Trading and underwriting activities continue to increase as capital moves from traditional, low-yield investments to higher-yield and frequently more complex investments.

Several trends in particular seem to be dominating the environment in which securities broker-dealers operate: continued development of new and increasingly complex financial products and services, continued expansion of the marketplace around the globe, and continued emphasis on cost containment. Trends such as these tend to significantly increase the business risks to which entities in the securities industry are subjected and, as a result, may increase audit risk as well.

The development of new financial products and services along with innovative and complex trading and other business strategies has had a dramatic effect on the risks associated with the industry. In an environment in which trading strategies often involve foreign currency, arbitrage, options, global trading, and complicated financing arrangements, there are increased risks that relate to the complexity of the strategies as well as to the traditional credit, liquidity, and operational risks. Auditors of broker-dealers should understand the new products and services offered by their clients, the underlying trading and financing strategies, the means of executing and processing the transactions and the risks associated with all of those factors.

As a growing number of countries are breaking down the legal and regulatory barriers in their financial markets, the industry is finding itself operating in a global marketplace where trading takes place virtually around the clock. As firms actively pursue business operations in such countries, they assume additional risks as well. For example, control procedures to assess market and credit risks must be extended to cover global operations.

The continuing emphasis on cost control in the industry may have audit risk implications as well. Tens of thousands of jobs in the industry have been eliminated since the stock market crash of 1987 and a number of firms are finding that some activities can better be handled by a few firms acting on behalf of many. One example of this trend is the development of the practice of correspondent clearing, in which one firm may offer clearing services for dozens or hundreds of other firms. Auditors of broker-dealers that use such services should consider how the use of services provided by such organizations might affect the audit procedures they perform.

Over the last decade technology has transformed the manner in which business is conducted and the variety of products that can be offered. In addition, buyer demographics have shifted, with increasing numbers of institutional investors and baby boomers arriving to invest. As a result, pressure to remain competitive has significantly intensified.

Because interest rates are at historic lows (compared to the past decade) and price-earnings ratios of stocks are very high, a drop in stock prices could reduce transaction activity in the secondary market as well as discourage new stock issues in the primary market. An increase in interest rates could cause a similar contraction in bond trading.

Regulatory Developments

AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards,* vol. 1, AU sec. 311), requires that in planning their audits, auditors consider matters affecting the industry in which an entity operates, including, among other things, government regulations. Auditors consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1, AU sec. 317), distinguishes between two types of laws and regulations:

- Those that have a direct and material effect on the determination of financial statement amounts
- Those that relate more to an entity's operating aspects than to its financial and accounting aspects and therefore have only an indirect effect on the financial statements

While auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts, an audit performed in accordance with generally accepted auditing standards does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

The securities industry is subject to extensive regulation by a number of federal and state authorities. As a result, auditors of broker-dealers should be familiar with applicable rules and regulations of governmental agencies and other regulatory bodies, including the Securities and Exchange Commission (SEC), and industry member regulatory bodies such as the National Association of Securities Dealers and national securities exchanges such as the New York Stock Exchange.

Auditors of broker-dealers that are also commodities brokers should also consider rules and regulations of the Commodity Futures Trading Commission (CFTC). The CFTC was created by Congress in 1974 and is the federal agency with regulatory and oversight responsibility for the trading of commodity futures and options contracts on the U.S. futures exchanges. Since 1982, the CFTC has also regulated operations on futures contracts and options on physical commodities trading on commodity markets.

A summary of some of the recent regulatory developments that may affect the audits of broker-dealers follows.

Minimum Capital Requirements

SEC rule 15c3-1 prescribes net capital requirements for broker-dealers. In November 1992, the SEC issued final rule amendments (Release No. 34-31511) to the net capital rule. The amendments raise the minimum net capital required of certain registered broker-dealers as follows:

1. Broker-dealers that hold customer funds or securities will be required to maintain at least $250,000 in net capital.
2. Broker-dealers that clear customer transactions but do not hold customer funds or securities beyond the settlement of the transaction will be subject to a $100,000 minimum net capital requirement.
3. Broker-dealers that introduce customer accounts to other broker-dealers will be required to maintain $50,000 or $5,000 in minimum net capital, depending on whether or not they receive securities. Broker-dealers that make markets in certain securities will be required to maintain greater net capital in proportion to the number of securities in which they make markets. The maximum on this additional market-maker minimum net capital requirement will be raised from $100,000 to $1,000,000.

4. The minimum net capital requirement for certain mutual fund broker-dealers will be increased to $25,000.

The amendments also prescribe standardized "haircuts" that must be taken in computing both basic and alternative net capital requirements and revisions to the computation of aggregate indebtedness.

The amendments will be implemented over a period of eighteen months, beginning January 1, 1993.

Haircut Rules for Derivatives and Other Sophisticated Financial Instruments

The SEC staff is continuing its review of the application of its haircut rules to sophisticated financial instruments such as collateralized mortgage obligations (CMOs). Currently, CMOs issued by government agencies or government-sponsored enterprises, such as Fannie Mae or Freddie Mac, are afforded the same haircut treatment as U.S. government securities. Privately issued CMOs are afforded the same haircut treatment as corporate bonds, based on the CMOs' ratings by independent securities rating agencies such as Standard & Poor's. The SEC is considering creating a separate haircut treatment under which CMOs would be assigned haircuts related to their risk attributes.

The SEC has issued a concepts release on derivative products (Release No. 34-32256), which addresses the issue of how such products should be treated in computing broker-dealers' statutory net capital requirements. The SEC broadly defines a derivative product as a financial instrument that derives its value from the performance of other assets, including securities, interest rates, or indexes. The current net capital treatment of financial instruments used in formulating derivatives is described in the release and includes listed and unlisted options, swaps, forwards, futures, and options on futures. Credit risk is also recognized as a significant risk in derivative products. The SEC is requesting comments on the appropriate capital treatment to reflect the risks of over-the-counter derivative products and has posed twenty-one questions for comment.

Record Preservation Rule

The SEC has proposed amendments to the broker-dealer record preservation rule (Release No. 34-32609), that would allow broker-dealers, under certain conditions, to employ optical storage technology to maintain required records. Another proposed amendment would codify a staff interpretation that allows broker-dealers to use microfiche for record-retention purposes.

The CFTC has amended its general record-keeping rules (FR 27458) to permit substantially similar record-retention compliance.

Ready Marketability of Foreign-Equity Securities

The SEC staff has taken an interim no-action position, which permits broker-dealers to treat foreign-equity securities that are listed on the FT-A World Indices as having a ready market in computing statutory net capital requirements. The SEC has also issued a concepts release (Release No. 34-32748), which solicits comments on a number of questions regarding the treatment of foreign-equity securities under the ready-market provisions of the net capital rule, rule 15c3-1, of the Securities Exchange Act of 1934. Following receipt of public comments, the SEC intends to determine whether proposed rule making or other action is appropriate.

FOCUS Report Revision

The staffs of the SEC and the CFTC, in cooperation with the Capital Committee of the Securities Industry Association, are revising the Financial and Operational Combined Uniform Single (FOCUS) report, which is the uniform regulatory report required to be filed with regulators. The CFTC permits futures commission merchants (FCMs) who are also registered broker-dealers to file the FOCUS report instead of the currently required CFTC Form 1-FR. After the revised FOCUS report has been approved for use, the CFTC intends to allow FCMs, whether or not they are broker-dealers, to file CFTC reports using the new FOCUS report. The revised report is expected to prohibit broker-dealers from including subordinated debt in a combined total with equity on the balance sheet. However, no change is anticipated that would prohibit including qualifying subordinated debt in regulatory net capital.

CFTC Developments

Introducing Broker Reporting. The CFTC amended its financial reporting requirements for introducing brokers (58-FR 10949) to reduce the minimum number of financial reports required to be filed from four to two: a year-end audited report and an unaudited mid-year report. In addition, the CFTC deleted the requirement that an introducing broker file copies of early warning notices that it files with the National Futures Association (the designated self-regulatory organization for introducing brokers) pursuant to regulation 1.12. Those rule changes became effective on March 23, 1993.

Internal Revenue Service Developments

The Internal Revenue Service (IRS) has increased its emphasis on information-reporting compliance. The daily sale and purchase of securities and frequent cash distributions made by broker-dealers as brokers for third parties subject them to numerous IRS reporting regulations. Failure to properly file information returns, such as Form 1099DIV reporting dividends to shareholders, with the IRS can result in substantial penalties.

Audit Issues and Developments

Derivatives and Other High-Risk Investments

Recent years have seen a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Users and issuers of such instruments must have the expertise necessary to understand and manage the related risks. As discussed below, auditors should also be familiar with such instruments and the associated risks. One class of instruments—derivatives—requires particular attention.

Derivatives are complex financial instruments whose values depend on the values of one or more underlying assets or financial indexes. Derivatives generally fall into at least two categories:

1. Asset-backed securities, which include mortgage-backed securities, interest-only and principal-only strips, and tranches of collateralized mortgage obligations
2. Off-balance-sheet instruments such as forward contracts, interest-rate and currency swaps, futures, options and other financial contracts

Some of the specific derivatives and financial instruments with which auditors of broker-dealers should be familiar include—

- Interest-rate swaps, which are agreements between counterparties to exchange periodic payments based on specific interest-rate differentials applied to a specified notional amount. A swap allows one party to effectively change the interest-rate structure of a debt obligation or of an investment through the exchange of payments with another party. Swaps enable participants to obtain financing from the cheapest markets and simultaneously hedge unwanted risks.
- Cap agreements, which provide that during a specified period a seller will pay a buyer the excess of the prevailing market interest

rate over a specified index rate (cap index rate) on a notional amount whenever the index rate is above the protected interest rate on a rate determination date (option or ceiling rate). Cap agreements provide entities that have outstanding floating-rate debt with protection against rising interest rates.

- Floor agreements, which provide that during a specified period a seller will pay a buyer the excess of a specified minimum rate (floor) over a specified index market rate on a notional amount whenever the index rate falls below a specified point. A floor agreement provides the owner of a floating-rate asset with a guaranteed minimum return.
- Interest-rate swap options ("swaptions"), which allow buyers to enter into or exit an interest-rate swap transaction at a future date, at a specified interest rate based on a notional amount.
- Commodity swaps, which are similar to interest-rate swaps except that the underlying index is usually based on the price of a commodity, such as metals, energy products, or grains.
- Equity-derivative products, which include longer-term warrants or options on indexes or equities that are customized to a particular client's needs.

By reconfiguring cash flows associated with underlying assets, an issuer can create asset-backed securities that meet the needs of and are attractive to various potential users by isolating, enhancing, or diluting one or more of credit, liquidity, interest rate, and other risks inherent in the underlying cash flows. For example, through mortgage-backed securities, the issuer can enhance the marketability of underlying mortgage loans by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Similarly, users find certain derivatives attractive because they can purchase the risks and rewards they desire most, or can synthetically create a security with the desired risk and reward characteristics.

Increased volatility of interest rates, foreign exchange rates, and commodity and other prices has also fostered tremendous innovation in financial products to meet the needs of users attempting to hedge or alter the related risks. Swaps, for example, are financial contracts in which two parties exchange streams of payments over a period of time. An entity with debt that carries variable interest rates (such as an entity that has short-term certificates of deposit) might swap interest-rate payments on an agreed-upon principal amount with a counterparty by paying a fixed rate and receiving a variable rate. The entity locks into an interest rate for the term of the swap, reducing the risk that increases in interest rates will increase the entity's cost of funds as its liabilities are refunded or related interest rates are reset. The entity takes on other risks, however, such as the risk that the counterparty could default on its payments. By locking into fixed rates, the entity will no longer benefit from interest rate decreases during the term of the swap and it is often costly to terminate a swap. Further, the fair value of derivatives can be volatile in periods of changing market conditions.

Accounting. Accounting for derivatives is complex. The AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* includes detailed discussions of accounting for specific types of securities, including a number of derivatives. Given the constant innovation and complexity of derivatives, accounting literature does not explicitly cover some derivatives, though, several related projects are under way.

The Financial Accounting Standards Board (FASB) has been carrying out a major project on the recognition and measurement of financial instruments, which has already resulted in the issuance of FASB Statements of Financial Accounting Standards No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* and No. 107, *Disclosures about Fair Value of Financial Instruments,* and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts,* that address related issues. The FASB's project includes a comprehensive review of accounting for hedging and risk-adjusting derivatives. Also, the International Accounting Standards Committee is in the process of developing an international accounting standard for financial instruments.

Several accounting issues involving derivatives have also been addressed by the FASB's Emerging Issues Task Force (EITF). Other guidance is provided by FASB Statements of Financial Accounting Standards No. 52, *Foreign Currency Translation,* and No. 80, *Accounting for Futures Contracts.* In addition, AICPA Issues Paper No. 86-2, *Accounting for Options,* discusses various matters related to options.

Auditing. The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more financial institutions enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used by the managements of broker-dealers to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. The substance of transactions in such instruments, rather than their form, should be a primary factor in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts.

SAS No. 22 requires that auditors understand the events, transactions, and practices that, in their judgment, may have a significant effect on the financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in derivatives and other complex securities as they plan their audits and should—

1. Assess management's expertise in monitoring, evaluating, and accounting for the securities.
2. Ensure that the entity has set appropriate policies and procedures for investment in high-risk securities and that there is adequate oversight by the board of directors.
3. Involve specialists, when necessary, in valuing and auditing these investments.

High-Risk Transactions

Securities firms often engage in transactions that present inherent risks unique to the industry. Such transactions include—

- Securities lending, the inherent risks of which include the possibility that the counterparty will fail to return either the securities borrowed or the collateral, resulting in the need to buy or sell the securities at a possible loss.
- Repo transactions, which present risks similar to those presented by securities lending.
- Risk arbitrage, which involves investments in securities of entities that are engaged in mergers or tender offers. Such investments present exposure to the risk that the merger will not be completed successfully. Such aborted mergers may precipitate dramatic declines in securities prices, resulting in loss to the investors.
- Tender offers, in which one company makes an offer for a specific number of shares of another company, reserving the option to accept all stock tendered over the minimum as well as a lesser number of shares. In this type of transaction, the price offered usually is substantially higher than the current market price of the securities. The risk, or exposure, to the firm relates to the possibility that the shares may not be accepted.

- Underwriting of securities, the unique inherent risks of which include the possibility that underwriters may be required to purchase unsold securities positions offered pursuant to a firm commitment underwriting. As a result, a securities firm may need to finance the securities, assume the market risk of ownership, and take haircuts pursuant to rule 15c3-1. Underwriting securities also presents the risk that lawsuits may also be initiated by the purchasers of the securities under Section 11 of the Securities Act of 1933, which specifies that all persons (including underwriters) connected with a registration statement have responsibility for material misstatements contained therein. Securities underwriting also presents the risk that customers who have committed to purchase securities being underwritten may refuse to honor their commitments, resulting in the underwriter's having to purchase the securities.

Service-Center-Produced Records

Broker-dealers frequently operate in an environment in which service organizations functioning as service agents, fund custodians, or transfer agents, or in other administrative capacities, play a critical role in the accounting function. In assessing control risk in such an environment, auditors must carefully consider the functions or processing of information performed by the service organizations. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations (AICPA, Professional Standards,* vol. 1, AU sec. 324), which was issued in April 1992 and supersedes SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations,* provides guidance to auditors performing audits of investment companies that use such organizations.

When a broker-dealer uses a service organization, the functions or processing performed by the service organization may have a significant effect on the broker-dealer's financial statements. Because the processing may be subjected to control policies and procedures that are physically and operationally separate from the broker-dealer, the internal control structure of the broker-dealer may include a component that is not directly under the control and monitoring of its management. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 319), requires an auditor to obtain a sufficient understanding of an entity's internal control structure to plan an audit. For this reason, planning the audit of a broker-dealer may require that the auditor gain an understanding of the control policies and procedures performed by service organizations. When a broker-dealer relies on a service organization's control policies and procedures over the processing of transactions that are material to the broker-dealer's financial statements, those control procedures should be considered by the auditor. One method of obtaining information about those policies and procedures is to obtain a service auditor's report as described in SAS No. 70.

Auditors frequently inquire whether it is necessary to obtain a service auditor's report when their clients use service organizations. The fact that an entity uses such an organization does not in itself require that such a report must be obtained. In certain situations, the broker-dealer may implement control policies and procedures that will obviate the need for a service auditor's report. For example, a broker-dealer using a payroll service may routinely compare the data submitted to the service organization with reports received from the service organization to check the completeness and accuracy of the data processed. The broker-dealer may also recompute a sample of the payroll checks for clerical accuracy and review the total payroll for reasonableness. In such circumstances, the broker-dealer is not relying on the service organization's controls.

Other factors that may be considered in determining whether to obtain a service auditor's report are—

- Whether the transactions or accounts affected by the service organization are material to the broker-dealer's financial statements.
- The extent to which the broker-dealer retains responsibility for authorizing the transactions and maintaining the related accountability.
- The availability of other information (for example, user manuals, system overviews, and technical manuals) at the investment company that may provide the auditor with sufficient information to plan the audit.

The AICPA's Auditing Standards Division expects to issue an Auditing Procedure Study, *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations,* early in 1994.

Reporting on Internal Control

In May 1993, the AICPA's Auditing Standards Board (ASB) issued Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AICPA, *Professional Standards,* vol. 1, AT sec. 400), which is effective for examinations of the efficacy of an entity's internal control structure over financial reporting when the entity's assertion is as of

December 15, 1993, or thereafter. SSAE No. 2 provides guidance to accountants who are engaged to examine and report on management's written assertions about the effectiveness of an entity's internal control structure over financial reporting as of a certain point in time. The Statement does *not* change the auditor's responsibility to consider the entity's internal control structure over financial reporting in an audit of financial statements.

SEC rule 17a-5 requires a report on the internal control structure of a broker-dealer. Reports prepared to meet the requirements of rule 17a-5 are *exempted* from the scope of SSAE No. 2. The Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* includes an illustration of a report that meets the requirements of rule 17a-5.

Accounting Developments

Revised Audit and Accounting Guide

The AICPA Stockbrokerage and Investment Banking Committee has prepared for exposure a revised version of the Audit and Accounting Guide *Audits of Brokers and Dealers in Securities.* The proposed guide focuses on special matters unique to auditing and reporting on financial statements of broker-dealers. The proposed guide describes the conditions or procedures unique to the industry and illustrates the form and content of broker-dealer financial statements. Included are discussions of business activities, accounting records, internal control policies and procedures (including those for safeguarding customer securities), unique aspects of the audit, and illustrations of various financial statements and independent auditors' reports.

The draft is expected to be exposed for comment in the first half of 1994.

* * * *

This Audit Risk Alert replaces *Securities Industry Developments—1992.*

* * * *

Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993,* which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022099.

Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

022123