Journal of Accountancy

Volume 26 | Issue 5 Article 7

11-1918

Stock Brokerage Audits

Edwin S. Halter

Stock Brokerage Audits*

By Edwin S. Halter

Audits of various kinds may be made of the accounts of a stock brokerage firm, the exact nature of the audit and the extent to which the accounts should be examined being determined when the purpose of the audit is known. Briefly speaking, the following audits may be made:

1. Balance-sheet audit,
2. Detailed audit,
3. Verification of securities and cash.

A balance-sheet audit is usually desired by a firm when a member or confidential and trusted employee, usually the office manager, has complete control of the detailed operations of the office so that a thorough examination of the income and expense accounts by the auditor is oftentimes not desired. A balance-sheet audit may also be made for credit purposes for use at banks, although such is rarely the case, as banks seldom make loans without having them secured by collateral with a ready market, and therefore seldom require a certified balance-sheet.

Another purpose for which a balance-sheet audit may be required is when the firm is being considered as banker to float an issue of securities. An audit of this nature, besides comprising the verification of the assets and liabilities, usually requires at least a cursory examination of the income and expense accounts. In this case, or whenever he is to certify as to the result of his examination, the auditor should insist on covering every feature which he deems necessary and if permission is not granted to investigate everything to his satisfaction, such as a scrutiny of the private ledger accounts, he should be careful to qualify his report or certificate accordingly.

In a detailed audit, besides verifying the assets and liabilities, a thorough examination or an exhaustive test should be made of the income and expense accounts for the period under audit. Besides, the investment and private account should be thoroughly gone into for the purpose of verifying income and interest and other items contained therein. An audit of this kind is usually required when the members of the firm are not in close touch

*A thesis presented at the May, 1918, examination of the American Institute of Accountants.

with the general work of the office. When this is the case, an earnings or profit and loss statement, besides the balance-sheet, is usually desired by the client.

An audit covering only the verification of securities and cash is often desired, because these items being the stock-in-trade of a stock brokerage firm and being extremely valuable, they are the only features in which the client is vitally interested.

Besides having audits made for the purposes described above, stock brokers derive a certain degree of satisfaction when their customers are apprised of the fact that a verification is being made of the accounts. The customers then have a feeling of added security that their brokers are using every precaution to safeguard their interests.

The audit is usually started on the last day of the month, but, whatever the date, the best time during the day is immediately after the market closes. If many inactive securities are held for customers in safe-keeping, or the firm is carrying large quantities of securities for its own account, it is possible that the audit may be started before the market closes, for such securities, being rarely disturbed, may be examined earlier in the day.

The work of balancing the securities should be started at the very outset of the audit and should be continued without loss of time until all the securities have been accounted for. This is essential, for if control is lost over them before they are balanced, the entire audit may prove to be practically valueless. This is particularly the case if there is a rapidly changing market, for substitutions and transfers of securities are then made so often that great difficulty may be experienced in re-establishing control of them, and such an amount of time would be consumed that other important features of the audit, such as the verification of the sufficiency of margins in customers' accounts, would be delayed for a considerable period.

A physical examination should be made of all securities on hand. Care should be observed to see that the stocks and registered bonds are in the name of the firm, or, in case they are in some other name, that they are endorsed in negotiable form. In the case of coupon bonds, it should be noted that the coupons maturing on the next interest date and all subsequent coupons are attached.

The active securities are usually kept separately and are referred to by stock brokerage houses as being in the "box." As the securities are counted, such securities as are recorded in the box book should be checked, or a separate list may be made of them. The box book, or list, should be kept under the control of the auditor until the securities have been balanced or at least a proper record has been made of errors existing. No time should be lost in counting the securities in the box as they usually must be deposited in the safe deposit vaults by five o'clock in the evening. It is a great advantage if the examination be completed before that hour, for the following morning when the securities are brought back to the office time will not often permit their being examined before the opening of the market. When this happens and the regular routine of the office work is started, many of the securities are likely to be disturbed. Of course, if it is impossible to count all the securities on the day of the commencement of the audit and a complete count is not made until certain changes have occurred, such changes may be followed through the office record known as the "blotter." It is desirable that this be avoided if possible.

The securities in the box are but a small portion of those for which the broker is responsible; therefore confirmation of the others should be started as soon as possible. The greater portion of the securities will undoubtedly be at the banks where they are used as collateral on loans. Some will be in the hands of other brokers in the form of securities on loans and securities "failed to receive," while others may be at the transfer offices. Likewise, the firm may be holding securities which it has borrowed from or "failed to deliver" to other brokers.

Confirmations should be prepared in duplicate for all such securities. They should then be compared with their respective books where they are recorded and the money balances should be proved with their controlling accounts in the ledger. Every effort should be made to mail the confirmations the same night so that they will be received by the various banks and brokers the next morning. The office staff of the recipients of the confirmations will then be in a position to compare them with their records or with the actual securities before any changes are made. If the sending of confirmations is delayed, the recipients may be put to a great dea lof inconvenience in referring back a few days on their records. If this occurs they are likely not to take the trouble of confirming them, with the result that the auditor may experience difficulty in trying to verify such securities.

When mailing confirmations, a stamped addressed envelope to the auditor's office should be enclosed.

When the confirmations have been returned to the auditor he should immediately compare them with the duplicates in order to see if any differences exist. If they do, they should be immediately investigated.

The securities are recorded in a security record. When large quantities of securities are carried, it is preferable to have separate stock and bond records. The accounts in these records comprise the different securities, and all noted therein should be accounted for. Each account will show the position of the security, one side of the account showing those "long" and the opposite side those "short." The long side represents purchases for the account of customers or for the firm, securities borrowed and "failed to deliver." The short side represents short sales by the customers or firm, securities held by banks as collateral on loans, "failed to receive," securities lent, etc.

As soon as the record is released to the auditor as being completely posted, the list of securities counted and the duplicate confirmations should be compared with it and all errors found should be carefully noted. The securities in the investment and customers' accounts should then be compared with the record. The customers' securities may be checked either direct from the statements after the latter are surrendered to the auditor by the bookkeeper, or from the collateral sheets often furnished by the margin department. If the collateral sheets are used, care must be taken to preserve such sheets so that the customers' statements may be compared with them before the statements are mailed.

When the securities from all sources have been compared with the record, the latter should be completely checked and the securities should be balanced. This is done by footing the long and short sides, the totals being in agreement. If they do not agree it is evident that some posting has been omitted or entries have been made which do not belong there. Such errors in footing should be noted with other items in the accounts which are not checked out. If the errors are purely clerical they will balance against each other, the errors being revealed when the confirmations have been received.

The security record should be kept in the control of the auditor until all securities have been balanced or until all errors have been noted by him. If the latter is done, the errors may be followed up from his memoranda.

It will be seen that the confirmations are the main source for verifying the securities. Usually all errors will be located when the confirmations have been received. If after all have been received, errors still exist, each item in the account will have to be traced from the source of entry to its disposition. In this manner the error either will be found or information will be furnished as to its location.

Statements showing money and security balances, enclosed with a letter requesting confirmation direct to the auditor's office, should be mailed to all customers if possible, and lists of statements mailed should be prepared, these lists to be used later to compare with the confirmations when the latter are returned. If statements are not prepared and mailed for all accounts, a plausible reason should be given therefor and such accounts should be taken up with a responsible person. The investment accounts should be taken up with a member or members of the firm for the purpose of obtaining his or their confirmation of the money and security balances.

All accounts for which confirmations are being sent are naturally being verified by the auditor, provided the customers respond. All other accounts will have to be taken up individually as to their nature, such as certain private ledger accounts and income and expense accounts. As previously stated, the extent to which the audit is made will determine how far these accounts should be examined.

The cash should be verified by counting the cash on hand and verifying the bank reconciliations. A confirmation of the balances should be obtained by the auditor by correspondence with the banks. The state transfer stamps and the United States internal revenue stamps should be counted and compared with the records and the controlling accounts in the ledger.

The ledger accounts should be compared with the trial balance and the lists of customers' statements should be compared with the latter to see that the balances are in agreement.

An important feature of an audit and one which brokers are often desirous of having verified is the sufficiency of the margins in customers' accounts. Most brokerage houses require a minimum margin of ten points, and where the securities in the account are inactive or are high priced, a much larger margin is demanded. When calculating margins, the bid price of the market should be used, for if the securities were thrown on the market this would be the best price obtainable. Particular attention should be given to accounts with debit balances having no securities; also accounts with debit and security balances where no margin exists. As soon as such accounts and accounts with insufficient margin are discovered, they should immediately be brought to the attention of a member of the firm so that prompt action may be taken to save as much of the equity in the account as is possible or to limit the loss.

Where securities are owned by the firm it is good practice to inventory them on the most conservative basis, i. e., cost or market, whichever is lower, the exception possibly being where there is an abnormally low market for securities and it would not be fair to write off a large loss during the period, especially if the securities are permanent investments.

Other features of an audit should be the verification of income and expense accounts. The income is derived from securities owned by the firm, commissions charged for execution of trades and interest charged both to customers and brokers. Commissions are usually verified from the blotters and the interest from the press copy of the customers' statements. Commissions and interest as a rule are only tested, as it would entail a considerable amount of work to verify them completely, and generally a very good internal check is maintained by the office force.

The expenses, besides being those incurred in other lines of business, such as rent, salaries, stationery, telephone and telegraph, etc., would also include expenses incidental to the conduct of a stock brokerage business, such as stock exchange dues, printing of market letters, quotation sheets, financial papers, commission bills, etc. A test is usually made of expenses incurred, care being taken to see that such expense items are supported by properly approved vouchers. In cases where vouchers are missing, the items in question should be taken up with some one in authority.