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## Balance Sheet Audit of Stock Brokers' Accounts

BY HARRY MASON SMITH, C.P.A.

When one considers the vast sums handled in the daily transactions of a stock broker's office without any really efficient internal check, as well as the fact that such alarming defalcations are made public from time to time, it would appear that as a safeguard, most brokers should submit their accounts to a Certified Public Accountant for examination and review. Yet, as a matter of fact, comparatively few brokers, despite the obvious weakness of their accounting systems, resort to this independent supervision of their accounts.

However, as accountants, we are not particularly interested in the responsibility for such conditions, but rather are we concerned in the manner of conducting such an examination when our assistance is invited. The subject of auditing such accounts is not at all a difficult one, although it may be explained that, as in most businesses, there are several classes of audits. One is the completed audit, embracing a periodical review and verification of all the accounts. Another is both detailed and continuous and consists of the monthly examination of some portion of the accounts with the view of verifying all during a certain period; this particular form has perhaps the best moral effect on the brokers' office force, as it is not known by them at any time, just what will be examined next. Another form is the preparation of an Equity Balance Sheet on a liquidating basis; this has many advantages to the broker, among which may be included the benefit of seeing at a glance the exact standing of each of his customer's accounts.

We, however, at this time, are to consider a more limited form of audit embracing the independent verification of all the assets and liabilities; it is one frequently resorted to by brokers and is of decided value to them in many ways.

The examination of a stock broker's accounts may be said to be similar in many respects to that of a banking institution. The nature of the accounts being such that many of the items which require verification change materially with the resumption of each day's business it is therefore absolutely necessary to obtain on

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the first day of the audit the full details of all such items, verification of which must subsequently be secured.

An outline of the examination should be prepared before the commencement of the work, so that the desired results may be obtained with a minimum of effort and without hindering the usual course of the broker's routine business. The order in which the matters that claim immediate attention should be taken up, may be determined by the auditor in charge; but it should be such that the efforts of his staff will be directed to the items already mentioned. It is perhaps unnecessary to state that the work should be commenced at the close of a day's business, preferably the last day of the month and obviously, without previous notice to the client's office force.

An auditor undertaking an examination of this nature would do well to use every precaution and to be most circumspect, as there are many opportunities for fraud, particularly during an active market, when under the rush of business such might be carried on indefinitely, unless the accounts are made subject to a systematic, searching and intelligent review by a competent auditor. Quite apart from fraud is the danger of clerical errors being made in the calculations of commissions or interest, which might result in extensive losses to the broker if the transactions were not carefully verified.

An auditor may frequently be called upon to examine a business of which he has no particular knowledge; and yet, guided by general principles and by experience, his examination may prove entirely satisfactory and his report of value to those concerned. It appears to the writer, however, that a certain technical knowledge of a stock broker's business is absolutely necessary in order to make a comprehensive audit of it. An auditor unfamiliar with stock broker's accounts and Wall Street methods and terms would no doubt be greatly confused were he to attempt such an audit without any experience in such accounts. The methods of accounting differ materially from those employed in commercial houses; certain principles of accounting appear to be reversed and many of the captions of the accounts are strange and misleading.

However, it is not the purpose of this article to discuss the qualifications of auditors, so we shall now proceed with the audit itself. Let it be clearly understood at this point, that an audit

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of only the items comprising the Balance Sheet is to be considered; an audit of the transactions which affect the Profit and Loss Account may be detailed in a subsequent paper.

As already stated, the scope of the examination should be outlined before the actual commencement of the audit and then there is less chance of overlooking some important point which may subsequently be difficult to prove. Under the following headings, therefore, we shall consider the items that require prompt attention the first day of the examination.

1. Cash on hand and in bank.
2. Revenue Stamps on hand.
3. Securities in the box.
4. Confirmation by correspondence of Money Loans, Stock Loans, Stock Failures and Stocks in Transfer.
5. Customers' statements.

1. *Cash on hand and in Bank*: Usually, but a small amount of cash is carried in the office and its verification is a simple matter. A complete record should be preserved of the details of the cash settlement and these details should subsequently be examined and verified. Anything other than actual cash should be referred to a member of the firm and should be accepted only with his approval.

All pass books should be obtained by the auditor after the close of the day's business and should be sent by one of his staff to the banks for settlement. It is important that the broker's force be notified that they are not to secure the pass books from the banks. One of the firm should be requested to address a letter to each bank directing that the pass books with cancelled cheques be delivered only to the representative of their auditors. This simple precaution should not be neglected in any audit that concerns a cash settlement; it is the best assurance that an auditor may have, to be absolutely certain that he obtains his client's genuine pass books. Instances have been known where two pass books for one account have been in existence and the fraudulent one has been handed to the auditor by employes who were desirous of concealing their fraud.

2. *Revenue Stamps*: This item does not present any difficulty, as it is customary to keep a ledger account known as "Revenue Stamps" or "Tax Stamps"; this is debited with the cost of all stamps purchased and is credited with such stamps as are charged

to customers on sales of stocks at the rate of two cents per one hundred dollars par value. The ledger account should thus control the stamps and indicate the value of those on hand. After counting the actual stamps, it should only be necessary to make reference to the ledger to ascertain that the value of the stamps on hand is correct, although allowances may have to be made for stamps given to the delivery clerk for certain of the following day's transactions; this, however, may readily be verified by examination of the blotter.

3. *Securities in the box*: The verification of the securities in the box by actual inspection and count is one of the important points in an audit of this nature. As a matter of fact, the term "box" may include half a dozen good-sized boxes and any one who frequents the vicinity of Wall Street, either before or after the hours of business on the Exchange, may see such boxes being carried through the streets to or from the safe deposit vaults, more or less carefully guarded.

The "box" may be understood to include bonds, stocks or other valuable papers kept therein. As the contents are ever changing, it is absolutely necessary to obtain the exact amount of all such securities at the close of business the first day of the audit.

In many houses, it is the custom of one of the firm at certain periods, usually monthly, to compare the securities in the box with the list furnished by the cashier and to accept that as conclusive. From the standpoint of an auditor, however, but little good is accomplished by such a proceeding, inasmuch as the box list furnished will be certain to agree with the contents of the box; if a cashier be dishonest, he will take good care that the two will be in agreement.

Rather than permit the auditor to make a physical examination of the contents of the box, some firms prefer to furnish a certified box list. Others, however, allow access to the box and in that event, the auditor in charge should carefully examine the securities, noting for instance, that such coupons as are payable have been cut and also that all stock certificates have been properly endorsed. A schedule, alphabetically arranged for future reference, should be prepared of the entire contents before the box is released. This schedule will be necessary when balancing stocks, as will be explained later.

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It will sometimes be found that there are certain securities in the box that belong to customers and do not represent collateral on open accounts; these should be controlled by the stock record as are all other securities, but should be designated by a distinguishing mark to indicate the customers' complete ownership. A record, of course, should be made of such securities and confirmations should subsequently be mailed direct to the customers requesting them to confirm their correctness. The custom varies in different houses as to these items and the auditor, of course, must be guided accordingly.

4. *Confirmation of Loans, etc.*: Under this heading, we shall consider the following items:

- Money Borrowed
- Money Loaned
- Securities Borrowed
- Securities Loaned
- Securities Failed to Receive
- Securities Failed to Deliver
- Securities in Transfer

Details of all the above may be found in subsidiary records, the totals of which, of course, must be verified by the general ledger balances before the confirmations are mailed. As a rule, any number of assistants may be employed in preparing these confirmations, which should be prepared in duplicate; the originals should be mailed and the duplicates preserved for comparison with the stock record. Care must be exercised in the preparation of all the above items and they should be carefully compared before mailing. It is perhaps unnecessary to state that a return envelope should be enclosed so that the reply may be returned direct to the auditor's office.

Most auditors having a Wall Street clientele have their own printed forms which they use when confirming all the above items. These forms are so designed that they reduce the labor of preparing the confirmations to a minimum. Two forms are sufficient: one for the first two items mentioned; the other covering the remainder. In order that the party to whom the confirmation is sent may readily identify the particular transaction, it will be necessary to give complete information. For instance in asking confirmation of securities in transfer, in addition to giving the number of shares and the name of the security to the transfer

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agent, the name of the person appearing on the surrendered certificate should also be shown.

5. *Customers' Statements:* The mailing by the auditor of the customers' statements, after he has confirmed the correctness not only of the money balances, but also of the securities, is one of the very important points of an audit of this nature. As in the case of the other confirmations, the auditor's return envelope should be enclosed with each statement.

Most houses require that certain of the customers' statements be mailed the last night of the month. Should the stock record be posted to date, it is only necessary to compare the statements with the stock record as to securities, checking the items, of course, on the stock record, and then to note on a schedule of "Statements sent in advance" the name and money balance of each statement. If, however, the stock record is not ready, it will be necessary to note the details of the securities on the schedule. It is obvious that once the stock record is in the possession of the auditor, it should not be released by him until the open items have been checked and stocks balanced.

As a rule, the bulk of the statements are not turned over to the auditor until about the third day of the audit and as we are only considering the work of the first night at this time, we shall not discuss this point fully.

*Miscellaneous:* We have now considered the important matters that must be attended to the first night. Of course as the nature of the business of different houses vary, so will the items that require attention vary. The auditor, however, should have ascertained before the examination just what would require his attention; this may be done by scrutiny of the items entering into a recent trial balance and by questioning the broker as to the nature of the business.

It will usually be found that most houses trade on the Cotton and Produce Exchanges. In that event, before his first night's task may be regarded as completed, the auditor will do well to examine the warehouse receipts covering "Spots" and the certificates of deposits representing margins on open trades held by banks. It will also be necessary to balance and confirm the customers' as well as "Street" options on open trades.

This, however, is a subject we shall not discuss in detail at this time as the writer has in mind to consider it at some future

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time in a separate article, should there be any interest in an audit of such a nature.

The points already discussed will complete the work of the first day and it will usually be found to have taken a considerable portion of the night. As an examination of this kind is somewhat of a nervous strain, it is not advisable to attempt to verify any items other than those that actually require prompt attention.

Upon resuming the examination the next day, the auditor should obtain, if possible, the trial balance and should prepare a copy of it. Having secured this, it should be compared as soon as possible with the ledgers as to its correctness. The totals of the items verified the day previous should be initialled on the auditor's copy of the trial balance.

*Customers' Statements:* The most urgent matter now will be the sending of the customers' statements. As soon as these are secured, they should be compared with the trial balance as to the money balances and with the stock record as to the securities. It is obvious that any discrepancies discovered in comparing the statements with the stock record should be adjusted before the statements are mailed. The fact that a statement has been secured may be indicated on the trial balance by marking "S" opposite the amount of those obtained.

The statements once they are verified should not be allowed out of the auditor's possession, but should be mailed by him direct to the customers. A request to the customer to confirm his account should accompany each statement. These requests should be prepared by mimeograph on the brokers' letter heads and should be worded so that they will appear to have been sent by the broker, but will request that the reply be sent in the enclosed envelope to the auditor's office. There are several forms of these requests; some are very complete and indicate the money balance due to or by the customer, as well as the details of all the securities long or short; this, however, places quite a burden on the auditor's staff to prepare. The form preferred by the writer is simply a letter requesting confirmation of the statement, as it requires only the writing the name of the customer at the head, sufficient space being left at the bottom of the form for the customer to sign and return.

The trial balance should be examined as soon as possible and



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such accounts, other than nominal accounts, as do not bear the evidence of independent verification should be scheduled and gone over in detail with a member of the firm. The auditor should not accept responsibility, without independent verification, for the correctness of any real or personal account; all such should be passed only with the approval of a responsible person, reference being made in the text of the report to such accounts as are accepted in this manner and a schedule of the same should also be attached to the report.

*Balancing Stocks:* Having disposed of the statements, the auditor should now proceed to "balance stocks." This is an expression generally used in a discussion of a stock broker's accounts, but not often explained. There are, no doubt, several methods of balancing stocks, but in the writer's opinion, the simplest and most effective method is to compare all the data already secured, direct with the stock record, balancing on par values or number of shares and noting that the footings of the long and short sides are in agreement.

The position of the securities appearing on the stock record may be set up as follows:

<i>Long Side:</i>	<i>Short Side:</i>
Customers	Customers
Securities Borrowed	Securities Loaned
Securities Failed to Deliver	Securities at Banks as collateral
	Securities in Box
	Securities Failed to Receive
	Securities in Transfer

No attempt should be made to verify the stock record until all the customers' statements have been sent and then the stock record should not be released until the work of balancing has been completed.

The duplicates of all the confirmations sent out the first day, together with the box list, will furnish all the necessary data to complete the verification of the stock record, and it is a simple matter working from the stock record to compare the details and to note any discrepancies; these, of course, must be investigated promptly and adjusted.

It is advisable to send out about the end of the third day, a second request for the confirmation of all items, other than customers' statements, not confirmed at that time.

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In the examination of the stock record, it will usually be found that there are securities of customers on hand paid for outright or held for safe keeping, which may not appear on the ledgers; confirmations, of course, should be sent for all such securities.

*Testing Sufficiency of Customers' Margins:* There are so many opportunities for fraud and manipulation of the accounts of a broker that it is a difficult matter to state that one thing is more important than another. It may be possible to find fraud, if such has been committed, in every one of the subjects considered so far.

The mere balancing of securities, including the independent confirmation of every item entering into the accounts, may be useless, if no effort be made to ascertain that the customers, or at least certain of them, have sufficient margin to protect the broker. As a matter of fact, if an equity balance sheet be prepared on a liquidating basis, a broker, if his accounts are properly margined, should not have any Accounts Receivable.

It is an easy matter to ascertain the broker's rate of margin for carrying certain securities and then to extend the values of certain or all of the customers securities at the closing prices of the day of the audit. This will result in disclosing such accounts as are weakly margined; these, of course, must be referred to the broker for such action as he may consider necessary.

To illustrate the point of fraud in unexpected places in a broker's accounts, the writer recalls an instance of a margin clerk (who by the way is supposed to be independent of the cashier, as well as the bookkeeping department and therefore safe) who had reopened an old customers' account and used it for his individual trades, without the broker's knowledge. At first the account was well margined, but later the market turned and the account showed a loss. Despite this fact, the employee, by reason of his position, managed to draw considerable cash, by having the cashier draw several cheques apparently on the customer's order and then forging the endorsements and having the cheques cashed. The fraud was made possible by reason of the fact that the margin department advised that the account was amply margined; the connection of the clerk with the account not being suspected.

Fortunately, during the course of an audit the fraud was discovered, as this account was one selected in which to test the sufficiency of the margins. An irregularity of this nature

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had never been considered possible by the client, as the margin department was located apart from all bookkeeping, as well as from the actual handling of the securities and was really depended upon to promptly report any account that fell below the required margin. What house could protect itself against fraud of this nature unless the system of internal check were almost ideal or unless the accounts were comprehensively audited at frequent intervals.

*Bank Accounts:* As previously stated, letters to obtain the pass books from the banks should have been obtained about the beginning of the examination. The cheques returned by the banks should be examined as to form and endorsements and compared with the stubs; the deposits as per the pass books should also be compared with the stubs, care being taken that the dates are in agreement. Certain of the details should be compared with the blotters so as to be certain that the receipts and payments as shown by the books are in agreement with the actual transactions passed through the bank accounts.

It is also advisable to ascertain that all cheques drawn to "Cash" or "Bearer" are accounted for properly. Sometimes such cheques are drawn apparently for cash for certain customers; they are charged to the customer's account and yet for obvious reasons, do not appear on the statement sent to the customer. This point has frequently been used to manipulate such accounts.

*Conclusion:* The items considered will be found to embrace the assets and liabilities of the average broker, but as previously stated, the items will vary as the nature of the business varies. The auditor of course must be guided by conditions as he finds them.

The matter of submitting a report is most important; the scope of the examination may be given with more or less detail, attention being directed to loose or dangerous methods, comments and suggestions being offered for a correction of the same.

It is not often that a balance sheet or statement of the profit and loss account is required. As a rule the broker simply desires to know that his accounts are correct. He is not interested in obtaining a certified balance sheet for submission to a bank for credit; while the banks furnish most of the money that enables the broker to do business, they obtain, as is not usually the case in their dealings with commercial businesses, collateral which they can more or less readily convert into cash.