

Deficiencies in the Presentation of Information Required by Form
X-17A-5, Uniform Questionnaire for Broker-Dealers

An Address by
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Rule X-17A-5 requiring reports to be made by certain exchange members and brokers and dealers, together with Form X-17A-5 was adopted by the Securities and Exchange Commission on January 1, 1943. The Rule and the Form were devised after conferences with members of stock brokerage firms, members of the accounting profession, experts in stock brokerage accounting, accounting officials of the various national securities exchanges, officials of the National Association of Securities Commissioners, representatives of the American Institution of Accountants, and of the New York State Society of Certified Public Accountants. The completed form and the rule represented the best views of experts in the field of stock brokerage accounting.

Although the form has been in effect for approximately 7 years, the Commission is still conducting an educational program with respect to the proper submission of information required by the form. The Journal of Accountancy in the June 1946 issue editorially set forth "a warning to auditors" in an effort to bring to the attention of public accountants the requirements governing the various types of audits which they undertook, particularly the examination of stock brokerage accounts. This educational process is made necessary because often accountants with little or no special experience in the audit of financial statements for stock brokerage firms make such audits and certify the financial statements based on such audits on the basis of what is generally designated as "commercial accounting practices". The submission of such statements to the Commission may result in the citation of deficiencies. The practitioner who attempts the audit of a stock brokerage firm without previous experience and without advice or consultation with persons expert in the field of stock brokerage accounting soon discovers that like many other fields, stock brokerage auditing is a specialty and a certain amount of preparation and an understanding of the problems presented by the books of a stock brokerage firm is essential in the preparation of Form X-17A-5.

I wish to cite a few examples of deficiencies which the Securities and Exchange Commission has noted since the adoption of Form X-17A-5.

The deficiencies which have been most frequently cited in the filing of Form X-17A-5 appear to be the result of a lack of knowledge of stock brokerage techniques with respect to the maintenance of securities accounts. At times deficiencies appear to arise from the failure of accountants to read Rule X-17A-5 and Form X-17A-5 carefully.

It is manifest from a reading of Form X-17A-5 that the answers to the various questions should not be made on the Form itself but should be stated in a separate report as answers to the various questions contained in the Form. In many instances brokers have submitted copies of the printed form with money balances opposite the question number without furnishing totals.

Paragraph (b) (2) (A) of the Rule requires that there shall be attached to the report an oath or affirmation that, to the best knowledge and belief of the person making such oath or affirmation, (A) the financial statement and supporting schedules are true and correct and (B) neither the member, broker, or dealers, nor any partner, officer, or director, as the case may be, has any proprietary interest in any account classified solely as that of a customers. However, statements often fail to include either the oath or the proprietary statements as part of the report. In the case of the oath of affirmation, it is a definite requirement of the Rule that all statements should be accompanied by a notarized affirmation. The statement with respect to proprietary interest in any account classified solely as that of a customer, may be omitted from the affirmation only in those cases where the financial statements do not reflect any customers' accounts under Question 6 and 7 of Form X-17A-5.

Instruction C appearing on page 1 of Form X-17A-5 states that the information furnished in response to questions contained in the Form should result in a statement of financial condition. It states further that a separate column should be used for ledger debit balances; ledger credit balances; long security valuations; short security valuations; gains in commodities future and losses in commodities futures. All columns are required to be totaled; the totals of debits should equal the totals of credits; and the total valuations of long securities should equal the total valuations of short securities. Furthermore, Form X-17A-5 contains 14 separate questions with various subdivisions thereof, the answers to which should provide information which will enable the Commission to determine compliance with the Commission's rules, particularly the rules with respect to net capital and aggregate indebtedness as contained in Rule X-15C3-1. This rule defines aggregate indebtedness and net capital and prohibits a broker-dealer from incurring indebtedness in excess of 2000 per centum of his net capital as computed by the rule. Form X-17A-5 was so designed to furnish information necessary for the computation of net capital and aggregate indebtedness.

Deficiencies under instruction "C" sometimes result from the failure to include where required, the market value of long and short securities; to balance the total security values and to balance the debits and credits.

A common error is the submission of the response to Form X-17A-5 in the standard form of a "commercial balance sheet" showing the assets on the left and the liabilities on the right with market values of long and short securities either not totaled or not shown against the appropriate debit or credit balance. Also, where this type of balance sheet is submitted, it is frequently found that net balances of long and short securities are furnished, whereas, the market value of long securities and the market value of short securities should be stated separately against their respective debit and credit balances. In other cases, we find debit and credit balances are netted against each other; thus,

eliminating certain essential figures necessary for the computation of aggregate indebtedness and net capital.

Question 2 of Form X-17A-5 --- Money Borrowed, and Accounts Carried for Respondent by other Banking or Brokerage Houses, Secured by or Containing Customers' Collateral - bears a specific footnote that money borrowings and accounts collateralized entirely by securities exempted from registration under the Securities Exchange Act of 1934 be stated separately. Where the report of financial condition fails to state separately those accounts which are collateralized by exempted securities, the accurate computation of aggregate indebtedness under Rule X-15C-1 becomes impossible since that Rule excludes from the computation of aggregate indebtedness moneys borrowed and collateralized by exempted securities. Failure to separate these borrowings properly, results in a high computation of aggregate indebtedness; and where such computation indicates a violation of the net capital rule, inquiry must be made of the registrant or his accountant for an accurate separation of the amount of exempted securities and non-exempted securities hypothecated for the loan, in order that a proper computation of aggregate indebtedness may be made.

Question 9 of Form X-17A-5 is separated into (A) accounts of general partners who have signed agreements that cash, securities and equities recorded in these accounts are to be included as partnership property and (B) all other individual accounts of general partners which are not subject to signed agreements: In many instances, the subdivision required by Question 9 is omitted and all general partners' individual accounts are included in one sum total. The result of such filing is that in the computation of net capital such securities and equities are not considered part of the firm capital and where an apparent deficiency in net capital occurs from such computation, it becomes necessary for the Commission to determine by supplemental inquiry whether there should have been a subdivision between part A and part B of Question 9.

Question 10 -- Trading and Investment Accounts of Respondent --- requires under Part II -- Supplementary Information of Form X-17A-5 -- that a separate schedule be submitted by the broker giving full description including quantity, price, and valuation of each security and commodity position supporting each total valuation reported in answer to Question 9. The deficiencies noted in response to this question are generally in the failure to furnish the schedule and the failure to state the market values of the securities. Where book values are used, rather than market values, the accountant should explain in detail the basis of the valuation. Part II of Form X-17A-5, calling for Supplementary Information, is often not read carefully with the result that schedules required by Part II of the Form are omitted in submitting the statement of financial condition.

The Commission has had many inquiries about the necessity for certifying the reports of financial condition required by Rule X-17A-5. Not all reports are required to be certified by a Certified Public Accountant or a Public Accountant. Paragraph (b) of Rule X-17A-5 requires that a broker must file a certified financial statement (a) if he is required to file a certified statement with an agency of any state in which he does business as a condition of doing business in securities in that state or (b) if he is required to file a certified financial statement with any national securities exchange of which he is a member. Also, the Rule requires that the statement be certified if during the year preceding the date as of which its financial condition is reported, the broker has made a practice of extending credit in any form to customers such as carrying margin accounts or selling securities on a partial payment or installment basis, or if he has made a practice of holding securities owned by customers except where either of these is done as an incident to transactions with or for customers which are promptly consummated by payment. The question whether certification is necessary depends largely upon existing circumstances, and in cases of doubt the practitioner may find it wise to submit the existing circumstances to the Commission for an opinion as to whether certification is necessary.

Paragraph (b) (1) of the Rule states that where certification is required the statement should be certified by a certified public accountant or a public accountant who is in fact independent. In view of the fact that some accountants maintain accounts with stock brokers, the question has arisen in the past as to the independence of an accountant who maintains an open account represented by cash or securities or both with a client - a stock broker. In view of Accounting Series Release No. 47, dated January 23, 1944, it seems clear that such a relationship is of a kind which casts doubt on the accountant's independence. If the amounts involved are material in comparison with the registrant's assets or the accountant's resources, it is felt that the relationship as long as it exists precludes the recognition of the accountant as independent for the purpose of certifying statements of the client required to be filed with the Commission pursuant to Rule X-17A-5.

Paragraphs (g), (h), and (i) of Rule X-17A-5 contain the requirements for the accountant's certificate and it is in regard to the certificate that the majority of deficiencies seems to have arisen. The requirements of these paragraphs of the Rule are also contained elsewhere in Commission rules and have general acceptance. Certificates accompanying X-17A-5 reports generally contain the required statement as to auditing standards and generally accepted accounting principles, though there have been instances when these have been omitted. However, it has been found that in a great many instances the accountant fails to comply with paragraph (g) (2) (A) which requires the certifying accountant to state that he has reviewed the procedures followed for safeguarding

the securities of customers. The particular paragraph of the rule reads as follows:

Representations as to Audit:

(g)(2).....The accountant's certificate (A) shall contain a reasonably comprehensive statement as to the scope of the audit made, including a statement as to whether the accountant reviewed the procedures followed for safeguarding the securities of customers, and including, if with respect to certain items in the report covered by the certificate, any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (B) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (c) shall state whether the audit made omitted any procedures deemed necessary by the accountant under the circumstances of the particular case.

The statement regarding customers' securities is unique insofar as accountants' certificates are concerned. It is found only in Rule X-17A-5 where it is particularly applicable, but it is frequently omitted by accountants. It is apparent that the purpose of this requirement is to require that where the procedures reviewed are deemed by the accountant to be inadequate, it is the accountant's duty to so state in his certificate.

Appended to Form X-17A-5 are "Minimum Audit Requirements Pursuant to Rule X-17A-5". These minimum audit requirements were evolved after considerable study and consultation with experts in the field of stock brokerage accounting and authorities in the field of auditing. They represent what is generally believed to be the minimum steps which an auditor may take in order that he may properly certify to a financial statement submitted pursuant to Rule X-17A-5. Lack of familiarity with the techniques of stock brokerage accounting and attempts to conduct an audit of a stock broker's books along the same lines that an accountant uses to review the accounts and records of a commercial concern may result in serious violations of basic stock brokerage accounting principles. It is of the utmost importance that in the preparation of financial statements pursuant to Rule X-17A-5, the accountant perform not less than the minimum audit requirements prescribed under the Rule. Numerous cases have come to the attention of the Commission where accountants have ignored the instructions and have omitted the confirmation of customers' accounts, accounts with other brokers and dealers, the physical verification of securities on hand, the verification of securities in transit or in transfer, the verification of securities collateralizing loans, and the obtaining of written confirmations with respect to bank balances.

In conclusion, I wish to state that the Commission's educational program will continue and that the Commission's personnel is available at all times for discussion. You may be sure that the Commission will continue this work with the accounting profession to the end that there may be developed a complete understanding of the requirements of Rule and Form X-17A-5.