[Journal of Accountancy](https://egrove.olemiss.edu/jofa)

Volume 48 | Issue 1 Article 2

7-1929

New York Stock-exchange Questionnaire

Harlan Johnson

New York Stock-exchange Questionnaire*

BY HARLAN JOHNSON

In 1792, twenty-four men, who called themselves "brokers for the purchase and sale of public stocks," met under a tree on old Wall street in New York, and formed the organization which was destined to play by far the most important rôle in the financial history of the United States. This organization was the New York stock exchange.

The business of the organization remained small for quite a number of years, but the discovery of gold in California and the increase in national wealth gave impetus to speculation and enlarged the volume of trading done on the exchange. The civil war, the expansion of the national debt, and, after the war, railroad construction and the industrial development of the country focussed more and more attention on matters of finance and the volume of the trading in securities likewise increased. With the creation of corporations and combinations, the New York stock exchange became the center for trading in the United States. Later on, the world war and subsequent financial expansions have caused the volume of trading to soar to almost unbelievable heights.

In all this expansion the members of the New York stock exchange have been governed by a strict code of regulations enforced by various committees appointed by the exchange. One of the most important as well as most active committees is the committee on business conduct. This committee has practically unlimited power over the membership, and the broker who fails to keep to the straight and narrow path of the regulations soon hears from the committee.

It can be stated without fear of contradiction, I believe, that in no business are there greater opportunities for a firm or member of a firm to misappropriate or wrongfully use customers' securities or funds than in the banking and stock-brokerage business. The very nature of the business, wherein customers have millions of dollars' worth of securities and credit balances in the hands of the broker, presents a very great temptation to anyone of weak will. Years ago, and not so many at that, we regularly heard of failures

*Address delivered at a meeting of the Maryland Association of Certified Public Accountants.

of members of the New York stock exchange. In nearly every case when the testimony was boiled down it was found that the broker either had no capital or insufficient capital, or wilfully used the property of his customers in speculation, and then crashed. Always, customers had to bear the brunt of these failures, and usually the recoveries were very, very small. Today, however, and for the past seven or eight years, the news of a failure of a member of the New York stock exchange would be news in the real sense of the word.

The committee on business conduct, seven or eight years ago, evolved the plan to demand periodically a statement of the financial condition of each member or member firm—a statement that laid bare their financial condition. This call for a statement, which is usually in the nature of a surprise, is in the form of a questionnaire and may be made at any time by the committee. The questionnaire calls for an audit of the books coincident with the preparation of the answer, and the audit must be made in conformity with the regulations prescribed by the committee on business conduct. It is also stipulated that the firm's name must not appear on the questionnaire, and in this way, by using a system of key numbers, the confidential nature of the answer is maintained. The answer to the questionnaire must be accompanied by a certificate signed by each member of the firm and by those who conduct the audit. This certificate states that the questionnaire has been prepared after an audit has been made as prescribed by the committee on business conduct and that the answer as rendered is correct in every detail.

With reference to the audit, it will probably surprise some accountants who may be unfamiliar with stock-brokerage accounting to learn that a statement as prepared from the general ledger of a stock-brokerage firm gives very little insight into its financial position. This is because of the fact that in a statement so rendered no consideration is given to the value of securities therein. The stock-brokerage business is one of the few businesses where two values run through the books, usually in the same accounts, and both values must be accounted for. Reference is made to the cash balance in any account and the value of securities that may be carried in that account. In addition to the cash balances, only the number of shares of stock or the par value of bonds is usually carried in the individual accounts for accounting purposes; therefore, a true statement of a brokerage business must be subjected to application of the security values before a comprehensive view of the financial condition may be obtained.

In no audit is it more important for an accountant to plan his work before proceeding than in the audit of a stock-brokerage house. On the first day of the audit, which usually begins at the close of the last day of the month, the accountant must control practically everything in the brokerage office in the way of cash and securities. If he loses control of these elements at the beginning of the audit, he would save time by stopping immediately and beginning all over again, for by losing that control at the start the error apparently expands and multiplies as the work proceeds. To give an idea of the number of things to be done on the first day of the audit, the following examples are cited.

The securities in the box must be counted rapidly and listed accurately. The accountant making the count must be careful to distinguish between stocks of similar issue, bonds of similar dates and rates, stocks that are issued in units, and stocks and bonds on which part payments have been made or received. Confirmations must be prepared for all loans to the broker and securities that he has hypothecated thereon; stock that he has lent or has borrowed must be confirmed by the borrower or lender; bank confirmations must be prepared and sent out; confirmations must be prepared and sent out for stocks in transfer and for bonds out of the office for exchange. The cash on hand must be counted; the securities on the counter must be counted; the securities in the registered mail going out at the close of the day must be counted and listed and controlled until they are deposited in the post-office; documentary stamps must be counted; confirmations of the customers' accounts and trial balances thereof must be prepared; confirmation of joint accounts of the broker with others must be prepared; confirmations of "when issued" and "delayed delivery" contracts with customers must be sent. These contracts are usually in the form of tickets in a memorandum file and change from day to day, and, therefore, it is imperative that a list be obtained on the first day, as it would be very difficult to obtain such a list after changes have occurred. When all this has been completed it is usually midnight or one o'clock in the morning, and the accountants may then go home to bed, with nothing to do until the next day.

It is believed that the foregoing list of confirmations includes practically all the confirmations that must be sent, but there may be special accounts that need special confirmations, as the regulations prescribed by the committee on business conduct require that practically all accounts be confirmed.

After getting a long night's rest, the accountants appear bright and early the next morning, fresh for another day's work, and one of the most interesting things in accounting is then begun; namely, the balancing of all securities carried on the books of the brokerage firm. By the word "balancing," it is meant that for the aggregate of the long securities of any issue there must be a corresponding aggregate of short securities. For those who have had little experience with the terms "long" and "short" the following rule of thumb may help solve any difficulty with these terms in the future: the term "long security" means "due to"; the term "short security" means "due from." Thus, if a customer's account is long a certain security it means that the security is due to that customer; if a customer's account is short a security it means that the security is due from that customer. The term "short" also means location; for instance, if the security is on hand, it is said that the box is short. In other words, the security is due from the box. If the security is carried with a New York correspondent, is hypothecated on a loan, or is out for transfer or exchange, it is said that the respective holders are short. In other words, the security is due from the respective holders.

To begin the balancing of securities two ways are considered the best. Every broker maintains a position book which shows him the long and short position of each individual security on his books every day and the changes every day. If the broker is willing to have his position books under the accountant's control for at least a week, the most expeditious way to balance securities is to use that book and post the positions thereto from the accountant's work papers. The work is expedited by using these books in that the pages have been headed and the names of customers have been written in. The other way is for the accountant to prepare an independent position book of his own, but this necessitates the heading of an ordinary ledger sheet for each individual security and the listing, on the debit side, of names of customers and the shares of stock or par value of bonds held by them and, on the credit side, the location of such securities or from whom they are due. The volume of this work is great, as the average broker carries from one thousand to fifteen hundred different securities on his books. The balancing of securities will take from four days to two weeks, depending on the volume, and in the meantime it is considered good policy to control the box of the broker in case an error in the counting has been made and a recount is necessary to balance any particular security. After the securities have been balanced, a trial balance of the position books is run off with each security segregated on columnar paper under long securities of customers, long securities of the firm, long securities of partners or long securities of correspondents, and these are offset by short securities with New York brokers and securities hypothecated on bank loans, in transfer and in the box. When this is done, the accountant has an alphabetical list and a cross-section of the securities position of the broker. Quotations from financial journals are then obtained and prices are extended for long and short securities on this same sheet. The sheets are then added and cross-footed, and the result is the total values of securities carried on the broker's books.

There is one peculiarity in the questionnaire that now becomes evident. In the preparation of the answer the value of all safekeeping securities and what are termed free securities must be cast out of the calculation. The term "free securities" means securities held by the broker which he must deliver on demand against no balance. Technically they are safekeeping securities, but they may be carried in the customers' regular accounts. The casting out of safekeeping items and free securities is accomplished by checking customers' accounts and eliminating such securities from the box values. These values are likewise eliminated from the customers' long security-values column and the cross-section of the security values remains in balance.

One more task is to be done with the cross-section of security values before the accountant is ready to apply the security values in the preparation of the liquidated balance-sheet. The questionnaire calls for the security values shown in four ways—listed on the New York stock exchange, with market values over $5.00 a share and market values under $5.00 a share, and not listed on the New York stock exchange, with market values over $5.00 a share and market values under $5.00 a share.

Now, when all the confirmations have been received and checked off, and all discrepancies traced and corrected, the accountant is ready to answer the ten questions in the questionnaire, presuming, of course, that the regular detailed audit procedure with regard to cash and profit-and-loss accounts has been completed. The answer to the questionnaire is probably best prepared in a statement of six columns, the first two columns showing the ledger debit and credit balances; the next two columns showing the security valuations, the shorts being debits and the longs credits; and the last two columns showing the liquidated balance-sheet of the firm after giving effect to security valuations, the first column being assets and the second column liabilities.

The first question to be answered is the total amount of bank balances, and as there is no specific place for cash on hand it is usually included therein. The aggregate thereof is entered in the ledger debit column, and as there are no security values in the cash account, it is immediately extended to the asset column of the liquidated section.

The second question is amount of loans from banks, other brokerage houses, etc. The aggregate of bank loans is entered in the ledger credit column and the total value of securities hypothecated on those loans is entered in the short column of the security-valuation section. The value of these securities is usually from 25 to 50 per cent. in excess of the amount of loans and the difference between the amount of the loan and the value of the securities is the broker's equity in the transaction and is extended as an asset in the liquidated section. The accounts with correspondent brokers also come under this section. The firm owes them the cash balances and the correspondent brokers owe the firm certain securities. These securities naturally have an excess value over the cash balance and this difference is extended as an asset in the liquidated section. The ledger balances of the stock borrowed, stock lent, failures to deliver and failures to receive are stated, and excess of security valuations is extended as asset or liability, as the case may be, in the liquidated section.

The third question covers the market value of negotiable securities in the box and the transfer books. Naturally there is no cash balance against the box and the market value of these securities is immediately listed in the short column of the security-valuation section and is immediately extended in the asset column of the liquidated section.

The fourth question covers customers' accounts. Those with debit balances are considered first. These must be classified in three ways: secured, partly secured and unsecured. These segregations are obtained by applying the security values in the accounts against the cash balances without regard to the margin requirements. The partly secured and unsecured accounts are usually very small in amount and consist principally of cash transactions which clear the next day. However, the cash balances are segregated and placed in the ledger debit column. Long security valuations in such accounts are placed in the long column of the security-valuation section and the excess of security values over the cash balances, which represents the liability of the firm to the customer, is extended as a liability in the liquidated section. In other words, the firm owes the customer the amount of the excess of his security values over the cash owed the broker by the customer. The second classification under customers' accounts is credit balances. Credit balances are also classified in three ways: short credit balances, credits as margin on commodity contracts, and free credit balances. Short credit balances are placed in the ledger credit column. Short security valuations in such accounts are placed in the short column of the security-valuation section, and the excess is extended as an asset or liability, as the case may be, in the liquidated section. Credits as margin on commodity contracts are handled in the same way, the credit balances being entered in the ledger credit column, the value of the contracts being entered in the security section, and the equity or deficit, as the case may be, extended as an asset or liability in the liquidated section. Free credit balances are extended directly from the ledger credit column to the liability column in the liquidated section.

The fifth question covers firm and partners' accounts. They are handled in the same manner as the customers' accounts. The cash balances are placed in the ledger debit or credit columns, the security values are placed in the short or long columns of the security-valuation section, and the firm's and partners' equities are extended in the liability column of the liquidated section. Partners' capital accounts are extended directly from the ledger credit column to the liability column of the liquidated section.

The sixth question covers profit-and-loss accounts. This question may be answered by giving one net amount which will eventually be closed to profit and loss. This amount is extended directly from the ledger balance section to the asset or liability column, as the case may be, in the liquidated section.

The seventh question covers any other accounts which may not have been explained in the foregoing answers. The ledger balances and the value of securities should be given and the net amounts should be extended in the liquidated section. These accounts will include stock-exchange seats, office furniture, revenue stamps, dividend accounts, etc.

These seven questions cover the whole financial statement, and the statement may be ruled off at this point and added, each one of the three sections balancing itself.

The eighth question is a request for the firm to state its practice with reference to one of the rules of the governing committee which declares that "an agreement between a member and a customer does not justify the member in pledging or loaning more of said securities than is fair and reasonable in view of the indebtedness of said customer to said member." When that question is boiled down, it means that the broker must state that he has periodically scanned his customers' accounts and placed in the box safekeeping securities and securities which may represent excess collateral in the customers' accounts.

The ninth question covers contingent liabilities that are not included in any ledger account. Under this question are stated the total commitments, of customers, firm and partners, of "when issued" and "delayed delivery" contracts. Other items to be listed, if the firm has any, are accommodation endorsements, endorsements of puts and calls, rediscounted notes, or participation in any activity subject to future demands.

The tenth question covers partners' accounts with other brokers, if they have any. They must state the debit and credit balances and the security valuations in such accounts.

This completes the answer to the questionnaire. How it is checked by the stock-exchange authorities is not definitely known, but it is believed that they have a formula which is applied to the answer to the questionnaire to determine whether or not the broker has sufficient capital to carry on the business as shown in the questionnaire. The requirements of the stock exchange are no doubt based on certain percentages of the security valuations carried by the firm and partners in their accounts and of the cash balances of customers.

From the broker's net worth is deducted the value of certain fixed assets which would not be of value in case of quick need. Among these are the value of stock-exchange seats, furniture and fixtures and other such accounts. When these are deducted from the broker's net worth there remains the available net worth.

If the available net worth is in excess of the requirement, the broker is considered to have sufficient capital to carry on. If his available net worth is not equal to the requirement, he must immediately obtain more capital or liquidate some of his customers' accounts.

In closing, it must be stated that too much credit can not be given to the committee on business conduct for the thoroughness with which it maintains a strictly confidential supervision over the financial and ethical conduct of members of the New York stock exchange. Other types of business would do well to blaze such a trail in their own spheres to the end that business as a whole might be conducted on a higher financial and ethical plane.