INTERNAL AUDITORS DIVISION
An Affiliate of SIFMA

Internal Audit Guidelines

Dividends, Interest & P&I

Updated September 2008

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I. Introduction and Background

I. INTRODUCTION AND BACKGROUND

A. Overview

Dividends

Dividends constitute the distributions of a company's profits to its shareholders. Since the distribution is made from accumulated profits it represents a discretionary payment that must be approved by a company's board of directors (dividends on preferred shares have different characteristics). Normally dividends are paid on a quarterly basis.

Issuing dividends is a complex and frequently voluminous activity for which the issuing corporation generally does not have the processing infrastructure required. Therefore, a dividend disbursing agent (usually a bank) is employed to make the dividend payments based on the shareholder ownership records maintained by the transfer agent.

There are several dates which determine the timing of the dividend issuance process. These dates are as follows:

- Declaration date- Date on which a company's board of directors approves payment of the dividend.

- Record date- Date on which the recipients of the dividend are determined based on the shareholder ownership records.

- Ex-date- Date on which the stock trades without the dividend to be paid (and the stock price is reduced by the amount of the dividend). This date is established by the securities market on which the stock trades.

- Payable- Date on which the dividend is paid to the 'shareholders of record.'

The ex-dividend date sometimes causes confusion. When a security is traded between the declaration date and the record date the purchaser is entitled to the dividend. However, when the trade will not settle until after the record date the ownership records will not be updated in time to reflect the new beneficial owner. Consequently, the exchange will establish the ex-date when the opening price of the security is reduced by the amount of the dividend. This will ensure that the purchaser receives the benefit of the dividend through a lower price even though the seller will actually receive the dividend on payable date.

Stock dividends and splits are also processed by the Dividend Department, except for reverse splits which are handled by the Reorganization Department. Stock dividends and splits involve the distribution of additional shares. In the case of stock dividends, the shareholders may or may not have the option of receiving cash-lieu payments for fractional shares. Typically, stock splits involve distributions of 25% or more, while stock dividends represent distributions of less than 25%.

Other types of distributions handled by the Dividend Department include return of capital, paid-kind- bonds and like kind exchanges. These distributions usually involve special tax treatment on the part of the beneficial owner and thus must be appropriately coded for tax reporting purposes.

Interest

Interest represents the periodic payments required on debt obligations and, as such, is not a voluntary distribution as is the case with dividends. It is almost always paid out in cash at specific intervals as described in the debt instrument. Interest is paid on corporate bonds, municipal bonds and government debt instruments. Depending on the type and nature of the obligation, interest may be paid monthly, quarterly, semi-annually or annually. The most common interval for payment is semi-annually. These payment intervals are referred to as being 'J&J' (January and July), 'F&A' (February and August), 'M&S' (March and September), etc.

Unlike dividends, interest payments are predetermined based on the interest rate and payment interval of the obligation. An exception to this is the interest on variable rate obligations, where the rate is re-set periodically based on a benchmark rate as specified in the debt instrument.

Principal and Interest

Unlike bonds which customarily pay interest semi-annually, and equities which commonly pay dividends quarterly, asset-backed securities, the most common of which are mortgage-backed securities (MBS) and asset-backed securities (ABS), pay both principal and interest (P&I) monthly to holders of record as of the last day of each calendar month.

While the record date is usually the last day of the month, the various MBS products have different "delay periods" creating a variety of different payable dates. Additionally, some MBS products include the concept of "beneficial owner date" which is a different date from the record date and determines which MBS holder is entitled to the P&I. One of the key elements in processing P&I payments is the determination of what portion of the payment represents the principal portion and what portion represents the interest portion. Factors are published monthly that, when applied to the remaining principal amount, enable this determination to be made.

Processing Dividends, Interest and P&I

<u>Overall Responsibilities</u>:
The two primary functions of the Dividend, Interest and P&I Department are: (1) the accounting for and collection of dividends, interest, and P&I, and (2) the payment of dividends, interest and P&I to customers or other brokerage firms. In some organizations, domestic dividends and interest processing, foreign dividends and interest processing, and/or MBS/ABS P&I processing may be separated organizationally.

A brokerage firm may hold in their "streetname" thousands of shares of a corporation's securities for many customers and will receive one dividend, interest or P&I check from the disbursing agent or, more commonly, one bulk payment in book entry form from the depository where the shares are held. The disbursing agent pays the depository who, in turn, pays the brokerage firm. The Dividend, Interest and P&I Department will be responsible for verifying that the expected amount was received and for crediting the proper accounts/customers with their proportionate share of the payment. The dividend and interest functions will generally have staff responsibilities assigned based on a portion of the alphabet within a product, whereby the individual will be responsible for processing all the receivables and payables for record date events for securities whose issuers start with letters within their assigned alpha portion. The P&I functions may be organized along product lines such as pass-throughs and CMOs/REMICs. For foreign securities, the functions may be divided between ADRs and ordinaries, and may further be divided by the various foreign currencies. The dividend, interest and P&I functions that are usually segmented by product are:

- Dividends - on all domestic equity securities
- Corporate Bond Interest - on debt instruments
- Municipal Bond Interest - interest processing
- Government Securities - principal and/or interest processing of U.S. bonds and governmental agencies (e.g. GNMAs and FHLMCs)
- Foreign Instruments - other than U.S. securities

Identifying Record Date Events and Expected Payments:
As stated earlier in the Overview Section, the main responsibilities in the area are collecting the appropriate dividends and interest and paying the appropriate amounts. These receipts and payments only occur when there is a "record date event." Therefore, in order to fulfill these responsibilities, the brokerage firm must first be made aware of all record date events so that collections and payments relating to these events can be made. For fixed income securities, the Security Master File is a key tool to identify record date events for interest payments. When "setting up" a security for the first time (often after the first trade), the Security Master File data fields for interest rate and payment frequency (e.g., annual or semi-annual), and payable dates (e.g., "J and J" bonds) are populated. This may be done manually by the area responsible for maintaining the Security Master or through an automated interface between the Security Master and a data feed obtained by a service provider. Consequently, the procedures and controls over Security Master File maintenance are critical to dividend and interest processing. Maintenance of the Security Master File involves updates for bonds in default or bankruptcy (via an interface with the Reorg System). Unlike interest-related record date events, dividend-related record date events must be "declared" by the board of directors. The dividend-disbursing agent pays the dividend rate to all "holders of record" as determined by the transfer agent. The brokerage firm must maintain a database of actionable dividend-related record date events as determined by a variety of sources. The dividend record date event database consists of incoming transmissions from reliable service bureaus and manual additions from other sources, such as advices from DTC and S&P. Even with the best of record date event databases, the brokerage firm will occasionally first learn of a dividend missed when the firm receives an unexpected dividend payment, or worse, an inquiry from a customer asking why they were not paid. The master file of actionable record date events from the Security Master file (interest) and from service bureaus (dividends) will interface with the stock record file (which identifies holders of record) to begin the processing cycle.

In domestic dividends and interest processing, the standard practice in most cases is to "prepay" the interest or dividends. This means that the brokerage firm will credit customers on payable date who are long over record date, possibly before the brokerage firm itself is credited or paid the interest or dividends by the depository or disbursing agent. Customer short positions are normally charged on record date rather than on payable date to avoid the possibility that the account will not be on the firm's books when it comes time to charge. Between record date and payable date, the Dividends and Interest Department works with a "Take-Off Sheet" (an edited weekly stock record as of record date) to assure that the dividend/interest is "balanced" by performing "record date proofs". This means that procedures are put in motion to ensure that sufficient dividends and interest will be collected to cover the payments to the long record date holders.

The following are typical stock record accounts used for record date proofs and how they affect interest and dividends processing:

- <u>Fail-to-Receive</u>- issue a claim to collect dividends or interest from the brokerage firm failing to deliver (they received a dividend they are not entitled to). This is normally done after payable date.

- <u>Repurchase Agreement</u>- issue a claim to collect interest from the brokerage firm holding the collateral.

- <u>Stock Loan</u>- same as repurchase agreement, but the claim is for dividends rather than interest.

- <u>Short Suspense or Stock Record Break</u>- resolve as soon as possible to expedite collection.

- <u>Transfer</u>- for securities which were in transfer over record date, analyze the security received from the transfer agent to determine whether it "made transfer" in time to receive the dividend or interest. If not, issue a claim to the previous registered holder.

- <u>Box</u>- expect to receive a check from the disbursing agent. Check for the correct name on the certificate. If the certificate is in a different name, issue a claim.

- <u>Safekeeping-</u> assure that the customer long positions related to the safekeeping location are not credited by the brokerage firm because the customers are the registered owners and will receive the interest or dividends directly.

- <u>Depository Positions-</u> check for "breaks" between the omnibus accounts and the depository statements or transmissions as of record date, and adjust as necessary.

- <u>Long Streetside Positions</u>- expect to receive a claim for payment.

<u>Payment Date Activity</u>:
On payable date, the Dividends, Interest and P&I Department focuses on balances and positions in the dividend/interest accounts to guide the department's workflow. If "everything goes right" on payable date, the dividends and interest accounts should end up "flat" because all automatic dividends and interest credited to customers long on stock record over record date (creating a receivable for the firm) will be completely offset by dividends and interest received by depositories or disbursing agents. Any payable date or post payable date balance or position in the dividend and interest accounts must be researched to determine the cause of the balance and the appropriate steps taken to flatten the account.

<u>Claims</u>:
A large portion of dividend and interest account balances will typically be "claim" related. Once research indicates that claims need to be processed, the corresponding balances should be journaled from the dividend and interest account range to a separate claim account range without altering the aging of the items. Claims may be processed individually, or batched and processed through NSCC's DSS Claim Processing System. As stated earlier, claims need to be processed when there are fails-to-receive, stock loan, and repurchase agreements on the stock record over record date. Aside from claim related items, dividends and interest suspense account balances and positions may be caused by record date events not on the firm's database (i.e., the long customers were not paid), erroneous payouts, failure to charge customer shorts, failure to resolve record date suspense positions, and erroneous credits to long customers whose securities are held in the firm's safekeeping box.

After the initial research and claims procedures, ongoing procedures include management and regulatory reporting of aged dividends and interest, responding to requests for payment by customers and others, and reacting to unresolved receivables and payables via write-offs and escheatment, respectively.

<u>Stock Dividends</u>:
Processing stock dividends is similar to processing cash dividends except that stock is received instead of cash. It should be noted that for large stock dividends or stock splits, the ex-dividend date will be one day after payable date, creating the need for a due bill tracking period because the holders of record (the holders who receive the large stock dividends) may not be the holders over ex-dividend date that are entitled to receive the stock dividend. Short stock dividends create exposure to the brokerage firm because they may have to be bought-in at increasing prices (SEC Rule 15c3-3 requires that short stock dividends be bought-in within forty-five days). Stock dividend information from the Dividend System must interface with other systems and files within the brokerage firm that use this data such as the Margin System, the Open Order (GTC) File, and the Open Options File.

Aside from cash dividends and interest and stock dividends, the Dividend Department will also be involved in processing capital gains and return of capital distributions, mutual fund distributions, cash in lieu payments, payment in kind bonds and dividend reinvestment programs. The concepts are similar, but the special handling is beyond the scope of this general audit guide.

<u>MBS P&I</u>:
A distinguishing aspect of P&I processing, as compared with dividends and interest processing, is that as the cash representing the "principal" portion of P&I is received, the amortized face amount of the MBS is reduced. Some brokerage firms maintain their stock record at amortized face because market prices are applied to the amortized face. It should be noted that certain depositories, including the Fed, maintain their positions at original face. Thus, the stock record quantities will need to be grossed up by the factor to compare with such depositories. Physical certificates also reflect original face amounts. Some broker-dealers may keep their stock record at original face, and apply the factor when pricing positions. The auditor should be aware of stock record "pay down" entries as well as cash entries for principal payments.

Be aware that there will be no P&I payments on TBAs (to be announced) MBS positions. P&I is only paid on specified pools, not TBAs. Two days before settlement date for TBA trades, sellers allocate to buyers specified pools whose amortized face amounts equal (within PSA tolerance thresholds) the amount of the TBA trade.

For MBS, which have separate beneficial owner dates, a due bill tracking period will be necessary because the trustee will pay owners of record, while the beneficial owners are the holders truly entitled to the P&I. The Security Master File should include the delay periods, payable dates, beneficial ownership dates, and factor history. These attributes from the Security Master File interface with the stock record to create the database of actionable record date (and sometimes beneficial owner date) events. Factor information (portion of remaining principal) comes from service bureaus, and in the case of some private label CMOs/REMICs, from the trustees. Once the actionable record date events are identified, processing will be similar to that for dividend and interest, except as noted in this section.

The P&I cash and pay-down entries result from the interaction of several files. The cash interest entry uses positions from stock record (which reflects the prior month's pay-downs) and the interest rate from the Security Master File. The cash principal entry and the stock record paydown entry reflecting the "change" in factors are calculated by utilizing the current period factor (from service bureaus or trustees) and the prior period factor from the Security Master File. It should be evident that even if a factor is late, the interest entry can still be made on time.

Most MBS are issued with a factor of 1.0. Certain MBS will have a factor of 1.0 for an extended period of time and pay interest only until pay-downs begin. "Z-bonds" are an example of an MBS that pays no principal for an extended period of time (the factor may be 1.0 or more, from accretion, for many years before paydowns begin). MBS with "negative amortization," such as graduated payment mortgages (GPMs) will show factors greater than 1.0 because the principal will increase to offset lower initial interest payments. Of course interest only (I/O) strips pay no principal and principal only (P/O) strips pay no interest. (Please refer to the Mortgage-Backed Securities Audit Guideline (dated July 2007) for further explanation of these products.)

<u>Foreign Dividends and Interest</u>:
Most of the systems and processing for foreign dividends and interest is similar to domestic processing. Several differences, however, are described in this section. One of the ways to distinguish between the various types of foreign securities dividends and interest processing is to draw a distinction between American Depository Receipts (ADRs) and "ordinaries." ADRs trade on the U.S. exchanges like domestic securities and pay dividends and interest in U.S. dollars. Ordinary foreign securities trade on foreign exchanges and usually pay dividends and interest in foreign currencies.

In processing foreign dividends and interest, aside from utilizing the Security Master File and an actionable record date event database, a customer "Name and Address" master file will be needed to determine which customers are to be paid in U.S. dollars and which are to be paid in a foreign currency. The dividend and interest system may interface with a foreign exchange (FX) trading system to accommodate situations where the brokerage firm receives dividends or interest in foreign currency but must credit the customer in U.S. dollars. An FX contract is created to facilitate this transaction.

A major distinction between domestic versus foreign dividends and interest processing is that while customers are usually "pre-paid" dividends and interest for domestic securities, customers are usually only paid dividends and interest for many foreign securities if and when the brokerage firm itself gets paid. The firm must keep track of record date events where incoming payments are late because customers will be calling for their late dividends and interest. The "take-off sheet" must be retained as of record date and should be reviewed and updated.

Another special aspect of processing foreign dividends is processing and accounting for foreign tax withholdings. The U.S. usually has tax treaties with the countries where the issuing corporations reside. These treaties specify the applicable withholding rates. The disbursing agents pay the dividends and interest net; however the long customers must be credited with the gross dividend or interest and partially offset this with a charge for withholding taxes. Some taxpayers can receive a U.S. tax credit for the foreign withholding taxes paid. Some countries that require withholding taxes do not allow for any subsequent "reclaim" of part or all of the taxes withheld. However, other countries will refund part or all of the foreign taxes withheld if the appropriate "foreign tax reclaim forms" are filed with the foreign governments. The customers charged withholding tax should subsequently be credited for the portion reclaimed.

Legal and Regulatory

There are three major legal and regulatory concerns involved in processing dividends, interest and P&I: abandoned property requirements, adherence with exchange rules and compliance with Securities and Exchange Commission (SEC) rules.

Aged unclaimed credits in dividend accounts are subject to state escheatment laws. In general, the state to which property is to be given is governed by the last known domicile of the customer. Dormancy requirement periods vary from state to state depending on the jurisdiction of specific courts and the particular type of property. Systems and procedures should be in place to identify and age abandoned property and to ensure that appropriate due diligence is performed to locate the owner of the property.

While in July 2007 Financial Industry Regulatory Authority (FINRA) was created based on the consolidation of the National Association of Securities Dealers (NASD) with the member regulation, enforcement and arbitration functions of the New York Stock Exchange (NYSE), FINRA has not yet established their own rule book. Therefore, pre-existing NASD and NYSE rules governing dividend related activity intended to facilitate various street related processes associated with dividends and interest still apply. Since the two organizations' rules are comparable to each other, only the applicable NYSE rules will be noted.

- NYSE Rule 257 – Deliveries After Ex-Date
- NYSE Rule 239 – Claims for Dividends, Rights, etc.
- NYSE Rule 249 – Registered Bonds "Flat," Due Bills for Interest
- NYSE Rule 251 – Cash Adjustments for Coupons
- NYSE Rule 256 – Forms of Due Bills
- NYSE Rule 259 – Due Bills – Redemption
- NYSE Rule 282 – Mandatory Buy-In

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The major SEC rules which impact dividends processing are the Net Capital Rule (15c3-1) and the Customer Reserve Requirement (15c3-3).

- SEC Rule 15c3-1
  Requires 100% charge for receivables aged over 30 days from payable date.

- SEC Rule 15c3-3
  Item 6 in the formula includes the market value of stock splits and similar distributions aged over 30 calendar days (over 7 days if using the Alternative Method).
  Item 8 in the formula includes credit balances in dividend accounts aged over 30 calendar days (over 7 business days if using the Alternative Method).
  Item 10 may include debit balances in dividend accounts providing that:
  - The debit items can be allocated to credits in the formula resulting from crediting customer accounts for the same dividends/interest.
  - The dividends/interest is receivable from DTC.
  - Receivables are outstanding for no more than five business days.
  - Stock dividends receivable over 45 calendar days old must be bought in.

B. Examination Objectives

The magnitude of funds flowing through the Dividend, Interest and P&I Department warrants an evaluation of the adequacy of internal controls over the processing of receivables and payables. The quality of systems has a direct impact on the control environment as well as the efficiency of operations. Significant exposure to the firm could be realized as a result of insufficient procedures, inadequate recordkeeping and retrieval capabilities, and failure to act on a timely basis.

Internal controls should be reviewed to identify key areas of controlling, recording and processing of transactions and accounts. The audit objectives should include, but not be limited to, ensuring:

- Transactions are complete and valid and are properly recorded.
- Procedures are in place to prevent duplicate processing or payment.
- Journal entries are properly authorized and verified.
- Transactions contain adequate supporting documentation.
- There is an adequate segregation of accounts by security and period.
- Adequate reviews and approvals are in place for adjustments, reconciliation of suspense accounts, disbursements, monitoring the aging of account balances for collectibility and the timeliness of recording transactions.
- Unresolved items are identified, aged and followed up by appropriate personnel for resolution/collection.
- Coupon clipping procedures provide for adequate physical safeguards.
- Management and external reporting is appropriate and accurate.
- Systems and procedures are adequate to properly identify record date events.
- Access to bearer bonds is limited and controlled.
- Procedures and controls provide for compliance with states’ escheatment laws.
- Proper treatment is afforded to dividend amounts in the Net Capital and Reserve Formula calculations.
- There is an adequate segregation of duties.

C. Audit Scope

The Internal Audit Guidelines for Interest, Dividends & Principal & Interest (P&I) is a tool designed to facilitate the internal auditors' determination and assessment of the potential risks inherent in processing interest, dividends and P&I distributions and the related controls which an organization may use to manage, monitor and evaluate those risks. Also included are possible work steps that the internal auditor may perform to assess the effectiveness of controls and processes related to a firm's collection and payment of dividends, interest and P&I.

D. Audit Risks

Financial/Fraud risk is present in any environment where processing involves receipt and disbursement of a significant amount of funds. Failure to collect all amounts due or improper crediting of amounts to third parties will expose the firm to financial loss either inadvertently or through misappropriation of funds.

Accounting risk is present to the extent that dividend, interest and P&I activity is not recorded accurately or timely.

Regulatory risk relates to the potential exposure associated with non-compliance with escheatment laws and SEC rules.

II. Audit Guidelines

II. AUDIT GUIDELINES

Risks to be Managed	Types of Controls to Manage/Eliminate Risks	Potential Audit Work Steps
A. Financial/Fraud Risk		

Inadequate procedures and controls over receivables and payables could result in financial loss and/or reputational risk.
• Actionable record date events might occur and not be recognized.
• Record date positions may not be properly balanced.
• Customers are not credited amounts due timely or accurately.
• Short positions are not charged timely or accurately.
• Accounts that are short on record date may not be on the books on payable date.
• Entries and claims are not verified and approved.
• Due bills are not tracked resulting in payment of erroneous due bills or failure to issue due bills.
	Identification of record date events:
	• Actionable record date events are received from various vendors and automatically compared to each other to ensure that all events are identified.
	• An exception report is generated of actionable record date events reported by vendors which do not appear on the database of events.
	• Unanticipated payments that are received are credited to a suspense account and researched in order to determine which customers are entitled to receive the distribution.
		Identification of record date events:
		• Determine whether appropriate exception reports are used to ensure the accuracy of the record date event database.
		• Ascertain the reasons why dividend, interest and P&I accounts contain credit balances indicating payments received that have not been paid out.
		• Assess procedures to address customer complaints related to dividend, interest and P&I payments.
		  – Verify that all long customers have been credited, not just the customer complaining.
		  – Analyze complaints to determine whether there are any negative trends based on the nature of complaints received.
		• Select a sample of record date events from an independent source and trace related entries to customer and streetside accounts to determine whether correct rates and factors have been applied.

Risks to be Managed	Types of Controls to Manage/Eliminate Risks	Potential Audit Work Steps
A. Financial/Fraud Risk (Continued)		
• Receivables are not aged properly or monitored. • Write offs and pair offs are not reviewed and approved. • Inadequate controls over the handling of checks could lead to misappropriation of funds. • Foreign dividends are credited net of withholding or incorrect withholding rates are used. • Redemption of detachable coupons on bearer bonds is not adequately controlled. • Inadequate segregation of duties could lead to misappropriation of funds.	• Customer complaints relating to distributions not received are forwarded to Compliance for monitoring / resolution. **Balance record date positions:** • Record date positions are balanced on record date. – Reconciliations are reviewed for accuracy. – Unreconciled positions will result in a balance in the dividend account, requiring research and resolution. **Dividend entries:** • All accounts with long or short record date positions are auto-matically credited or charged on payable date. • The margin system is notated on record date for any customer account that is short the security.	**Balance record date positions:** • Review a sample of record date position listings: – Verify the accuracy of the reconciliations. – Determine the validity of a sample of the positions on the listing by tracing to the stock record as of the record date. – Verify that expected payments have been received. – Verify the accuracy of any adjustments (e.g., 'as of's) made by examining supporting documentation. – Ascertain that the reconciliations, and any related adjustments, have been reviewed and approved. – Evaluate procedures performed to identify all dividends declared prior to record date. – Determine that there is timely follow-up and resolution of out of balance positions. **Dividend entries:** • Evaluate the process used to debit and credit accounts with positions on payable date. – For the sample selected above of record date events, verify that debits and credits are processed accurately and timely. – Ascertain that adequate procedures exist to prevent accounts with short positions on record date from being closed prior to payable date.

Risks to be Managed	Types of Controls to Manage/Eliminate Risks	Potential Audit Work Steps
A. Financial/Fraud Risk (Continued)		
	Claims processing: • Incoming claims are verified against record date reports and other books and records. • Once verified claims are approved by supervisory personnel. • Request for payment of the claim is processed by someone independent of the verifier of the claim. • Outgoing claims are prepared based on record date reports and reviewed a supervisor. • All claims are recorded and aged in a separate claim account range. • Reports of aged claims are periodically produced for management review. • For P&I claims, an automatic interface between the open claims file and the fail file ensures that claims are processed promptly when the fail is closed.	**Claims processing:** • Evaluate the claims processing procedures and determine that: – Incoming claims are verified against record date reports and other books and records. – Claims are approved by a supervisor. – The payment of the claim is processed by someone independent of the verifier. – Outgoing claims are prepared based on record date reports and reviewed by a supervisor. – Claims are recorded in a separate claim account range. – Reports of aged claims are prepared periodically and distributed to management. • For a sample of completed incoming and outgoing claims verify that they are: – Adequately supported by appropriate documentation. – Processed on a timely basis. – Approved by a supervisor. – Recorded in a separate claim account range • For a sample of unresolved claims determine that: – Files are maintained supporting the claim. – The claims have been recorded in the claims account. – The claims appear on the report of aged claims. – The report of aged claims is complete and accurate and agrees to the general ledger balance. – Adequate follow-up is being performed on claims which have been outstanding for an extended period of time. • For P&I claims, determine that there is an automated interface between the open claims file and the fail file. If no automated interface exists, assess the adequacy of manual controls. • For a sample of P&I claims, verify that they are processed promptly and accurately when the fail is closed.

Risks to be Managed	Types of Controls to Manage/Eliminate Risks	Potential Audit Work Steps
A. Financial/Fraud Risk (Continued)		
	Due bills: • The dividend system flags possible required due bills. • Due bills are controlled automatically in the system and activity is updated through an interface with the cashiering system. **Aged Receivables:** • Account structure provides for ready aging of receivables. • Reports of aged receivables are prepared periodically. • Reserves are established for uncollectible receivables by the Accounting Department.	**Due bills:** • From the database of record date events for a given period of time, select a sample of trades set up for physical receive/deliver that settled on or before record date, but were received or delivered between record date and payable date and determine that: – The dividend, interest and P&I system flagged the item as due bill situations. – Cashiering was informed of each due bill situation, and that the due bills were attached/ received with the appropriate receives/delivers. – The same items were not also handled via claims. • Assess procedures for ensuring that outside due bill tracking services issued accurate and complete credits and debits and test the supporting documentation for a selection of such adjustments. **Aged Receivables:** • Review the process for aging and monitoring aged receivables: – Verify the accuracy of the aging. – Determine that partial adjustments or reclassifications to balances will not ‘reset’ the aging. – Ascertain that aged receivable reports are periodically distributed to appropriate management personnel. – Determine that adequate follow-up is being performed to collect aged items. – Review with the Accounting Department the adequacy of reserves established for uncollectible receivables.

Risks to be Managed	Types of Controls to Manage/Eliminate Risks	Potential Audit Work Steps
A. Financial/Fraud Risk (Continued)		
	Write offs and pair offs: • Write offs over a "de minimus" threshold are approved by supervisory personnel. • Write offs are reported periodically to management. • Reports of debit entries made to payable accounts are produced and reviewed to detect inappropriate pair offs.	**Write offs and pair offs:** • Review the departmental written procedures and determine whether a specific dollar amount for write-offs not needing approval is stated and whether inappropriate pair-offs are prohibited. • For a sample of activity statements for the write-off account(s), verify whether there is documentation of approval for write-offs exceeding the "de minimus" threshold. For especially large write-offs, review if there is documentation indicating that the receivables are uncollectible. • For a selection of debits to dividend, interest and P&I payables, determine the offsetting side of the entry and ascertain that it does not represent an inappropriate pair-off. • Determine whether any payable reductions are versus employee accounts or P.O. Box accounts and verify that such reductions are appropriate.
	Check processing: • Mail is opened by personnel independent of dividend processing. • Checks are restrictively endorsed, deposited and copies are provided to the Dividend Department for processing.	**Check processing:** • Document and assess the flow of incoming dividend, interest, and P&I checks. Determine whether dividends, interest and P&I personnel have direct access to the actual incoming checks. • Ensure that incoming checks are received in a central location within the firm (e.g. the mailroom and check collections unit) and immediately restrictively endorsed and deposited promptly, with a copy to Operations for further processing. • Verify that checks are recorded accurately and timely. • Determine that the record date balancing process would identify which stock record locations checks should be expected from and determine that there will be follow-up when expected checks are not received.

<table>
<tr><th>Risks to be Managed</th><th>Types of Controls to Manage/Eliminate Risks</th><th>Potential Audit Work Steps</th></tr>
<tr><td colspan="3">A. Financial/Fraud Risk (Continued)</td></tr>
<tr><td></td><td>Foreign dividends:
• A database is maintained of withholding rates which interfaces with the customer master file and the dividend system.
• Customers are not credited until the foreign dividends are received.
• Entries for foreign dividends are automatically generated gross with a charge for the applicable withholdings.
• Reclaimed amounts are journaled out of the dividend accounts to a separate range of reclaim accounts.
Coupon processing:
• Physical access to bearer bonds and coupons is restricted to authorized personnel.</td><td>Foreign dividends:
• Review the file of foreign tax withholdings and reclaims tables and assess whether it is organized, complete and up-to-date. Trace a sample of the detail to supporting documentation, if available.
• Assess the adequacy of procedures to ensure that the dividend and interest system remains current and reflects all changes to the withholdings tables.
• For a selection of foreign interest and dividend payments:
– Verify that customers were not credited the interest or dividend until payment was received
– Ascertain that customers were credited the gross amount and separately charged the correct withholdings tax
– Test the tax reporting fields to verify that the “tax buckets” are accreting properly
• Assess the accounting for, and the processing of, foreign tax reclaims.
– Understand how dividends and interest personnel ensure that all reclaims are processed
– Determine whether there is a separate range of reclaim accounts and that the accounts are reviewed, aged, and reconciled to the subsidiary records
– Select a sample of reclaims processed and trace to the supporting documentation, the customer statements, and the general ledger

Coupon processing:
• Assess the adequacy of physical access controls over the area where the bearer bonds and detachable coupons are kept.
• Review quarterly count procedures for the bearer bond box and ascertain that bearer bonds are examined for any past due coupons. If not performed during quarterly counts, determine that there is a periodic examination of bearer bonds to identify past due coupons.</td></tr>
</table>

Risks to be Managed	Types of Controls to Manage/Eliminate Risks	Potential Audit Work Steps
A. Financial/Fraud Risk (Continued)		
	• Bonds are periodically examined for the detection of any past due coupons. • Coupon clipping process is performed by at least two individuals who are not responsible for processing coupon entries. • Coupons are clipped in a secured area, placed in an envelope and presented to the paying agent for redemption. • A copy of the deposit slip is given to the dividend department for recording and subsequent reconciliation to the firm's records. **Segregation of duties** • There are written job descriptions detailing responsibilities. • Dividend department personnel do not handle checks or securities.	• Assess controls over the process of clipping and cashing bearer bond coupons and ascertain that the process is performed by at least two individuals with no other coupon processing responsibilities. • Determine that the clipping takes place in a secured area and that coupons are placed in the appropriate envelope and promptly presented for redemption. • Ensure that a copy of the deposit slip is given to the dividend department for recording and is reconciled to the firm's records. **Segregation of duties** • Obtain the written job descriptions for all the employees in the dividends, interest and P&I area. Read the job descriptions and determine whether there are any incompatible functions. • Observe operations and determine whether there appear to be any incompatible job functions. • Ascertain that Dividend Department personnel do not handle checks and securities. • Determine that recording and reconciling activities are performed by separate individuals. • Verify that system access is appropriately limited to authorized users.

Risks to be Managed	Types of Controls to Manage/Eliminate Risks	Potential Audit Work Steps
A. Financial/Fraud Risk (Continued)		
	• Recording and reconciling activities are performed by separate individuals. • System access is limited to authorized users.	
B. Accounting Risk		
General ledger accounts and, as a result, financial statements may not accurately reflect dividend, interest and P&I processing activities. • Entries are not processed timely or accurately. • Control accounts do not agree with subsidiary records. • Dividend, interest and P&I accounts are improperly netted. • Management reports are not adequate to monitor dividend, interest and P&I activity.	**Recording activity:** • An account structure is established that facilitates the recording, identification and aging of dividend, interest and P&I activity. • Dividend, interest and P&I subsidiary accounts are reconciled monthly to the general ledger control accounts. – Reconciliations are performed by individuals who are not responsible for processing / recording activity. – Reconciliations are reviewed by a supervisor.	**Recording activity:** • Become familiar with the dividend, interest and P&I account structure and ascertain that it is adequate for purposes of recording, identifying and aging applicable amounts. • Review the trial balance and determine that: – Someone is responsible for every account within the dividend, interest and P&I range. – The purpose of any account not utilized for recording record date activity and claims is understood, is appropriate and is adequately monitored. • For a sample of subsidiary account reconciliations: – From the reconciliations, trace the data back to the general ledger and the subsidiary ledgers. – Check the reconciliations for clerical accuracy. – Check the reconciliations for evidence of supervisory review. – Test the cause and resolution of any reconciling items. – Determine that reconciliations are performed by individuals who have no processing and recording responsibilities. – If no formal reconciliations are prepared, determine whether there are adequate compensating controls.

Risks to be Managed	Types of Controls to Manage/Eliminate Risks	Potential Audit Work Steps
B. Accounting Risk		
	• The processing system nets receivables and payables down to each individual record date event. – Trial balance system picks up the broad balances from the dividend, interest and P&I system. – When claims are identified the related amounts are reclassified from the dividend account to a separate claim account range. **Management reports:** • Management reports are produced and distributed periodically covering such matters as: – Aged dividends – Claims – Unreconciled positions and accounts – Short stock dividends – Regulatory charges	• Scan the subsidiary ledgers and determine whether there is a trail for the applicable time period covered by the accounts, preferably as part of the account number. • Scan the subsidiary ledgers and determine whether netting does not go beyond the CUSIP/date level. • Trace a selection of totals from the subsidiary ledger to the general ledger to ensure that no further netting occurs. • Ascertain that claims are reclassified from the dividend account to a separate claim account (see work steps re claims). **Management reports:** • Obtain at least one sample of each type of management report for a selected period of time and determine whether the universe of management reports obtained includes reporting on areas deemed important such as: – Aged control account receivables and payables. – Aged claims and reclaims receivables and payables. – Write-offs over a predetermined threshold. – Due bills received but not redeemed. – Critical work volume statistics. – Coupons available to be clipped vs. actually clipped vs. redeemed. – Short stock dividends over 45 days old (which should be bought in per SEC Rule 15c3-3) • Assess the appropriateness of the distribution and content of management reports.

Risks to be Managed	Types of Controls to Manage/Eliminate Risks	Potential Audit Work Steps
C. Regulatory Risk		
Non-compliance with applicable SEC rules and escheatment requirements may expose the organization to regulatory sanctions, legal action and reputation damage. • Failure to properly age and monitor unclaimed amounts may result in misappropriation of funds and non-compliance with state escheatment requirements. • Inadequate procedures and controls could result in improper reporting under the requirements of SEC Rule 15c3-1 and SEC Rule 15c3-3. • Inadequate record maintenance and retention procedures might result in non-compliance with SEC Rules 17a-3 and 17a-4.	**Escheatment:** • Written procedures have been developed that clearly delineate appropriate states' escheatment requirements and the procedures to be followed to ensure compliance. • Accounts are aged accurately in accordance with the account structure. • Amounts to be escheated are recorded in separate accounts for each year and state. • Management reviews all escheatments prior to submission to the applicable state.	**Escheatment:** • Select a sample of escheatments made to various states and determine that: – Escheatment procedures adhere to the applicable states' requirements. – The escheatment was remitted and recorded accurately and timely. – Management has reviewed and approved the escheatment. – The aging procedures are accurate. – A separate account is utilized for each state. • Determine that sufficient due diligence is performed to locate the beneficial owner of the property. • Verify that adjustments made to unclaimed property accounts are reviewed and approved.

Risks to be Managed	Types of Controls to Manage/Eliminate Risks	Potential Audit Work Steps
C. Regulatory Risk (Continued)		
	Rules 15c3-1 and 15c-3: • Charges are automatically calculated. • Any manual adjustments are reviewed and approved. • Charges are reviewed by the dividend department, by the regulatory reporting area and by management. **Books and records:** • Written procedures exist describing the books and records to be maintained and their specific retention period.	**Rules 15c3-1 and 15c-3:** • Test the accuracy of amounts reported and their aging, as used for the required computations and trace them to the FOCUS Report. • Ensure that all accounts are included. • Verify that manual adjustments are reviewed and approved. • Consider the internal review and approval process performed prior to dissemination of this information. • Determine how the firm ensures that the computer program creating the reports calculating the regulatory adjustments is kept up-to-date and complete. **Books and records:** • Review written procedures covering maintenance and retention of dividend, interest and P&I records: – Assess adequacy of the procedures for complying with Rules 173-4 and 17a-4. – For a sample of records determine that they can be produced in a timely fashion.

INTERNAL AUDITORS DIVISION
A Division of SIFMA

III. Glossary

III. GLOSSARY

The definitions in this section shall apply to the terms used in the guidelines. Where terms are not defined in this section or within another chapter, they shall be defined using their ordinarily accepted meanings within the context in which they are used.

Abandoned Property	A client's property that is undeliverable or unclaimed. After a prescribed number of years the property is to be escheated to the appropriate state.
American Depository Receipt (ADR)	An ADR represents ownership in the shares of a foreign company trading on U.S. financial markets. The owner of an ADR has the right to obtain the foreign stock it represents.
Announcement	When the corporation decides to declare a dividend, it will send a notice in advance of the date that the dividend will be paid. Copies of this notice or announcement are sent to the stock exchange on which the corporation's stock is listed and to newspapers and financial publications. The exchange will send a summary of this notice to its members.
ABS	Asset-backed security.
Bad Debt	A dividend or registered interest receivable that is uncollectible.
Basis Price	The market value or price set by the corporation paying a stock dividend or stock split to determine the value of fractional shares.
Beneficial Owner	Legal or rightful owner; may not always be the registered owner.
Books Closing	See Record Date.
Books of the Company (stock record file)	Records that show the registered holders of stock and bonds and the denominations and certificate numbers issued and dates of issue. These records may be maintained by the company or an appointee of the company (e.g. bank) and are used to determine those entitled to receive dividends or interest as of the record date.
Box - Location	A short/credit position on the stock record that shows where certificates are physically held.
Cash Dividend	A payment of money to shareholders from corporate profits or retained earnings.
Cash Due Bill	A post-dated check in payment of a dividend or registered interest that is normally issued after the record date and prior to the payable date. The check cannot be cashed until the payable date.

Cash-in-Lieu	Money paid to shareholders in lieu of receiving fractional shares.
Claim	A request for payment of the dividend or interest that was paid to the registered holder of a certificate as of the record date by or for the beneficial owner.
Collateralized Mortgage Obligation (CMO)	A multiclass bond backed by a pool of mortgage pass-through securities or mortgage loans. See “REMIC.”
Coupon Bond	A bond with interest coupons attached. Payment of interest is made only when the coupons are clipped as they come due and are presented for payment.
Credit Entries	Entries used by the Dividend Department to credit cash dividends and interest and charge stock dividends to accounts on the books of the brokerage firm.
Date of Record	See Record Date.
Debit Entries	Entries used by the Dividend Department to charge cash dividends and interest and credit stock dividends to accounts on the books of the brokerage firm.
Declaration Date	The date on which the Board of Directors of a corporation announces the current dividend to be paid by the corporation.
Defaulted Dividend or Interest Payment	A dividend or interest payment that has not been honored according to its terms.
Deferred Dividend or Interest Payment	A dividend or interest payment that is postponed until a later date.
Dishonor	The refusal to pay a cash or stock due bill because it was issued in error or when a dividend or interest claim is rejected.
Dividend	Payment from profits or retained earnings to stockholders in amounts proportionate to their holdings as declared by the Board of Directors of the corporation.
Dividend Accounts	Bookkeeping records of dividend entries and transactions.

Dividend and Interest Accounts Payable	Accounts maintained by the Dividend Department that represent interest, cash, and stock dividends owed by the brokerage firm to others.
Dividend and Interest Accounts Receivable	Accounts maintained by the Dividend Department that represent interest, cash, and stock dividends owed to the brokerage firm.
Dividend or Interest Disbursing Agent	The bank, trust company, company, or individual appointed by the corporation to perform the distribution of payment to registered stockholders or bondholders.
Dividend Settlement Service (DSS)	NSCC centralized claims processing system that manages the collection of dividends and interest owed to participants by other financial institutions. DSS enables users to claim funds due them by charging other DSS participants through NSCC's clearance and settlement system.
Due Bill	A document issued by a brokerage firm stating that dividends, rights to subscribe, etc. are the property of the holder of the due bill.
Equivalent New York Record Date	The last business day upon which securities that have an out-of-town transfer agent may be mailed from New York City by regular mail and reach the out-of-town office in time to make transfer for the record date.
Ex-Dividend	A synonym for "without dividend". The purchaser of a stock selling ex-dividend is not entitled to the current declared dividend. A stock that is sold ex-dividend is sold without the dividend – usually beginning two business days before the Record Date. During the two-day period from the ex-dividend date to the record date, the price of the stock is reduced by the dividend rate.
Ex-Interest	A synonym for "without interest". The purchaser of a bearer or registered bond selling ex-interest is not entitled to the current interest payment.
Ex-Rights	A synonym for "without rights". Corporations may offer their stockholders the right to subscribe to new or additional stock. The purchaser of stock selling ex-rights is not entitled to this offer by the corporation.
Extra Dividend	A dividend (cash and/or stock) paid in addition to the regular or usual dividend the corporation has historically paid.
Face Value	The value stated on the face of the bond. Normally, the face value is the principal amount to be paid at maturity of the issue.
Factor	The remaining principal balance of a mortgage - backed security.

Fails-to-Deliver	Securities that have not been delivered on the specified settlement date.
Fails-to-Receive	Securities that have not been received on the specified settlement date.
Firm Name Stock and Bonds	Stock and bonds which are registered in the name of a particular firm.
Fractions Paid-in-Cash	Stockholders who are entitled to receive a fraction of one share will receive cash-in-lieu of the fraction.
Guaranteed Stock	A stock on which dividends are guaranteed by another corporation.
Holder of Record	The listed registered owner on the transfer records of a corporation.
Indenture	The written agreement under which bonds are issued, stating the interest rate, maturity date, and other terms of the issue.
Issuance Date	The date on the face of a certificate that shows when the registered holder was recorded as the owner on the books of the corporation.
Late Announced Dividend	A dividend that is not publicly announced in time to allow the stock to be quoted ex-dividend in the normal manner-that is, four business days prior to the record date.
Long Position	The quantity of shares or bonds owned by an account(s) per the brokerage firm’s books on the record date.
MBS	Mortgage - Backed Securities.
New York Record Date	See Equivalent New York Record Date.
Optional Dividend	A dividend that is payable in either stock or money, at the option of the holder of record.
Par Value	The nominal value of an equity security which is determined by an issuer at a minimum price. Par value for bonds is equal to the face value.
Passed Dividend	The omission of a regular or scheduled dividend by the Board of Directors of a corporation.

Payable Date	The date on which a stockholder or bondholder should receive the dividend or interest payment from the disbursing agent. When the stock or bond is held by the brokerage firm (e.g. in the firm's name for the client), the payable date will be the date the client is credited with the stock or cash dividend or bond interest.
Paying Agent	An entity responsible for paying distributions on behalf of the issuer.
Pool	A collection of mortgage loans assembled by an originator as the basis for a pass-through security.
Proof Sheet	A listing that shows all the firm's positions for client and firm accounts and the locations of the stock or bond paying the dividend or interest.
Prospectus	Document that describes the details of a new bond or stock offering.
Reclaims	The process of reclaiming foreign withholding taxes.
Rate	The amount of money or stock to be paid by the corporation on each share of stock outstanding on the record date for the currently-declared dividend. Also the amount of interest paid annually on a $1,000 bond.
Record Date	The date on which the stockholder or registered bondholder must be registered on the books of the corporation in order to receive the declared dividend or interest payment from the disbursing agent on the payable date. When the certificate is being held in the name of a brokerage firm or its nominee for a client, it is the date on which the client must own the stock or bond on the firm's records.
Registered Bond	A bond registered on the books of the corporation in the name of the owner.
Registrar	A bank or a trust company appointed by a corporation to ensure that the total number of shares or bonds issued does not exceed the total amount authorized.
Registration	The name on the face of a stock or registered bond certificate. The name shown is always the registered holder on the books of the corporation, but the registered holder is not necessarily the beneficial owner.
Real Estate Mortgage Investment Conduit (REMIC)	A form of a CMO. As a result of the 1986 Tax Reform Act, most CMOs are issued in REMIC form to create certain tax advantages to the issuer. The terms "REMIC" and "CMO" are used interchangeably.

Safekeeping Certificates	Securities registered in the name of clients held by the brokerage firm. The certificates may be negotiable or non-negotiable.
Script Certificate	A certificate evidencing ownership of less than one full share in a corporation. The certificate may be in bearer or registered form.
Segregation Certificates	A client's fully-paid-for security held by a brokerage firm in the firm's name.
Settlement Date	The date on which a security transaction is to be settled by the delivery or receipt of the security for the receipt or payment of cash.
Short Position	The total quantity of a particular security (stock or registered bond) that a client was short (owed by the client to the firm) over the record date.
Short Against the Box	A customer may elect to sell stock short in a short account and simultaneously be a holder of the same stock in a margin account. This is usually done when the customer wants to receive the proceeds of the sale in the current year and have a taxable event in the next year. Dividends in the short account must be reported to the IRS as dividend income. Dividends in the margin account cannot reduce the amounts reported in the short account but, rather, are computed as a capital gain or loss.
Short Sale	A short sale is the sale of stock in a special margin account where the client does not own the stock. The client will purchase the stock at a later date (covering the short). If the price of the stock goes down, a profit is realized. Dividends on short sales are not reported to the IRS as income but, rather, are computed as a capital gain or loss when the short is covered.
Spin-Off	A dividend paid by a corporation in stock it holds of other corporations.
Stock Dividend	A dividend paid in stock. The total number of shares paid is less than 25% of the outstanding shares.
Stock Due Bill	A promissory note issued by a broker or bank promising to pay in the future the amount of the stock distribution owed.
Stock Split	A dividend paid in stock. The total number of shares paid is 25% or more of the outstanding shares. The par value or stated value of the stock is changed, permitting an increase in the number of shares without changing each shareholder's proportionate interest.

Stockholder or Bondholder of Record	The person whose name is registered on the books of the corporation as of the close of business on the record date.
Street Stock or Registered Bonds	Any negotiable stock or registered bond certificate held by a firm in a name other than that of the firm.
Trade Date	The date a stock or bond transaction is entered into.
Substitution Payments	Long holders of record are credit for short customers rather than being credited via "payment from source".
TBA (To be announced)	MBS where the pool numbers have not yet been specified.
Transfer Agent	A bank, trust company, or individual appointed by a corporation to transfer its stock or registered bonds from one owner to another and to maintain ownership records to reflect quantities, certificate numbers, and registration of the certificates.
Unannounced Dividend	A dividend that is not publicly announced and is not known until the registered holders on the books of the company on the record date receive a dividend check and/or the stock on the payable date.
Value Date	See Settlement Date.