



Audit Guideline Suspense Accounts

Updated November 2005

SECURITIES INDUSTRY ASSOCIATION
INTERNAL AUDITORS DIVISION
AUDIT GUIDELINES COMMITTEE

The Audit Guidelines (the "guidelines") are intended to provide members of the Securities Industry Association ("SIA"), Internal Auditors Division with information for the purpose of developing or improving their approach towards auditing certain functions or products typically conducted by a registered broker-dealer. These guidelines do not represent a comprehensive list of all work steps or procedures that can be followed during the course of an audit and do not purport to be the official position or approach of any one group or organization, including SIA or any of its divisions or affiliates. Neither SIA, nor any of its divisions or affiliates, assumes any liability for errors or omissions resulting from the execution of any work steps within these guidelines or any other procedures derived from the reader's interpretation of such guidelines. In using these guidelines, member firms should consider the nature and context of their business and related risks to their organization and tailor the work steps accordingly. Internal auditors should always utilize professional judgment in determining appropriate work steps when executing an audit.

I. Background

A. Definition

A suspense account is used to temporarily record securities and/or monies that cannot be immediately identified and cleared. The following explains the type of entries which may appear in a suspense account:

- A long security position indicates securities held by the company for which the proper account is unidentified. Under SEC Rule 15c3-3 (Reserve Formula) these positions are to be treated as if they were customer positions for possession or control purposes. If a long position is not offset by a debit money balance, it is required to be treated as a free long position in a customer cash account and thus considered fully paid for possession or control purposes. Long positions in suspense are also subject to state abandoned property laws if not cleared within stipulated time frames.
- A short security position indicates securities which are “missing” or receivable by the company. Prompt resolution of these items is crucial to the company from both a regulatory and financial viewpoint. The concept of market risk and proper treatment for Rules 15c3-1 (Net Capital) and 15c3-3 (Reserve Formula) are explained in Section III.
- A debit money balance indicates money due the company. If not resolved, such a balance could result in a financial loss to the company. In addition, high interest rates increase the cost of financing such receivables.
- A credit money balance indicates money held by the company for which the proper account is unidentified. These balances are subject to state abandoned property laws if not cleared within stipulated timeframes.
- A long position offset by a debit money balance and a short position offset by a credit balance, as explained in Section III of this document.

The most common reasons for security positions in suspense are bad receives and delivers, D.K. items, CUSIP errors on input and clerical errors related to quantity of securities (typographical, etc.). Money items normally arise from incorrect money on receives and delivers, incorrect P & S calculations as to principal and interest on bonds or commissions on equities, checks paid or received in error and clerical errors (transpositions, etc.). However, it

should be noted that due to increased efficiencies in the clearance and settlement of securities the incidence of suspense items from these activities have been dramatically reduced.

Suspense account entries are also required pursuant to the requirements of Rule 17a-13, with respect to unresolved differences which are determined as a result of the quarterly verification of certain security positions.

B. Areas Utilizing Suspense Accounts

Suspense accounts can arise in virtually every area of responsibility within a brokerage house. The number of accounts utilized is determined by the volume of business transacted by the broker-dealer and the number of suspense items which arise. A small broker-dealer with an effective and efficient operation may utilize one suspense account for all operations, while a larger one or one with operational problems may establish a number of suspense accounts for each operating department. The most common areas utilizing suspense accounts include customer and institutional receive and deliver, fail to receive/ deliver, P & S, stock loan/borrow, and transfer. These accounts must be carefully monitored as heavy activity is normally indicative of underlying problems in the area involved. Suspense account analyses should be considered vital to any management information system developed. Upon discovering a high level of activity and/ or aged (based on Rule 15c3-1) security and money balances in suspense, management should look into: the adequacy of procedures; supervisory controls; level of experience of personnel; validity of source documents; and the ability of the processing system to handle the volume and type of transactions. In addition, the heavy use of suspense accounts can have a negative impact on other operating areas, most notably dividends.

Whenever a security position remains in suspense over record date, a dividend problem results which must also be corrected in the ultimate clearance of the related position.

II. Audit Objectives

The audit objectives in reviewing suspense accounts are:

A. Ascertain the Adequacy of Procedures and Controls

Procedures and controls over any suspense account should insure that all entries made are properly recorded and documented. In addition, procedures should insure that all items are researched and cleared on a timely basis. The following is a brief outline of the basic controls which should be established. They are addressed in greater detail in Section IV of this document:

- A specific individual should be assigned responsibility for monitoring items in any given account.
- All entries made, whether setting up or clearing suspense items, should be documented and approved by the supervisor or officer in charge of the area.
- All documentation of entries should be maintained and filed as part of the day's work for the area.
- Daily reconciliations of open items in each account should be prepared. The reconciliation should include the date that each item was initially recorded in the account, the security position involved (description and CUSIP #), the principal value or number of shares long, the principal value or number of shares short, the market value of long and short positions, the debit money balance and the credit money balance. In addition, the reconciliation must be reviewed by the supervisor or officer in charge of the area for propriety and to insure that it balances to stock record positions and general ledger money balances. If properly maintained, such a reconciliation provides all information needed to facilitate prompt clearance of items and for regulatory reporting purposes.
- Proper segregation of duties requires that the individual responsible for clearance of suspense items has no control over the movement of money and securities.
- The inclusion of suspense accounts in the management information system governing brokerage operations is required. The review of the status of suspense accounts by senior management provides relevant information for use in evaluating operating performance and potential financial exposure.

To the extent possible, the above procedures and controls should be addressed by the data processing programs and systems utilized by the operations area involved.

B. Verify that Procedures are Being Properly Followed and that Items are Being Timely and Accurately Resolved

Once established, it is essential that procedures and controls are followed and that suspense items are resolved on a timely basis. This requires monitoring on the following levels:

- *Operation Areas Officers*
The officer in charge of the area should be closely monitoring suspense activity as part of their daily supervisory function.
- *Senior Management*
By reviewing suspense balances and agings as part of their management information system, senior management can pinpoint problem areas and spur action to remedy the situation.
- *Regulatory Reporting*
By performing an analytical review of information provided by operations for inclusion in the various regulatory reports, the regulatory reporting area is able to flag particular problem areas and notify members of management so that appropriate corrective action can be taken.
- *Internal Audit*
The Internal Audit Department must test procedures and controls over suspense accounts during each audit to insure that they are adequate and functioning as designed.

C. Ascertain that Suspense Accounts are Afforded Proper Treatment for Regulatory Reporting Purposes

The proper treatment of suspense accounts for regulatory reporting purposes is detailed in Section III of this document. A key concern is that the required information be forwarded from operations to regulatory reporting on a timely basis. This necessitates coordination between the two areas as to the detail and format of information required. The daily reconciliation of each account should

contain all required information. This reconciliation as of the appropriate date, and a separate schedule summarizing positions and money balances in the appropriate categories for reserve formula and/or net capital treatment, is the most efficient and effective manner of documentation to facilitate the needs of the regulatory reporting department.

III. Risks

Inadequate procedures for handling of suspense accounts will subject the broker/dealer to four basic risks: potential capital or reserve requirements; financial loss; inaccurate financial statements and reports; excessive activity in suspense accounts indicative of operational problems. The operational problems might inhibit the broker/dealer from making timely deliveries of securities thereby exposing the company to further financial risks.

A. *Potential Capital and Reserve Requirement Risks*

Securities and Exchange Commission Rule 15c3-1 requires the following net capital treatment for security positions and money balances in suspense accounts which remain unresolved for seven business days from the date of discovery:

- Long position and related debit balance, short position and related credit balance and proprietary commitments cannot operate to increase net capital;
- Long position only — ignored;
- Short position only — deduct 25% of the current market value for differences unresolved after seven business days, 50% after 14 days, 75% after 21 days and 100% after 28 days;
- Credit balance only — included in aggregate indebtedness;
- •Debit balance only — charged.

Under the reserve requirements of Rule 15c3-3 the treatment of suspense items varies depending upon whether the firm follows the basic or alternative method of computing net capital under Rule 15c3-1. The rules assume, under both methods that aged unresolved short positions and credits in suspense accounts are customer related and require treatment as such in the formula. •

- For firms using the basic net capital method, the greater of the market value of short security positions or the related credit balance unresolved after 30 calendar days, must be included as a credit in the formula. In addition, short security count differences (short position only in suspense accounts) over

30 calendar days must also be included as a credit in the formula.

- For firms using the alternative method, the requirements are the same as above except that the age of suspense items to be included as a credit in the formula is seven business days instead of 30 calendar days.

It is evident from the above requirements that a firm's capability in resolving suspense account items can have a direct impact on the net capital or reserve requirements of that firm.

B. *Risk of Financial Loss*

There are many situations where untimely or inaccurate resolution of items in suspense accounts could result in financial loss to the firm. For example, resolution of a suspense item might require the firm to buy in a position. Fluctuations in the market value of the security being bought could result in a financial loss that would not have occurred had the suspense item been resolved sooner. Untimely resolution of suspense items could cause the firm to borrow securities unnecessarily in order to meet delivery requirements thereby incurring a financing cost.

C. *Inaccurate Financial Statements and Reports*

Suspense accounts represent transactions for which the proper accounting treatment has not yet been determined. The ultimate disposition of items in suspense accounts has a direct impact on the firm's financial records. To the extent that the items in such accounts are not properly resolved the financial records of the firm will be inaccurate. Financial statements and regulatory reports are derived from the firm's records and, consequently, their accuracy depends entirely on the underlying records.

D. *Type of Accounts*

Where appropriate, suspense accounts should be established for each area of responsibility within the brokerage house. The exact level at which they are set up will depend upon the volume of the broker-dealer and of suspense items in the house. For example, a small organization might be appropriately served by one suspense account for the entire firm while

a larger firm might require individual suspense accounts for operational units within a specific department. The goal is to establish that system which is most beneficial to the firm, providing adequate control with a minimum of paperwork required.

E. Detail to Be Maintained

A detailed history (reconciliation) of the components comprising the balance in the suspense account should be maintained. This should provide as much detail as necessary (e.g., date, entry code, CUSIP#, dollar amount) to facilitate clean up of open items and provide regulatory reporting information.

F. Responsibility for Accounts

A specific individual should be assigned responsibility for monitoring the items in any given account. This would permit a ready identification of the person who should be contacted if an account balance becomes excessive.

G. Review of Resolutions

All resolutions of suspense account items should be reviewed by a responsible official. The review should include examination of the supporting documentation of the resolution and approval of the manner in which the item is being cleared.

H. Separation of Duties

The authority for the clearance of suspense account items (journal entry preparation and approval) should be separated from the control of money and securities. Separating these responsibilities will deter, in the absence of collusion, the inappropriate diversion of money or securities from suspense accounts through incorrect bookkeeping entries.

I. Periodic Reporting of Suspense Accounts

Reports detailing the components of suspense accounts (including an aging) and information relating to the clean up of suspense account items should be prepared on a periodic basis. These reports should be reviewed by management. For example, a trend analysis, on a historical basis, could be maintained so as to facilitate identification of potential operational problem areas (i.e., a large increase in dollar amount, market value or number of suspense items). In fact, a specific dollar limitation might be established which, when exceeded would require that the account be reported to senior management. Such analytical information should be subject to continuous management review.

J. Systems

Many of the controls noted above can be achieved through the use of an effective automated system for suspense accounts. For example, the computer system might provide the detail components of suspense using tag numbers for clean ups and identification. Analytical and trend reports could be generated. Finally, a permanent suspense “flag” might be assigned to a suspense item upon entry into the suspense account and would restrict the ways in which it might be corrected.

IV. Audit Procedures

A. General

The principal concern from an audit standpoint is evaluating the adequacy of the firm’s system of procedures and controls with respect to suspense accounts. In this regard, the auditor should first obtain a thorough knowledge of the procedures for recording suspense transactions, and their subsequent research and clearing. The auditor can then evaluate the adequacy of the firm’s procedures and determine the specific auditing procedures to be performed.

B. Specific Procedures

- Ascertain that the firm’s accounting system is sufficient to adequately account for suspense items.
- Review the trial balance and identify all suspense accounts.
- Determine that responsibility for monitoring suspense accounts has been assigned to a specific individual who has no control over the movement of money and securities.
- Obtain or prepare a schedule of the detailed statements in support of all suspense accounts (i.e., debit and credit money balances and corresponding security positions).
- Reconcile the statements or the schedule referred to above, to the money trial balance and the stock record.
- Review the accounts for any illogical transactions (i.e., debit money vs. short security position or credit

money vs. long security position) and investigate any such items.

- Examine documentation in support of significant or unusual items within the accounts which appear to be closed transactions (i.e., money balances and no related security positions). To the extent that the accounts contain such closed transactions, ascertain that proper adjusting entries have been made charging or crediting income for such amounts.
- With respect to significant open transactions in the accounts (i.e., money balances together with related security positions), perform the following:
 - determine how the error occurred;
 - examine documentation (i.e., trade tickets, purchase and sale blotters, customer confirmations and statements, etc.) in support of the resolution of the items;
 - ascertain that proper accounting treatment was achieved in clearing the items;
 - determine that proper approval was obtained for the adjustments clearing the suspense items;
 - verify the calculation of mark to market and the related unrealized gain or loss on open suspense account transactions;
 - review the firm's net capital and reserve requirement computation to determine that suspense items are being properly reflected in such computations;
 - ascertain that sufficient periodic reporting of suspense accounts, including an aging, is being made to management.

Reference Material

1. Rule 15c3-1 (Net Capital Rule) under The Securities Exchange Act of 1934,
2. Rule 15c3-3 (Customer Protection Rule) under the Securities Exchange Act of 1934.
3. Interpretation Handbook of the New York Stock Exchange, page 1541.
4. Brokers and Dealers in Securities – AICPA Audit and Accounting Guide

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