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United States Government Accountability Office
Washington, DC 20548

April 21, 2006

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission

Subject: *Internal Control: Improvements Needed in SEC's Accounting and Financial Reporting Procedures*

Dear Mr. Cox:

On November 15, 2005, we issued our report¹ on the U.S. Securities and Exchange Commission's (SEC) fiscal years 2005 and 2004 financial statements and on SEC's internal control as of September 30, 2005. We also reported on the results of our tests of SEC's compliance with selected provisions of laws and regulations during fiscal year 2005.

The purpose of this report is to discuss issues identified during our fiscal year 2005 audit concerning internal controls and accounting procedures that could be improved.² This report contains 14 recommendations that we are proposing SEC implement in order to improve its internal controls and accounting procedures. These recommendations are in addition to those we already provided to SEC as a result of our prior audit of SEC's financial statements.³

Results in Brief

Our November 15, 2005, report concluded that SEC continues to face the same material weaknesses⁴ in internal control that we reported as part of our audit of

¹ GAO, *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2005 and 2004*, GAO-06-239 (Washington, D.C.: Nov. 15, 2005).

² The internal control issues concerning information security are discussed in a separate report: GAO, *Information Security: Securities and Exchange Commission Needs to Continue to Improve Its Program*, GAO-06-408 (Washington, D.C.: Mar. 31, 2006).

³ Recommendations were addressed in our internal control reports issued as part of our fiscal year 2004 SEC financial statement audit: GAO, *Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report*, GAO-05-691R (Washington, D.C.: July 27, 2005), *Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures*, GAO-05-693R (Washington, D.C.: Aug. 12, 2005).

⁴ A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors, fraud, or noncompliance in amounts that would be material to the financial statements may occur and not be detected promptly by employees in the normal course of their duties.

SEC's fiscal year 2004 financial statements. These weaknesses related to SEC's controls over (1) preparing financial statements and related disclosures, (2) recording and reporting disgorgement⁵ and penalty⁶ activity, and (3) information security. SEC has made some progress in resolving these issues; however, these matters remain material weaknesses as of September 30, 2005, and therefore, increase the risk that misstatements material in relation to the financial statements would not be prevented or detected on a timely basis. Further details on the implementation status of the recommendations from our prior audit of SEC's financial statements are provided in enclosure I.⁷

During our fiscal year 2005 audit, we also identified other internal control issues that although not considered to be material weaknesses or reportable conditions,⁸ we believe warrant management's consideration. These issues concern (1) responsibilities of the contracting officer's technical representative, (2) reviewing filing fee calculations, and (3) compliance with the prompt payment act.

Our recommendations follow the discussion of each of these issues in the following sections. In commenting on a draft of this report, the Chairman generally agreed with our recommendations, and indicated that SEC made progress in fiscal year 2005 in addressing its internal control weaknesses and has redoubled its efforts in fiscal year 2006. The Chairman also identified specific actions and initiatives undertaken since the completion of our fiscal year 2005 audit.

Scope and Methodology

As part of our audit of SEC's fiscal years 2005 and 2004 financial statements, we evaluated SEC's internal controls and tested its compliance with selected provisions of laws and regulations. We designed our audit procedures to test relevant controls over financial reporting, including those designed to provide reasonable assurance that transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition. We requested comments on a draft of this report from the Chairman of SEC or his designee. SEC's written comments are reprinted in enclosure II. We conducted our audit in accordance with U.S. generally accepted government auditing standards. Further details on our scope and methodology are included in our report on the results of our audits of SEC's fiscal years 2005 and 2004 financial statements⁹ and are reproduced in enclosure III.

⁵ A disgorgement is the repayment of illegally gained profits (or avoided losses) for distribution to harmed investors whenever feasible.

⁶ A penalty is a monetary payment from a violator of securities law that SEC obtains pursuant to statutory authority. A penalty is fundamentally a punitive measure, although penalties occasionally can be used to compensate harmed investors.

⁷ GAO-05-691R and GAO-05-693R.

⁸ Reportable conditions are defined as significant deficiencies in the design or operation of internal control that could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in financial statements.

⁹ GAO-06-239.

Financial Statement Preparation and Reporting

Fiscal year 2005 was the second year that SEC prepared a complete set of financial statements to be audited. In response to the findings of our fiscal year 2004 audit, SEC has taken some steps to address control weaknesses over the preparation of financial statements and related disclosures. For example, in August 2005, SEC drafted policies and procedures for parts of its financial statements preparation process. SEC also has improved its ability to produce subsidiary ledgers that support financial statement amounts.

For both fiscal years 2004 and 2005, SEC's financial statement preparation and reporting processes were manually intensive, time consuming, and difficult to follow, and required numerous ad hoc procedures. For certain financial statement line items and disclosures, the detailed support for the balances and underlying transactions was not readily available and was difficult to retrieve. The issues underlying the material weaknesses, combined with SEC's practice of determining certain key account balances only on a quarterly basis and preparing footnote disclosures only at year-end, necessitated intensive efforts by both SEC and GAO to meet the November 15 financial reporting date.

Key causes of material weakness in SEC's financial statement preparation and reporting processes are that SEC did not have (1) finalized, written, comprehensive policies and procedures for several significant accounts and processes; (2) an adequate audit trail between the financial statements, the general ledger, and supporting subsidiary schedules; and (3) an integrated system for recording disgorgement and penalty transactions. Although SEC has started to prepare policies and procedures for some of its financial statement preparation processes, these policies and procedures are still in draft and are not sufficiently comprehensive to address accounting for significant activities, such as determining disgorgement and penalty accounts receivable, recording investment activity, and reconciling certain account balances such as the fiduciary liability. Of the policies and procedures that do exist, some are outdated and do not reflect SEC's current practices. Among these are SEC's policy for recording disbursements into the case-tracking system used for disgorgements and penalties.

These issues were further exacerbated by the fact that during fiscal year 2005, SEC's Office of Financial Management continued to operate with a staffing shortage both in terms of number and expertise. These issues, if not addressed, increase the risk and difficulty in meeting future financial reporting dates and making measurable progress in improving internal control over financial reporting.

SEC does not have a documented process or template for compiling financial statement amounts to enable a crosswalk from the financial statements to the general ledger and supporting subsidiary schedules. For example, some numbers, including significant adjustments in the Statement of Custodial Activity, were recorded on a spreadsheet but could not be easily traced to the account balances that aggregate to the line items on the financial statement. In other instances, the available audit trails

included a series of numbers in a formula without an explanation or a clear explanation of the various general ledger accounts constituting the total. Furthermore, in cases where SEC's financial statements deviate from Treasury's standard form and content crosswalk because of adjustments and certain unique activity, SEC did not show a clear link or audit trail.

SEC is in the process of establishing, but has not yet implemented, a formalized Financial Management Oversight Committee to provide advice and regularly review the agency's financial operations and policies. The charter for the Financial Management Oversight Committee has been drafted. The committee now needs to become operational. This is a critical step that needs to be taken as SEC begins to take actions to address the weaknesses in financial reporting.

SEC's interim quarterly financial statements do not reflect the proper cutoff period for certain significant activity, such as disgorgement and penalty receivables. This is primarily attributable to the lack of an integrated system for recording disgorgement and penalty activity, which results in SEC having to perform extensive, time-consuming, manual calculations to arrive at the related end-of-quarter receivable amounts. SEC's current practice of preparing footnote disclosures only with its September 30 financial statements increases the amount of preparation, review, and audit work necessary at year-end, increasing the risk that SEC may not meet its financial reporting deadlines.

If properly designed and implemented, a financial statement preparation process with documented comprehensive policies and procedures, a clear audit trail between the financial statement balances and the detailed support, an integrated core financial management system, and quality assurance reviews should reasonably assure SEC management that the balances presented in the financial statements and related disclosures are supported by SEC's underlying accounting records and are fairly stated in conformity with U.S. generally accepted accounting standards for the federal government. The process should provide a discipline that facilitates SEC's consistent preparation of financial statements without having to go through the intensive efforts that were needed in fiscal year 2005.

Recommendations

We recommend that SEC take the following actions, in addition to our previous recommendations, to improve controls over financial statement preparation and reporting:

1. Staff the Office of Financial Management with the collective knowledge, skills, and experience necessary to achieve effective implementation of internal control over the financial statement preparation and reporting process.
2. Finalize formal, written policies and procedures governing financial reporting processes and related internal control and quality assurance, including the basic documentation, audit trails, and crosswalks needed to

support financial statement amounts, to facilitate management review of financial information.

3. Formalize and place into operation a senior management council or committee to oversee financial reporting activities; provide advice; and regularly review the agency's financial information, operations, and policies.
4. Determine cutoff dates for significant account balances that are both appropriate and practical to facilitate interim financial reporting and meeting year-end financial reporting deadlines.
5. Prepare interim footnote disclosures to facilitate meeting year-end financial reporting deadlines.

Disgorgements and Penalties

As part of its enforcement responsibilities, SEC issues and administers judgments ordering, among other things, disgorgements, civil monetary penalties, and interest against violators of federal securities laws. These transactions involve material amounts of collections, which amounted to more than \$1.6 billion in fiscal year 2005, and the recording and reporting of fiduciary and custodial liability balances on the financial statements.¹⁰ As a result of this significant collection activity, SEC was holding approximately \$2 billion in a fiduciary capacity as of September 30, 2005, for potential distribution to harmed investors.

SEC has taken several actions to address the material weakness that we reported in this area based on our fiscal year 2004 audit; however, these actions have not been sufficient to provide reliable disgorgement and penalty data. For example, SEC completed a comprehensive review of the disgorgement and penalty financial data in its case-tracking system, which includes data on over 12,000 parties in SEC enforcement actions. SEC's review uncovered a significant amount of financial data inaccuracies. During our audit, we noted a significant number of cases for which inaccuracies had already been corrected; however, our audit continued to identify additional errors in disgorgement and penalty data. During fiscal year 2005, SEC's Office of Financial Management and Division of Enforcement instituted weekly meetings to better coordinate and discuss disgorgement issues. In addition, the Office of Financial Management began comparing its financial information for disgorgement/penalty receivables to data on enforcement actions maintained by the

¹⁰ Fiduciary liabilities arise when SEC collects disgorgements, penalties, and interest from securities law violators for the purpose of distributing the funds to injured investors. When SEC collects fiduciary receipts, they are held in Fund Balance With Treasury accounts or invested in Treasury securities, pending distribution to injured investors. Custodial liabilities arise in respect of accounts receivable for disgorgements, penalties, and interest assessed against securities law violators. SEC records a custodial liability in respect of the net amount of such receivables, after taking into account the estimated allowance for doubtful accounts. When SEC collects on the receivable, the collection is either deposited to the Treasury as a government receipt or becomes a fiduciary liability for future distribution to injured investors.

Division of Enforcement to provide some assurance as to the completeness of the subsidiary data. However, our audit continued to find instances in which the Office of Financial Management, the office responsible for entering and maintaining financial data on disgorgements and penalties in the case-tracking system and making the necessary entries into the general ledger, was not made aware of certain disgorgement activities by the Division of Enforcement in a timely manner.

Although we were able to determine that SEC's estimated collectible amount was not materially misstated, we continued to note significant errors and misstatements in the recorded gross accounts receivable balance of \$1.365 billion and the related allowance for loss of \$1.269 billion, as well as data inaccuracies in the case-tracking system. Specifically, we noted errors, inconsistent treatment, or both in recording judgment and interest amounts, terminated debts, waivers, and amounts paid by defendants. For example, we reviewed several cases for which waiver or termination of the debts had been approved several years prior but had not yet been recorded. In addition, for many of the terminations that we reviewed, there was not adequate documentation evidencing approval of the termination in the official case file at the time of our review. We also found cases that were incorrectly recorded in the case-tracking system as being payable to SEC. Contributing to these errors is the lack of a clear formalized policy, communication, and coordination between SEC's Office of Financial Management and its Division of Enforcement, both responsible for various portions of disgorgement and penalty activity.¹¹ In addition, also contributing to those errors is the lack of follow-up procedures to ensure that the activity is being recorded in a timely fashion and in the proper reporting period.

We also identified a new risk in this area associated with tracking fiduciary balances, including corresponding investments, by case. SEC is using spreadsheets as a subsidiary ledger for these amounts, and does not have a policy that includes formal procedures to provide assurance that cash collections and disbursements of disgorgements and penalties have been properly recorded to the appropriate cases in the subsidiary spreadsheets. In addition, during our testing of investments, we noted problems with the accuracy of fiduciary amounts recorded in the case-tracking system where the amounts recorded as collected in the case-tracking system did not correspond to the amounts collected and invested according to the investment balances from the Bureau of the Public Debt statements. We also noted cases where disbursements of fiduciary amounts had not been properly recorded in the case-tracking system. A key cause of those issues is that SEC does not have formal, comprehensive policies concerning the initiation, recording, and monitoring of activity associated with investment accounts. In addition, SEC's current practice of recording significant accounting activity, such as disgorgement and investment activity, only on a quarterly basis increases the risk of errors not being detected in a timely manner.

¹¹ This finding is similar to a finding in a recent GAO review of SEC penalties. See GAO, *SEC and CFTC Penalties: Continued Progress Made in Collection Efforts, but Greater SEC Management Attention Is Needed*, GAO-05-670 (Washington, D.C.: Aug. 31, 2005).

It is critical that SEC develop policies, procedures, and key controls in the area of fiduciary accounting, so that it has adequate assurance that balances for disgorgements and penalties by case are accurate in preparation for distribution of funds to harmed investors.

According to GAO's *Standards for Internal Control in the Federal Government*, internal control needs to be clearly documented through management directives, administrative policies, or operating manuals, and the documentation should be readily available for examination. As we have again found during the fiscal year 2005 financial statement audit, not having comprehensive policies and controls increases the risk that disgorgement and penalty transactions will not be completely, accurately, and consistently recorded and reported.

Recommendations

We recommend that SEC, in addition to our previous recommendations, develop, document in writing, and implement comprehensive policies, procedures, and controls over disgorgement and penalty transactions that include the following:

1. An accounting policy for disgorgements and penalties that will provide SEC management with reasonable assurance that the subsidiary ledger for disgorgement/penalty receivables is accurate and complete.
2. The type of documentation and procedures needed to record the termination or waiver of a debt and the proper notification and communication for approved terminations and waivers, such that management has assurance that only valid and approved terminations are recorded.
3. The recording of activity by case for fiduciary balances, including monthly reconciliations and management review, to ensure that balances by case are accurate.
4. The initiation, recording, and monitoring of investments, including the monthly reconciliation of investment activity, to provide assurance that these fiduciary amounts are accurate and complete.

Other Issues

Although not considered to be reportable conditions, the following weaknesses warrant management's consideration.

Responsibilities of Contracting Officer's Technical Representative

According to SEC Regulation SEC10-15, *Contract Officer's Technical Representative (COTR) and Inspection and Acceptance Official (IAO)*, a COTR's responsibilities include the following:

- Reviewing vouchers for cost-reimbursement type work and recommending approval by the contracting officer if the contractor's costs are consistent with the contractor's proposal or negotiated amounts, and if progress is satisfactory and commensurate with the rate of expenditure.
- Verifying receipt of goods and services and reviewing and approving invoices for fixed-price deliverables.
- Processing all invoices and vouchers within 5 days of receipt by the COTR, and ensuring that payment is in accordance with the contract payment schedule.
- Calculating the accurate amount owed to the contractor, and documenting the decision when authorizing payment of an amount different than the contractor's requested amount.
- Returning invoices to the Office of Financial Management with discrepancies noted, if any.
- Submitting approved invoices to the Office of Financial Management within the time required to avoid prompt payment interest penalties.
- Marking the final invoice as "final" to facilitate closing the obligation.
- Forwarding closeout documentation to the contracting officer in a timely fashion following physical completion of the contract.
- Completing the *Contract Completion Statement*, Form SEC 2414, required within 60 days of physical completion of the contract.

Further, SEC Regulation SECR10-8, *Management Oversight of Service Contracting*, includes in the COTR's responsibilities "reporting the amount of excess funds remaining at the end of a contractor's performance... to the Branch, Procurement and Contracting. The contract will be modified to deobligate excess funds."

During our testing of nonpayroll expenditures, we found evidence that all the COTR responsibilities identified in SEC's regulations are not being fully satisfied. In several cases, there was no evidence that the invoices had been thoroughly reviewed and whether the invoices were paid at rates, prices, or both exceeding those stipulated in the corresponding contract. With respect to the timeliness of invoice processing, we found a number of instances in which proper invoices were not returned to the Office of Financial Management as approved within 5 days as SEC Regulation SECR10-15 provides. We also found that improper invoices were not always returned to vendors in a timely manner. This has implications for prompt payment penalties. Under the Prompt Payment Act and its implementing regulations, an agency's payment due date for paying an invoice without incurring an interest penalty is generally 30 days after the agency's receipt of a proper invoice (5 C.F.R. § 1315.4(f), (g)). Prompt Payment Act regulations provide that the agency shall return an improper invoice to the vendor with the reasons why the invoice is improper within 7 days of receipt (5 C.F.R. § 1315.4(c)(2)). To the extent SEC takes longer than 7 days to return an improper invoice to a vendor, SEC's 30-day period to pay a resubmitted proper invoice is reduced by the excess days (5 C.F.R. § 1315.4(g)(5)). Reducing the 30-day period increases the chance that interest penalties will be incurred.

In addition, our review of accounts payable identified several unliquidated obligations recorded as accounts payable for which the corresponding purchasing documentation specified a period of performance ending in a prior fiscal year. For example, a contract we reviewed for expert witness services stipulated a period of performance from March 5, 2003, to March 4, 2004, and SEC has not received any invoices related to this obligation since December 9, 2003. SEC regulations state that all obligations should be deobligated in a timely manner, if physical completion of the contract has occurred.

Recommendation

We recommend that SEC clarify guidance regarding policies and procedures (as described in SECR10-8 and SECR10-15) for the COTR's responsibilities and take actions to help ensure existing policies and procedures are being followed consistently.

Internal Review of Filing Fee Calculations

SEC collects fees from registrants for fee-bearing filings they submit to SEC, including securities registration, tender offers, mergers, and other filings. According to SEC policy, the Office of Filings and Information Services (OFIS) is responsible for recalculating each fee-bearing filing submitted to SEC to verify the required fee amount to be charged to the filer. OFIS recalculates the required fee based on data submitted by the filer along with the official filing. If an error is noted, SEC corrects the filing to reflect the correct required fee. For 10 of the 167 filing fee amounts we reviewed, we identified errors in the amounts charged to filers during fiscal year 2005 that were not identified by OFIS during its review. In some cases the filer was charged a lesser amount than was required, while in other cases the filer was charged a greater amount than was required. In addition, we could not find documented evidence of the OFIS recalculation for 8 of the 45 fee-bearing filings we reviewed.

GAO's *Standards for Internal Control in the Federal Government* requires that all transactions be clearly documented and that the documentation be accurate and readily available for examination. Consistent with GAO's *Standards for Internal Control in the Federal Government*, SEC's internal controls should provide reasonable assurance that its financial transactions are recorded properly and accurately. Without controls over the recording of filing fees, there is a risk that incorrect revenue amounts will be collected for filing fees.

Recommendations

We recommend that SEC take action to help ensure that

1. its policy on recalculating fee-bearing filing amounts is consistently followed, and
2. the recalculation of the required filing fees is clearly documented.

Compliance with Prompt Payment Act

Under the Prompt Payment Act and its implementing regulations, an agency's payment due date for paying an invoice without incurring an interest penalty is generally 30 days after the agency's receipt of a proper invoice (5 C.F.R. § 1315.4(f), (g)).¹² If the agency does not pay a proper invoice by the payment due date, the agency is to calculate a late interest penalty from the day after the payment due date until the payment is made (5 C.F.R. § 1315.10(a)). The applicable interest rate is established by the Secretary of the Treasury and is the rate in effect on the day after the payment due date (5 C.F.R. § 1315.2(d)).

During our audit we reviewed 45 nonpayroll expenditures for compliance with the Prompt Payment Act. We identified seven instances in which SEC incorrectly calculated the interest penalty for late payments. SEC's incorrect interest calculations were attributable to using the wrong date for SEC's receipt of a proper invoice, which caused an incorrect determination of the payment due date after which interest was due.

Recommendations

We recommend that SEC

1. incorporate a review of the invoice receipt date as part of its daily review of Momentum (SEC's general ledger) invoice entries to ensure the invoice receipt dates are accurately entered into Momentum, and
2. take action to help ensure that the policy requiring the timely return of improper invoices to the vendor to allow for timely payment is followed.

Agency Comments

In commenting on a draft of this report, the Chairman indicated that SEC made progress in fiscal year 2005 in addressing its internal control weaknesses and stated that SEC has redoubled its efforts in fiscal year 2006. The Chairman also identified specific actions and initiatives undertaken since the completion of our fiscal year 2005 audit that are not included in this report. The actions cited by the Chairman include:

- adding resources and expertise to the Office of Financial Management;
- nearing completion of a comprehensive set of written procedures governing the financial reporting processes and related internal controls;
- beginning in the second quarter, implementation of SEC's Financial Management Oversight Committee to provide executive-level review of SEC's financial statements and regular oversight of the agency's financial and accounting policies and internal control; and

¹² Different payment due dates may result from laws or contracts. Also, invoices are not required for all payments.

- convening a working group to address weaknesses in controls over disgorgements and penalties. This group, which is comprised of representatives from the Division of Enforcement and the Offices of Financial Management, Information Technology, the Secretary, and the Executive Director, has undertaken several initiatives including clarifying and streamlining responsibilities and documenting and implementing a comprehensive set of procedures and controls, designing a new financial management system to replace the financial portion of the existing Enforcement database, eliminating inaccuracies in the existing database, and clarifying SEC's policies with respect to debt terminations and write-offs.

The Chairman also stated that SEC's objective is to fully resolve the material weaknesses in the areas of financial statement preparation and disgorgements and penalties during fiscal year 2006. We will evaluate SEC's actions and initiatives during our fiscal year 2006 audit.

SEC's written comments are reprinted in enclosure II of this report.

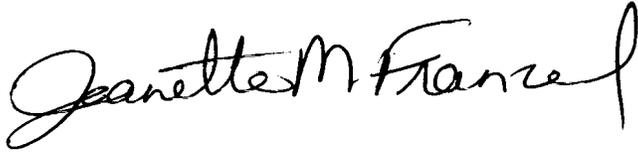
This report contains recommendations to you. The head of a federal agency is required by 31 U.S.C. § 720 to submit a written statement on actions taken on our recommendations to the Senate Committee on Homeland Security and Governmental Affairs and to the House Committee on Government Reform not later than 60 days from the date of this report. A written statement also must be sent to the House and Senate Committees on Appropriations with agency's first request for appropriations made more than 60 days after the date of this report.

This report is intended for use by management of SEC. We are sending copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs; the Senate Committee on Homeland Security and Governmental Affairs; the House Committee on Financial Services; and the House Committee on Government Reform. We are also sending copies to the Secretary of the Treasury, the Director of the Office of Management and Budget, and other interested parties. In addition, this report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

We acknowledge and appreciate the cooperation and assistance provided by SEC management and staff during our audit of SEC's fiscal years 2005 and 2004 financial statements. If you have any questions about this report or need assistance in addressing these issues, please contact me at (202) 512-9471 or by e-mail at

franzelj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.

Sincerely yours,

A handwritten signature in black ink that reads "Jeanette M. Franzel". The signature is written in a cursive style with a large, looped initial "J".

Jeanette M. Franzel
Director
Financial Management and Assurance

Enclosures – 3

Enclosure I

Status of GAO Recommendations from Our Audit of SEC's 2004 Financial Statements

Table 1 provides the status of the Securities and Exchange Commission's (SEC) efforts to implement our previous recommendations related to the material weaknesses and other opportunities for improvements in SEC's internal control and accounting procedures identified during our audit of SEC's 2004 financial statements.¹ The table lists (1) recommendations made, (2) the status of each recommendation and corrective action SEC has taken or planned as of January 2006, and (3) our analysis of whether the issues that gave rise to the recommendations have been effectively and fully addressed based on the work performed during our fiscal year 2005 financial audit. As of January 2006, we concluded that SEC had taken actions to close 13 of the 34 recommendations we made as a result of our prior SEC financial audit. Effectively implementing recommendations is critical for SEC to resolve its financial management challenges.

¹ GAO, *Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report*, GAO-05-691R (Washington, D.C.: July 27, 2005) and *Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures*, GAO-05-693R (Washington, D.C.: Aug. 12, 2005).

Table 1: GAO Recommendations and Status

| Count | Recommendation | Source report | Status of recommendation | |
|-------|---|--|---|--|
| | | | Per SEC | Per GAO |
| 1 | Establish clearly defined roles and responsibilities for the staff involved in financial reporting and the preparation of interim and year-end financial statements. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Closed. Completed policies identify units and individuals responsible for preparation of elements of the financial statements. Additional tactical plans assign work to individual staff members by name. Any further specificity in documenting assignments is limited by personnel policy concerns. | Closed. The draft Financial Statements Preparation Guidance prepared by the Office of Financial Management (OFM) establishes roles and responsibilities for the staff involved in financial reporting and the preparation of financial statements. |
| 2 | Collect common closing and adjusting entries in a formal listing, which is used in the general ledger closing process and in preparing financial statements. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Closed. Listing is complete and policies describe how closing and adjusting entries are compiled and recorded. | Closed. SEC's journal voucher log master collects common closing and adjusting entries in a formal listing. |
| 3 | Maintain subsidiary schedules and documentation supporting all delivered and undelivered orders transactions and related amounts recorded in the general ledger. The documentation should be at a detailed level sufficient to facilitate management review and the external audit process. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Closed. Subsidiary schedules for undelivered orders prior to budget fiscal year 2002 are not available at a detailed level; however, data are available for all subsequent years and are reconciled to the general ledger. | Closed. During our 2005 audit, we noted that SEC was able to reconcile the total delivered orders balance and the undelivered orders balance for budget fiscal years after 2002 to subsidiary schedules. Although detailed support is not available for undelivered orders transactions for budget fiscal years prior to 2002, we were able to reconcile the summary-level support to the general ledger with only an immaterial difference. |

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|---|---|--|---|--|
| 4 | Separate key responsibilities over the handling and recording of cash receipts so that no one individual handles all key aspects concerning the receipts. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Closed. SEC has implemented procedures to ensure that two individuals are present to open mail, handle cash, and log in checks. | Closed. During our 2005 audit, we observed the dual control procedures over cash receipts that SEC has implemented. |
| 5 | Perform periodic reconciliations of successful fee-bearing filings in EDGAR and revenue recorded in the general ledger. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Closed. SEC has implemented procedures to perform periodic reconciliations of the data in EDGAR and the general ledger. | Closed. During our 2005 audit, we reviewed the reconciliations prepared by SEC without exception. |
| 6 | Develop for this reconciliation process written policies and procedures that address the maintenance of documentation supporting the general ledger balances. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Closed. Documentation and implementation of the policies and procedures have been completed. | Closed. During our 2005 audit, we reviewed the written policies and procedures prepared by SEC for the filing fee revenue reconciliation. Our testing indicated that these procedures have been implemented. |

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|---|---|--|--|---|
| 7 | Document its review of the monthly Fund Balance With Treasury (FBWT) reconciliation to help ensure the timeliness of these reconciliations and the accuracy and validity of adjustments resulting from these reconciliations. At a minimum, reviewers should sign and date the reviewed documents and provide any comments that may be appropriate in the event that their reviews identified problems or raised questions. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Closed. Documentation of the policies and procedures over this review has been completed. | Closed. During our 2005 audit, we noted documented review of the monthly FBWT reconciliation. |
| 8 | Appropriate SEC management officials review recorded apportionment amounts to provide assurance over the accuracy of these amounts. The review should be evidenced in some manner, such as a signature and date. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Closed. The Planning and Budget Office has been restructured, creating an additional level of checks and balances, and the newly created Budget Officer slot has been filled. The policy has been changed to include verification and approval by the Assistant Director, Planning and Budget, of the apportionment documents once they are entered into the general ledger by the Budget Officer. | Closed. During our 2005 audit, we noted documented evidence of appropriate SEC management review of recorded apportionment amounts. |

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|----|--|--|--|--|
| 9 | Develop written policies and procedures governing the payroll processing and reconciliation procedures, which would include requirements for documenting supervisory review of the performance of the payroll procedures performed during each pay period. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Closed. SEC has completed documentation of the payroll file processing and reconciliation process. | Closed. During our 2005 audit, we noted that SEC developed written policies and procedures for payroll processing and reconciliation. Our testing indicated that these procedures have been implemented. |
| 10 | Train other individuals to perform payroll processing and reconciliation procedures. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Closed. A new staff person has been trained and performs the reconciliations with supervisory review. | Closed. During our 2005 audit, we noted that SEC has trained another individual to perform this function. |
| 11 | Develop policies and procedures to help ensure that expenditures (1) are recorded in the proper Budget Object Class (BOC) code on the basis of the nature of the expenditure and (2) are properly allocated across BOC codes as appropriate. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Closed. Contracting Officer's Technical Representative and OFM staff have been reminded of the requirement to assign invoice charges to the appropriate contract line/CLIN when approving and processing payments. | Closed. SEC staff has been reminded of existing SEC regulations regarding assignment of invoice charges (SEC Regulation 10-15). During our 2005 audit, we noted no exceptions during our testing of BOC codes. |
| 12 | Refer eligible debt that is delinquent over 180 days to Treasury as required by the Debt Collection Improvement Act (DCIA). | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Closed. All eligible debt is being referred to Treasury as required by DCIA. | Closed. During our 2005 audit, we verified that SEC is properly referring eligible debt to Treasury as required by DCIA. |

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| 13 | Review its property and equipment capitalization thresholds and document the analysis used to select the capitalization thresholds. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Closed. SEC's Property Accountability Task Force performed and documented this analysis. | Closed. During our 2005 audit, we reviewed SEC's analysis and concluded that the capitalization thresholds are reasonable. |
| 14 | Review the disgorgement and penalty judgments and subsequent activities documented in each case file by defendant to determine whether the individual amounts recorded in the case-tracking system are accurate and reliable. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Closed. SEC has completed a comprehensive review of case data. | Open. SEC completed a comprehensive review of case data and appropriate adjustments have been recorded. However, our audit continued to find data inaccuracies in the case-tracking system. |
| 15 | Implement a system that is integrated with the accounting system or that provides the necessary input to the accounting system to facilitate timely, accurate, and efficient recording and reporting of disgorgement and penalty activity. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. SEC has begun a replacement of the financial components of the Case Action Tracking System. The replacement system will be integrated into the general ledger. SEC estimates completion in fiscal year 2006. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |
| 16 | Implement controls so that the ongoing activities involving disgorgements and penalties are properly, accurately, and timely recorded in the accounting system. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. Staff from the Division of Enforcement and OFM meet weekly to discuss improvements in business processes, and staff have been added or reorganized to increase assurance of accurate and timely recordation in the accounting system. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |

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| 17 | Strengthen coordination, communication, and data flow among staff of SEC's Division of Enforcement and OFM who share responsibility for recording and maintaining disgorgement and penalty data. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. Staff from the Chairman's Office, Division of Enforcement, and the Offices of Financial Management, Information Technology and Security, and the Secretary meet weekly to discuss operating procedures and plan for development of the new system. The Division of Enforcement is in the process of scanning documents to provide joint electronic access to both itself and OFM in the interim. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |
| 18 | Develop and implement written policies covering the procedures, documentation, systems, and responsible personnel involved in recording and reporting disgorgement and penalty financial information. The written procedures should also address quality control and managerial review responsibilities and documentation of such a review. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. Draft policies have been prepared but must be updated. The replacement financial system is likely to trigger improvements to business processes which will need to be documented. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |
| 19 | Develop written policies and procedures that provide sufficient guidance for the year-end closing of the general ledger as well as the preparation and analysis of quarterly and annual financial statements. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. SEC has approved a plan to add a number of staff to OFM and has awarded two task orders for accounting support to free up more senior staff to complete the documentation of policies and procedures. Some policies have already been drafted. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |

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| 20 | Prepare a crosswalk between the financial statements and the source systems, general ledger accounts, and the various account queries and analyses that make up key balances in the financial statements. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. The draft Financial Statements Preparation Guidance provides narrative on the crosswalk. Additional documentation will be completed in 2006. | Open. The draft Financial Statements Preparation Guidance refers to the Treasury Form and Content Crosswalks; however, several of SEC's financial statement line items deviate from the standard crosswalk because of adjustments and certain activity unique to SEC. |
| 21 | Maintain subsidiary records or ledgers for all significant accounts and disclosures so that the amounts presented in the financial statements and footnotes can be supported by the collective transactions making up the balances. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. Subsidiary ledgers are maintained; however, full documentation must still be completed. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |
| 22 | Perform monthly reconciliations of subsidiary records and summary account balances. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. New staff have been hired, which will enable OFM to increase monthly reconciliations and the documentation of procedures for current and future reconciliations. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |
| 23 | Consider a "formal closing" of all accounts at an interim date(s), which will reduce the level of accounting activity and analysis required at year-end. The formal closing entails ensuring that all transactions are recorded in the proper period through month's end. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. SEC is considering workable alternatives to facilitate accelerating the audit process. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |

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| 24 | Require supervisory review for all entries posted to the general ledger and financial statements, including closing entries. A supervisor should review revisions to previously approved entries and revised financial statements and footnotes. All entries and reviews should be documented. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. OFM is implementing procedures to document reviews. These procedures will become standardized and fully implemented. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |
| 25 | Establish milestones for preparing and reviewing the financial statements by setting dates for critical phases, such as closing the general ledger; preparing financial statements, footnotes, and the performance and accountability report; and performing specific quality control review procedures. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. OFM has a work plan with milestones and detailed tasks for the financial statement preparation each fiscal quarter. OFM needs to work with other SEC divisions and offices to prepare the same for the preparation of the performance and accountability report (PAR), review of the management representation letter, the Federal Managers' Financial Integrity Act of 1982 process, and other financial reporting functions. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |
| 26 | Utilize established tools (i.e., checklists and implementation guides) available for assistance in compiling and reviewing financial statements. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. SEC needs to determine how this recommendation can be implemented and documented. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |

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| 27 | Maintain documentation supporting all information included in the financial statements and footnotes. This documentation should be more self-explanatory than what has been retained in the past. The documentation should be at a level of detail to enable a third party, such as an auditor, to use the documentation for substantiating reported data without extensive explanation or re-creation by the original preparer. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. As workload permits, new staff will be assigned to tasks that may help to simplify documentation and maintain it in a more user-friendly format. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |
| 28 | Take advantage of in-house resources and expertise in establishing financial reporting policies, internal controls, and business practices, as well as in the review of financial statement and footnote presentation. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Closed. SEC has publicly committed to the establishment of a senior financial management oversight committee or audit committee. The 2004 and 2005 financial statements, footnotes, and PAR were extensively reviewed by management and staff in multiple divisions and offices within SEC. | Open. The 2005 financial statements, footnotes, and PAR were extensively reviewed by management and staff in multiple divisions and offices within SEC, including the Offices of the General Counsel, the Chief Accountant, and the Chairman. However, the Financial Management Oversight Committee still needs to become operational. |
| 29 | Develop or acquire an integrated financial management system to provide timely and accurate recording of financial data for financial reporting and management decision making. | <i>Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report (GAO-05-691R, July 27, 2005)</i> | Open. SEC has considered replacing the central accounting system. This will not be accomplished any earlier than 2008. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |

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| 30 | Periodically reconcile the cash receipts log to the documentation supporting the deposit amount in the general ledger. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Closed. During the first quarter of fiscal year 2006, SEC implemented procedures to reconcile the daily receipts ledger to the transaction journal on a monthly basis. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit. |
| 31 | Review all existing leases for property and equipment to determine if they should be capitalized or expensed and make any necessary adjustments to the related general ledger balances. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Open. Full documentation of the evaluations of new property leases has been completed; however, the documentation for equipment leases has not been completed. | Open. SEC has reviewed property leases but not equipment leases. During our 2005 audit, we noted that SEC properly reviewed all new property leases and a sample of existing property leases, as was agreed to by SEC and GAO staff. Based on our review of the leases, it was not deemed necessary to review all existing property leases. We will evaluate SEC's corrective actions relating to equipment leases during our fiscal year 2006 financial audit. |
| 32 | Develop policies and procedures to properly account for future property and equipment leases on an ongoing basis. | <i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i> | Open. Documentation of the policies and procedures needs to be completed. | Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit to ensure leases are evaluated on a timely basis and are properly recorded. |

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| 33 | <p>Periodically reconcile its active employees to the Federal Personnel and Payroll System (FPPS). To do this, consideration should be given to maintaining an independent database of active employees and other payroll-related information, wherein active employee data could be readily compared with and reconciled to FPPS-generated payroll records. This reconciliation should be documented.</p> | <p><i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i></p> | <p>Open. SEC has instituted a management process to verify the listing of active employees. Documentation of the reconciliation with FPPS is in process.</p> | <p>Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit.</p> |
| 34 | <p>Require documented support and review of SEC's corrective actions to provide evidence that actions taken in response to audit recommendations fully correct identified deficiencies prior to closing out the audit issues in the tracking system.</p> | <p><i>Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures (GAO-05-693R, Aug. 12, 2005)</i></p> | <p>Open. The Executive Director's office now requires additional support to document corrective actions. Formal policies and procedures remain to be issued.</p> | <p>Open. We will evaluate SEC's corrective actions during our fiscal year 2006 financial audit to ensure proper documentation.</p> |

Source: GAO.

Enclosure II

Comments from the Securities and Exchange Commission

CHRISTOPHER COX
CHAIRMAN
HEADQUARTERS
100 F STREET, N.E.
WASHINGTON, D.C. 20549



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April 10, 2006

Ms. Jeanette M. Franzel
Director
Financial Management and Assurance
Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Ms. Franzel:

Thank you for the opportunity to review and comment on the draft report of the Government Accountability Office entitled *Internal Control: Improvements Needed in SEC's Accounting and Financial Reporting Procedures*. The report discusses issues identified during GAO's fiscal year 2005 audit of the financial statements of the Securities and Exchange Commission and reflects the state of the SEC's internal controls as of September 30, 2005. I would like to acknowledge and commend the efforts of you and the GAO staff in working with the SEC to meet our financial reporting deadlines and to improve the SEC's controls over financial reporting.

GAO's audit report for fiscal year 2005 noted three material weaknesses in the SEC's internal controls over financial reporting. This report provides additional information and recommendations with respect to two of the control weaknesses that existed at the end of last year's audit: controls over preparing financial statements and related disclosures, and controls over recording and reporting disgorgement and penalty activity. The SEC's information security controls are addressed in a separate GAO report and in my letter of March 24, 2006 to Gregory Wilshusen.

As you have noted, the SEC made progress in fiscal year 2005 in addressing its internal control weaknesses, and we have redoubled our efforts in fiscal year 2006. Specifically, since the end of last year's audit, we have taken steps to implement GAO's recommendations through several actions that are not reflected in your report.

With respect to financial reporting, we have made substantial progress in addressing each of GAO's recommendations. We have added resources and expertise to the Office of Financial Management, and we are nearing completion of a comprehensive set of written procedures governing financial reporting processes and related internal controls. In addition, beginning with our second quarter financial statements, our

Ms. Jeanette M. Franzel
Page 2

Financial Management Oversight Committee will provide executive-level review of the SEC's financial statements, and the Committee will also provide regular oversight with respect to the agency's financial and accounting policies and internal controls. We expect to have this weakness fully resolved well before the completion of GAO's fiscal 2006 audit.

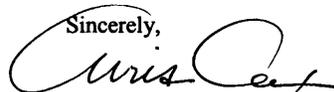
The SEC has also made substantial progress in addressing its weakness in controls over recording and reporting of disgorgement and penalty activity. For the past several months, the agency has convened a regular working group comprised of representatives from the Division of Enforcement and the Offices of Financial Management, Information Technology, the Secretary, and the Executive Director, with the objective of fully resolving this material weakness during fiscal year 2006. The group has undertaken the following principal initiatives:

- clarifying and streamlining responsibilities across divisions and offices and documenting and implementing a comprehensive set of procedures and controls,
- designing a new financial management system to replace the financial portion of the existing Enforcement database,
- eliminating inaccuracies in the existing database to ensure data integrity in the new financial system going forward, and
- clarifying the SEC's policies with respect to debt terminations and write-offs and clearing out a backlog of old, uncollected debts.

We believe these initiatives are responsive to GAO's recommendations and will substantially improve the SEC's controls over disgorgement and penalty activity.

As Chairman, I remain committed to enhancing the SEC's financial and operational effectiveness, so that the agency can lead by example when it comes to compliance with internal control requirements. I appreciate your support of these efforts, and look forward to continuing our productive dialogue during the course of this year's audit.

Thank you again for the opportunity to comment on this report. If you have any questions relating to our response, please contact me at 202-551-2100.

Sincerely,


Christopher Cox
Chairman

Enclosure III

Details on Audit Scope and Methodology¹

To fulfill our responsibilities as auditor of the financial statements of SEC, we did the following:

- Examined, on a test basis, evidence supporting the amounts and disclosure in the financial statements.
- Assessed the accounting principles used and significant estimates made by management.
- Evaluated the overall presentation of the financial statements.
- Obtained an understanding of internal controls related to financial reporting and compliance with laws and regulations.
- Obtained an understanding of the recording, processing, and summarizing of performance measures as reported in Management's Discussion and Analysis.
- Tested relevant internal controls over financial reporting and compliance, and evaluated the design and operating effectiveness of internal control.
- Considered SEC's process for evaluating and reporting on internal control and financial management systems under the Federal Managers' Financial Integrity Act of 1982.
- Tested compliance with selected provisions of the following laws and regulations: the Securities Exchange Act of 1934, as amended; the Securities Act of 1933, as amended; the Anti-Deficiency Act; laws governing the pay and allowance system for SEC employees; and the Prompt Payment Act.

We requested comments on a draft of this report from the Chairman of SEC or his designee. We received written comments from the Chairman of SEC. We conducted our audit in accordance with U.S. generally accepted government auditing standards.

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¹ For further explanation of our audit scope and methodology, see the financial audit report (GAO-06-239).

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