United States Government Accountability Office

GAO

Report to the Chairman, U.S. Securities and Exchange Commission

May 2005

FINANCIAL AUDIT

Securities and Exchange Commission's Financial Statements for Fiscal Year 2004

GAO

Accountability ★ Integrity ★ Reliability

GAO-05-244

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Highlights

Highlights of GAO-05-244, a report to the Chairman of the Securities and Exchange Commission

FINANCIAL AUDIT

Securities and Exchange Commission's Financial Statements for Fiscal Year 2004

Why GAO Did This Study

Established in 1934 to enforce the securities laws and protect investors, the Securities and Exchange Commission (SEC) plays an important role in maintaining the integrity of the U.S. securities markets.

Pursuant to the Accountability for Tax Dollars Act of 2002, the SEC is required to prepare and submit to Congress and the Office of Management and Budget audited financial statements. GAO agreed, under its audit authority, to perform the initial audit of SEC's financial statements. GAO's audit was done to determine whether, in all material respects, (1) SEC's fiscal year 2004 financial statements were reliable, (2) SEC's management maintained effective internal control over financial reporting and compliance with laws and regulations, and (3) SEC's management complied with applicable laws and regulations.

www.gao.gov/cgi-bin/getrpt?GAO-05-244.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Jeanette M. Franzel at (202) 512-9406 or franzelj@gao.gov.

What GAO Found

In GAO's opinion, SEC's fiscal year 2004 financial statements were fairly presented in all material respects. However, because of material internal control weaknesses in the areas of recording and reporting disgorgements and penalties, preparing financial statements and related disclosures, and information security, in GAO's opinion, SEC did not maintain effective internal control over financial reporting as of September 30, 2004. SEC did maintain in all material respects effective internal control over compliance with laws and regulations material in relation to the financial statements as of September 30, 2004. In addition, GAO did not find reportable instances of noncompliance with laws and regulations it tested.

SEC prepared its first complete set of financial statements for fiscal year 2004 and made significant progress during the year in building a financial reporting structure for preparing financial statements for audit. However, GAO identified inadequate controls over SEC's disgorgements and civil penalties activities, increasing the risk that such activities will not be completely, accurately, and properly recorded and reported for management's use in its decision making. In addition, GAO identified inadequate controls over SEC's financial statement preparation process including a lack of sufficient documented policies and procedures, support, and quality assurance reviews, increasing the risk that SEC management will not have reasonable assurance that the balances presented in the financial statements and related disclosures are supported by SEC's underlying accounting records.

GAO also found that SEC has not effectively implemented information system controls to protect the integrity, confidentiality, and availability of its financial and sensitive data, increasing the risk of unauthorized disclosure, modification, or loss of the data, possibly without detection. The risks created by these information security weaknesses are compounded because the SEC does not have a comprehensive monitoring program to identify unusual or suspicious access activities.

SEC is currently working to improve controls in all these areas.

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Abbreviations

FISMA	Federal Information Security Management Act
FMFIA	Federal Managers' Financial Integrity Act
OMB	Office of Management and Budget
SEC	Securities and Exchange Commission

G A O

Accountability * Integrity * Reliability

Comptroller General of the United States

United States Government Accountability Office
Washington, D.C. 20548

May 26, 2005

The Honorable William H. Donaldson
Chairman
U.S. Securities and Exchange Commission

Dear Mr. Donaldson:

This report presents our opinion on whether the financial statements of the Securities and Exchange Commission (SEC) are presented fairly for the fiscal year ended September 30, 2004. This report also presents (1) our opinion on the effectiveness of SEC's internal control over financial reporting and compliance as of September 30, 2004, (2) our evaluation of SEC's compliance with selected laws and regulations during 2004, and (3) weaknesses in financial reporting controls detected during our 2004 audit.

The Accountability of Tax Dollars Act of 2002 requires that SEC prepare and submit to Congress and the Office of Management and Budget (OMB) audited financial statements. Fiscal year 2004 was the first year SEC prepared its first complete set of financial statements. GAO agreed, under its audit authority, to perform the initial audit of SEC's financial statements. GAO conducted this audit in accordance with U.S. generally accepted government auditing standards and OMB audit guidance. The accomplishment of the first-ever audit of SEC's financial statements was made possible by the tremendous dedication of time and effort from both SEC management and staff.

We are sending copies of this report to the Chairman and Ranking Minority Members 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 the GAO Web site at http://www.gao.gov.

This report was prepared under the direction of Jeanette M. Franzel, Director, Financial Management and Assurance, who can be reached at (202) 512-9406 or franzelj@gao.gov. If I can be of further assistance, please call me at (202) 512-5500.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

United States Government Accountability Office
Washington, D.C. 20548

To the Chairman of the U.S. Securities and Exchange Commission

In our audit of the U.S. Securities and Exchange Commission (SEC) for fiscal year 2004, we found

- the financial statements as of and for the fiscal year ended September 30, 2004, including the accompanying notes, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles;
- SEC did not have effective internal control over financial reporting (including safeguarding of assets), but had effective control over compliance with laws and regulations that could have a material effect on the financial statements as of September 30, 2004; and
- no reportable noncompliance with laws and regulations we tested.

The following sections discuss in more detail (1) these conclusions as well as our conclusions on Management's Discussion and Analysis and other supplementary information and (2) the objectives, scope, and methodology of our audit.

Opinion on Financial Statements

The SEC's balance sheet as of September 30, 2004, and its related statements of net cost, changes in net position, budgetary resources, financing, and custodial activity, with accompanying notes for the fiscal year then ended, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

However, misstatements may nevertheless occur in other financial information reported by SEC as a result of the internal control weaknesses described in this report.

Opinion on Internal Control

SEC prepared its first complete set of financial statements for fiscal year 2004 and made significant progress during the year in building a financial reporting structure for preparing financial statements for audit. However, because of the material weaknesses in internal control discussed below, in our opinion, SEC did not maintain effective internal control over financial reporting (including safeguarding of assets) as of September 30, 2004. Consequently, SEC's internal control did not reduce to a relatively low level the risk that misstatements material to the financial statements may occur and not be detected on a timely basis by employees in the normal course of performing their assigned functions. We did find that SEC maintained in all material respects effective internal control over compliance with laws and regulations that could have a direct and material effect on the financial statements as of September 30, 2004.[1] The material weaknesses in internal control noted above may adversely affect unaudited information used by SEC for decision making.

Despite the specific issues with internal control, SEC was able to prepare, in part through tremendous dedication of time and effort from SEC staff, financial statements that were fairly stated in all material respects for fiscal year 2004.

Material Weaknesses

The material weaknesses we have identified and discuss in this report relate to SEC's internal control over (1) recording and reporting of disgorgements and penalties, (2) information security, and (3) preparing financial statements and the related disclosures. These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of SEC's fiscal year 2004 financial statements, and our opinion on internal control does not affect our opinion dated February 11, 2005, on these financial statements. The details surrounding these weaknesses are being reported separately to SEC management, along with recommendations for corrective actions. Less significant matters involving SEC's system of internal controls and its operations will also be reported to SEC separately.

[1] Our opinion on internal control is based on criteria established under 31 U.S.C. § 3512 (c), (d), commonly referred to as the Federal Managers' Financial Integrity Act (FMFIA) and the Office of Management and Budget (OMB) Circular A-123, revised June 21, 1995, Management Accountability and Control.

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 and reported fiduciary and custodial liability balances on the financial statements. Since fiscal year 2003, SEC has made significant progress towards documenting financial information concerning moneys owed and paid in connection with disgorgement and penalty enforcement actions.[2] SEC's work in this area, which continued during fiscal year 2004, includes a process of upgrading its disgorgements and penalties database to allow for accurate, timely, and proper reporting of disgorgements and penalties data, and entering financial data on over 12,000 parties in SEC enforcement issues. SEC's progress in addressing data reliability concerns over disgorgements and penalties data is encouraging, and it should continue to work to assure that data are accurate, timely, and properly reported.

In August 2004, SEC's Office of Financial Management assumed responsibility for entering and maintaining financial data on disgorgements and penalties, and making the necessary calculations and adjustments for the preparation of its financial statements. To compensate for limitations in the disgorgements and penalties database, SEC staff performed extensive manual procedures to compile quarterly subsidiary ledgers to update the accounting system for disgorgement- and penalty-related balances and activity. While SEC had a draft policy covering certain aspects of accounting for disgorgements and penalties, the policy was not comprehensive and did not include the process and controls for determining the amounts to be recorded and for reviewing the disgorgement and penalty financial information and related accounting entries. Not having comprehensive policies and controls increases the risk that disgorgement and penalty transactions will not be completely, accurately, and consistently recorded and reported.

Although we were able to obtain sufficient audit support for the estimated net amounts receivable from disgorgements and penalties, we found errors in the recorded balances for the related gross accounts receivable and allowance for loss. Specifically, we noted errors and inconsistent treatment in recording judgment and interest amounts, terminated debts, and

[2] Material weaknesses and system nonconformance issues concerning data integrity and financial reporting for disgorgements and penalties are reported in SEC's FMFIA reports for fiscal years 2002, 2003, and 2004.

collection fees imposed by Treasury. In most cases, these errors and inconsistencies were offsetting; however, such errors raise concern about the controls over the reliability of the gross accounts receivable and related allowance amounts reported in footnote 3 to the financial statements.

Establishing controls over the recording of disgorgement and penalty activity, if properly designed and implemented, should provide reasonable assurance that disgorgement and penalty transactions are recorded in a complete, accurate, and timely manner for management's use in decision making and tracking of operations, and to facilitate the preparation of financial statements and related disclosures. The process should also include maintaining supporting documentation that, in reasonable detail, accurately reflects the transactions that are recorded, and evidences supervisory review.

Information Security

SEC relies extensively on computerized information systems to process, account for, and report on its financial activities. GAO's *Standards for Internal Control in the Federal Government*[3] provide an overall framework for establishing and maintaining internal control, including a discussion of general control activities that apply to information systems. As part of the financial statement audit, we assessed the effectiveness of SEC's information system general controls. Effective information system general controls are essential to providing reasonable assurance that financial information is adequately protected from inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction. These controls include entitywide computer security management, access controls, system software, application development and change control, segregation of duties, and service continuity controls.

[3] GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

During fiscal year 2004, numerous information security control weaknesses existed at SEC.[4] Specifically, SEC had not consistently implemented effective electronic access controls, including user accounts and passwords, access rights and permissions, network security, or audit and monitoring of security-relevant events to limit and detect access to its critical financial and sensitive systems. In addition, weaknesses in other information security controls, including physical security, segregation of computer functions, application change controls, and service continuity, further increase the risk to SEC's information systems. As a result, sensitive data—including payroll and financial transactions, personnel data, regulatory, and other mission critical information—were at increased risk of unauthorized disclosure, modification, or loss, possibly without being detected. Thus, SEC did not have adequate assurance that users only had access needed to perform their assigned duties and its network was sufficiently protected from unauthorized users. The risks created by these weaknesses are compounded because SEC does not have a comprehensive monitoring program to identify unusual or suspicious access activities. The details surrounding these weaknesses were reported separately to SEC management, along with recommendations for corrective actions.[5]

A key reason for SEC's information security control weaknesses is that SEC has not fully developed and implemented a comprehensive security management program to provide reasonable assurance that effective controls are established and maintained and that information security receives significant management attention. An effective program would include issuing guidance and implementing procedures for assessing risks, establishing policies and related controls, raising awareness of prevailing risks and mitigating controls, evaluating the effectiveness of established controls, and using the results of management's evaluation to continuously improve controls. While SEC has taken some actions to improve security management, including establishing a central security management function and appointing a senior information security officer to manage the overall security management program, it still needs to take additional steps

[4] In its fiscal year 2004 report pursuant to the Federal Information Security Management Act (FISMA), SEC's Office of Inspector General reported that SEC was not substantially in compliance with FISMA requirements that are intended to strengthen information security. Also, SEC has reported problems with its information security program as a material weakness in its FMFIA report since 2002.

[5] GAO, *Information Security: Securities and Exchange Commission Needs to Address Weak Controls Over Financial and Sensitive Data*, GAO-05-262 (Washington, D.C.: March 2005).

to address all key elements of an information security management program. Such a program is critical to provide SEC with a solid foundation for resolving existing information security problems and continuously managing information security risks.

Financial Statement Preparation Process

For fiscal year 2004, SEC did not have documentation showing the procedures, systems, analysis of accounts, and personnel involved in developing key balances and preparing the financial statements and related disclosures, or the related quality control and review procedures. SEC's opening balances for its fiscal year 2004 financial statements contained material misstatements, some of which also affected the fiscal year 2004 reported operating results. SEC posted the necessary audit adjustments and produced financial statements for fiscal year 2004 that were fairly presented in all material respects. However, summarized documentation supporting the financial statement preparation process and the development of related balances is needed to provide structure and discipline to the process and the related quality control procedures. In addition, SEC's process for preparing its fiscal year 2004 financial statements was manually intensive, time consuming, and did not include documentation of quality control 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. Finally, comprehensive accounting policies and procedures for several major areas were still in draft or needed to be developed.

Controls over the financial statement preparation process should be designed to provide reasonable assurance regarding the reliability of the balances and disclosures reported in the financial statements and related notes in conformity with generally accepted accounting principles, including the maintenance of detailed support that accurately and fairly reflects the transactions making up the balances in the financial statements and disclosures. GAO's *Standards for Internal Control in the Federal Government*[6] provide an overall framework for establishing and maintaining internal control, including a discussion of control activities, management review, and documentation of processes and transactions. A financial statement preparation process with documented policies and procedures, support, and quality assurance reviews, if properly designed

[6] GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

and implemented, should provide SEC management with reasonable assurance that the balances presented in the financial statements and related disclosures are supported by SEC's underlying accounting records. We believe SEC can use the lessons learned from the fiscal year 2004 financial reporting and audit processes to formalize and further improve its process for developing and reviewing the figures needed to compile and prepare its year-end and quarterly financial statements.

Compliance with Laws and Regulations

Our tests of compliance with selected provisions of laws and regulations related to financial reporting disclosed no instances of noncompliance that are reportable under U.S. generally accepted government auditing standards or OMB audit guidance. However, our objective was not to provide an opinion on compliance with laws and regulations. Accordingly, we do not express such an opinion.

Consistency of Other Information

SEC's Management's Discussion and Analysis, required supplementary information, and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We did not audit and do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with SEC officials. Based on this limited work, we found no material inconsistencies with the financial statements or nonconformance with OMB guidance.

Objectives, Scope, and Methodology

SEC management is responsible for (1) preparing the financial statements in conformity with U.S. generally accepted accounting principles; (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met; and (3) complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles; and (2) management maintained effective internal control that provides reasonable, but not absolute, assurance the following objectives are met:

- Financial reporting: Transactions are properly recorded, processed, and summarized to permit the timely and reliable preparation of financial statements in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

- Compliance with applicable laws and regulations: Transactions are executed in accordance with (1) laws governing the use of budgetary authority, (2) other laws and regulations that could have a direct and material effect on the financial statements, and (3) any other laws, regulations, or governmentwide policies identified by OMB audit guidance.

We are also responsible for (1) testing compliance with selected provisions of laws and regulations that could have a direct and material effect on the financial statements and for which OMB audit guidance requires testing, and (2) performing limited procedures with respect to certain other information appearing in SEC's Performance and Accountability Report. In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;

- assessed the accounting principles used and significant estimates made by SEC management;

- evaluated the overall presentation of the financial statements;

- obtained an understanding of internal control related to financial reporting (including safeguarding of assets) and compliance with laws and regulations (including execution of transactions in accordance with budget authority);

- 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 with applicable laws and regulations, 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 FMFIA; and
- tested compliance, and related internal controls over compliance, with selected provisions of the following laws and their related regulations:
  - the Securities Exchange Act of 1934, as amended;
  - the Securities Act of 1933, as amended;
  - the Antideficiency Act;
  - laws governing the pay and allowance system for SEC employees; and
  - the Prompt Payment Act.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by the FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate.

We did not test compliance with all laws and regulations applicable to SEC. We limited our tests of compliance to those required by OMB audit guidance and other laws and regulations that had a direct and material effect on, or that we deemed applicable to, SEC's financial statements for the fiscal year ended September 30, 2004. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our work in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

SEC Comments and Our Evaluation

In commenting on a draft of this report, SEC was pleased to receive an unqualified opinion on SEC's first-ever financial statements. SEC also acknowledged the material weaknesses in internal control and stated it is moving aggressively to address and resolve the weaknesses. SEC indicated that by June 2006, it will implement corrective actions for information technology security weaknesses and that weaknesses related to disgorgements and penalties should also be resolved by fiscal year 2006. To address the material weakness pertaining to preparation of financial statements, SEC plans to hire additional staff, formalize policies and procedures for preparing and reviewing financial statements, and establish a formal audit committee to engage in financial reporting issues.

The complete text of SEC's response is included in appendix I.

David M. Walker
Comptroller General
of the United States

February 11, 2005

Management's Discussion and Analysis

SECTION 1: MANAGEMENT'S DISCUSSION AND ANALYSIS

The Securities and Exchange Commission is the federal agency that administers the federal laws governing the U.S. securities markets. As such, the SEC plays a fundamental role in maintaining the integrity and vitality of America's ownership society. The following section outlines the agency's vision, mission, values, and set of goals to achieve its desired outcomes, as presented in the SEC's five-year strategic plan. In addition, the section highlights the SEC's major accomplishments during fiscal year 2004, its upcoming challenges, and the results of some of its primary performance measures. The section concludes with a discussion of the SEC's financial highlights.

Vision

The Securities and Exchange Commission aims to be the standard against which federal agencies are measured. The SEC will strengthen the integrity and soundness of U.S. securities markets for the benefit of investors and other market participants, and conduct its work in a manner that is as sophisticated, flexible, and dynamic as the securities markets it regulates.

Mission

The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

Values

Integrity • Fairness

Accountability • Resourcefulness

Teamwork • Commitment to Excellence

GOALS

To enforce compliance with federal securities laws. The Commission seeks to detect potential problems or issues in the securities markets early and prevent violations of federal securities laws. If violations occur, the SEC alerts investors to possible wrongdoing and takes prompt action to halt and sanction the misconduct.

To sustain an effective and flexible regulatory environment. Federal securities laws seek to promote fair, orderly, and competitive markets that protect investors from undisclosed risk while fostering innovation and market access. The Commission's role is to establish a regulatory environment that both protects investors and permits competition to flourish.

To encourage and promote informed investment decisionmaking. An educated investor ultimately provides the best defense against fraud and costly mistakes. The SEC works to promote informed investment decisions through two main approaches—reviewing disclosures to help ensure clear, complete, and truthful information is provided to the investing public, and implementing a variety of investor education initiatives.

To maximize the use of SEC resources. An efficient, well-managed, proactive SEC is critical for protecting investors and the markets. As such, the Commission concentrates on enhancing organizational effectiveness, investing in its human capital, as well as new technologies, and strengthening internal controls.

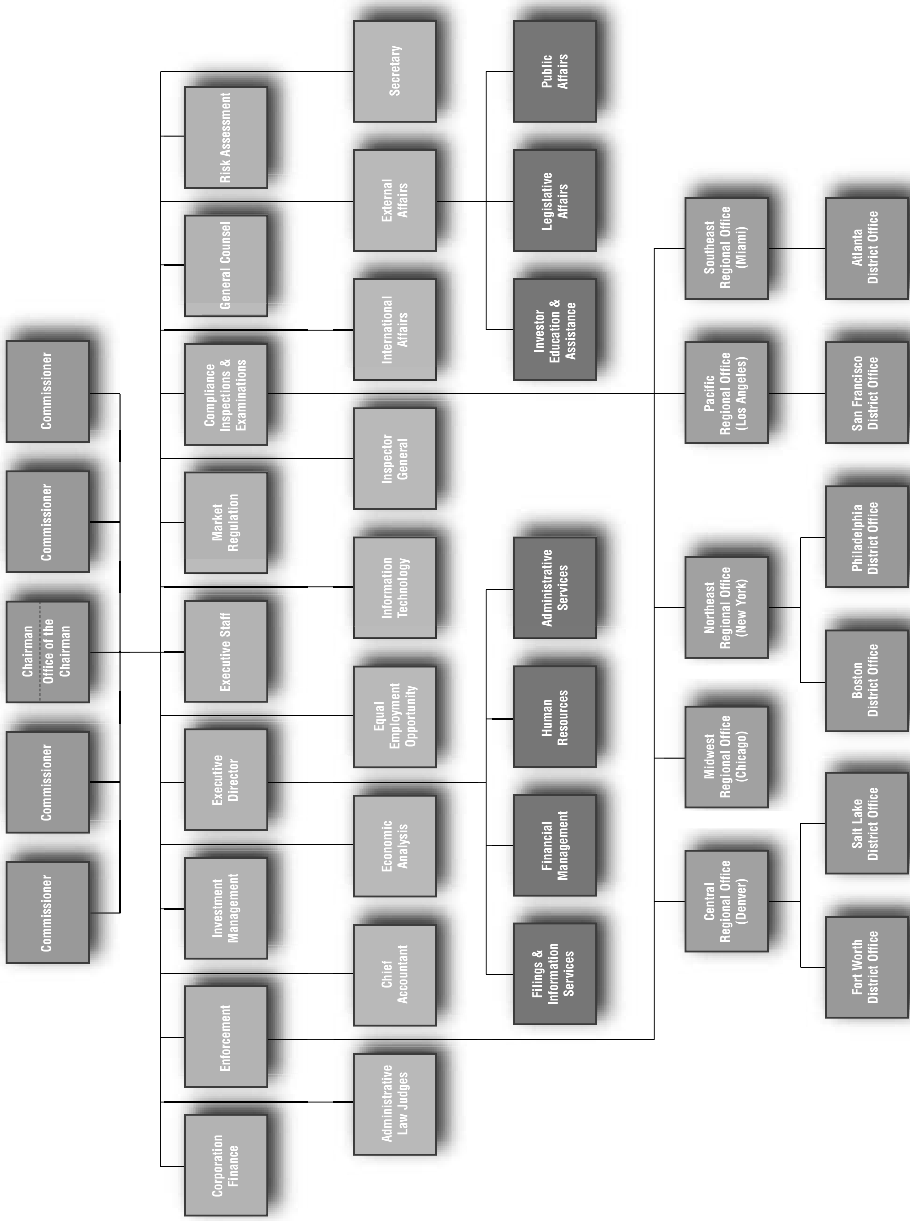
The SEC updated its four agency-wide goals to achieve desired outcomes, along with its vision, mission, and values, as part of its new strategic plan for FY 2004 through FY 2009.

ORGANIZATIONAL STRUCTURE OVERVIEW

The SEC is an independent federal agency that is headed by a bipartisan five-member commission, comprised of the Chairman and four Commissioners who are appointed by the President and confirmed by the U.S. Senate. The SEC operates under the authority of federal laws, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), among others.

At the end of FY 2004, the SEC had more than 4,000 permanent and more than 70 temporary staff positions. The SEC is organized into four divisions and 21 offices, with its headquarters in Washington, D.C. In addition, the Commission maintains 11 regional and district offices throughout the country. The SEC's organization chart is presented in *Figure 1.1.*

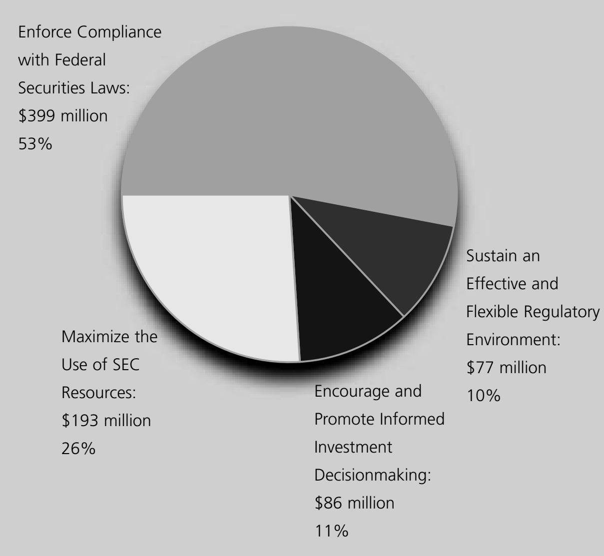
Figure 1.1 SEC Organization Chart



RESOURCES

Since 2001, Congress and the President have significantly increased the SEC's available funding and staff resources. For FY 2004, the SEC received the authority to spend $811.5 million and maintain 3,550 full-time equivalents (FTEs) and 4,090 positions. These figures represent an 83 percent increase in dollars and a 21 percent increase in FTEs from FY 2001 levels. Of the $811.5 million authorized, *Figure 1.2* displays the SEC's actual FY 2004 budget obligations of $755 million, as allocated to each of the four strategic goals outlined on page 9.

Figure 1.2 SEC FY 2004 Obligations by Strategic Goal



MAJOR ACCOMPLISHMENTS

Under Chairman Donaldson's leadership, in FY 2004 the SEC achieved a great deal on a variety of fronts. These accomplishments can be grouped into five major themes, which are discussed below. The SEC's major performance indicators also are displayed where appropriate. Because many of the measures are new, prior year data may be limited or unavailable.

Implemented the Sarbanes-Oxley Act and Improved Disclosures to Investors

This year marked the second anniversary of the Sarbanes-Oxley Act and was the opening season for filings reflecting major aspects of the Sarbanes-Oxley Act. The Commission completed on schedule the last of the ten rulemaking projects that the Sarbanes-Oxley Act required. The Commission also fulfilled its ongoing responsibilities to supervise the Public Company Accounting Oversight Board (PCAOB) and its regulation of auditors of public companies.

In FY 2004, the Commission approved the PCAOB's code of ethics, process for setting auditing standards, and annual budget. As required under the Sarbanes-Oxley Act, the Commission conducted independent rulemaking before approving the PCAOB's auditing standards, including Standard No. 2, which outlines requirements for audits of companies' internal controls over financial reporting.

The Commission also launched several regulatory initiatives to improve disclosures to investors so they can make better-informed investment decisions (see *Figure 1.4* on page 17). Highlights of this rulemaking agenda included the following:

> ***"Tagged Data."*** The Commission solicited comment on a rule allowing voluntary supplemental filings of financial data using eXtensible Business Reporting Language (XBRL), beginning with the 2004 calendar year-end reporting season. This proposal is part of a broad, multi-year initiative to assess the benefits of tagged data, which could dramatically improve the ability of investors and SEC staff to analyze issuers' financial data.

Asset-Backed Securities. In FY 2004, the Commission released a package of proposals updating the registration, reporting, and disclosure requirements for asset-backed securities (ABS). In less than 25 years, SEC-registered ABS have become an important segment of the fixed-income capital markets, with annual public issuance of up to $800 billion. These proposals set new disclosure requirements that are more relevant for ABS transactions, as the current requirements are designed primarily for corporate issuers and therefore do not always provide information that is material to the ABS market.

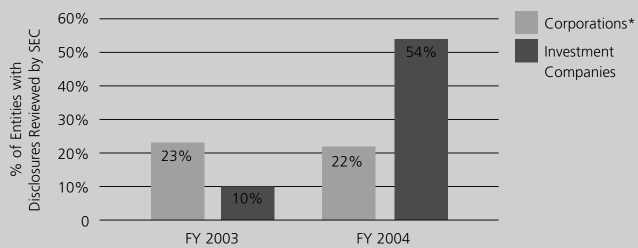
Deterring Fraud and Abuse by Shell Companies. The Commission proposed rules to prohibit the use of Form S-8 by shell companies for capital-raising transactions. Also, the proposal would provide more appropriate and timely information for "reverse mergers" and "back door registrations."

Proxy Access. The Commission proposed a new rule that would require the inclusion of shareholder nominees in the company's proxy materials under limited circumstances. Overly compliant boards of directors at times have allowed management unfettered control over the proxy process and other critical governance issues. This proposal attempts to find a middle ground between forcing shareholders to give up their long-term interest in the company and sell their stock, on the one hand, and forcing them to wage a wasteful proxy fight on the other.

During FY 2004, the Commission continued to improve its disclosure review program. Under the Sarbanes-Oxley Act, the SEC is required to review each reporting company and each investment company issuer at least once every three years. While the SEC was unable to review as many reporting companies during the first two years of this three-year cycle as anticipated due to its inability to quickly hire and train additional staff, it did strengthen its review processes by adopting new approaches to selecting filings for review and focusing its resources on material issues in filings. The Division of Corporation Finance also continued its review focus for the second year on the largest public companies, which required the most substantial resources.

With these enhancements, the Division of Corporation Finance is working diligently to meet this Sarbanes-Oxley Act requirement. In addition, during FY 2004, the SEC reviewed disclosures for 54 percent of all investment companies and is on track to review 100 percent by the end of the first three-year cycle (see *Figure 1.3* on page 15).

Figure 1.3 New Performance Measure: Percentage of Corporations and Investment Companies with Disclosures Reviewed by the SEC



* Some corporations were reviewed in both FY 2003 and 2004, and have been counted in both years.

Analysis of Results: The Division of Investment Management reviewed more than half of investment companies in FY 2004 alone and is on track to review 100 percent by the end of the first three-year cycle. The Division of Corporation Finance continued its review focus on the largest public companies, and has not reviewed as many issuers as anticipated during the first two years of this three-year cycle. In the past two years, the Division of Corporation Finance experienced difficulties hiring the 175 additional staff, particularly accountants, needed to conduct the necessary reviews. With the assistance of the excepted service hiring authority that the SEC received in July 2003 and the enlistment of two nationally recognized executive recruiting firms, the Division of Corporation Finance was nearly finished with its hiring at the end of FY 2004, and is working diligently to review 100 percent of corporations by the end of this three-year cycle.

Performance Measure Description: The Sarbanes-Oxley Act requires that the SEC review the disclosures of all corporations and investment companies at least once every three years. These reviews help improve the disclosure information available to investors and can uncover serious violations of the federal securities laws. This performance measure identifies the percentage of corporations and investment companies reviewed each year during the first three-year cycle under the Sarbanes-Oxley Act.

During FY 2004, the SEC oversaw the accounting standard-setting process as the Financial Accounting Standards Board made progress on several major projects, such as the consolidation of variable-interest entities, accounting for stock compensation arrangements, and accounting for business combinations. In FY 2004, the SEC expanded its efforts to monitor standards development by the International Accounting Standards Board to promote the convergence of U.S. and foreign accounting standards and facilitate cross-border securities offerings.

The SEC also created an Office of Global Security Risk within the Division of Corporation Finance to identify companies engaging in activities that raise global security and humanitarian concerns that are material to investors.

Improved Market Structure, Governance, and Transparency

In FY 2004, the Commission pursued an extensive and ambitious agenda to improve the structure and governance of the U.S. securities markets (see *Figure 1.4* on page 17). For example, after the SEC asked each of the self-regulatory organizations (SROs) to review the adequacy of their governance practices the New York Stock Exchange (NYSE) issued a series of proposals to enhance its governance. These proposals, approved by the Commission in December 2003, included the creation of the following: a smaller, independent board of directors; four key board committees overseeing certain critical functions; and an autonomous regulatory office headed by a Chief Regulatory Officer. The Commission is carefully considering proposals to tighten SRO governance further and ensure that SROs are performing their regulatory obligations.

Over the last few decades, the facilities and rules that link our securities markets have been tested severely by new technologies and trading patterns. In February 2004, the Commission published for public comment Regulation National Market System (NMS), a far-reaching set of proposals designed to improve and modernize the regulatory structure of the U.S. equity markets. Regulation NMS covers four substantive areas: trade-throughs, market access, sub-penny quoting, and market data. The SEC is currently reviewing more than 700 comment letters received to date on proposed Regulation NMS and intends to take final action on the rules in FY 2005.

The Commission moved to reform short sale regulations and to address abusive "naked short selling." These rules imposed a requirement that broker-dealers, prior to effecting a short sale of any equity security, must "locate" securities available for borrowing so that the security can be delivered on the settlement date. The Commission approved additional delivery requirements for certain equity securities with substantial delivery failures. Also included in the new rule was a one-year pilot program for specified securities that temporarily suspends the operation of the "tick test" and other short sale price tests. The pilot will assist the Commission in examining the current price test structure and considering alternatives for future short sale regulation.

Performance Measure Description: For FY 2004, the Commission and staff set ambitious goals to propose or adopt several major rulemaking activities covering a wide range of topics. This agenda included proposals to enhance significantly the regulations governing the mutual fund industry, modernize the structure of the U.S. securities markets, and register hedge fund advisers. This performance measure gauges whether the SEC successfully implemented its major regulatory goals during FY 2004.

Figure 1.4 New Performance Measure: Milestones Achieved for High-Priority Rulemakings

RULEMAKING	PLAN	ACTION TAKEN
Investment Management		
Market Timing and Selective Disclosure	Propose & Take Final Action	Adopted
Breakpoint Sales Load Disclosure	Propose & Take Final Action	Adopted
Directors' Approval of Advisory Contracts	Propose & Take Final Action	Adopted
Portfolio Manager Disclosure	Propose & Take Final Action	Adopted
Investment Adviser Codes of Ethics	Propose & Take Final Action	Adopted
Mutual Fund Governance Rules	Propose & Take Final Action	Adopted
Prohibit Use of Brokerage Commissions to Finance Distribution of Mutual Funds	Propose & Take Final Action	Adopted
Fund and Adviser Compliance Programs	Take Final Action	Adopted
Hedge Fund Adviser Registration	Propose	Proposed
Redemption Fee for Mutual Funds	Propose	Proposed
Pricing of Mutual Fund Shares	Propose	Proposed
Corporation Finance		
Shareholder Nomination Process	Propose	Proposed
Asset-Backed Securities	Propose	Proposed
Securities Act Reform	Propose	Proposed
Shell Companies	Propose	Proposed
8-K Disclosure Enhancements	Take Final Action	Adopted
"Tagged Data"	Propose	Proposed
Market Regulation		
National Market System	Propose	Proposed
Short Sale Regulation	Propose	Adopted
Consolidated Supervised Entities	Propose	Adopted
Point-of-Sale Disclosure/ Confirmation Requirements	Propose	Proposed
Regulation B	Propose	Proposed

Analysis of Results: The Commission and its staff implemented all of the planned actions related to major rulemaking proposals. Among other goals, these rules were designed to combat mutual fund market timing and late trading practices, improve the compliance culture of investment companies and advisers, modernize the regulatory structure of the U.S. equity markets, and provide a comprehensive registration and disclosure regime for ABS. As a result, these rules address many of the most important challenges facing the securities markets and will have significant effects for years to come. As the SEC finishes this major wave of rulemaking activities, the SEC will work to devise ways to measure these effects over time.

The Commission established a new regime for overseeing the capital requirements of the largest international financial conglomerates. In April 2004, the Commission adopted a new program that established a voluntary, alternative method of computing deductions to net capital for certain broker-dealers. As a condition of a broker-dealer's use of this alternative method, the broker-dealer and its holding company and affiliates, collectively referred to as a consolidated supervised entity, must consent to group-wide Commission supervision, including record-keeping and reporting requirements.

In January 2004, the Commission proposed two new rules to provide point-of-sale disclosure and improve confirmation disclosure related to sales fees and conflicts of interest arising from the distribution of mutual funds, 529 plans, and related securities. The SEC received over 1,000 comments on these proposals, underscoring the intense level of interest in this area from investors and the securities industry. The SEC is carefully examining those comments and intends to develop final rules that will provide investors with timely, practical, and cost-effective information about distribution costs and conflicts of interest.

Vigorously Addressed Challenges in the Mutual Fund and Hedge Fund Industries

In FY 2004, the SEC led a prompt and multi-pronged response to identified abuses in the mutual fund industry. In addition to aggressive enforcement activity and broad-based, risk-targeted examinations (which are discussed below), the SEC strengthened the mutual fund oversight and regulatory framework to minimize the possibility of potential abuse in the future. These actions helped restore investor confidence in the industry.

Among the many major regulatory initiatives related to the mutual fund industry in FY 2004 (see *Figure 1.4* on page 17), the Commission accomplished the following:

- Adopted a comprehensive package of fund governance rules that will require, among other things, an independent board chairman and a board comprised of 75 percent independent directors. These rules are designed to bolster the effectiveness of independent directors and solidify the role of the fund board as the primary advocate for fund shareholders.
- Adopted rules to require that all registered investment advisers adopt codes of ethics and that funds and their advisers have comprehensive compliance policies and procedures in place, including the appointment of a designated Chief Compliance Officer. These rules are designed to reinforce the fundamental importance of integrity and compliance with the federal securities laws in the investment management industry.
- Enhanced mutual fund disclosure by requiring more frequent disclosure of portfolio holdings, requiring that shareholder reports include dollar-based expense information, improving disclosure regarding a portfolio manager's potential conflicts of interest with the fund, requiring improved disclosure of breakpoint discounts, and proposing significant amendments to the information that a broker-dealer provides its customers in connection with mutual fund transactions.
- Adopted an amendment to rule 12b-1 to prohibit the use of brokerage commissions to compensate broker-dealers for the distribution of a fund's shares. This step will eliminate a practice that potentially compromises the best execution of a fund's portfolio trades, increases portfolio turnover, and biases broker-dealers' recommendations to their customers.

- Proposed to address late trading abuses by permitting same-day pricing for fund orders only if they are received by the fund, its designated transfer agent, or a registered clearing agency before the fund's designated pricing time.
- Put forth a series of initiatives to address market timing, especially so-called "arbitrage" market timing. The initiatives include improved fair value pricing disclosure, enhanced disclosure regarding a fund's anti-market timing policies and practices, and a proposal that funds impose a mandatory two percent redemption fee when investors redeem their shares within five days of purchase.

In July 2004, the Commission voted to propose registering hedge fund advisers. Hedge fund managers are, directly and indirectly, providing advisory services for many U.S. investors with significant impact not only on the investors but also on the operation of the U.S. securities markets. In addition, intermediaries are purchasing hedge funds on behalf of millions of smaller investor beneficiaries, such as retirees, pensioners, and others not generally thought of as the traditional hedge fund investor. The increased use of hedge funds in pension plans and other funds makes it critical that the Commission has basic information about the activities of hedge fund managers. In October 2004, the Commission voted to adopt this proposal.

Strengthened the SEC's Examination and Enforcement Programs

As a result of recent increases in staff and resources, the SEC significantly improved its efforts to enforce compliance with the federal securities laws. These efforts have two main components: inspecting regulated entities to promote compliance and uncover violations, and investigating and litigating violations of law.

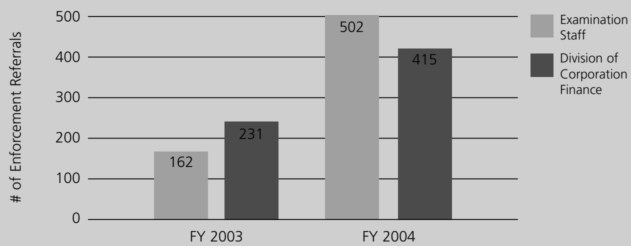
In FY 2004 the SEC's examination program launched a variety of initiatives to significantly enhance its oversight of the investment management industry, broker-dealers, and SROs. As part of the Chairman's risk assessment initiative, the Office of Compliance Inspections and Examinations enlisted front-line examiners across the country to identify major and emerging risks throughout the industry. The Office of Compliance Inspections and Examinations then addressed these risk areas in part through dozens of special examinations targeted at those risks, called risk-targeted sweeps. Topics included mutual fund market timing and late trading, use of fair value pricing by international funds, fixed-income mark-ups, and the misuse of non-public information from Private Investment in Public Equity structures and loan syndicates. As a result of these risk-targeted sweeps, the number of significant deficiencies detected by the Office of Compliance Inspections and Examinations increased, and needed regulatory improvements were recommended (see *Figure 1.5* on page 22).

In FY 2004, significant compliance problems found by the examination program included the following:

> ***"Directed Brokerage and Revenue Sharing."*** Examinations revealed that fund assets increasingly were being used for sales and marketing payments to broker-dealers outside of rule 12b-1 distribution agreements. These findings resulted in SEC enforcement actions, a new Commission rule barring funds from using brokerage commissions to pay marketing incentives to broker-dealers, and an SEC rule proposal that would require greater point-of-sale disclosure to customers about the incentives received by broker-dealers to sell a particular fund.
>
> ***Violations by Specialists.*** Examinations revealed that NYSE specialists were "trading ahead" of their customers' orders. This finding resulted in SEC and NYSE enforcement actions against NYSE specialist firms.

Performance Measure Description: The SEC's Division of Enforcement receives referrals that come from a variety of sources including SEC staff referrals. Both the Division of Corporation Finance and the Office of Compliance Inspections and Examinations strive to uncover serious potential deficiencies and violations of the federal securities laws through the SEC's disclosure review and examination programs. When possible deficiencies or violations are found, they may be referred to the SEC's Division of Enforcement for further investigation. This performance measure tracks the number of enforcement referrals arising from significant deficiencies detected by examination staff and the Division of Corporation Finance's disclosure review program by fiscal year. During FY 2004, the Office of Compliance Inspections and Examinations used enforcement referrals as a proxy for significant deficiencies detected. In FY 2005, data on the number of significant deficiencies detected will be collected and reported.

Figure 1.5 New Performance Measure: Significant Deficiencies Detected and Referrals to the Division of Enforcement from Examination Staff or the Division of Corporation Finance



Analysis of Results: Increases in the number of significant deficiencies detected by the examination staff can be attributed in part to the shift in the examination program's emphasis from routine inspection cycles to a more risk-based approach. In FY 2004, examination staff identified hundreds of possible risks to investors and then conducted risk-targeted sweeps directed at the most salient risks to investors, an approach that uncovered many more potentially serious violations than in previous years. With respect to the Division of Corporation Finance, enforcement referrals rose in part due to the delinquent filer program, in which dozens of issuers who failed to make disclosure filings as required under federal law were identified.

Disclosure and suitability problems in the sale of variable annuities. Examinations revealed that many broker-dealers were selling variable annuities without adequately disclosing their features, to individuals for whom these products were unsuitable, and with poor supervision and training. These findings led to the issuance of a public report by the SEC and the National Association of Securities Dealers (NASD), describing poor and best practices for broker-dealers in this area, and an NASD rule proposal designed to ensure better disclosure and sales practices.

Broker-dealers' failure to provide "breakpoint" discounts. An examination sweep by the SEC, NASD, and NYSE found widespread failures to provide "breakpoint" discounts to customers. The sweep resulted in the creation of an industry task force that identified systemic solutions, a new SEC rule to better disclose available "breakpoint" discounts, and SEC and NASD enforcement actions.

The extent of "market timing" and late trading in the mutual fund industry. After initial indications that mutual funds had collusive market timing arrangements with certain hedge funds and other traders, SEC examiners conducted a large-scale examination sweep of hundreds of firms to identify the scope of the problem. As a result of the risk-targeted sweeps, enforcement actions have been brought against ten mutual fund complexes to date, and others are still under investigation.

Lack of strong internal controls in the sale of certain structured finance products. After Enron and other financial fraud, examiners worked together with federal banking regulators to inspect broker-dealers and banks involved in the structuring and sale of these products. Together, the SEC and the federal banking regulators proposed for public comment various internal controls that firms should adopt.

The enforcement program, including its regional offices, increased its staffing by approximately 29 percent between FY 2003 and 2004 as a result of increased funding authorized by the Sarbanes-Oxley Act. With these new employees, the SEC's enforcement staff opened approximately 950 investigations, particularly with respect to mutual funds, investment advisers, and the mutual fund sales practices of broker-dealers. The following is a sampling of the year's significant enforcement actions:

Mutual fund market timing, late trading, and selective disclosure actions. The Commission brought 29 actions against participants in the mutual fund industry, including Pilgrim Baxter & Associates, Putnam Investment Management, Alliance Capital Management, Massachusetts Financial Services, and Strong Capital Management. For such cases, the Commission ordered a total of $552 million in disgorgement and $480 million in penalties, which will be distributed to injured investors through the "Fair Funds" provision of the Sarbanes-Oxley Act.

The specialists cases. The Commission and the NYSE found that five specialist firms executed orders for their dealer accounts ahead of executable public customer or "agency" orders. In settling, the firms agreed to pay a total of $247 million in penalties and disgorgement and improve compliance procedures.

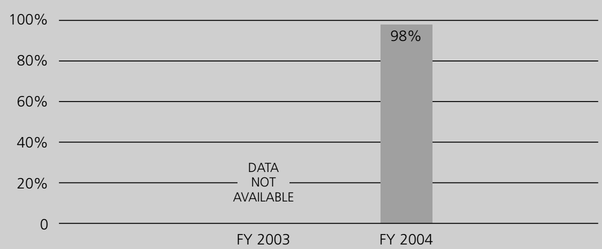
SEC v. Lucent Technologies Inc., et al. The Commission charged Lucent Technologies and certain current and former Lucent officers, executives, and employees, and alleged that the company fraudulently and improperly recognized about $1.1 billion of revenue and $470 million in pre-tax income during FY 2000. Lucent and three of its former employees agreed to settle the case. The company agreed to pay a $25 million penalty for its lack of cooperation.

SEC v. Computer Associates International Inc.; SEC v. Sanjay Kumar and Stephen Richards; and SEC v. Steven Woghin. The Commission filed seven separate actions against Computer Associates and seven former top executives alleging that Computer Associates, one of the world's largest software companies, prematurely recognized revenue totaling over $3 billion, and that the former executives obstructed the Commission's investigation. In addition to other relief, over $225 million was ordered to be returned to shareholders.

SEC v. Royal Dutch Petroleum Company and The "Shell" Transport and Trading Co., PLC.; In the Matter of Royal Dutch Petroleum Company and The "Shell" Transport and Trading Co., PLC. The Commission filed enforcement proceedings against two foreign-based oil companies in connection with their overstatement of 4.47 billion barrels of previously reported proved hydrocarbon reserves. In settlement of these actions, the defendants consented to a cease and desist order and to, among other things, payment of $120 million in penalties.

In total, the staff instituted about 375 administrative proceedings and 264 civil proceedings, prevailing in the great majority of the enforcement actions decided by district courts or administrative law judges (see *Figure 1.6).* In FY 2004, more than $3 billion, a record amount in penalties and disgorgement, was ordered in cases brought by the SEC. Criminal proceedings were brought against 302 entities and individuals in matters relating to SEC cases in FY 2004.

Figure 1.6 New Performance Measure: Enforcement Cases Successfully Resolved



Analysis of Results: In FY 2004, the SEC successfully resolved the cases against the vast majority of the defendants or respondents it charged. In general, the SEC strives to bring cases that are as strong as possible but, at the same time, aims to file large, difficult, or precedent-setting cases when appropriate, even if success is not assured.

Performance Measure Description: Once the SEC determines through an enforcement investigation that a person or company has violated the law and should be charged, the SEC works to secure a judgment against the violator and appropriate sanctions. These cases are filed either in U.S. District Court or before an administrative law judge. Successfully resolved is defined as those parties against whom the SEC successfully obtained an administrative order or a judgment by consent, by default, through summary judgment, or following a bench or jury trial. This performance measure identifies the percentage successfully resolved in FY 2004 of all parties against whom a judgment was entered that year.

Improved the SEC's Operational Effectiveness

Since Chairman Donaldson was appointed, he has focused on improving the SEC's ability to anticipate potential problems across the securities industry by "looking over the hills and around the corners" for the next emerging abuse of securities laws. The Chairman initiated a thorough internal review of how the SEC identifies current problems and, equally important, future risks. As a result of this review, the SEC launched a new risk assessment program and created an Office of Risk Assessment, the first of its kind at the Commission.

The goal of the SEC's risk assessment program is twofold: to become better equipped to anticipate potential problems; and then to prevent these problems from affecting the markets. Toward these ends, the SEC first launched risk assessment activities within its various divisions and offices, creating internal risk teams that employed a "bottom-up" approach to mapping risk within each program. For those areas of greatest concern, the SEC proactively initiated risk-targeted examination sweeps, enforcement investigations, and disclosure reviews. Such efforts have helped focus the SEC's operations on those areas that present the biggest risks to investors. In addition, the recently hired Director of the Office of Risk Assessment will coordinate internal risk teams and help the entire Commission anticipate new or resurgent forms of fraud and questionable activities.

The SEC completed comprehensive workforce and workflow reviews of all SEC divisions and offices, leading to more efficient organizational structures and an improved alignment of the SEC's resources, needs, and mission priorities. These reviews helped ensure that all resources were allocated efficiently on the basis of well-defined program objectives so that the Commission has "the right people in the right place at the right time."

Chairman Donaldson also launched the "dashboards" initiative to regularly track divisions' and offices' progress in achieving programmatic, operational, staffing, and budgetary objectives. These management reports help the Chairman and senior managers gauge performance and adjust operations and resources, as necessary.

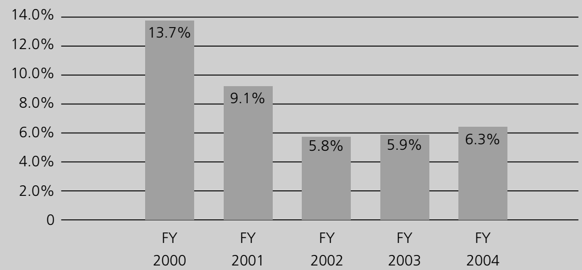
The Commission received authority from Congress to hire more than 840 new staff in February 2003, and in July 2003 the SEC was allowed to expedite the hiring of accountants, economists, and examiners. These two actions set the stage for a tremendous hiring wave in FY 2004. With the help of a significantly enhanced recruitment and orientation program, and without compromising quality, the SEC hired more than 1,000 new employees between FY 2002 and FY 2004, reducing its vacancy rate substantially (see *Figure 1.7* on page 28). As the Commission continues to fill normally occurring vacancies, it will continue to explore innovative ways to attract top talent from diverse backgrounds, particularly accountants.

The SEC also continued to develop several important programs to retain employees with valuable skills. For example, the SEC continued its compensation program that rewards superior performance through a new pay-for-performance system. The Commission also offered an expanded benefits package that includes a number of programs, including: the student loan repayment program, which in FY 2004 covered about ten percent of the SEC's workforce; offering dental and vision benefits; maintaining life cycle accounts to help employees address work-life issues; and continuing its childcare subsidy program. The Commission also continued its commitment to staff training through the creation of the SEC University (SEC-U). These efforts have already begun to yield results. The GAO surveyed SEC staff and found them "significantly more satisfied with their pay and their ability to use flexitime and flexiplace." In addition, the SEC's turnover rate has remained at historically low levels, although it has increased slightly in the past two fiscal years (see *Figure 1.7* on page 28).

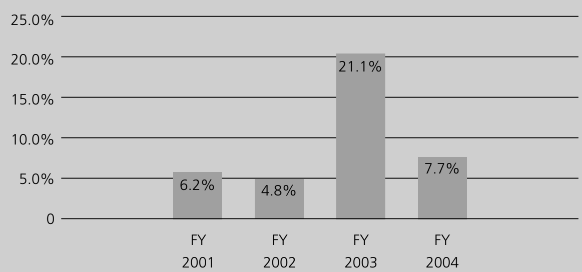
Performance Measure Description: Most of the functions performed by the SEC require highly trained staff to perform duties such as investigating violations of the federal securities laws, reviewing the activities or disclosures of securities market participants, or drafting new securities regulations. Therefore, the SEC has focused its energies on retaining high-performing staff and closely tracked its turnover rate to gauge the success of these efforts. Also, in FY 2003 Congress increased the SEC's size by more than 840 new staff positions. Therefore, a major goal for the SEC in FY 2004 was to fill these new positions and reduce the vacancy rate back to previous levels.

Figure 1.7 Performance Measure: SEC Turnover and Vacancy Rates

SEC Turnover Rate



SEC Vacancy Rate



Analysis of Results: In the late 1990s and early 2000s, the SEC experienced high turnover rates, mainly due to the availability of higher pay and benefits at other federal financial regulators and in the private sector. In FY 2001, the SEC gained the authority to set pay and benefits commensurate with other financial regulators within the federal government. Since that time, the Commission has implemented a pay-for-performance system, enhanced benefits, invested in new work-life programs, and bolstered its training programs through the SEC-U in an effort to reduce turnover. These efforts contributed to substantially lower turnover rates in the past few years. With respect to vacancies, the chart shows that the SEC had a high vacancy rate at the end of FY 2003, largely because it had not yet filled many of the more than 840 new positions that Congress approved for the SEC that year. The SEC has since launched a variety of new recruiting initiatives, significantly expanding its outreach, hiring two executive recruiting firms, and creating a new recruiting video. The SEC has lowered its vacancy rates substantially and also has about 100 additional staff hired and set to come on board early in FY 2005, which will reduce vacancies further.

Separately, in addition to hiring a Director of Risk Assessment, the Chairman also rounded out the SEC's senior management team by hiring a new Chief Accountant, Chief Economist, and Chief Information Officer (CIO).

The SEC also executed an aggressive 20-month effort to prepare its first audited financial statements and Performance and Accountability Report (PAR). The SEC began reporting quarterly financial results in FY 2004 and worked diligently to strengthen its financial and internal controls.

Finally, the Office of Information Technology implemented an aggressive agenda under the SEC's new CIO (see *Figure 1.8* on page 30). A few highlights of the many initiatives launched in FY 2004 are listed below:

- As part of its "data tagging" initiative, the SEC automated Forms 3, 4, and 5 using eXtensible Markup Language (XML) tagging formats, which permit filings over the web and enable SEC and public users to obtain data in a format useful for analysis.
- The Office of Information Technology continued to implement a document imaging and management system for the SEC. The initial stages of the effort focused on imaging the Division of Enforcement's large backlog of paper-based discovery documents. Concurrently, the Office of Information Technology upgraded many elements of the SEC's information technology (IT) infrastructure enabling it to handle the large-scale storage and retrieval of image files. This system will save staff time spent searching and analyzing millions of pages of documents, and protect this information in the event of an emergency that would damage paper documents.
- The point-to-point network redesign initiated in FY 2003 was made fully operational by the middle of FY 2004, providing continuous communications between SEC sites in the event that a disaster forces headquarters or the operations center to close.
- In FY 2004, the Office of Information Technology implemented the initial stages of a comprehensive redesign of its capital planning and investment control (CPIC) processes. The initial changes focused on new operating budget approvals and investment approval thresholds, which went into effect in early FY 2005.
- The SEC's enterprise architecture (EA) planning improved substantially in FY 2004, with the finalization of the EA repository and an internal website to provide EA information to all SEC staff. As a result, all project sponsors and managers are able to access the SEC's business reference model, information resource catalog, and other core elements of the SEC's EA in planning their projects.

Performance Measure Description: The SEC focused its IT investments on five primary areas to enhance program effectiveness and operational efficiencies. A variety of projects have been implemented in these areas, ranging in complexity and duration (e.g., some may be completed in a single fiscal year while others span multiple fiscal years). This performance measure identifies some of the SEC's major IT initiatives and whether the SEC successfully achieved major project milestones.

Figure 1.8 New Performance Measure: Milestones Achieved for High-Priority IT Projects

	FY 2004 PLAN	FY 2004 ACTION TAKEN
EDGAR/Disclosure *The EDGAR (Electronic Data Gathering Analysis and Retrieval) system is operated by the Commission and allows for electronic submission, analysis, and dissemination of virtually all filings with the Commission.*	a. Electronically enhance Form 8-K	a. Completed
	b. Modify EDGAR to electronically accept Forms 3, 4, and 5 using XML	b. Completed
	c. Identify the elements of forms in anticipation of using a mark-up language	c. Completed
	d. Implement voluntary program to accept tagged financial data in filings	d. Initiated
Enforcement/Examination Activities	a. Image backlog of paper-based discovery documents	a. In Progress
	b. Conduct a pilot to better handle electronic media evidence	b. Completed
	c. Provide fully automated processing of equity and options trade records in support of enforcement investigations	c. Completed (equity); Initiated (options)
Internal Productivity	a. Replace desktop, laptop, and monitor infrastructure to help employees work more productively inside and outside of the office	a. Completed
	b. Deploy a new generation of personal digital assistants to critical staff	b. Completed
	c. Upgrade the Freedom of Information Act system	c. Completed
Security/Disaster Recovery	a. Expand agency-wide network capacity and implement point-to-point design for improved resiliency	a. Completed
	b. Migrate to an alternate data center outside of downtown Washington D.C.	b. In Progress
Electronic Government (e-Gov)/EA and CPIC	a. Redesign the CPIC processes	a. Completed
	b. Implement version one of the SEC's EA program	b. Completed

Analysis of Results: The SEC made significant progress in each of the major areas identified above. In particular, efforts such as the introduction of "tagged data" into EDGAR, document imaging, the implementation of the point-to-point system design, and progress on developing the Commission's EA will have major impacts on the efficiency and effectiveness of the SEC's programs. The SEC has formulated plans to build on these initiatives in FY 2005 through efforts such as developing the Commission's data mining and forensics applications, electronic media capture and search capabilities, and disclosure-related systems.

CHALLENGES

Although the SEC successfully implemented an ambitious agenda in FY 2004, many challenges remain. Over the next year, the SEC anticipates taking action to address these challenges, through initiatives outlined in its five-year strategic plan. These initiatives will provide important protections for investors, improve the markets' structure, and enhance the SEC's operational effectiveness. The following are some of the SEC's key challenges, and the ways, both past and future, that the Commission has worked to address them.

> ***Uncovering Emerging Threats to Investors.*** The SEC faces the continuing challenge of addressing new or resurgent forms of fraud and questionable activities before they pose a serious threat to investors. In FY 2004, the Commission began implementing an aggressive strategy to uncover emerging risks in their early stages through the risk assessment initiative launched by Chairman Donaldson. The SEC will expand upon this effort in FY 2005, hiring additional staff dedicated to risk management and developing new techniques to detect, gauge, and manage sources of potential risk, whether in disclosure filings, market data, evidentiary or examination documents, or elsewhere. New technologies may include diagnostic and data mining systems, collaborative software, or access to new databases. For example, within the examination program, the SEC will launch a surveillance system for funds and advisers. The system will provide current information about funds and their advisers, so that the Office of Compliance Inspections and Examinations can identify trends and patterns that require follow-up by examiners or other staff. The Office of Compliance Inspections and Examinations also will begin implementing a new initiative to deploy monitoring teams for the largest investment advisory organizations, which will serve as the SEC's "eyes and ears" for this critical industry.
>
> ***Analyzing Unprecedented Amounts of Data from Investigations and Examinations.*** The increasing complexity and technological sophistication of the securities markets has deeply affected the SEC's enforcement and examination programs, as the volume of data that

might be relevant to an SEC investigation or inspection has grown exponentially. The SEC must adapt accordingly, with new systems and processes that can help staff review huge amounts of information quickly and thoroughly. In FY 2005, the SEC plans to upgrade the enforcement program's IT forensics capabilities, allowing staff to obtain and analyze data more quickly in the course of enforcement investigations. The SEC also will deploy new tools to analyze e-mail and other electronic media received through investigations and examinations for any contextual relationships. The imaging project initiated in FY 2004 will continue, completing the remainder of the enforcement program's paper document backlog and ensuring that the vast majority of enforcement document reviews can leverage automated search and browsing tools.

Enhancing Disclosures to Investors. Technological advancements have given the SEC an unprecedented opportunity to make disclosures more easily accessible and usable by the investor community. To meet this challenge, the SEC will move forward with its initiative to deploy "data tagging" to make financial data easier to analyze across industries or funds. The Commission also will explore converting additional disclosure forms into "tagged" format, redesign the Internet portal for the EDGAR system, and rebid the EDGAR contract with an eye toward substantially improving the effectiveness and flexibility of the system.

Attracting and Retaining Quality Staff. The SEC has worked hard to bring its attrition rate down to the historic lows of the past few years. However, as shown above, with the recent economic recovery, the SEC's attrition rate is inching up again. Over the next fiscal year, the SEC must take a variety of additional steps to ensure that it becomes the "employer of choice" within the federal government, attracting and retaining a highly talented and diverse workforce. The SEC will continue to refine its compensation and benefits packages to ensure that they are competitive with those of other federal financial regulators. The Commission will enhance its training program through the SEC-U, offering courses covering areas such as continuing education for attorneys and accountants, securities industry training, and employee development and management. The SEC will work to create high-quality facilities that will improve staff morale and improve productivity. The SEC's facilities in Washington, D.C., New York, and Boston will implement such enhancements in FY 2005. Another priority is for the SEC to create a "virtual workforce" and expand the use of telework to permit staff to work from home and maintain work-life balance.

Financial Management System Controls. The SEC is committed to the effective and efficient management of the resources that have been entrusted to the Commission. The Commission has already taken a series of steps toward this goal and will continue to tighten internal controls in FY 2005, including the following:

- The SEC worked to enhance its internal controls in the area of property management and accountability. New procedures were implemented to identify, track, and report in-house software development costs, but they have not yet been formally documented.
- In FY 2003 the SEC met its goal of replacing the disgorgement tracking system with an upgrade to its Case Activity Tracking System, for which the financial components of the system were added in FY 2003 and populated in FY 2003 and FY 2004. Also in FY 2004, the SEC continued to work on procedures to ensure that all enforcement activities resulting in an assessment of penalties and disgorgement are properly documented and reported in a timely manner. In FY 2005, the enforcement and accounting staff will continue to work to ensure that the data meets the Commission's financial reporting needs.

Information Resources Management. The SEC is working continually to strengthen its information resources management program, which has been identified by the Inspector General as one of the agency's ongoing challenges. In FY 2004, the Commission's new CIO significantly restructured the Office of Information Technology by establishing EA and project management offices. In addition, the initial stages of a comprehensive redesign of its CPIC processes were implemented, an EA repository was finalized, and an internal website to provide ready access to the SEC's business reference model and information resources catalog was made available. Finally, the Commission produced an IT policy framework to align the Office of Information Technology's operational controls and policies with the Clinger-Cohen Act and the Office of Management and Budget (OMB) guidance. These efforts will continue in FY 2005, as the SEC continues to redesign its CPIC processes, implements new tools for tracking IT projects, and completes its EA plan.

The SEC continues to make progress in developing and implementing a mature information security program. In FY 2004, the Office of Information Technology certified eight major IT systems and began working on completing the accreditation documentation. Further, the SEC initiated development of plans to improve its incident response capability, provided IT security training to 4,200 SEC employees and contractors, and continued its specialized training program for technical staff. In FY 2005, the certification and accreditation of the SEC's IT systems will continue, and the Office of Information Technology will conduct a comprehensive review of its security policies, procedures, and technical architecture to ensure compliance with the best practices in information security. Also, the Office of Information Technology will deploy a new generation of intrusion detection and monitoring tools for its IT systems and network.

MANAGEMENT CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS

SEC management is responsible for the fair presentation of the principal financial statements in conformity with GAAP and the requirements of OMB Bulletin Number 01-09. Management is also responsible for the fair presentation of the SEC's performance measures in accordance with OMB requirements. The quality of the SEC's internal control rests with management, as does the responsibility for identifying and complying with pertinent laws and regulations.

Federal Managers' Financial Integrity Act

The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires agencies to annually evaluate their system of internal control and report to the President and Congress on whether it complies with the standards and objectives set forth in the Act. If noncompliant, an agency's report must identify the material weaknesses and the plans for correcting those weaknesses. FMFIA also requires a statement indicating whether the agency's accounting system conforms to the principles and standards of the Comptroller General of the United States.

On December 22, 2004, the Chairman provided qualified assurance that, taken as a whole, the SEC's system of controls for the fiscal year ended September 30, 2004, was adequate and effective and had achieved the intended objectives under Section 2 of FMFIA. This qualified assurance considered two material weaknesses, which are discussed below.

The Chairman also reported that the financial management systems were generally in conformance with the principles and standards developed by the Comptroller General and implemented through OMB Circular A-127. One instance of material nonconformance was identified and is described below.

While the SEC acknowledged weaknesses in its internal controls and financial management systems, it also emphasized its commitment to be effective and efficient in the management of the resources entrusted to the Commission. A discussion of the corrective actions taken and planned by the SEC to address these matters is also described in the following pages.

FMFIA Management Control Program and Review Process

In accordance with guidance issued by the Commission's Executive Director, 26 management control components conducted informal reviews of their financial, administrative, and program management controls. In addition, the SEC's Office of Inspector General completed 23 alternative reviews during FY 2004. Most components were reviewed, with some undergoing multiple reviews.

Further, the SEC's Executive Review Board, which is responsible for overseeing the use of the Commission's human resources, conducted a thorough assessment of the management responsibilities of all supervisors, managers, and senior officers. The review involved developing a framework that would ensure adequate supervision of staff and equitable distribution of responsibility and workload among supervisors and managers.

Finally, GAO conducted an audit of the SEC's financial statements. GAO's procedures included audits of the financial statements, the management controls over the financial systems and operating procedures affecting the statements, and the SEC's compliance with selected provisions of laws and regulations applicable to the management of financial resources.

Status of Management Controls

In December the SEC reported two material weaknesses under Section 2 of the FMFIA and one material nonconformance under Section 4. During the audit of SEC's financial statements, a third material weakness was identified related to the SEC's preparation of financial statements. The three material weaknesses and the material matter of nonconformance are outlined below.

The internal control standards for Federal agencies established by the GAO defines a material weakness as a significant deficiency or deficiencies in the design or operation of one or more internal control components that fail to reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements would occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. OMB guidance defines nonconformance as "instances in which financial management systems do not substantially conform to financial systems requirements."

1. Penalties and Disgorgement

Description: The SEC has a material weakness related to its collection and management of financial information on penalties and disgorgement ordered as a result of SEC enforcement actions and one nonconformance related to federal financial management system requirements. These issues arise because the agency did not have a management information system in place to collect accurate data on penalties and disgorgement when the requirement for audited financial statements was set. The SEC needs to finish the development of comprehensive policies and implement internal controls for the system developed in the past two years to collect the needed financial data. To compensate for the system limitations, the SEC staff performed extensive manual procedures to compile necessary information and update the accounting system which the GAO then tested to obtain support for the estimated net amounts receivable. However, errors and inconsistent reporting were noted that confirmed a need for improved controls.

Corrective Actions Taken: Since the beginning of calendar year 2003, SEC staff identified data needed for financial reporting, designed and implemented a system to record and report on data collected, designated and trained reporting and reviewing staff, developed manuals and procedures, and entered data on over 12,000 parties to SEC enforcement actions. In the Chairman's December 2004 FMFIA report, management recognized the need to reexamine and change certain documentation and data entry procedures and to strengthen coordination and communication among offices. In addition, the report indicated that the new system for tracking and recording penalties and disgorgement requires further adaptations to strengthen data integrity support, and to assure effective internal controls exist to provide for accurate financial reporting on complex aspects of judicial and administrative orders.

Corrective Actions Planned: During FY 2005 the staff will complete a comprehensive review of files and data and review and strengthen policies and procedures. The enhanced procedures will strengthen internal control over the existing management information system. It is anticipated that consistent application of the internal controls and limited system redesign, to improve recording and reporting capabilities, will be adequate to resolve the material weakness in FY 2006. However, replacement of the current system will provide more effective assurance that internal controls are consistently applied. To that end, in FY 2005 the SEC also will begin a multi-year project to replace the existing system. A requirements analysis will be completed in FY 2006.

2. Information Systems and Security Controls

Description: Effective information system controls are required to provide assurance that financial information is adequately protected from misuse, fraud, improper disclosure, or destruction. These controls take the form of technical safeguards such as firewalls and application design, as well as procedural controls such as access management and segregation of duties. The SEC has previously reported a material weakness related to its information systems and security controls. These issues stem from the historical lack of a comprehensive agency program to manage information security; specifically, weaknesses have been identified in access control management, network security, audit and monitoring functions, user awareness, and other areas. Compliance with the requirements of OMB Circular A-130, Appendix III, regarding accreditation of applications and the Federal Information Security Management Act also requires strengthening.

The GAO audit confirmed many of the findings reported in prior years through the FMFIA and audit programs related to general controls over information technology security. While the auditors did not note any instances of security breaches that would affect the financial systems or records, they concluded that these information security control weaknesses put sensitive data—including payroll and financial transactions, personnel data, and other program-related information—at increased risk of unauthorized disclosure or modification. In addition, the SEC was found to lack a comprehensive monitoring program to identify unusual or suspicious activity. However, their review of existing controls and agency remediation plans provided adequate assurance that financial data and systems were auditable.

Corrective Actions Taken: The SEC has launched a series of initiatives to reorganize its information security program, and reorient it towards resolving the control issues outlined above. The Commission began its certification and accreditation efforts in FY 2003 to ensure that all major information systems are designed and operated with acceptable levels of security risk; this effort is ongoing. In FY 2004 the SEC hired a Chief Information Security Officer to centrally manage and implement the various components of its information security program. SEC staff also began revising information security control documents and all policies, procedures and guidelines to reflect National Institute of Standards and Technology guidelines as mandated by FISMA. The SEC continued to promulgate security awareness training internally—4,200 employees and contractors were trained in FY 2004—and implemented a specialized security training program for technical staff.

Corrective Actions Planned: Both SEC general support systems and financial applications will be certified and accredited by the end of calendar year 2005. Corrective actions for the specific control weaknesses identified in the GAO review are being implemented according to a quarter-by-quarter timeline, and will be complete by June 2006. Meanwhile, the agency will continue to redesign and enhance its overall information security program by: (1) clarifying roles and responsibilities for enterprise information security, (2) developing and revising security risk assessment processes, (3) implementing a comprehensive set of information security policies and procedures, (4) providing security awareness training to employees and contractors, and (5) systematically testing policies and procedures for their appropriateness and effectiveness.

3. Preparation of Financial Statements

Description: The SEC produced its first complete set of financial statements in 2004. In preparing the financial statements, material errors were noted in the opening balances and procedures did not exist to support the process to accumulate the necessary data to complete the financial statements. As a result, the process to prepare the FY 2004 financial statements was manually intensive, consumed significant staff resources, and did not include documentation of quality control procedures. Additionally, comprehensive accounting policies and procedures for several major areas were still in draft or still needed to be developed.

Corrective Actions Taken: The SEC assigned financial reporting staff and developed procedures to compile and issue FY 2004 annual financial statements. The staff drafted and applied the accounting policies necessary to prepare the complete set of financial statements. The SEC has made all necessary accounting adjustments to correct the errors in the opening balances and, as a result of implementation of the new policies, does not expect errors of this nature to recur. The SEC is now developing a plan to review, update and document the preliminary accounting procedures established during FY 2004.

Corrective Actions Planned: During FY 2005, the SEC will increase its financial reporting staff and formalize policies and procedures used in the first year of financial reporting. The SEC will develop policies and procedures where they did not exist and preliminary accounting procedures still in draft will be finalized. Consistent application of the enhanced procedures for recording penalties and disgorgement also will increase assurance that significant balances are reported accurately.

Efforts to solicit advice from staff experts within SEC will continue. In addition, this spring the SEC will establish a formal audit committee to provide regular review by key management officials of SEC financial reports and to provide advice to strengthen operations, policies and controls.

The Office of Management and Budget recently issued a revised Circular A-123 on Management's Responsibility for Internal Control. By the end of FY 2005 SEC will develop a plan for implementation, as the revisions will become effective for FY 2006.

Financial Management Systems

Although the SEC is not required to report under the Federal Financial Management Improvement Act, the Commission believes it is in substantial compliance with federal financial management system requirements, federal accounting standards, and the U.S. Government Standard General Ledger, except for the forgoing discussion on reporting under Section 4 of FMFIA.

Federal Information Security Management Act

FISMA requires federal agencies to conduct an annual self-assessment review of their IT security program, to develop and implement remediation efforts for identified security weaknesses and vulnerabilities, and to report compliance to OMB. SEC's Office of Inspector General performed an independent review of SEC's compliance with FISMA requirements. The report confirmed the SEC had successfully eliminated a previously identified significant deficiency, however, during this review four additional significant deficiencies were noted. The SEC submitted its annual FISMA report to OMB in November 2004.

Prompt Payment Act

The Prompt Payment Act requires federal agencies to report on their efforts to make timely payments to vendors, including interest penalties for late payments. In FY 2004, the SEC did not pay interest penalties on 95.4 percent of the 13,487 vendor invoices processed, representing payments of approximately $138.8 million. Of the invoices that were not processed in a timely manner, the SEC was required to pay interest penalties on 623 invoices, and was not required to pay interest penalties on 983 invoices, where the interest was calculated at less than $1. In FY 2004, the SEC paid over $90,000 in interest penalties, or $649 in interest penalties for every million dollars of vendor payments.

Improper Payments Information Act

The Improper Payments Information Act requires federal agencies to annually review all programs and activities they administer, identify those which may be susceptible to significant erroneous payments and the extent of the erroneous payments in its programs, and report the actions it is taking to reduce erroneous payments. During FY 2004, the SEC had controls in place to identify and correct erroneous payments that, in total, did not exceed the $10 million threshold.

Debt Collection Improvement Act

The Debt Collection Improvement Act prescribes standards for the administration, collection, compromise, suspension, and termination of federal agency collection actions and referral to the proper agency for litigation. In FY 2004, the SEC referred $271.1 million to Treasury for collection. Collections of delinquent debt by Treasury for the same period was $178,700.

PERFORMANCE MEASURES SUMMARY

The SEC's performance measurement systems have been significantly enhanced by two major efforts in FY 2004. First, the Commission approved a new five-year strategic plan that sets the direction for the SEC with a new vision, mission, values, and goals. The SEC also launched the "dashboards" initiative to enhance its performance measures and provide senior managers with regular snapshots of the agency's progress toward its goals. As a result of these efforts, many of the measures listed below are new, and some do not yet show data for FY 2004 or previous years.

These performance measures gauge how much activity the Commission conducts in a given fiscal year, how quickly it accomplishes its tasks, and what effects these activities have on the markets and for investors. However, for the SEC, measuring outcomes is the most challenging area of the three, as is the case with many regulatory and law enforcement agencies. In many instances, the Commission's impact can only be assessed indirectly. The SEC has devised a number of proxy measures that, when taken as a whole, provide a reasonable picture of its effectiveness in fulfilling its mission. As the Commission learns from its experience in this area, it will continue to refine these measures, both in the "dashboards" and in future performance reports. A summary of the SEC's major performance measures, organized by goal, is presented in *Figure 1.9* on page 43.

A discussion of the SEC's implementation of the President's Management Agenda is located in *Section 2: Performance Section.*

Level of Performance Attained

+	Exceeded Target or Prior Year's Performance Level
✓	Achieved Target or Maintained Prior Year's Performance Level
–	Less Than Target or Prior Year's Performance Level
n/a	Data Not Available

Figure 1.9 Performance Results Summary

GOAL 1: ENFORCE COMPLIANCE WITH THE FEDERAL SECURITIES LAWS	FY 2004 PERFORMANCE
1. Significant deficiencies detected and referrals to the Division of Enforcement from:	
a. Examination Staff	+
b. Division of Corporation Finance	+
2. Enforcement cases successfully resolved.	+
3. Number of investment advisers and investment companies examined.	✓
4. Number of requests to and by foreign regulators for enforcement assistance.	✓
5. Percentage of first enforcement cases filed within two years.	+
6. Monetary penalties and disgorgement ordered and the amounts and percentage collected by the SEC:	
a. Ordered	+
b. Collected	+
7. Distribution of cases across core enforcement areas.	✓

GOAL 2: SUSTAIN AN EFFECTIVE AND FLEXIBLE REGULATORY ENVIRONMENT	FY 2004 PERFORMANCE
1. Milestones achieved for high-priority rulemakings.	✓
2. Percentage of households owning mutual funds.	✓
3. Global access to U.S. markets:	
a. Number of new foreign private issuers	–
b. Dollar value of securities registered by foreign private issues	+
4. Percentage of SRO rule filings closed within 60 days.	+
5. Percentage of responses to exemptive, no-action letters, and interpretive requests issued within six months.	+

GOAL 3: ENCOURAGE AND PROMOTE INFORMED INVESTMENT DECISIONMAKING	FY 2004 PERFORMANCE
1. Disclosure filings reviewed by SEC:	
a. Corporations with disclosures	–
b. Investment companies with disclosures	+
2. Number of corporate disclosure filings significantly improved by staff comments and number of significant actions taken by disclosure review staff to protect investment company shareholders.	n/a
3. Percentage of investment company reviews completed within timeliness goals.	+
4. Average time to issue initial comments on Securities Act filings.	✓
5. Number of online searches for EDGAR filings.	+
6. Percentage of forms and submissions filed electronically and in structured formats.	n/a
7. Number and percentage of investor complaints, questions, and requests completed by the Office of Investor Education and Assistance within seven calendar days.	✓
8. Investor education publications distributed by the General Services Administration.	+

GOAL 4: MAXIMIZE THE USE OF SEC RESOURCES	FY 2004 PERFORMANCE
1. SEC turnover and vacancy rates:	
a. Turnover rate	✓
b. Vacancy rate	+
2. Milestones achieved on major IT projects.	✓
3. Milestones achieved on major human capital initiatives.	✓
4. Milestones achieved on major facilities projects.	✓
5. Receive an unqualified audit opinion on the SEC's audited financial statements with no material weaknesses noted on the Commission's internal controls:	
a. Audit opinion	✓
b. Material weaknesses	–
6. Percentage of IT projects that conform to the SEC's CPIC process.	✓

FINANCIAL HIGHLIGHTS

The SEC's financial statements summarize its financial activity and financial position. The SEC prepared audited financial statements for the first time in FY 2004 pursuant to the mandate of the Accountability of Tax Dollars Act of 2002. The statements were audited by the GAO and received an unqualified opinion. The audit also addressed the SEC's internal controls and compliance with federal laws and regulations that have a direct effect on the financial statements. The auditors' findings on those subjects are addressed in *Section 3: Financial Section.*

The financial statements and footnotes, and the balance of the required supplementary information, appear in *Section 3: Financial Section.* As these are the SEC's first audited financial statements, they reflect only FY 2004 results. In future years, the statements will be presented on a comparative basis.

Net Position

The major components of the SEC's financial activities consist of Fund Balance With Treasury (FBWT), Accounts Receivable, Property and Equipment, Liabilities, and Revenues and Costs. A brief discussion of each of these components is presented on pages 45 to 51.

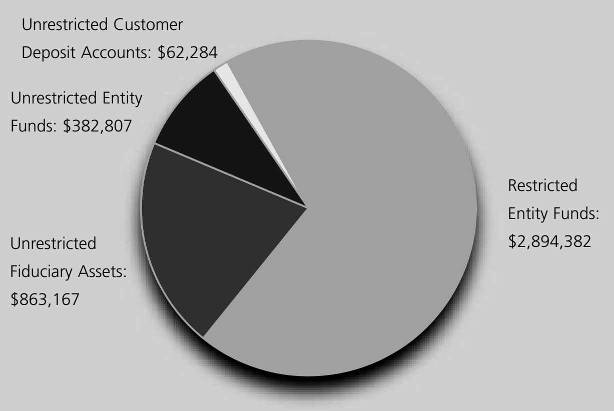
Figure 1.10 Composition of SEC's Assets, Liabilities, and Net Position as of September 30, 2004
(Dollars in Thousands)

	2004	PERCENT
Cash	$ 11	—
Fund Balance With Treasury	4,202,640	91.80
Accounts Receivable (Net)	326,502	7.13
Property and Equipment (Net)	49,103	1.07
Prepayments	11	—
Total Assets	$4,578,267	100.00
Fiduciary Liability	$ 863,167	67.03
Custodial Liability	279,054	21.67
Customer Deposit Accounts	62,284	4.84
Accrued Payroll, Leave, and Benefits	52,334	4.06
Accounts Payable	24,511	1.90
Other Liabilities	5,816	0.46
Commitments and Contingencies	500	0.04
Total Liabilities	$1,287,666	100.00
Cumulative Results of Operations	$3,290,288	99.99
Unexpended Appropriations	313	.01
Net Position	$3,290,601	100.00
Total Liabilities and Net Position	$4,578,267	100.00

Fund Balance With Treasury

As of September 30, 2004, the SEC's FBWT of $4,202.6 million represents 91.80 percent of assets totaling $4,578.3 million. As summarized in the chart below, FBWT includes (1) restricted entity funds that represent funds not available for use by the SEC and can only be made available by the U.S. Congress; (2) unrestricted fiduciary assets, which include the collection of civil monetary penalties, interest, and disgorged ill-gotten gains that may be paid out to harmed investors pursuant to authorized distribution plans; (3) unrestricted entity funds that are obligated and unobligated balances available to finance expenditures; and (4) unrestricted customer deposit accounts for customers who maintain a deposit account at the SEC to facilitate filing processes.

Figure 1.11 Fund Balance With Treasury as of September 30, 2004
(Dollars in Thousands)



Restricted funds are the bulk of the SEC's FBWT and are primarily an accumulation of fees and assessments paid to the Commission since 1991 pursuant to Section 6(b) of the Securities Act of 1933 and Sections 13(e), 14 (g), and 31 of the Securities Exchange Act of 1934 in excess of amounts that the SEC was authorized to use in its annual operations through the Congressional appropriations process. The SEC does not have authority to spend these funds unless it obtains permission through legislation from Congress.

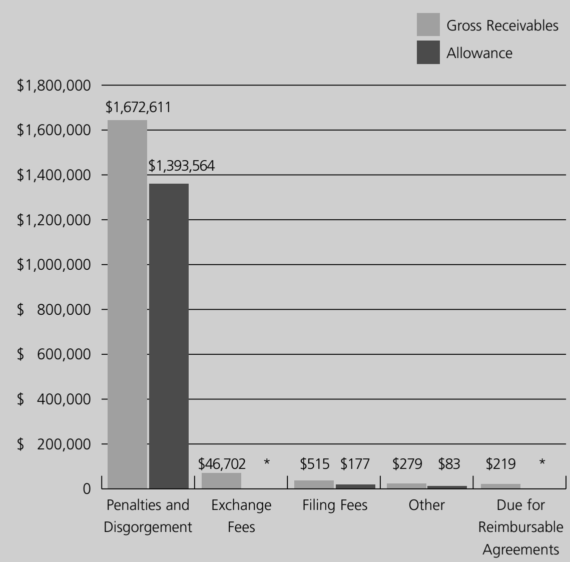
Given the restricted nature of these fees, SEC management has begun exploring ways for a permanent resolution that would allow the SEC to exclude these funds from its assets. SEC management is also undertaking a multi-year legislative effort to bring the amount of fees generated by the SEC in line with its annual operating budget and eliminate surplus fees.

Accounts Receivable

The SEC's net accounts receivable as of September 30, 2004, of $326.5 million consists of gross accounts receivable and an estimated allowance for uncollectible amounts of $1,720.3 million and $1,393.8 million, respectively (see *Figure 1.12).*

Civil monetary penalties levied against violators of federal securities laws constitute most of the SEC's accounts receivable activity. The SEC has a fiduciary responsibility to collect, manage, and distribute civil monetary penalties and disgorgement to non-federal individuals or entities pursuant to plans approved by the court or Commission. These fiduciary receipts constitute the SEC's collection, management, and disposition of cash or other assets in which non-federal individuals or entities have an ownership interest that the SEC must uphold. When collected, fiduciary receipts are included in

Figure 1.12 Accounts Receivable as of September 30, 2004
(Dollars in Thousands)



* No allowance for uncollectible amounts established.

FBWT, and an equal and offsetting liability for assets held by the SEC at or outside of the U.S. Department of the Treasury (Treasury) is reported in the name of the SEC as a non-entity liability in the Balance Sheet. The SEC has a custodial responsibility over non-entity accounts receivable, which are established when the SEC has been designated in administrative proceedings or court-ordered judgments to collect, manage, or distribute the assessed disgorgement, penalties, and interest. When collected, these funds are returned to the General Fund of the Treasury. The SEC is not authorized to use the funds.

The SEC's allowance for doubtful accounts is an estimate of how much of the gross accounts receivable are uncollectible. The overall allowance of 81.02 percent is based on an analysis of certain large individual accounts and historical collection activity.

Property and Equipment

The SEC's property and equipment consists of software and general purpose equipment, capital improvements made to buildings that the SEC leases for office space, and internal-use software development costs for projects in development. The cost of the SEC's property and equipment as of September 30, 2004, is summarized in *Figure 1.13.*

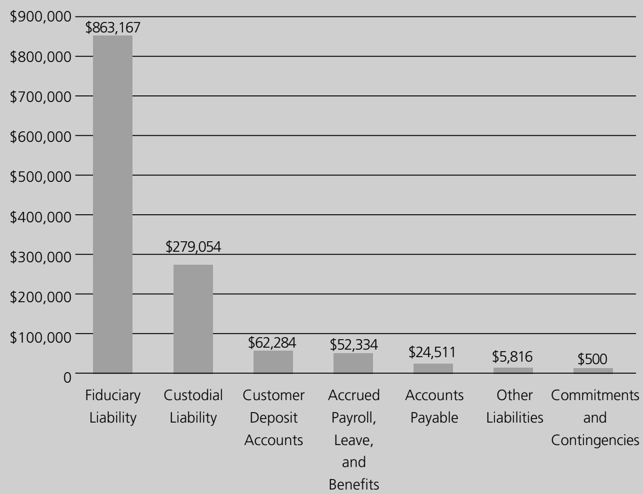
Figure 1.13 Cost of Property and Equipment as of September 30, 2004
(Dollars in Thousands)

	2004	PERCENT
Equipment	$23,939	29.24
Software	36,591	44.68
Software-in-Progress	3,758	4.59
Leasehold Improvements	17,600	21.49
Total Property and Equipment	$81,888	100.00

Liabilities

A summary of the SEC's liabilities as of September 30, 2004, is presented in *Figure 1.14.*

Figure 1.14 Liabilities as of September 30, 2004
(Dollars in Thousands)



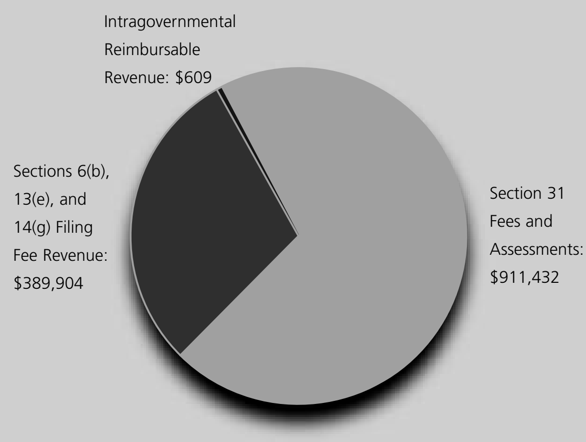
Most of the SEC's liabilities are the result of its fiduciary and custodial liabilities. Fiduciary activities consist of the receipt, management, accounting, and disposition by the SEC of cash or other assets in which non-federal individuals or entities may have an interest that the SEC or federal government must uphold. The SEC's fiduciary liabilities arise out of cases brought by the SEC against respondents. This monetary relief can take the form of civil monetary penalties or disgorged ill-gotten gains. In administrative proceedings, assessed civil monetary penalties may be added to disgorged illegal gains and become part of the disgorgement fund that the SEC maintains for distribution to the victims of the violations. The fund balances result from fiduciary activities undertaken pursuant to the SEC's statutory direction and authority.

The SEC's custodial liability as reported on the Statement of Custodial Activity (see *Section 3: Financial Section)* consists primarily of disgorgement, penalties, and interest paid by violators of federal securities laws into the General Fund of the Treasury. Non-federal individuals or entities do not have an ownership interest in these moneys, and the SEC is not authorized by law to use the funds.

Revenues and Costs

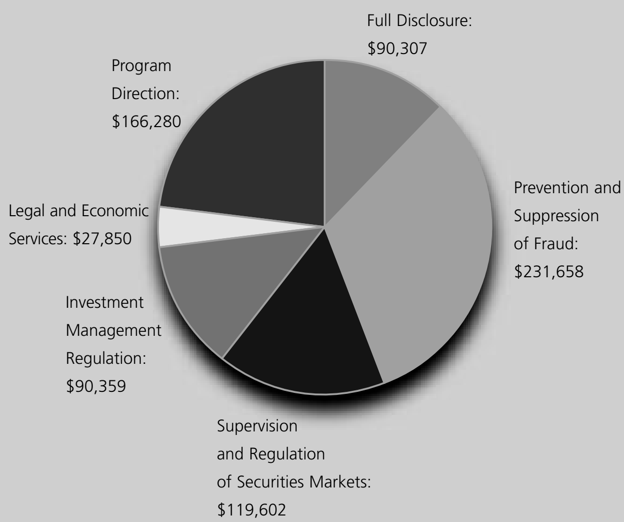
The SEC's $575.8 million net income from operations is a result of gross revenues and cost of operations in the amounts of $1,301.9 million and $726.1 million, respectively. The SEC's revenues represent fees and assessments paid pursuant to Section 6(b) of the Securities Act of 1933 and Sections 13(e), 14 (g), and 31 of the Securities Exchange Act of 1934, which are summarized in *Figure 1.15.*

Figure 1.15 Revenue Summary for the Year Ended September 30, 2004
(Dollars in Thousands)



These fees and assessments support the SEC's six major program areas, including Full Disclosure, Prevention and Suppression of Fraud, Supervision and Regulation of Securities Markets, Investment Management Regulation, Legal and Economic Services, and Program Direction. The gross cost of operations for these six program areas is presented in *Figure 1.16*. SEC management plans to explore reorganizing the structure of its programs in FY 2005.

Figure 1.16 Gross Cost of Operations for the Year Ended September 30, 2004
(Dollars in Thousands)



Limitations

The SEC has prepared its FY 2004 financial statements in accordance with the requirements of OMB Bulletin Number 01-09, Form and Content of Agency Financial Statements. OMB Bulletin Number 01-09 incorporates the concepts and standards contained in the Statements of Federal Financial Accounting Concepts and the Statements of Federal Financial Accounting Standards (SFFAS) issued by the Federal Accounting Standards Advisory Board (FASAB).

On October 19, 1999, the American Institute of Certified Public Accountants Council designated the FASAB as the accounting standards-setting body for federal government entities. Therefore, the SFFAS constitute the generally accepted accounting principles (GAAP) for the federal government. The FASAB established these concepts and standards to help federal agencies comply with the requirements of the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. These two acts demand financial accountability from federal agencies and require integrated accounting, financial management, and cost accounting systems.

The financial data in this report and the financial statements that follow have been prepared from the SEC's accounting records in conformity with GAAP. The SEC's financial statements consist of the Balance Sheet, the Statement of Net Cost, the Statement of Changes in Net Position, the Statement of Budgetary Resources, the Statement of Financing, and the Statement of Custodial Activity. The financial statements were prepared pursuant to the requirements of 31 United States Code 3515 (b). The following limitations apply to the preparation of the financial statements:

- While the statements are prepared from books and records in accordance with the formats prescribed by the OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.
- The statements should be read with the understanding that the SEC is a component of the U.S. Government, a sovereign entity. One implication is that unfunded liabilities cannot be liquidated without legislation that provides the resources to do so.

In addition, certain information contained in this report may be deemed forward-looking statements about events and financial trends that may affect future operating results and financial position. Such statements may be identified by words such as "estimate," "project," "plan," "intend," "believe," "expect," "anticipate," or variations or negatives thereof or by similar or comparable words or phrases. Prospective statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in the statements. Such risks and uncertainties include, but are not limited to, the following: changes in U.S. or global economic conditions; the availability, hiring, and retention of qualified staff employees; government regulations; disputes with labor organizations; and deployment of new technologies. The SEC undertakes no obligation to publicly update its financial statements to reflect events or circumstances after the date hereof, or to reflect the occurrence of unanticipated events.

Financial Statements

Balance Sheet

SECTION 3: FINANCIAL SECTION

U.S. SECURITIES AND EXCHANGE COMMISSION

Balance Sheet

As of September 30, 2004

(DOLLARS IN THOUSANDS)	
ASSETS	
Intragovernmental:	
Fund Balance With Treasury (Notes 1-J and 2)	$4,202,640
Accounts Receivable (Notes 1-K and 3)	219
Total Intragovernmental	$4,202,859
Cash (Note 1-M)	11
Accounts Receivable, Net (Notes 1-K, 3, and 5)	326,283
Advances and Prepayments (Note 1-L)	11
Property and Equipment, Net (Notes 1-N and 4)	49,103
Total Assets	$4,578,267
LIABILITIES	
Intragovernmental:	
Accounts Payable (Notes 1-P and 6)	$ 8,055
Unfunded FECA Liability (Notes 1-Q and 7)	1,120
Total Intragovernmental	$ 9,175
Accounts Payable (Notes 1-P and 6)	16,456
Accrued Payroll and Benefits (Notes 1-P and 6)	17,369
Accrued Leave (Note 1-R)	28,705
Customer Deposit Accounts (Notes 5 and 6)	62,284
Actuarial Liability (Notes 1-S and 7)	5,140
Fiduciary Liability (Notes 1-V, 5, and 15)	863,167
Custodial Liability (Notes 1-U and 14)	279,054
Commitments and Contingencies (Note 16)	500
Other Accrued Liabilities	5,816
Total Liabilities (Notes 1-P and 6)	$1,287,666
NET POSITION	
Unexpended Appropriations	$ 313
Cumulative Results of Operations	3,290,288
Total Net Position	$3,290,601
Total Liabilities and Net Position	$4,578,267

The accompanying notes are an integral part of these financial statements.

Statement of Net Cost

U.S. SECURITIES AND EXCHANGE COMMISSION

Statement of Net Cost

For the year ended September 30, 2004

(DOLLARS IN THOUSANDS)	
NET COST OF OPERATIONS (Notes 10 and 11)	
Full Disclosure	
Intragovernmental Gross Cost	$ 5,032
Gross Cost with the Public	85,275
Total Gross Cost	90,307
Prevention and Suppression of Fraud	
Intragovernmental Gross Cost	17,349
Gross Cost with the Public	214,309
Total Gross Cost	231,658
Supervision and Regulation of Securities Markets	
Intragovernmental Gross Cost	6,560
Gross Cost with the Public	113,042
Total Gross Cost	119,602
Investment Management Regulation	
Intragovernmental Gross Cost	4,926
Gross Cost with the Public	85,433
Total Gross Cost	90,359
Legal and Economic Services	
Intragovernmental Gross Cost	1,613
Gross Cost with the Public	26,237
Total Gross Cost	27,850
Program Direction	
Intragovernmental Gross Cost	56,772
Gross Cost with the Public	109,508
Total Gross Cost	166,280
Total Entity	
Total Gross Cost	726,056
Less Earned Revenue	(1,301,945)
Net (Income)/Cost from Operations	$ (575,889)

The accompanying notes are an integral part of these financial statements.

Statement of Changes in Net Position

U.S. SECURITIES AND EXCHANGE COMMISSION

Statement of Changes in Net Position

For the year ended September 30, 2004

(DOLLARS IN THOUSANDS)	CUMULATIVE RESULTS OF OPERATIONS	UNEXPENDED APPROPRIATIONS
Net Position, Beginning of Period	$2,684,949	$ 313
Budgetary Financing Sources:		
Appropriations Not Available	(994)	—
Other Financing Sources:		
Imputed Financing (Note 9)	30,444	—
Total Financing Sources	$ 29,450	$ —
Net Income/(Cost) from Operations	575,889	—
Net Position, End of Period	$3,290,288	$ 313

The accompanying notes are an integral part of these financial statements.

Statement of Budgetary Resources

U.S. SECURITIES AND EXCHANGE COMMISSION

Statement of Budgetary Resources

For the year ended September 30, 2004

(DOLLARS IN THOUSANDS)	
BUDGETARY RESOURCES	
Budget Authority:	
Net Transfers (Note 12)	$ —
Unobligated Balance:	
Beginning of Period	2,409,706
Net Transfers, Actual (Note 12)	—
Spending Authority from Offsetting Collections:	
Earned	
Collected	1,392,878
Customer Receivables and Refund Payables	39
Change in Unfilled Customer Orders	
Without Advance Received	182
Subtotal	$ 1,393,099
Actual Recoveries of Prior Year Obligations	75,327
Permanently Not Available	(994)
Total Budgetary Resources	$ 3,877,138
STATUS OF BUDGETARY RESOURCES	
Obligations Incurred (Note 13):	
Direct	$ 827,619
Unobligated Balance Available:	
Realized and Apportioned for Current Period	56,020
Exempt from Apportionment	600
Unobligated Balance Not Available	
Restricted and Expired Funds	2,992,899
Total Status of Budgetary Resources	$ 3,877,138
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS	
Obligated Balance, Net, Beginning of Period	$ 183,787
Accounts Receivable	(219)
Unfilled Customer Orders from Federal Sources	(182)
Undelivered Orders	179,886
Accounts Payable	48,795
Obligated Balance, Net, End of Period	$ 228,280
Outlays:	
Disbursements	$ 707,578
Collections	(1,392,878)
Net Outlays	$ (685,300)

The accompanying notes are an integral part of these financial statements.

Statement of Financing

U.S. SECURITIES AND EXCHANGE COMMISSION

Statement of Financing

For the year ended September 30, 2004

(DOLLARS IN THOUSANDS)	
RESOURCES PROVIDED TO FINANCE ACTIVITIES	
Budgetary Resources Obligated (Note 13):	
Obligations Incurred	$ 827,619
Less: Spending Authority from Offsetting Collections and Recoveries	(1,468,426)
Net obligations	$ (640,807)
Other Resources:	
Imputed Financing from Cost Absorbed by Others	30,444
Total Resources Provided to Finance Activities	$ (610,363)
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS	
Change in Budgetary Resources Obligated for Goods, Services, and Benefits Ordered but Not Yet Provided	$ (48,328)
Resources That Finance the Acquisition of Assets Capitalized on the Balance Sheet	(30,816)
Net Decrease in Revenue Receivables Not Generating Resources until Collected	90,876
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	$ 11,732
COMPONENTS OF NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD	
Components Requiring or Generating Resources in Future Periods:	
Costs That Will Be Funded by Resources in Future Periods	$ 5,729
Other	89
Total Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods	$ 5,818
Components Not Requiring or Generating Resources:	
Depreciation and Amortization	$ 14,050
Revaluation of Assets or Liabilities	2,624
Other Costs That Will Not Require Resources	250
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	$ 16,924
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	$ 22,742
Net (Income)/Cost from Operations	$ (575,889)

The accompanying notes are an integral part of these financial statements.

Statement of Custodial Activity

U.S. SECURITIES AND EXCHANGE COMMISSION

Statement of Custodial Activity

For the year ended September 30, 2004

(DOLLARS IN THOUSANDS)	
REVENUE ACTIVITY	
Sources of Cash Collections:	
Penalties and Disgorgement	$216,255
Other	98
Total Cash Collections	$216,353
Accrual Adjustments	213,164
Total Custodial Revenue (Notes 1-U and 14)	$429,517
DISPOSITION OF COLLECTIONS	
Amounts Transferred to the:	
Treasury General Fund	$216,353
Total Disbursements	$216,353
Change in Liability Accounts	213,164
Total Disposition of Collections	$429,517
NET CUSTODIAL ACTIVITY	$ —

The accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements

NOTES TO FINANCIAL STATEMENTS
As of and for the fiscal year ended September 30, 2004

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

The United States Securities and Exchange Commission (SEC) is an independent agency of the United States established pursuant to the Securities Exchange Act of 1934. The SEC's mission is to protect investors; maintain fair, honest, and efficient securities markets; and facilitate capital formation. With this mission in mind, the SEC works with the United States Congress, self-regulatory organizations (e.g., stock exchanges and the National Association of Securities Dealers), state securities regulators, and many other organizations in support of the agency's mission.

These financial statements report on the SEC's six major program areas: Full Disclosure; Prevention and Suppression of Fraud; Supervision and Regulation of Securities Markets; Investment Management Regulation; Legal and Economic Services; and Program Direction. These programs are intended to promote the public interest by protecting investors and preserving the integrity and efficiency of the securities markets; encouraging international regulatory and enforcement cooperation; educating and assisting investors; overseeing the operations of the nation's securities markets and participants; regulating investment companies; and ensuring compliance through inspection, examination, and full disclosure.

B. Fund Accounting Structure

These financial statements present the SEC's individual funds and accounts. The SEC is classified in the Other Independent Agencies section of the federal budget. The SEC's financial activities are accounted for by the Treasury account fund symbol, summarized as follows:

> ***Salaries and expenses*** (5040100) include the appropriated general funds used to carry out the SEC's missions and functions for the fiscal year.
>
> ***Special fund receipts*** (50X0100) include revenues collected by the SEC in excess of appropriated funds (see *Note 2. Fund Balance With Treasury).*

Deposit funds (50F3875 and 50F3880) account for customer moneys held temporarily until earned by the SEC, civil monetary penalties and disgorged ill-gotten gains collected and held on behalf of harmed investors, and to hold collections awaiting disposition or reclassification.

Miscellaneous receipt accounts (501099 and 503220) hold non-entity receipts and accounts receivable from SEC custodial activities that cannot be deposited into funds under SEC control.

The SEC does not have lending or borrowing authority, except as discussed in *Note 16. Commitments and Contingencies*. The SEC does have custodial and fiduciary responsibilities, as described in *Note 14. Custodial Revenues and Liabilities* and *Note 15. Fiduciary Liabilities,* and as described below.

Custodial revenues are the collection of non-exchange revenues for the General Fund of the Treasury, a trust fund, or other federal recipient entities. These revenues arise when the SEC exercises its powers to demand payments from the public and has a specifically identifiable, legally enforceable claim to cash or other assets, and collection is probable and the amounts are measurable.

Fiduciary liabilities arise from the receipt, management, accounting, and disposition by the SEC of cash or other assets which non-federal individuals or entities have an ownership interest that must be upheld.

C. Intra- and Inter-Agency Relationships

The SEC does not transact business among its own operating units, and therefore, intra-entity eliminations are not necessary. The SEC does have certain oversight responsibilities with respect to the Financial Accounting Standards Board (FASB); Securities Investor Protection Corporation (see *Note 16. Commitments and Contingencies);* and the Public Company Accounting Oversight Board. These entities have been excluded from the SEC reporting unit and the accompanying financial statements.

D. Basis of Presentation

The accompanying financial statements present the financial position, net cost of operations, changes in net position, budgetary resources, financing, and custodial and fiduciary activities of the SEC's core business activities in conformity with accounting principles generally accepted in the United States for the federal government and Office of Management and Budget (OMB) Bulletin 01-09, *Form and Content of Agency Financial Statements*. Therefore, they may differ from other financial reports submitted pursuant to OMB directives for the purpose of monitoring and controlling the use of SEC budgetary resources. The SEC's books and records serve as the source of the information presented in the accompanying financial statements. Assets, liabilities, revenues, and costs have been classified in these financial statements according to the type of entity associated with the transactions. Intragovernmental assets and liabilities are those from or to other federal entities. Intragovernmental earned revenues are collections or accruals of revenue from other federal entities, and intragovernmental costs are payments or accruals to other federal entities.

E. Basis of Accounting

Transactions are recorded on the accrual and budgetary bases of accounting. Accrual accounting allows for revenue to be recognized when earned and expenses to be recognized when goods or services are received without regard to the receipt or payment of cash. Budgetary accounting facilitates compliance with the requirements for and controls over the use of federal funds.

The accompanying financial statements are presented on the accrual basis of accounting. The accounting principles and standards applied in preparing these financial statements are in accordance with the accounting policies and practices summarized in this note and the following hierarchy of accounting principles:

- Federal Accounting Standards Advisory Board (FASAB) Statements and Interpretations plus American Institution of Certified Public Accountants (AICPA) and FASB pronouncements if made applicable to federal governmental entities by a FASAB Statement or Interpretation;
- FASAB Technical Bulletins and the following pronouncements if specifically made applicable to federal government entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position;
- AICPA Accounting Standards Executive Committee Practice Bulletins if specifically made applicable to federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB;
- Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the federal government; and
- Other accounting literature published by authoritative standard-setting bodies and other authoritative sources (a) in the absence of other guidance in the first four parts of this hierarchy, and (b) if the use of such accounting principles improves the meaningfulness of the financial statements.

F. Budgets and Budgetary Accounting

The Securities Exchange Act of 1933 and the Securities Exchange Act of 1934 established the securities registration, securities transaction, tender offer, merger, and other fees and charges collected by the SEC to offset its appropriated funds. Until passage of the National Securities Market Improvement Act in 1996, the United States Congress continued to increase fee rates to offset partially the cost of funding the agency. The National Securities Market Improvement Act in 1996 reduced fee rates and provided future annual reductions in fee rates. In 2002, the Investor and Capital Markets Fee Relief Act was signed into law. This legislation set fee rates for FY 2002 and requires the SEC to adjust the fee rates for FY 2003 through FY 2011, and make a final adjustment to fix the fee rates for FY 2012 and beyond.

The SEC is subject to certain restrictions on statutory fees and charges. Revenue collected in excess of appropriated amounts constitutes offsetting receipts deposited in a restricted special fund receipt account at the United States Department of the Treasury (Treasury). The special fund receipt account has no liabilities currently, and the entire fund balance remains restricted for use by the SEC. The SEC may use funds from this account only as authorized by the United States Congress, made available by OMB apportionment, and upon issuance of a Treasury warrant.

Fees other than the restricted excess fees are offsetting collections subject to an annual congressional limitation of $812.1 million for the budget FY 2004. Funds appropriated but not used in a given fiscal year are transferred to the special fund receipt account for use in future periods, as appropriated by the United States Congress.

Each fiscal year, the SEC receives an appropriation of Category A funds from the OMB, which apportions budgetary resources by fiscal quarter. The SEC also receives a small amount of Category B funds, or those funds exempt from quarterly apportionment.

G. Use of Estimates

The preparation of financial statements in conformity with United States generally accepted accounting principles for the federal government requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from estimates contained in the accompanying financial statements.

H. Revenue and Other Financing Sources

The SEC's revenue and financing sources include exchange revenues, which the agency has earned by providing goods and services to other federal entities or the public, and non-exchange revenues, which arise from the SEC's authority to collect fees or donations from the public.

The SEC's funding is through primarily the collection of securities registration, securities transaction, and tender offer, merger, and other fees and charges. The SEC's fee rates are established by law and are applied to volumes of activity reported by self-regulatory organizations or to filings submitted by registrants. When received, these fees are recorded as exchange revenue. The SEC is authorized by law to include these amounts in its obligational authority or to offset its expenditures and liabilities upon collection. All amounts remitted by customers in excess of the fees for specific services are recorded as liabilities in deposit accounts until earned by the SEC from customer filings or returned to the customer pursuant to SEC policy, which calls for the return of customer deposits when an account is dormant for six months.

The SEC is also involved in litigation that results in the assessment of civil monetary penalties, interest, and disgorged ill-gotten gains by violators of federal securities laws. This activity is recognized as non-exchange revenue and presented on the Statement of Custodial Activity when the SEC collects this revenue on behalf of the General Fund of the Treasury, a trust fund, or another federal government entity. This activity may also be classified as fiduciary activities when the SEC collects these assessments on behalf of non-federal individuals or entities that have an ownership interest. An equal and offsetting liability for the assets held by the SEC at or outside the Treasury is reported in the Balance Sheet. The SEC does not record fiduciary assessments collected and held by another federal entity or a non-federal government entity, such as a court registry or receiver.

In addition, the SEC's share of the cost to the federal government for providing pension and other post-retirement benefits to eligible SEC employees is recognized as an imputed financing source. The SEC may also receive some gifts-in-kind that are used for primarily official travel to further the SEC's mission and objectives.

I. Entity/Non-Entity

Assets that an entity is authorized to use in its operations are titled entity assets, while assets held by an entity and not available for the entity's use are termed non-entity assets. Although constrained by statute, most of the SEC's assets are entity assets available to carry out its mission, except portions of Fund Balance With Treasury that contains special fund receipts or customer deposit accounts, and custodial accounts receivable and fiduciary assets that represent the amount of uncollected and collected but undisbursed civil monetary penalties, interest, and disgorged ill-gotten gains.

J. Fund Balance With Treasury

Fund Balance With Treasury represents obligated and unobligated balances available to finance expenditures. It also includes balances restricted for use without further authorization by the United States Congress and apportioned by the OMB. All SEC banking activity is conducted in accordance with directives issued by the Treasury, Financial Management Service (FMS). All revenue and receipts are deposited in commercial bank accounts maintained by the FMS or wired directly to a Federal Reserve Bank. The Treasury processes all disbursements made by the SEC. All moneys maintained in commercial bank accounts are transferred to the Federal Reserve Bank on the next business day following the day of deposit.

Fund Balance With Treasury also includes funds that the SEC collected and holds at or outside the Treasury in the name of the SEC on behalf of non-federal individuals or entities that have an ownership interest. These funds represent the collection of civil monetary penalties, interest, and disgorged ill-gotten gains that will be paid out to harmed investors pursuant to authorized distribution plans (see *Note 15. Fiduciary Liabilities).*

K. Accounts Receivable and Allowance for Uncollectible Accounts

Entity and non-entity accounts receivable consist of amounts due primarily from the public.

Entity accounts receivable from the public represent a small portion of the SEC's business activities because agency fee legislation requires payment at the time of filing or registration in the conduct of its core business activities, and stock market exchange fees are payable to the SEC twice a year—in March for the period September through December and in September for the period January through August. Therefore, these accounts receivable comprise exchange and filing fees due and payable to the SEC primarily for activity during the month of September; goods or services provided pursuant to requests made under the Freedom of Information Act (FOIA); host reimbursement of SEC employee travel; and other employee-related debt.

Non-entity accounts receivable comprise disgorgement, civil monetary penalties, and interest levied against violators of federal securities laws. The SEC maintains a custodial responsibility over these non-entity accounts receivable that are recognized when the SEC has been designated in authorized judgments to collect the assessed civil monetary penalties and interest. When collected, these funds are returned to the General Fund of the Treasury, as non-federal individuals or entities do not have an ownership interest in these revenues, and the SEC is not authorized to use the funds, except as discussed below.

In certain cases, orders granting monetary relief to harmed investors in the form of civil monetary penalties and disgorged ill-gotten gains from federal securities law violators and respondents constitute a fiduciary responsibility for the SEC. These fiduciary receipts represent the collection or receipt, management, protection, accounting, investment, and disposition by the SEC of cash or other assets in which non-federal individuals or entities have an ownership interest that the SEC must uphold. When collected, fiduciary receipts are held in Fund Balance With Treasury, and an equal and offsetting liability for assets held by the SEC at or outside the Treasury in the name of the SEC is reported as a non-entity liability in the Balance Sheet.

As of September 30, 2004, the SEC recorded a $1,393,608 thousand allowance for uncollectible amounts to reduce the gross amount of its non-entity accounts receivable to its estimated net realizable value, as summarized in *Note 3. Accounts Receivable, Net.* A provision for estimated losses for uncollectible amounts of $466,283 thousand has been recorded as a reduction of non-exchange revenue in FY 2004. The allowance for uncollectible amounts and the related provision for estimated losses for Penalties and Disgorgement and FOIA accounts receivable are based on reserving 100 percent of debts over two years old, an analysis of the collectibility of individual account balances for the largest remaining debts, and on historical collection data to determine on a percentage basis the value of gross accounts receivable that are likely to be collected by the SEC. This percentage is applied to the remaining Penalties and Disgorgement and FOIA accounts receivable to reflect the balances at their estimated net realizable value. The allowance for uncollectible amounts and the related provision for estimated losses for Filing Fees and Other is based on historical collection data to determine on a percentage basis the value of gross accounts receivable that are likely to be collected by the SEC; and no allowance for uncollectible amounts and the related provision for estimated losses has been established for Due for Reimbursable Agreements and Exchange Fees, as these gross accounts receivable are deemed to represent their net realizable value. In addition, unless a court or administrative proceeding order specifies the amount of pre- and post-judgment interest, the SEC does not recognize such interest as accounts receivable.

L. Advances and Prepayments

The SEC may advance funds to its personnel for travel costs and these amounts are expensed when the travel takes place. The SEC may also prepay amounts in anticipation of receiving future benefits. These payments are expensed when the goods have been received or services have been performed.

M. Cash

The SEC's cash balance consists of petty cash funds maintained to reimburse personnel for minor expenses.

N. Property and Equipment, Net

The SEC's property and equipment consist of software and general purpose equipment used by the agency; capital improvements made to buildings leased by the SEC for office space; and internal-use software development costs for projects in development. Property and equipment purchases and additions are stated at cost. Property and equipment acquisitions that do not meet the capitalization criteria, normal repairs, and maintenance are charged to expense as received or incurred by the SEC.

Property and equipment are depreciated over their estimated useful lives using the straight-line method of depreciation. Contractor costs for developing custom internal-use software are capitalized when incurred for the design, coding, and testing of the software. Software-in-progress is not amortized until placed in service. The table below summarizes the major classes of depreciable property and the SEC's capitalization policies.

CLASS OF PROPERTY AND EQUIPMENT	CAPITALIZATION THRESHOLD FOR INDIVIDUAL PURCHASES	CAPITALIZATION THRESHOLD FOR BULK PURCHASES
Equipment	$15 thousand or greater	$500 thousand or greater
Furniture	$15 thousand or greater	$50 thousand or greater
Software	$300 thousand or greater	$300 thousand or greater
Software-in-Progress	$300 thousand or greater	Not applicable
Leasehold Improvements	$300 thousand or greater	Not applicable

Software-in-progress may be expensed when the project is abandoned because the SEC has determined that the project will no longer provide value to the agency.

O. Non-Entity Assets

Assets held by and not available to the SEC for obligation are considered non-entity assets. These assets consist primarily of accounts receivable established for SEC custodial activities for transfer to the General Fund of the Treasury, and fiduciary assets held by the SEC on behalf of non-federal individuals or entities that have an ownership interest, which the SEC must uphold on their behalf.

P. Liabilities

The SEC records liabilities for amounts that are likely to be paid as the result of events that have occurred as of September 30, 2004. The SEC considers liabilities covered by three types of resources: realized budgetary resources; unrealized budgetary resources that become available without further Congressional action; and cash and Fund Balance With Treasury. Realized budgetary resources include obligated balances that fund existing liabilities and unobligated balances as of September 30, 2004. Unrealized budgetary resources represent fee collections in excess of amounts appropriated for current fiscal year spending. These resources are used to cover liabilities when appropriation language makes these unrealized budgetary resources available in the fiscal year without further Congressional action.

Cash and Fund Balance With Treasury include amounts for liabilities that will never require the use of a budgetary resource. These liabilities consist of customer deposit accounts, refunds payable to customers for filing fee overpayments, and undeposited collections. Due to the SEC's funding structure, certain fees that were collected are withheld and deposited into a restricted special fund receipt account. These funds cannot be considered a budgetary resource until appropriated by the United States Congress and made available by OMB apportionment and issuance of a Treasury warrant.

Q. Injury and Post-employment Compensation

Claims brought by SEC employees for on-the-job injuries fall under the Federal Employees' Compensation Act (FECA) administered by the United States Department of Labor (DOL). The DOL bills each agency annually as its claims are paid, but payment on these bills is deferred for two years to allow for funding through the budget process. As of September 30, 2004, the SEC recorded a $482 thousand liability for claims paid on its behalf during the benefit period October 1, 2003, through September 30, 2004.

Similarly, SEC employees who lose their jobs through no fault of their own may receive unemployment compensation benefits under the unemployment insurance program also administered by the DOL. The DOL bills each agency quarterly for paid claims. For FY 2004, the SEC paid $30 thousand for claims paid by the DOL on behalf of former SEC employees.

R. Annual, Sick, and Other Leave

Annual leave and compensatory time are accrued as earned, and the accrual is reduced when leave is taken. Each fiscal quarter, an adjustment is made to ensure that the balances in the accrued leave accounts reflect current leave balances and pay rates. Accrued leave as of September 30, 2004, was $28.7 million. No portion of this liability has been obligated. Funding will be obtained from future financing sources to the extent current or prior year funding is not available to pay for leave earned but not taken. Sick leave and other types of non-vested leave are expensed as used.

S. Employee Retirement Systems and Benefits

SEC employees participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS), depending on when they were hired by the federal government. The FERS was established by enactment of Public Law 99-335. Pursuant to this law, the FERS and Social Security automatically cover most employees hired after December 31, 1983. Employees who are rehired after a break in service of more than one year and who had five years of federal civilian service prior to 1987 are placed in the CSRS offset retirement system or may elect to join the FERS.

The SEC's financial statements do not report CSRS or FERS assets or accumulated plan benefits that may be applicable to its employees. The reporting of such liabilities is the responsibility of the United States Office of Personnel Management (OPM). While the SEC reports no liability for future payments to employees under these programs, the federal government is liable for future payments to employees through the various agencies administering these programs. The SEC does not fund post-retirement benefits such as the Federal Employees Health Benefit Program and the Federal Employees Group Life Insurance Program. The SEC is also not required to fully fund the CSRS pension liabilities.

Instead, the financial statements of the SEC recognize an imputed financing source and corresponding expense that represent the SEC's share of the cost to the federal government of providing pension, post-retirement health, and life insurance benefits to all eligible SEC employees. For the fiscal year ended September 30, 2004, the SEC made contributions based on OPM cost factors equivalent to approximately 6.81 percent and 10.39 percent of the employee's basic pay for those employees covered by CSRS and FERS, respectively.

All employees are eligible to contribute to a thrift savings plan. For those employees participating in the FERS, a thrift savings plan is automatically established, and the SEC makes a mandatory 1 percent contribution to this plan. In addition, the SEC makes matching contributions ranging from 1 to 4 percent for FERS-eligible employees who contribute to their thrift savings plans. FERS participating employees are also covered under the Federal Insurance Contributions Act (FICA), for which the SEC contributes a matching amount to the Social Security Administration. No matching contributions are made to the thrift savings plans for employees participating in the CSRS.

For the fiscal year ended September 30, 2004, the SEC's retirement plan contributions for CSRS and FERS participants were $36.9 million. The SEC also contributed to the Social Security Administration for FICA benefits totaling $21.4 million for the fiscal year.

T. Environmental Cleanup

The SEC does not have any liabilities for environmental cleanup.

U. Custodial Activities

The Statement of Custodial Activity presents the sources and disposition of SEC custodial activity that consists primarily of the assessment of civil monetary penalties and interest against violators of federal securities laws. When collected, the funds are returned to the General Fund of the Treasury, as non-federal individuals or entities do not have an ownership interest in these revenues, and the SEC is not authorized by law to use the funds, except as discussed in *Note 1-K. Accounts Receivable and Allowance for Uncollectible Accounts*.

V. Fiduciary Activities

Fiduciary activities represent the receipt, management, accounting, and disposition by the SEC of cash or other assets in which non-federal individuals or entities have an ownership interest that the SEC or federal government must uphold. These fiduciary activities are classified as fiduciary assets held by the SEC at the Treasury in the name of the SEC to be disbursed at some later date pursuant to a court- or SEC-approved disbursement plan.

Typically, these claims arise from enforcement action taken against federal securities law violators to grant monetary relief. Pursuant to a court order or judgment or at the SEC's discretion, assessed civil monetary penalties may be added to disgorged illegal gains against securities law violators and become part of the disgorgement fund maintained by the SEC for distribution to the victims of the violations. The SEC does not record fiduciary assessments collected and held by another federal entity or a non-federal government entity, such as a court registry or receiver.

Note 2. Fund Balance With Treasury

At September 30, 2004, Fund Balance With Treasury consisted of the following:

(DOLLARS IN THOUSANDS)	UNRESTRICTED FUNDS	RESTRICTED FUNDS	TOTAL
Funds Obligated but Not Disbursed	$ 228,692	$ —	$ 228,692
Funds Not Obligated	154,115	2,894,382	3,048,497
Subtotal Entity Funds	$ 382,807	$2,894,382	$3,277,189
Customer Deposit Accounts	62,284	—	62,284
Fiduciary Assets	863,167	—	863,167
Subtotal Non-Entity Funds	$ 925,451	$ —	$ 925,451
Total Fund Balance With Treasury	$1,308,258	$2,894,382	$4,202,640

Unrestricted funds are available to the SEC for obligation and expenditure; while restricted funds must be made available by the United States Congress before the SEC can obligate and expend these funds. No discrepancies exist between the fund balance reflected in the general ledger and the balance in the Treasury accounts. Non-entity funds consist of amounts held on deposit for the convenience of SEC filers and fiduciary assets held at the Treasury in the name of the SEC.

Customer deposit accounts are for filers who maintain a deposit account at the SEC to facilitate filing processes. These funds are drawn down when filers submit filings, and filers can replenish their deposit account as desired.

Account balances with no activity for six months are returned to the customer. Funds maintained in customer deposit accounts are not available for SEC use until a filing has been submitted to the SEC, and then the funds are reclassified to entity funds.

Fiduciary assets are funds collected and held on behalf of non-federal individuals or entities that have an ownership interest, which the SEC must uphold and distribute at some later date pursuant to a court- or SEC-approved distribution plan.

Note 3. Accounts Receivable, Net

At September 30, 2004, accounts receivable consisted of the following:

(DOLLARS IN THOUSANDS)	GROSS RECEIVABLES	ALLOWANCE	NET RECEIVABLES
Due for Reimbursable Agreements	$ 219	$ —	$ 219
Subtotal Entity Intragovernmental Assets	$ 219	—	$ 219
Exchange Fees	46,702	—	46,702
Filing Fees	515	177	338
Other	228	39	189
Subtotal Entity Assets	$ 47,664	$ 216	$ 47,448
Penalties and Disgorgement	1,672,611	1,393,564	279,047
FOIA	51	44	7
Subtotal Non-Entity Assets	$1,672,662	$1,393,608	$279,054
Total Accounts Receivable	$1,720,326	$1,393,824	$326,502

Note 4. Property and Equipment, Net

At September 30, 2004, property and equipment consisted of the following:

(DOLLARS IN THOUSANDS)

PROPERTY AND EQUIPMENT	DEPRECIATION/ AMORTIZATION METHOD	SERVICE LIFE (YEARS)	ACQUISITION VALUE	ACCUMULATED DEPRECIATION/ AMORTIZATION	BOOK VALUE
Equipment	S/L	3	$23,939	$11,510	$12,429
Software	S/L	3–5	36,591	21,275	15,316
Software-in-Progress	N/A	N/A	3,758	—	3,758
Leasehold Improvements	S/L	10	17,600	—	17,600
Total			$81,888	$32,785	$49,103

Leasehold improvements include costs incurred for the SEC's new building that is currently under construction. The SEC expects to occupy the building in 2005, and therefore, no depreciation expense has been recognized as of September 30, 2004.

Note 5. Non-Entity Assets

At September 30, 2004, non-entity assets consisted of the following:

(DOLLARS IN THOUSANDS)	
Customer Deposits	$ 62,284
Fiduciary Assets	863,167
Accounts Receivable, Net of Allowance	279,054
Total Non-Entity Assets	$1,204,505

Note 6. Liabilities

At September 30, 2004, liabilities consisted of the following:

(DOLLARS IN THOUSANDS)	
Liabilities Covered by Resources Intragovernmental	
Accounts Payable	$ 8,055
Total Intragovernmental Liabilities	$ 8,055
Accounts Payable	$ 16,456
Accrued Payroll and Benefits	17,369
Total Liabilities Covered by Resources	$ 41,880
Liabilities Not Covered by Resources Intragovernmental	
Unfunded FECA Liability	$ 1,120
Total Intragovernmental Liabilities	$ 1,120
Accrued Leave	$ 28,705
Actuarial Liability	5,140
Customer Deposit Accounts	62,284
Custodial Liability	279,054
Fiduciary Liability	863,167
Commitments and Contingencies	500
Other	5,816
Total Liabilities Not Covered by Resources	$1,245,786
Total Liabilities	$1,287,666

Note 7. Actuarial Liability

The FECA provides income and medical cost protection to covered federal civilian employees injured on the job and for those who have contracted a work-related occupational disease, and dependents of employees whose death is attributable to a job-related injury or occupational disease. Claims incurred for benefits under the FECA for the SEC's employees are administered by the DOL and are paid by the SEC ultimately.

The SEC's estimate is based on the DOL's model for estimating the FECA actuarial liability for federal agencies not specified in the DOL's FECA model. The model considers the average amount of benefit payments incurred by the SEC for the past three fiscal years, multiplied by the medical and compensation liability to benefits paid (LBP) ratio for the whole FECA program, estimated at approximately 11 times the annual payments. To capture variability, the model estimates the liability using three sets of LBP ratios, summarized as follows:

LBP CATEGORY	MEDICAL	COMPENSATION
High	9.30%	13.40%
Overall Average	8.00%	11.90%
Lowest	6.90%	11.50%

For FY 2004, the SEC used the Overall Average LBP rate to calculate the $5.1 million FECA actuarial liability.

Note 8. Leases

The SEC has the authority to negotiate long-term leases for office space. As of September 30, 2004, the SEC leased office space at 17 locations under annually renewable operating lease agreements that expire between 2005 and 2019. The SEC paid $51,869 thousand for rent for the fiscal year ended September 30, 2004. Under existing commitments, the minimum lease payments through FY 2009 and thereafter are as follows:

FISCAL YEAR *(DOLLARS IN THOUSANDS)*	MINIMUM LEASE PAYMENTS
2005	$ 59,491
2006	62,139
2007	60,285
2008	56,795
2009	54,557
2010 and thereafter	349,033
Total Future Minimum Lease Payments	$642,300

Note 9. Imputed Financing

The SEC recognizes an imputed financing source and corresponding expense to represent its share of the cost to the federal government of providing pension and post-retirement health and life insurance benefits (Pension/Other Retirements Benefits (ORB)) to all eligible SEC employees. For the fiscal year ended September 30, 2004, the components of the imputed financing sources and corresponding expenses were as follows:

PENSION/ORB CATEGORY *(DOLLARS IN THOUSANDS)*	AMOUNT
CSRS	$ 6,727
FERS	9,822
FEHB	13,813
FEGLI	75
Other	7
Total Pension/ORB	$30,444

Note 10. Program Costs

Program costs are accumulated by responsibility segment and consist of costs related directly to the individual business lines and overall support costs allocated to the business lines. All costs incurred during the fiscal year ended September 30, 2004, were assigned to specific programs. Total program or operating costs for the fiscal year ended September 30, 2004, by cost category are summarized below.

COST CATEGORY *(DOLLARS IN THOUSANDS)*	DIRECT	ALLOCATED	TOTAL COST
Personnel Services and Benefits	$275,608	$206,793	$482,401
Compensation and Benefits	32,777	3,396	36,173
Unfunded Personnel Services and Benefits	—	89	89
Travel and Transportation	5,068	6,231	11,299
Rent, Communications, and Utilities	16,255	45,639	61,894
Printing and Reproduction	14,048	79	14,127
Contractual Services	59,151	5,566	64,717
Loss on Abandonment of Software-in-Development	2,266	—	2,266
Training	2,324	—	2,324
Maintenance and Repairs	781	437	1,218
Supplies and Materials	411	1,142	1,553
Equipment Not Capitalized	30,700	2,214	32,914
Insurance Claims and Indemnities	673	—	673
Depreciation and Amortization	13,401	649	14,050
Loss on Asset Disposition	313	45	358
Total Program Costs	$453,776	$272,280	$726,056

Note 11. Program Cost by Category and Responsibility Segment

For the fiscal year ended September 30, 2004, program costs by cost category and responsibility segment were as follows:

COST CATEGORY *(DOLLARS IN THOUSANDS)*	FULL DISCLOSURE	PREVENTION AND SUPPRESSION OF FRAUD	SUPERVISION AND REGULATION OF SECURITIES MARKETS	INVESTMENT MANAGE-MENT REGULATION	LEGAL AND ECONOMIC SERVICES	PROGRAM DIRECTION	TOTAL
Direct Costs							
Personnel Services and Benefits	$71,202	$ 69,957	$ 34,711	$34,805	$23,129	$ 41,804	$275,608
Compensation and Benefits	5,462	10,995	5,929	4,596	1,799	3,996	32,777
Travel and Transportation	374	2,317	982	376	236	783	5,068
Rent, Communications, and Utilities	—	18	2	1	—	16,234	16,255
Printing and Reproduction	234	—	31	55	—	13,728	14,048
Contractual Services	301	12,282	38	69	145	46,316	59,151
Loss on Abandonment of Software-in-Development	—	2,266	—	—	—	—	2,266
Training	411	918	518	369	108	—	2,324
Maintenance and Repairs	—	—	—	—	—	781	781
Supplies and Materials	—	18	—	—	—	393	411
Equipment Not Capitalized	—	124	—	—	—	30,576	30,700
Insurance Claims and Indemnities	—	—	—	—	—	673	673
Loss on Asset Disposition	—	—	—	—	1	312	313
Depreciation and Amortization	3,352	1,482	437	1,921	—	6,209	13,401
Subtotal Direct Costs	$81,336	$100,377	$ 42,648	$42,192	$25,418	$161,805	$453,776
Allocated Costs							
Personnel Services and Benefits	$ 537	$106,024	$ 62,373	$37,797	$ 17	$ 45	$206,793
Compensation and Benefits	7	1,741	1,026	621	—	1	3,396
Unfunded Personnel Services and Benefits	14	31	18	12	4	10	89
Travel and Transportation	5	3,243	1,858	1,125	—	—	6,231
Rent, Communications, and Utilities	8,369	14,879	8,751	6,836	2,404	4,400	45,639
Printing and Reproduction	—	47	20	12	—	—	79
Contractual Services	35	2,998	1,559	948	7	19	5,566
Maintenance and Repairs	1	230	128	78	—	—	437
Supplies and Materials	2	597	338	205	—	—	1,142
Equipment Not Capitalized	—	1,131	675	408	—	—	2,214
Loss on Asset Disposition	—	23	14	8	—	—	45
Depreciation and Amortization	1	337	194	117	—	—	649
Subtotal Allocated Costs	$ 8,971	$131,281	$ 76,954	$48,167	$ 2,432	$ 4,475	$272,280
Total Program Costs	$90,307	$231,658	$119,602	$90,359	$27,850	$166,280	$726,056

Note 12. Transfers without Reimbursement

For the fiscal year ended September 30, 2004, transfers of budgetary authority (from) to other SEC funds consisted of the following:

	INTRA-AGENCY TRANSFERS		
(DOLLARS IN THOUSANDS)	INDEFINITE AUTHORITY	GENERAL FUND	NET TRANSFERS
To Fund Current Year Operations	$(120,000)	$120,000	$ —
To Transfer Cancelling Authority	3,882	(3,882)	—
Net Transfers	$(116,118)	$116,118	$ —

Note 13. Status of Budgetary Resources

A. Apportionment Categories of Obligations Incurred

For the fiscal year ended September 30, 2004, obligations incurred as reported on the Statement of Budgetary Resources consisted of the following:

OBLIGATIONS INCURRED *(DOLLARS IN THOUSANDS)*	
Direct Obligations	
Category A	$827,619
Category B	—
Total Direct Obligations	$827,619
Reimbursable Obligations	
Category A	$ —
Category B	—
Total Reimbursable Obligations	$ —
Total Obligations Incurred	$827,619

B. Explanation of Differences between the Statement of Budgetary Resources and the Budget of the United States Government

The distinction between Category A and B funds is that Category A funds are subject to apportionment by the OMB, while Category B funds are available for use by the agency without being subject to quarterly apportionment. As of September 30, 2004, there were no material differences between the Statement of Budgetary Resources and the Budget of the United States Government.

Note 14. Custodial Revenues and Liabilities

For the fiscal year ended September 30, 2004, custodial revenues consisted of the following:

(DOLLARS IN THOUSANDS)	SOURCE OF CUSTODIAL REVENUE		
	PENALTIES AND DISGORGEMENT	OTHER	TOTAL
Cash Collections	$216,255	$ 98	$216,353
Less: Refunds	—	—	—
Net Cash Collections	$216,255	$ 98	$216,353
Increase/(Decrease) in Amounts to Be Collected	213,198	(34)	213,164
Total Non-exchange Revenues	$429,453	$ 64	$429,517

For the fiscal year ended September 30, 2004, custodial liabilities consisted of the following:

(DOLLARS IN THOUSANDS)	SOURCE OF CUSTODIAL LIABILITY		
	PENALTIES AND DISGORGEMENT	FOIA	TOTAL
Gross Custodial Accounts Receivable	$1,672,611	$51	$1,672,662
Less: Allowance for Doubtful Accounts	1,393,564	44	1,393,608
Total Custodial Liability	$ 279,047	$ 7	$ 279,054

Note 15. Fiduciary Liabilities

As a civil law enforcement agency, the SEC has broad regulatory and enforcement powers and judicial and administrative remedies available to enforce federal securities laws. The principal laws that grant the SEC its authority include the: Securities Act of 1933; Securities Exchange Act of 1934; Public Utility Holding Company Act of 1935; Trust Indenture Act of 1939; Investment Company Act of 1940; Investment Advisers Act of 1940; Securities Investor Protection Act of 1970; Insider Trading Sanctions Act of 1984; Government Securities Act of 1986; Insider Trading and Securities Fraud Enforcement Act of 1988; Securities Enforcement Remedies and Penny Stock Reform Act of 1990; Market Reform Act of 1990; Unlisted Trading Privileges Act of 1994; Private Securities Litigation Reform Act of 1995; Philanthropy Protection Act of 1995; National Securities Markets Improvement Act of 1996; International Anti-Bribery and Fair Competition Act of 1998; Securities Litigation Uniform Standards Act of 1998; Gramm-Leach-Bliley Act; Commodity Futures Modernization Act of 2000; Investor and Capital Markets Fee Relief Act of 2001; and Sarbanes-Oxley Act of 2002.

Among many things, these acts require security issuers to provide investors with certain information on new and outstanding securities offered for sale to the public; prohibit fraud, manipulation, and insider trading in the securities markets; set fines for criminal violations of federal securities laws; permit the SEC to seek civil monetary penalties for gains or loss avoidance of insider trading transactions; establish the length of prison terms for federal securities law violations; permit the SEC to enter temporary and permanent cease-and-desist orders; seek court orders imposing civil monetary penalties; and enter administrative orders requiring respondents to disgorge gains.

Orders issued by administrative law judges or federal courts granting monetary relief to harmed investors in the form of civil monetary penalties and disgorged ill-gotten gains from federal securities law violators and respondents constitute the SEC's fiduciary activities. These fiduciary activities represent the receipt, management, accounting, and disposition by the SEC of cash or other assets in which non-federal individuals or entities have an ownership interest that the SEC or federal government must uphold. Pursuant to a court order or judgment or at the SEC's discretion, assessed civil monetary fines and penalties may be added to disgorged illegal gains against securities law violators and become part of the disgorgement fund maintained by the SEC for distribution to the victims of the violations. The balances in the funds result from fiduciary activities undertaken pursuant to the SEC's statutory direction and authority. At September 30, 2004, the assets held by the SEC in a fiduciary capacity and its offsetting liability consisted of the following:

FIDUCIARY ACTIVITIES *(DOLLARS IN THOUSANDS)*	
Assets	
Fund Balance With Treasury	$863,167
Total Assets	$863,167
Liabilities	
Fiduciary Liability	$863,167
Total Liabilities	$863,167

During the fiscal year ended September 30, 2004, the source and disposition of the SEC's fiduciary activities consisted of the following:

FIDUCIARY ACTIVITIES *(DOLLARS IN THOUSANDS)*	
Fund Balance With Treasury	
Beginning Balance	$134,915
Penalties and Disgorgement	728,252
Total Fund Balance With Treasury	$863,167
Fiduciary Liability	
Beginning Balance	$134,915
Penalties and Disgorgement	728,252
Total Fiduciary Liability	$863,167

Note 16. Commitments and Contingencies

A. Commitments

The Securities Investor Protection Act of 1970, as amended (SIPA) created the Securities Investor Protection Corporation (SIPC) to provide certain financial protections to customers of insolvent registered securities brokers, dealers, firms, and members of national securities exchanges for up to $500,000 per customer. The SIPA authorizes the SIPC to create a fund to maintain all moneys received and disbursed by the SIPC. The SIPA also gives the SIPC the authority to borrow funds from the SEC in an amount not to exceed in the aggregate $1 billion in the event that the SIPC fund is or may appear insufficient for purposes of the SIPA. If necessary, these funds would be made available to the SEC through the purchase by the Treasury of notes or other obligating instruments issued by the SEC. Such notes or other obligating instruments would bear interest at a rate determined by the Secretary of the Treasury. As of September 30, 2004, the SEC had not loaned any funds to the SIPC, and there are no outstanding notes or other obligating instruments issued by the SEC.

In addition to the future lease commitments discussed in *Note 8. Leases,* the SEC is obligated for the purchase of goods and services that have been ordered, but not yet received. Net obligations for all of the SEC's activities were $228,280 thousand as of September 30, 2004, and of this amount $53,390 thousand were delivered and unpaid.

B. Contingencies

The SEC is party to various routine administrative proceedings, legal actions, and claims brought by or against it, including threatened or pending litigation involving labor relations claims, some of which may ultimately result in settlements or decisions against the federal government. As of September 30, 2004, SEC management expects that it is probable that approximately $500 thousand may be owed for a settlement involving an Equal Access to Justice Act application. The SEC is also party to a grievance over the agency's implementation of its new pay system. Subsequent to September 30, 2004, an arbitrator issued a preliminary decision unfavorable to the agency, which the SEC fully intends to appeal. The SEC cannot predict the outcome of the appeal, and an amount or range of possible loss cannot be accurately estimated at this time.

Required Supplemental Information

Required Supplemental Information

As of September 30, 2004

Intragovernmental Assets:

(DOLLARS IN THOUSANDS)

	2004		
TRADING PARTNER	FUND BALANCE WITH TREASURY	ACCOUNTS RECEIVABLE, NET	TOTAL
20 Department of the Treasury	$4,202,640	$ —	$4,202,640
72 Agency for International Development	—	219	219
Total	$4,202,640	$219	$4,202,859

Intragovernmental Liabilities:

(DOLLARS IN THOUSANDS)

	2004		
TRADING PARTNER	ACCOUNTS PAYABLE	ACCRUED PAYROLL AND BENEFITS	TOTAL
04 Government Printing Office	$ 24	$ —	$ 24
05 Government Accountability Office	849	—	849
12 Department of Agriculture	3	—	3
14 Department of Interior	1	—	1
15 Department of Justice	2,378	—	2,378
16 Department of Labor	—	1,120	1,120
18 U.S. Postal Service	70	—	70
20 Department of the Treasury	815	—	815
24 Office of Personnel Management	77	—	77
47 General Services Administration	1,209	—	1,209
69 Department of Transportation	2,346	—	2,346
75 Department of Health and Human Services	253	—	253
88 National Archives and Records Administration	28	—	28
95 Independent Agencies	2	—	2
Total	$8,055	$1,120	$9,175

Intragovernmental Earned Revenues:

(DOLLARS IN THOUSANDS)

TRADING PARTNER	2004
72 Agency for International Development	$609
Total	$609

Gross Costs That Generated Intragovernmental Earned Revenues:

(DOLLARS IN THOUSANDS)

BUDGET FUNCTIONAL CLASSIFICATION	2004
Prevention and Suppression of Fraud	$609
Total	$609

The SEC has not deferred to a future period maintenance on the property and equipment presented on the Balance Sheet as of September 30, 2004.

Comments from the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

May 18, 2005

The Honorable David M. Walker
Comptroller General of the United States
Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Walker:

Thank you for the opportunity to respond to the Government Accountability Office's (GAO) draft report entitled "Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Year 2004". The GAO has completed the audit of the Securities and Exchange Commission's first-ever financial statements. We are pleased that the audit found that the statements and notes are presented fairly, in all material respects, and in conformity with U.S. generally accepted accounting principles for Federal agencies. Additionally, the audit found no instances of reportable noncompliance with laws and regulations tested. The report also presents GAO's opinion on the effectiveness of SEC's internal controls over financial reporting (including safeguarding of assets).

The opinion on internal controls identified three material weaknesses that the SEC is moving aggressively to address and resolve. In the area of general controls over information technology security, the audit confirmed many of the findings reported in prior years through the SEC's Federal Managers' Financial Integrity Act (FMFIA) and audit programs. In our response to GAO's related report, "Information Security: Securities and Exchange Commission Needs to Address Weak Controls over Financial and Sensitive Data," we indicated that by June 2006 the SEC will implement corrective actions for the specific control weaknesses identified in the audit according to a quarter-by-quarter timeline.

The material weakness identified in the area of documenting and reporting on financial data related to disgorgements and penalties arising from enforcement actions also confirms findings reported over the past three years through the SEC's FMFIA program. As mentioned in the report, the SEC has made significant progress in this area and continuing efforts to strengthen these operations remain an important programmatic and financial management initiative. During FY 2005 the staff will complete a comprehensive review of files and data and review and strengthen policies and procedures. It is anticipated that consistent application of strengthened internal controls and potentially some limited redesign of the program's existing management information system will be adequate to resolve the material weakness in FY 2006. However,

The Honorable David M. Walker
Page 2

replacement of the current system and a more thorough reexamination of the relevant business processes will provide more effective assurance and in FY 2006 the SEC will complete a requirements analysis as the first phase of the multi-year project to replace the system.

The third material weakness, preparation of financial statements, reflects the fact that the fiscal 2004 financial statements were the SEC's first, and the procedures and management systems used to prepare and review the statements have not been fully documented and integrated into agency operations. To resolve the weakness, we will increase our financial reporting staff this fiscal year and formalize policies and procedures. Financial management staff will continue to solicit advice from staff experts within the SEC. Senior management reviewed the 2004 statements and management processes supporting them; certain initial policies applied in the first year of financial reporting have been confirmed and others have been modified or recommended for further review. The agency will establish a formal audit committee to provide for continued regular review and advice by key management officials.

We remain committed to enhancing the financial and operational effectiveness of the SEC and appreciate your support of those efforts. We look forward to continuing our productive dialogue with the GAO on the issues addressed in the FY 2004 audit.

If you have any questions relating to our response, please contact Margaret Carpenter, Chief Financial Officer, at (202) 551-7854.

Sincerely,

M J Carpenter

Margaret J. Carpenter
Chief Financial Officer

James M. McConnell
Executive Director

Peter Derby

Peter Derby
Managing Executive for Operations

cc: Jeanette M. Franzel,
Director, Financial Management and Assurance
GAO

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