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United States Government Accountability Office
Washington, DC 20548

July 27, 2005

The Honorable Cynthia A. Glassman
Acting Chairman
U.S. Securities and Exchange Commission

Subject: *Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report*

Dear Ms. Glassman:

In May 2005, we issued our report expressing an opinion on the Securities and Exchange Commission's (SEC) fiscal year 2004 financial statements and an opinion on SEC's internal control as of September 30, 2004.[1] We also reported on the results of our tests of SEC's compliance with selected provisions of laws and regulations during fiscal year 2004.

Our report on SEC's fiscal year 2004 financial statements identified reportable conditions in the internal controls over financial reporting that we considered to be material weaknesses.[2] These weaknesses related to SEC's controls over (1) recording and reporting disgorgements[3] and penalties[4] pertaining to those who violate securities laws, (2) preparing financial statements and related disclosures, and (3) information security. In March 2005, we reported on the information security weaknesses, making six recommendations to address those weaknesses.[5] The purpose of this report is to provide SEC with 18 recommendations to addresses the remaining weaknesses concerning disgorgements and penalties, and financial statement preparation and reporting.[6]

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[1] GAO, *Financial Audit: SEC's Fiscal Year 2004 Financial Statements*, GAO-05-244 (Washington, D.C.: May 26, 2005).
[2] A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors, fraud, or noncompliance in amounts that would be material to the financial statements may occur and not be detected promptly by employees in the normal course of their duties.
[3] A disgorgement is the repayment of illegally earned profits.
[4] A penalty is a monetary sum that is to be paid by the registrant to SEC as a result of a security law violation. The monetary sum is usually based on amounts prescribed by statute or the amount of disgorgement.
[5] GAO, *Information Security: Securities and Exchange Commission Needs to Address Weak Controls over Financial and Sensitive Data*, GAO-05-262 (Washington, D.C.: Mar. 23, 2005).
[6] A separate report to management on other issues identified during our audit that, although not material in relation to the financial statements, warrant management's consideration, will be issued shortly.

As part of our audit of SEC's fiscal year 2004 financial statements, we evaluated SEC's internal controls and its compliance with selected provisions of laws and regulations. We designed our audit procedures to test relevant controls, including those for the proper authorization, execution, accounting, and reporting of transactions. We conducted our audit in accordance with U.S. generally accepted government auditing standards. SEC's written comments on a draft of this report are included in enclosure I. Further details on our scope and methodology are included in our May 2005 report on the results of our audit of the 2004 financial statements and are reproduced in enclosure II.

Disgorgements and Civil Penalties

As part of its enforcement responsibilities, SEC issues and administers judgments that order, among other things, disgorgements and civil penalties against violators of federal securities laws. The resulting transactions involve material amounts of collections, which amounted to about $945 million in fiscal year 2004, and the recording and reporting of fiduciary and custodial balances on the financial statements.[7]

Presently, SEC records and tracks information on disgorgements and penalties through a case-tracking system. In August 2004, the Office of Financial Management assumed responsibility from the Division of Enforcement for entering and maintaining financial data on disgorgements and penalties in the case-tracking system, and making the necessary calculations and adjustments for preparing SEC's financial statements.[8] However, the case-tracking system is not designed for financial reporting purposes and is not integrated with the general ledger.

To compensate for limitations in the system, SEC staff performed extensive and time-consuming manual procedures to compile quarterly subsidiary ledgers to update the accounting system for disgorgement and penalty balances and activity. Notwithstanding the inherent inefficiencies of such manual processes, they also increase the risk of reporting inaccurate amounts and inhibit timely reporting. Despite this risk, SEC did not perform the requisite control procedures to reasonably assure the completeness and reliability of the disgorgement and penalty financial information in the case-tracking system. The risk of incomplete or inaccurate disgorgement and penalty data is further increased because of ineffective coordination and communication between various SEC divisions and offices that share responsibility for recording and maintaining disgorgement and penalty information. Our audit noted instances where, while disgorgement activity was entered into the case-tracking system by the Division of Enforcement and supporting

[7] Fiduciary activities represent the moneys collected from federal securities law violators and maintained by SEC to be distributed to harmed investors. Custodial activities represent the moneys collected by SEC from violators of federal securities laws that are returned to the General Fund of the Treasury, as nonfederal individuals or entities do not have an ownership interest in these revenues.
[8] Prior to August 2004, SEC's Division of Enforcement was responsible for entering disgorgement and penalty information, including financial information, into the case-tracking database.

documentation was in the files maintained by the case managers, the finance staff responsible for the accounting entries did not have the documentation necessary to make the entries into the general ledger, and therefore, had not made the related entries.

GAO's *Standards for Internal Control in the Federal Government*[9] requires that agencies establish controls to ensure that transactions be recorded in a complete, accurate, and timely manner. SEC has a draft policy, dated October 1, 2002, that covers certain aspects of accounting for disgorgements and penalties, but the policy is not comprehensive. For example, the draft policy does not define who is responsible for the various aspects of recording disgorgement and penalty data or the documentation that should be maintained to support the amounts recorded. Of even more importance, the draft policy does not identify the processes and controls that are critical for determining the amounts to be recorded and for reviewing the disgorgement and penalty financial information and related accounting entries for completeness and accuracy. Nor does the policy address the supervisory review procedures necessary to ensure consistent application of the procedures. We found instances where documentation in the case files contained hand-written annotations, without sufficient evidence, instructing certain activity with regard to a disgorgement or penalty amount. While SEC did not make entries into the case-tracking system on the basis of these handwritten instructions, their existence raises concern about the reliability and accuracy of the amounts recorded in the case-tracking system.

A lack of comprehensive policies and controls increases the risk that disgorgement and penalty transactions will not be completely, accurately, and consistently recorded and reported. For example, in our audit of 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 where SEC had made entries to the accounting system that conflicted with information in the files, and we noted inconsistent treatment in recording judgment and interest amounts, terminated debts, and collection fees imposed by the Department of the Treasury. We believe that these errors and inconsistencies occurred because of the weaknesses discussed above. While, in most cases, these errors and inconsistencies were offsetting, such errors raise concern about the controls over the reliability of the gross accounts receivable and related allowance amounts reported in footnote 3 to SEC's financial statements.

Recommendations for Executive Action

We recommend that the Chairman, SEC, take the following five actions to improve internal controls over disgorgements and penalties:

1. Implement a system that is integrated with the accounting system or that provides the necessary input to the accounting system to facilitate timely,

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[9] GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

accurate, and efficient recording and reporting of disgorgement and penalty activity.

2. Review the disgorgement and penalty judgments and subsequent activities documented in each case file by defendant to determine whether the individual amounts recorded in the case-tracking system are accurate and reliable.

3. Implement controls so that the ongoing activities involving disgorgements and penalties are properly, accurately, and timely recorded in the accounting system.

4. Strengthen coordination, communication, and data flow among staff of SEC's Division of Enforcement and Office of Financial Management who share responsibility for recording and maintaining disgorgement and penalty data.

5. Develop and implement written policies covering the procedures, documentation, systems, and responsible personnel involved in recording and reporting disgorgement and penalty financial information. The written procedures should also address quality control and managerial review responsibilities and documentation of such a review.

Financial Statement Preparation and Reporting

GAO's *Standards for Internal Control in the Federal Government* requires that controls over the financial statement preparation process 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. Established tools, including checklists and implementation guides, are available to assist in developing controls over financial statement compilation and review.

We found that SEC had neither the formalized processes or documentation showing the procedures, systems, analysis of accounts, and personnel involved in developing key balances and preparing the financial statements and related disclosures, nor the related quality control and review procedures. As a result, SEC's opening balances for its fiscal year 2004 financial statements contained material misstatements, some of which also materially affected the unadjusted fiscal year 2004 reported operating results. Although SEC ultimately posted the necessary audit adjustments and produced financial statements for fiscal year 2004 that were fairly presented in all material respects, the lack of processes and documented procedures significantly delayed the reporting of SEC's fiscal year 2004 financial results, consumed significant SEC staff resources, caused audit inefficiencies, and resulted in higher financial statement preparation and audit costs. For example, SEC did not have documentation providing an explanation or a cross-walk between the financial statements and the source systems, general ledger accounts, account queries, and account analyses. SEC did not maintain a subsidiary ledger for certain activity, such as customer deposit amounts pertaining to filing fees. Accounting staff also had difficulty in retrieving support for certain account balances, such as undelivered orders amounts, and for certain property and equipment leases. In addition, reconciliations of subsidiary and summary account balances were not prepared for certain financial statement line items, such as for the customer deposit liability relating to filing fees and the associated earned filing fee revenue, the accounts receivable related to exchange fees and the related amount of earned exchange fee revenue, and the budgetary accounts related to undelivered and delivered orders, thus requiring SEC staff to create an audit trail after the fact in order to reconcile support to general ledger balances. There also was no consistent evidence of supervisory review of journal entries, including closing and adjusting journal entries made in connection with preparing quarterly and year-end financial statements. Another factor contributing to identified accounting issues was that comprehensive accounting policies and procedures for several major areas, including disgorgements and penalties, filing fees, exchange fees, and fixed asset capitalization, were still in draft or had not yet been developed.

If properly designed and implemented, a financial statement preparation process with documented policies and procedures, support, and quality assurance reviews should reasonably assure SEC management that the balances presented in the financial statements and related disclosures are supported by SEC's underlying accounting records. The process should include certain components and provide a discipline that should greatly help SEC in preparing financial statements without having to go through heroic efforts as was done in fiscal year 2004.

A fundamental problem leading to SEC's staff-intensive and time-consuming efforts to prepare financial statements is that SEC's general ledger and core financial management system are not set up to generate most data analysis user reports on a real-time basis. Users have to request reports that are generated on an ad hoc basis by a software application whose operations are known only to some SEC staff. Also, other management systems used at SEC, such as the case-tracking system used for disgorgements and penalties and the system used to track property, along with various spreadsheet applications, are not integrated with the core financial management system. Again, this means that such information is not readily available, and as we determined during the audit, necessitated significant manual processes to determine account balances.

OMB Circular No. A-127, *Financial Management Systems*, requires that each agency establish and maintain a single integrated financial management system. A single integrated financial management system is a unified set of financial systems linked together electronically in an efficient and effective manner to provide agencywide financial system support. Integration means that the user is able to have one view into systems such that, at whatever level the individual is using the system, he or she can obtain needed information efficiently and effectively through electronic means.

A single integrated financial management system does not necessarily mean having only one software application within each agency covering all financial management system needs or storing all information in the same database. Interfaces between systems are acceptable as long as the supporting detail to enable reconciliation between the systems is maintained and accessible to managers. Interface linkages should be electronic unless the number of transactions is so small that it is not cost beneficial to automate the interface. Reconciliations between systems, where interface linkages are appropriate, should be maintained to ensure data accuracy.

To support its financial management functions, SEC relies on several different systems to process and track financial transactions that include filing fees paid by corporations and disgorgements and penalties assessed and collected from enforcement activities. In SEC's case, without an integrated financial management system to help ensure timely and reliable financial data, decision makers run the risk of delays in attaining relevant data or using inaccurate information inadvertently while at the same time dedicating scarce resources toward the basic collection of information.

Recommendations for Executive Action

We recommend that the Chairman, SEC, take the following 13 actions to improve controls over financial statement preparation and reporting. The first 11 recommendations concern the minimum elements that should be included in policies and procedures covering the financial reporting process. The other 2 recommendations concern the leveraging of in-house resources for accounting advice and upgrading SEC's capacity to improve its financial reporting system.

1. Develop written policies and procedures that provide sufficient guidance for the year-end closing of the general ledger as well as the preparation and analysis of quarterly and annual financial statements.

2. Establish clearly defined roles and responsibilities for the staff involved in financial reporting and the preparation of interim and year-end financial statements.

3. Prepare a cross-walk between the financial statements and the source systems, general ledger accounts, and the various account queries and analyses that make up key balances in the financial statements.

4. Maintain subsidiary records or ledgers for all significant accounts and disclosures so that the amounts presented in the financial statements and footnotes can be supported by the collective transactions making up the balances.

5. Perform monthly reconciliations of subsidiary records and summary account balances.

6. Consider a "formal closing" of all accounts at an interim date(s), which will reduce the level of accounting activity and analysis required at year-end. The formal closing entails ensuring that all transactions are recorded in the proper period through month's end.

7. Collect common closing and adjusting entries in a formal listing, which is used in the general ledger closing process and in preparing financial statements.

8. Require supervisory review for all entries posted to the general ledger and financial statements, including closing entries. A supervisor should review revisions to previously approved entries and revised financial statements and footnotes. All entries and reviews should be documented.

9. Establish milestones for preparing and reviewing the financial statements by setting dates for critical phases such as closing the general ledger; preparing financial statements, footnotes, and the performance and accountability report; and performing specific quality control review procedures.

10. Utilize established tools (i.e., checklists and implementation guides) available for assistance in compiling and reviewing financial statements.

11. Maintain documentation supporting all information included in the financial statements and footnotes. This documentation should be more self-explanatory than what has been retained in the past. The documentation should be at a level of detail to enable a third party, such as an auditor, to use the documentation for substantiating reported data without extensive explanation or re-creation by the original preparer.

12. Take advantage of in-house resources and expertise in establishing financial reporting policies, internal controls, and business practices, as well as in the review of financial statement and footnote presentation.

13. Develop or acquire an integrated financial management system to provide timely and accurate recording of financial data for financial reporting and management decision making.

Agency Comments

In commenting on a draft of this report, SEC acknowledged the material weaknesses in internal control. SEC stated that our recommendations for resolving the material weakness related to disgorgements and penalties were consistent with the actions that it has planned, including completing a comprehensive review of files and data and strengthening and documenting policies and procedures for disgorgements and penalties. SEC anticipates that this weakness will be resolved in fiscal year 2006. Ultimately, SEC said it plans to undertake a multiyear project to replace the current case-tracking system with a system that is integrated with the accounting system in order to improve the timeliness and better ensure the accuracy of SEC's financial reporting for disgorgements and penalties.

With regard to the material weakness related to controls over the preparation of financial statements, SEC stated that it intends to continue active and serious efforts to complete documentation of the procedures and management systems that were used to prepare its financial statements. To address this issue, SEC has increased its financial reporting staff; SEC financial management staff will continue to solicit advice from in-house experts; and management has confirmed, modified, or recommended for further review certain policies applied in preparing the fiscal year 2004 financial statements. SEC also plans to establish a formal senior management committee to provide for continued regular review and advice by key officials.

The complete text of SEC's comments is included in enclosure I.

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This report contains recommendations to you. The head of a federal agency is required by 31 U.S.C. § 720 to submit a written statement to the Senate Committee on Homeland Security and Governmental Affairs and the House Committee on Government Reform of the actions taken on our recommendations no later than 60 days after the date of this report. A written statement also must be sent to the House and Senate Committees on Appropriations with agency's first request for appropriations made more than 60 days after the date of this report.

This report is intended for use by management of SEC. We are sending copies of this report to the Chairmen and Ranking 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 GAO's Web site at http://www.gao.gov.

We acknowledge and appreciate the cooperation and assistance provided by SEC management and staff during our audit of SEC's fiscal year 2004 financial statements. If you have any questions about this report or need assistance in addressing these issues, please contact me at (202) 512-9471 or at franzelj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.

Sincerely yours,

Jeanette M. Franzel

Jeanette M. Franzel
Director
Financial Management and Assurance

Enclosures - 2

Comments from the Securities and Exchange Commission

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

July 18, 2005

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

Dear Ms. Franzel:

Thank you for the opportunity to review and comment on the Government Accountability Office's (GAO) draft report entitled "Material Internal Control Issues Reported in the SEC's Fiscal Year 2004 Financial Statement Audit Report." The report provides additional information and recommendations on two of the three material weakness identified in GAO's opinion on the fiscal 2004 financial audit, as well as in the Management's Discussion and Analysis section of the SEC's 2004 Performance and Accountability Report. The two weaknesses are controls over recording and reporting on enforcement-related disgorgement and penalties and controls over financial statement preparation and reporting. GAO's recommendations on the third material weakness, information technology security, were included in a prior audit report. We appreciate the GAO's work in these two areas and we are pleased to offer the following general comments. In addition, our staffs have met to discuss the recommendations, at which time SEC staff provided additional verbal comments.

The material weakness related to disgorgements and penalties arising from enforcement actions confirms findings reported over the past three years through the SEC's Federal Manager's Financial Integrity Act (FMFIA) program. The recommendations for resolving the issue are consistent with the planned actions that we reported to you in our response to the opinion on the financial audit. During FY 2005, SEC staff will complete a comprehensive review of files and data and will strengthen and document policies and procedures. It is anticipated that consistent application of strengthened internal controls and potentially some limited redesign of the program's existing financial information system component will be adequate to resolve the material weakness in FY 2006. However, replacement of the current system 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 replacement system will be integrated with the accounting system to improve the timeliness and better ensure the accuracy of our financial reporting in this area.

Ms. Jeanette Franzel
Director
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The report provides some detailed recommendations to resolve the material weakness related to controls over the preparation of financial statements. The SEC staff and the GAO audit team have met to discuss in detail the recommendations proposed as the minimum elements that should be included in policies and procedures. The SEC intends to continue active and serious efforts to complete documentation of the procedures and management systems that were used to prepare its first financial statements in fiscal 2004. As part of that process, the GAO recommendations will be implemented as described to the audit team. As indicated in the SEC's response to the audit opinion that GAO provided to the SEC in May, as part of the plan to resolve the material weakness, we have increased our financial reporting staff this fiscal year. 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 senior management committee to provide for continued regular review and advice by key officials.

Progress has been made in both of these areas and we believe that many of the audit adjustments and findings on which these two material weaknesses are premised will not recur as sound controls were implemented late in FY 2004 or in FY 2005. We remain committed to enhancing the financial and operational effectiveness of the SEC and resolving all three material weaknesses. We appreciate your support of these efforts and 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, Associate Executive Director, Finance, at (202) 551-7854.

Sincerely,

M J Carpenter

Margaret J. Carpenter
Associate Executive Director, Finance

James M. McConnell
Executive Director

Details on Audit Scope and Methodology

To fulfill our responsibilities as auditor of the financial statements of the Securities and Exchange Commission (SEC), we did the following:

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

We performed our review from February 2004 through February 2005 in accordance with generally accepted government auditing standards. For a further explanation of our audit scope and methodology, see our financial audit report (GAO-05-244).

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