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United States Government Accountability Office
Washington, DC 20548

April 3, 2007

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

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

Dear Mr. Cox:

On November 15, 2006, we issued our report¹ on the U.S. Securities and Exchange Commission's (SEC) fiscal years 2006 and 2005 financial statements and on SEC's internal control as of September 30, 2006. We also reported on the results of our tests of SEC's compliance with selected provisions of laws and regulations during fiscal year 2006.

The purpose of this report is to discuss issues identified during our fiscal year 2006 audit concerning internal controls and accounting/operational procedures that could be improved.² This report contains six recommendations to SEC to improve these internal controls and procedures. These recommendations are in addition to those we already provided to SEC as a result of our prior audits of SEC's financial statements.³

Results in Brief

Our November 15, 2006, report concluded that based on SEC's efforts to address concerns with controls over disgorgements and penalties and over information systems, and based on improvements that we found in these areas during the fiscal year 2006 audit, we no longer considered these two previously reported weaknesses to be material weaknesses.⁴ However,

¹ GAO, *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2006 and 2005*, GAO-07-134 (Washington, D.C.: Nov. 15, 2006).

² The internal control issues concerning information security are discussed in a separate report: GAO, *Information Security: Sustained Progress Needed to Strengthen Controls at the Securities and Exchange Commission*, GAO-07-256 (Washington, D.C.: Mar. 27, 2007).

³ Recommendations were addressed in our internal control reports issued as part of our fiscal year 2004 and 2005 SEC financial statement audits: GAO, *Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report*, GAO-05-691R (Washington, D.C.: July 27, 2005); *Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures*, GAO-05-693R (Washington, D.C.: Aug. 12, 2005); and *Internal Control: Improvements Needed in SEC's Accounting and Financial Reporting Procedures*, GAO-06-459R (Washington, D.C.: Apr. 21, 2006).

⁴ A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors, fraud, or noncompliance in amounts

because many of these efforts represent compensating controls rather than permanent systemic solutions, we still considered these areas to be reportable conditions.⁵ We also concluded that SEC had taken sufficient action in the area of controls over the financial reporting process such that we no longer consider this issue to be a material weakness or reportable condition. In addition, we identified a new reportable condition concerning SEC's controls over recording property and equipment.

Tables 1 and 2 of enclosure I indicate the status of recommendations from our prior audits of SEC's financial statements.⁶ As of January 2007, SEC had taken actions to fully implement 18 of 35 open recommendations from our audits of the agency's 2004 and 2005 financial statements.

We also identified other internal control issues that although not considered to be material weaknesses or reportable conditions, we believe warrant management's consideration. These issues concern (1) payroll system access, approval of time and attendance records, and process documentation and (2) comparison of furniture and equipment received and ordered.

Our six recommendations follow the sections in which the corresponding issues are discussed. In commenting on a draft of this report, the Chairman cited actions taken and in progress with respect to our recommendations, and indicated that SEC made progress in fiscal year 2006 in addressing its internal control weaknesses and has redoubled its efforts in fiscal year 2007. The Chairman identified specific actions and initiatives undertaken since the completion of our fiscal year 2006 audit.

Scope and Methodology

As part of our audit of SEC's fiscal years 2006 and 2005 financial statements, we evaluated SEC's internal controls and tested its compliance with selected provisions of laws and regulations. We designed our audit procedures to test relevant controls over financial reporting, including those designed to provide reasonable assurance that transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in conformity with U.S. generally accepted accounting principles, and that assets are safeguarded against loss from unauthorized acquisition, use, or disposition. This report is based on the work performed during our audit of SEC's fiscal years 2006 and 2005 financial statements. We requested comments on a draft of this report from the Chairman of SEC. SEC's written comments are reprinted in enclosure II. We conducted our audit in accordance with U.S. generally accepted government auditing standards. Further details on our scope and methodology are included in our report on the results of our audits of SEC's fiscal years 2006 and 2005 financial statements⁷ and are reproduced in enclosure III.

that would be material to the financial statements may occur and not be detected promptly by employees in the normal course of their duties.

⁵ Reportable conditions are defined as significant deficiencies in the design or operation of internal control that could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

⁶ GAO-05-691R, GAO-05-693R, and GAO-06-459R.

⁷ GAO-07-134.

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 the recording and reporting of fiduciary and custodial liability balances on the financial statements.⁸

Our audit testing for fiscal year 2006 noted significant management oversight and efforts to address weaknesses in the internal controls over recording and reporting disgorgement and penalty information. During the year, SEC finalized policies and procedures for reporting disgorgement and penalty activity, improved reconciliations of disgorgement and penalty transactions, established an internal audit function within the Division of Enforcement, and had better and more timely coordination between the two key SEC units responsible for reporting and recording disgorgements and penalties. Of particular note was a comprehensive initiative SEC undertook during the year (referred to as the Delinquent Debt Project) to review and verify all the outstanding disgorgement and penalty debts. Through this project, SEC identified and corrected numerous errors in the database used to record and report disgorgements and penalties. These errors involved amounts due, judgment and due dates, the payees, and status of the cases. This project also identified steps needed with respect to collecting or terminating the debts. Because of the limitations of the current case-tracking system for disgorgements and penalties, SEC's efforts to determine the reliability of the data were far more than what would ordinarily be necessary under a more effective system. These efforts will most likely continue until SEC improves its financial system for recording and reporting disgorgement and penalty information.

Even with SEC's increased efforts to address concerns over reporting of disgorgements and penalties, our audit work for fiscal year 2006 continued to identify risks concerning the completeness of the disgorgement and penalty receivable amounts. For example, we identified a \$21 million disgorgement case that was erroneously omitted from SEC's disgorgement receivable balance at June 30, 2006. This is largely because SEC's process for determining its disgorgement and penalty receivable balances relies heavily on information being submitted to SEC's Office of Financial Management (OFM) from individual attorneys working on each case. To compensate for the risk presented by this process, in fiscal year 2006, SEC instituted a compensating control in which the Enforcement office heads were asked to certify the completeness and accuracy of the recorded disgorgement receivable balances at June 30, 2006, and at fiscal year-end. Through this certification process, a number of disgorgement cases were identified as not having current information related to dollar amounts, due dates, and payees in the case-tracking system used to establish the amounts receivable at a given date. While none of these instances resulted in a material misstatement to the receivable balance reported on the financial statements, relying on a

⁸ 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 Treasury, as nonfederal individuals or entities do not have an ownership interest in such amounts.

decentralized detective control such as this certification process requires significant analysis, data gathering, and follow-up, and increases the risk that disgorgement and penalty debts and related activity may not get recorded in a timely manner or in the proper period.

We are encouraged by SEC's commitment and management attention to strengthening controls over disgorgement and penalty activity to date, as well as SEC's planned future actions in this area. As discussed in its Management's Discussion and Analysis, SEC has designed procedures, controls, and documentation to track disgorgement and penalty actions from the time they are approved by the commission to their recording in the case-tracking system; these controls involve the participation of the Office of the Secretary and OFM, in addition to the Division of Enforcement.

Also, this past year SEC has begun training attorneys handling the cases on the steps necessary to maintain strong internal controls over updating and communicating information that could affect financial reporting. In its Management's Discussion and Analysis, SEC stated that the Division of Enforcement will continue its efforts to educate all enforcement attorneys about the additional steps necessary to maintain strong internal controls at SEC and to ensure transparency and uniformity in the agency's approach to monetary sanctions.

In addition, in fiscal year 2006, SEC designed a new financial management system for tracking disgorgements and penalties—known as Phoenix—that will replace the financial portion of the existing case-tracking system. SEC expects the new controls discussed above and the new disgorgement financial system to be fully operational in fiscal year 2007.

Until a permanent and systemic process is fully and effectively implemented and operational, SEC will not have sufficient assurance over the accuracy and completeness of its reporting and tracking of disgorgements and penalties. Therefore, we consider this area to still be a reportable condition.

SEC should continue to build on the significant progress already made in this area to fully resolve remaining open recommendations. These recommendations and the status of their resolution are included in tables 1 and 2 of enclosure I. We are not making any new recommendations in this area as a result of our 2006 audit of SEC's financial statements.

Property and Equipment

SEC's property and equipment consists of software and general purpose equipment used by the agency, capital improvements made to buildings leased by SEC for office space, and internal use software development costs for projects in development. The reported book value of property and equipment increased from approximately \$73 million at September 30, 2005, to nearly \$104 million at September 30, 2006. The significant increase in property and equipment is primarily due to SEC occupying new office space in Washington, D.C., Boston, and New York during fiscal year 2006.

During the course of testing fiscal year 2006 additions, we noted numerous instances of inaccuracies in recorded acquisition costs and dates for furniture and equipment purchases, as

well as unrecorded capitalization of furniture and equipment purchases and unrecorded depreciation, and errors in amounts capitalized for internal use software projects. Specifically, an inaccurate acquisition cost was recorded for 18 of 51 furniture and equipment purchases that we reviewed, including 1 for which an inaccurate date was also recorded. Inaccurate acquisition dates were also recorded for 17 other items. For the 18 items with an inaccurate cost recorded, we found the following:

- Amounts recorded for 9 items—8 information technology (IT) equipment items and 1 bulk purchase of furniture—were based on a vendor price quote, procurement requisition, or purchase order rather than a final invoice.
- Amounts recorded for 7 IT equipment items—3 servers, 3 routers, and a mass storage device—were incomplete because the cost of equipment components was excluded.
- We could not readily determine the basis of amounts recorded for 2 other IT equipment items (controller and mass storage device).

We also noted that 18 of the 51 items we tested had inaccurate acquisition dates recorded. Of those 18 items, 15 were copier machines with a date of October 1, 2005, originally entered instead of the correct date of October 1, 2004. According to SEC staff, this was likely caused by an administrative error. Based on our follow-up inquiry regarding the copier machines, we learned that the Office of Administrative Services (OAS) had already corrected the date for these items (and 15 other copiers not included in our samples, for a total of 30) in the asset-tracking system after an inconsistency was noted by OFM staff. Therefore, the dates recorded as of fiscal year-end were correct, but as a result of the errors, in fiscal year 2006, SEC recorded depreciation expense that should have been recorded in fiscal year 2005. Regarding the other 3 items for which inaccurate acquisition dates were recorded, all were bulk purchases of furniture with recorded dates that were inconsistent with receipt documentation. In 2 of the cases, it appeared that the dates recorded were based on the dates of corresponding purchase orders. In all 3 cases, SEC corrected the errors after we identified them, and the recorded fiscal year 2006 depreciation expense was correct.

According to the Associate Executive Director of OAS, actions have already been taken in response to our acquisition cost/date findings. Specifically, the OAS Property Specialist is now verifying all costs and dates before they are entered into the asset-tracking system; in addition, daily transaction reports are being used to identify errors and inconsistencies in recorded costs and dates. We plan to evaluate these new procedures as part of our fiscal year 2007 financial audit.

We identified approximately \$6.2 million of fiscal year 2006 furniture and equipment purchases that was not capitalized as of September 30, 2006. Most of this amount was for furniture and equipment that SEC purchased for its new Washington, D.C., office space, with the remaining amount attributable to a new phone system. Regarding the furniture and equipment for the new headquarters office space, amounts involved were being tracked by SEC staff as part of managing the ongoing contractor invoicing process. However, there was a conscious decision to delay entering these amounts in SEC's official asset-tracking system until all items constituting the corresponding bulk purchases had been identified and properly categorized. Although the amounts were ultimately submitted for entry into the tracking

system on September 27, 2006, these amounts were not entered in time to be reflected in the September 30, 2006, financial statements. Regarding the phone system, we concluded that the overall purchase, consisting of multiple components, was not properly identified as an asset that should be capitalized in accordance with SEC's established criteria.

In addition to the unrecorded furniture and equipment for the new Washington, D.C., headquarters office space, we also identified an unrecorded bulk purchase of furniture associated with office space in New York. Specifically, based on our interim testing of furniture purchased in February 2006 for the new office space in New York, we determined that approximately \$425,000 of furniture purchased in May 2003 for the previous space was moved to the new space but had not been capitalized. We were unable to determine why this purchase had not been recorded in the asset-tracking system. SEC acknowledged this error and recorded the furniture in the tracking system during the fourth quarter of fiscal year 2006, more than 3 years after its purchase. As a result, the furniture was included in SEC's financial statements, but this significant delay resulted in SEC recording 29 months of prior years' depreciation expense in fiscal year 2006.

We found errors in nearly half of the capitalized amounts that we tested for SEC internal use software projects. Specifically, we found errors in 7 of 16 amounts tested. Of the 7 total errors, 4 capitalized amounts were incomplete and 3 amounts included costs that should not have been capitalized. The largest error involved an addition of approximately \$360,000, all of which, in accordance with applicable generally accepted accounting principles, should have been expensed rather than capitalized. Most of this amount consisted of licenses for the software. One of the incomplete capitalization amounts resulted from the combination of transposing an amount from one invoice and inadvertently excluding an amount from another invoice. Another of the overstated amounts was caused by including hardware and product support costs that should not have been capitalized. Most of the 7 errors did not have an impact on amortization expense because nearly all of the corresponding projects were under development (software in progress) rather than in production; thus, SEC had correctly not yet begun amortizing capitalized amounts.

The Office of Information Technology (OIT) provides software project cost data to OFM based on quarterly data calls to project managers who are guided by SEC's *Capital Asset Policy* and OIT's *Implementing Instruction for Software Capitalization*. Based on our understanding of OIT's process for compiling these data, and the large number of errors identified in our testing, we concluded that (1) there is not a consistent understanding among project managers of the requirements that should govern their quarterly data submissions and (2) the data submitted by project managers are not subject to detailed supervisory review within OIT before being forwarded to OFM. In response to our findings, OIT officials informed us that detailed review of quarterly data submissions by the responsible assistant director would be implemented. We plan to evaluate OIT's implementation of detailed review during our fiscal year 2007 financial audit.

Overall, the systemic errors that we found did not materially affect the balances reported for property and equipment or the corresponding depreciation and amortization expense amounts in SEC's financial statements for fiscal year 2006. However, these conditions evidence a

significant deficiency in control over the recording of property and equipment that while not material, affects the reliability of reported balances. Without a process that integrates controls over capitalizing and recording property and equipment purchases, SEC does not have sufficient assurance over the accuracy and completeness of its reported balances for property and equipment.

GAO's *Standards for Internal Control in the Federal Government*⁹ provide an overall framework for establishing and maintaining internal control, including a discussion of control activities, for example, accurate and timely recording of transactions. Specifically, transactions should be accurately and promptly recorded to maintain their relevance and value to management in controlling operations and making decisions.

In its Management's Discussion and Analysis, SEC acknowledges the need to strengthen control over this area. Specifically, SEC indicates that it will update the agency's property management policies in fiscal year 2007 to reflect the current organizational structure and revised business processes, train staff on the new policies, and increase quality checks throughout the year. In addition, SEC indicates that it has begun preparing requirements to replace the agency's current outdated asset management system to enhance data integrity and maximize integration of its financial systems. These steps, if properly implemented, would significantly address the reportable condition. However, as indicated below, there are additional actions that SEC should take to fully address the deficiencies in this area.

Recommendations

We recommend that SEC take the following specific actions as part of its planned corrective measures to improve property and equipment controls:

1. Include, in its updated property management policies, detailed procedures for recording proper acquisition costs and dates in its asset-tracking system, and take steps to ensure that these procedures are being consistently implemented.
2. Implement procedures requiring periodic comparisons of related details in disbursement and property/equipment subsidiary records to identify any unrecorded purchases that satisfy established capitalization criteria.
3. Implement procedures to ensure that internal use software project managers have a complete and consistent understanding of the requirements that should govern compilation of cost data submitted for capitalization, including consideration of joint OIT and OFM training to software project managers on the requirements of applicable generally accepted accounting principles.
4. Implement procedures whereby OFM staff routinely review capitalized amounts for software projects against supporting documentation to provide additional assurance that the recorded amounts are accurate and complete.

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

Other Issues

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

Payroll System Access, Approval of Time and Attendance Records, and Process Documentation

During our fiscal year 2006 audit, we identified an excessive number of staff in SEC's Office of Human Resources (OHR) with the capability to initiate and approve both personnel actions and time cards. We also identified several cases in which administrative officers had approved time and attendance (T&A) for higher-level employees on a regular basis during fiscal year 2006. In addition, we determined that SEC lacks formal, comprehensive documentation of T&A and personnel action processes. We presented these findings to SEC officials in August 2006. As of the completion of our audit in November 2006, OHR had taken or planned corrective actions to address these issues.

SEC uses the Federal Personnel and Payroll System (FPPS), a system developed and maintained by the Department of the Interior's National Business Center in Denver, Colorado, to process personnel actions and payroll transactions. During our audit, we found that all 11 specialists and 8 assistants within OHR had FPPS access privileges allowing them to initiate and approve personnel actions for any SEC employee. In addition, all 19 staff had access privileges to initiate and approve time cards for employees within the offices that they service, including 3 who could do so for any SEC employee. According to OHR officials, these access privileges were put in place primarily for emergency situations where key staff may be unavailable. This condition introduces a risk factor from a segregation of duties perspective in that one individual could control all key aspects of personnel and payroll processing.

In late September 2006, OHR removed certain access privileges for 16 of its 19 specialists and assistants. The overall result was a reduction in the number of staff who can both initiate and approve a personnel action and initiate and approve a time card from 19 to 3. Going forward, OHR is planning to monitor personnel action processing on a monthly basis by producing a report of all actions initiated and approved by the same staff member that will be reviewed and signed by both (1) one of OHR's three branch chiefs (on a rotating basis) and (2) the assistant director. In addition, OHR plans to implement branch team leader review of all personnel actions prior to final processing as an internal operating procedure.

During our audit, we reviewed 45 payroll expenditures, including testing for proper T&A approval. We identified 3 cases in which an administrative officer approved the time card of a higher-level employee. After further inquiries and testing, we determined that time cards for all three employees had been improperly approved by an administrative officer on a regular basis during fiscal year 2006. GAO's guidance on controls over T&A reporting¹⁰

¹⁰ GAO, *Maintaining Effective Control over Employee Time and Attendance Reporting*, GAO-03-352G (Washington, D.C.: January 2003).

emphasizes that the integrity of the information in a T&A reporting system depends largely on the conscientious exercise of the supervisor (or other official) of his/her approval authority and an appropriate basis for such approval.

In response to the results of our payroll expenditure testing, OHR issued two memos in September 2006—one to division directors/office heads and one to administrative officers—emphasizing that administrative officers (1) have been given T&A certification authority for emergency situations only and (2) are not to certify T&A for higher-level officials on an ongoing basis. While such memos can serve as a useful reminder of current policy, we emphasized to OHR officials that active monitoring of compliance with current policy is a critical internal control. In this regard, OHR is planning to monitor the levels of staff that are approving time cards, with a focus on organizations in which exceptions were noted.

Consistent with GAO's *Standards for Internal Control in the Federal Government*, internal control should be clearly documented and the documentation readily available for examination. During the course of our audit, OHR management readily acknowledged the lack of written procedures governing personnel action and payroll processing. As a result, OHR is planning to incorporate these areas into a larger initiative to document "core processes" across its functional areas.

Given our understanding of SEC's overall control environment for personnel action and payroll processing, and the results of our current and prior year detail testing in these areas, we concluded that the deficiencies discussed above do not constitute reportable conditions. However, they are key components of SEC's system of internal control that warrant strengthening. The commission acknowledged in its Management's Discussion and Analysis that actions are needed to strengthen controls in these areas.

Overall, we are encouraged by the actions taken and planned by SEC to strengthen these areas. However, continued management attention will be critical to ensuring that actions already taken are periodically reassessed for adequacy, and that planned actions are effectively implemented. We plan to evaluate SEC's corrective actions during our fiscal year 2007 financial audit.

Recommendation

We recommend that SEC evaluate the overall effectiveness of its actions taken in response to our findings regarding payroll and personnel action processing, when fully implemented, to determine whether any modifications, additional actions, or both are needed.

Comparison of Furniture and Equipment Received and Ordered

In addition to the inaccuracies in recording acquisition costs and dates, we found that SEC did not have evidence that showed a comparison of the quantity and type of item received against the corresponding order(s) for most furniture and equipment items that we tested. Specifically, we received adequate evidence of this comparison in only 10 of 49 cases tested

for this attribute. Although we concluded that these comparisons are being performed, consistent with our *Standards for Internal Control in the Federal Government*, this fundamental component of procurement control activities should be consistently documented.

According to SEC's *Property Management Program Manual* (SECM9-1), upon receipt of property, staff are to sign and date the shipping receipt to evidence that the quantity and type of property received agrees with the corresponding purchase order. According to the Associate Executive Director of OAS, the current policy is outdated and comparisons are not being consistently documented in this manner. Therefore, the Associate Executive Director stated that SECM9-1 will be updated by OAS in cooperation with OIT's Asset Management Branch. Overall, the outdated policy and lack of documented evidence of a key control reflect a need for SEC to improve the "audit trail" for key asset management processes rather than a significant internal control deficiency.

Recommendation

We recommend that SEC retain, in its updated property management policy, a procedure to document comparison of quantity and type of item received with the corresponding purchase order, and take actions to ensure that the comparisons are being consistently documented.

Agency Comments

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

- implementing the new system (Phoenix) in February 2007 for tracking disgorgement and penalty receivable and collection activity;
- implementing—in conjunction with the rollout of the Phoenix system—new policies and procedures, as well as mandatory computer-based training modules for mid- and senior-level managers in the Division of Enforcement;
- hiring a contractor to update SEC's property and equipment policies and to develop procedures directed at ensuring proper implementation;
- implementing a semiannual process to compare invoices paid to property system data to identify any unrecorded purchases that meet established capitalization criteria; and
- instituting detailed supervisory-level review of all internal use software capitalization data provided by project managers.

With respect to fiscal year 2007, the Chairman stated that SEC has redoubled its efforts. Specifically, the Chairman cited plans to improve the process for recording and reporting disgorgement and penalty activity by further automation and review of the manual compensating controls currently in place, provide training to software project managers on

generally accepted accounting principles applicable to internal use software, and evaluate the effectiveness of revised payroll and personnel action processes to determine if any modifications are necessary or new processes needed. We will evaluate SEC's actions and initiatives during our fiscal year 2007 audit.

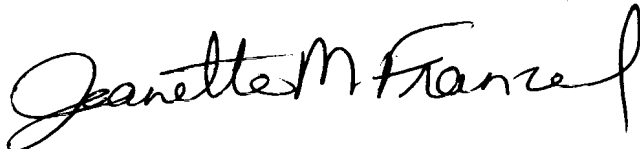
SEC's written comments are reprinted in enclosure II of this report.

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

This report is intended for use by management of SEC. We are sending copies of this report to the Chairmen 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 Oversight and Government Reform. We are also sending copies to the Secretary of the Treasury, the Director of the Office of Management and Budget, and other interested parties. In addition, this report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

We acknowledge and appreciate the cooperation and assistance provided by SEC management and staff during our audit of SEC's fiscal years 2006 and 2005 financial statements. If you have any questions about this report or need assistance in addressing these issues, please contact me at (202) 512-9471 or by e-mail at franzelj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.

Sincerely yours,



Jeanette M. Franzel
Director
Financial Management and Assurance

Enclosures – 3

Enclosure I

Status of Previously Reported Recommendations

This enclosure indicates the status of the U.S. Securities and Exchange Commission's (SEC) efforts to implement our previous recommendations related to opportunities for improvements in SEC's internal control and accounting and financial reporting procedures identified during our audits of SEC's 2004 and 2005 financial statements.¹ Table 1 lists the recommendations from our 2004 audit that we previously reported as open at the conclusion of our 2005 audit. Table 2 lists the recommendations from our 2005 audit. The status reflects our assessment of whether the issues that gave rise to the recommendations have been effectively and fully addressed based on the work performed during our fiscal year 2006 financial audit. As of January 2007, SEC had taken actions to close 18 of the 35 open recommendations from our audits of the agency's 2004 and 2005 financial statements. Effectively implementing recommendations is critical for SEC to resolve its financial management challenges.

¹ GAO, *Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report*, GAO-05-691R (Washington, D.C.: July 27, 2005); *Management Report: Opportunities for Improvements in SEC's Internal Controls and Accounting Procedures*, GAO-05-693R (Washington, D.C.: Aug. 12, 2005); and *Internal Control: Improvements Needed in SEC's Accounting and Financial Reporting Procedures*, GAO-06-459R (Washington, D.C.: Apr. 21, 2006).

Enclosure I

Table 1: Recommendations from 2004 Audit Reported as Open at Conclusion of 2005 Audit

Audit area/recommendation	Status of recommendation	
	Closed	Open
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, accurate, and efficient recording and reporting of disgorgement and penalty activity.		X
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.	X	
3. Implement controls so that the ongoing activities involving disgorgements and penalties are properly, accurately, and timely recorded in the accounting system.		X
4. Strengthen coordination, communication, and data flow among staff of SEC's Division of Enforcement and Office of Financial Management (OFM) who share responsibility for recording and maintaining disgorgement and penalty data.	X	
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.		X
Financial statement preparation and reporting		
6. 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.	X	
7. Prepare a crosswalk between the financial statements and the source systems, general ledger accounts, and the various account queries and analyses that make up key balances in the financial statements.	X	
8. 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.	X	
9. Perform monthly reconciliations of subsidiary records and summary account balances.	X	

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Audit area/recommendation	Status of recommendation	
	Closed	Open
10. 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.		X
11. 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.	X	
12. 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.	X	
13. Utilize established tools (i.e., checklists and implementation guides) available for assistance in compiling and reviewing financial statements.	X	
14. 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.	X	
15. 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.	X	
16. Develop or acquire an integrated financial management system to provide timely and accurate recording of financial data for financial reporting and management decision making.		X
Cash receipts		
17. Periodically reconcile the cash receipts log to the documentation supporting the deposit amount in the general ledger.	X	
Property and equipment leases		
18. Review all existing leases for property and equipment to determine if they should be capitalized or expensed and make any necessary adjustments to the related general ledger balances.		X

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Audit area/recommendation	Status of recommendation	
	Closed	Open
19. Develop policies and procedures to properly account for future property and equipment leases on an ongoing basis.		X
Federal Personnel and Payroll System data		
20. Periodically reconcile its active employees to Federal Personnel and Payroll System (FPPS). To do this, consideration should be given to maintaining an independent database of active employees and other payroll-related information, wherein active employee data could be readily compared with and reconciled to FPPS-generated payroll records. This reconciliation should be documented.	X	
Closing recommendations to address Federal Managers' Financial Integrity Act weaknesses		
21. Require documented support and review of SEC's corrective actions to provide evidence that actions taken in response to audit recommendations fully correct identified deficiencies prior to closing out the audit issues in the tracking system.		X

Source: GAO.

Note: Recommendations made in GAO-05-691R and GAO-05-693R.

Enclosure I

Table 2: Recommendations from 2005 Audit

Audit area/recommendation	Status of recommendation	
	Closed	Open
Financial statement preparation and reporting		
1. Staff OFM with the collective knowledge, skills, and experience necessary to achieve effective implementation of internal control over the financial statement preparation and reporting process.	X	
2. Finalize formal, written policies and procedures governing financial reporting processes and related internal control and quality assurance, including the basic documentation, audit trails, and crosswalks needed to support financial statement amounts, to facilitate management review of financial information.	X	
3. Formalize and place into operation a senior management council or committee to oversee financial reporting activities; provide advice; and regularly review the agency's financial information, operations, and policies.	X	
4. Determine cutoff dates for significant account balances that are both appropriate and practical to facilitate interim financial reporting and meeting year-end financial reporting deadlines.		X
5. Prepare interim footnote disclosures to facilitate meeting year-end financial reporting deadlines.	X	
Disgorgements and penalties		
Develop, document in writing, and implement comprehensive policies, procedures, and controls over disgorgement and penalty transactions that include the following (see items 6-9):		
6. An accounting policy for disgorgements and penalties that will provide SEC management with reasonable assurance that the subsidiary ledger for disgorgement/penalty receivables is accurate and complete.		X
7. The type of documentation and procedures needed to record the termination or waiver of a debt and the proper notification and communication for approved terminations and waivers, such that management has assurance that only valid and approved terminations are recorded.		X
8. The recording of activity by case for fiduciary balances, including monthly reconciliations and management review, to ensure that balances by case are accurate.		X

Enclosure I

Audit area/recommendation	Status of recommendation	
	Closed	Open
9. The initiation, recording, and monitoring of investments, including the monthly reconciliation of investment activity, to provide assurance that these fiduciary amounts are accurate and complete.		X
Responsibilities of contracting officer's technical representative (COTR)		
10. Clarify guidance regarding policies and procedures (as described in SECR10-8 and SECR10-15) for the COTR's responsibilities and take actions to help ensure existing policies and procedures are being followed consistently.		X
Internal review of filing fee calculations		
11. Take action to help ensure that its policy on recalculating fee-bearing filing amounts is consistently followed.		X
12. Take action to help ensure that the recalculation of the required filing fees is clearly documented.		X
Compliance with Prompt Payment Act		
13. Incorporate a review of the invoice receipt date as part of its daily review of Momentum (SEC's general ledger) invoice entries to ensure the invoice receipt dates are accurately entered into Momentum.	X	
14. Take action to help ensure that the policy requiring the timely return of improper invoices to the vendor to allow for timely payment is followed.		X ^a

Source: GAO.

Note: Recommendations from GAO-06-459R.

^aSEC has taken actions to address this recommendation. We plan to evaluate the effectiveness of these actions during our 2007 audit.

Comments from the U.S. Securities and Exchange Commission

CHRISTOPHER COX
CHAIRMAN

HEADQUARTERS
100 F STREET, NE
WASHINGTON, DC 20549



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

Dear Ms. Franzel:

Thank you for the opportunity to review and comment on the draft report of the Government Accountability Office (GAO) entitled *Internal Control: Improvements Needed in SEC's Accounting/Operational Procedures*, GAO-07-482R. The report discusses issues identified in GAO's fiscal years (FY) 2006 and 2005 audit of the financial statements of the Securities and Exchange Commission (SEC) and reflects the state of the SEC's internal controls as of September 30, 2006. I would like to acknowledge and commend your efforts and those of the GAO staff in working with the SEC to meet our financial reporting deadlines and improve the SEC's control over financial reporting.

I am pleased that the GAO's FY 2006 audit found that the SEC's financial statements and notes were presented fairly, in all material respects, and in conformity with U.S. generally accepted accounting principles; that the SEC had effective internal controls over financial reporting and compliance with laws and regulations, although certain controls should be improved; and that there were no instances of reportable noncompliance with laws and regulations tested by the GAO.

The GAO's draft report provides additional information and recommendations with respect to two of the three reportable conditions that existed at the end of last year's audit: controls over recording and reporting disgorgement and penalty activity, and controls over property and equipment activity. Although not considered reportable conditions, the report also provides information and a recommendation regarding payroll and personnel action processing. The SEC's information security controls are addressed in a separate GAO report.

As the GAO recognized, the SEC made progress in addressing its internal control deficiencies in FY 2006, and we have redoubled our efforts in FY 2007. Specifically, since the end of last year's audit, the SEC has taken steps to implement GAO's recommendations through several actions that are not reflected in the Management Letter.

With respect to the recording and reporting of disgorgement and penalty activity, we have made substantial progress in addressing each of the GAO's recommendations. We are pleased to report that on February 26, 2007, we implemented a new information technology system (Phoenix) for tracking disgorgement and penalty receivable and collection activity. The system has been designed to strengthen the SEC's internal controls so that all ongoing activities are properly, accurately and timely recorded. In conjunction with the rollout of the Phoenix system, the SEC implemented new policies and procedures as

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Enclosure II

Ms. Jeanette M. Franzel
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well as mandatory computer based training modules for approximately 200 mid- and senior-level managers in the Division of Enforcement. We plan to continue to improve the process by further automation and will review the manual compensating controls currently in place.

With respect to the recording and control of property and equipment activity, we have made progress in addressing each of the GAO's recommendations. We have hired a contractor to update the SEC's policies and to develop procedures and audit steps to ensure proper implementation. The revised policy on property and equipment is projected to be in place by the end of the fiscal year. In addition, we recently implemented a semi-annual audit to compare invoices paid to property system data to identify any unrecorded purchases that satisfy established capitalization criteria.

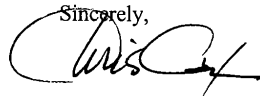
With respect to the recording of internal use software, we have implemented a number of initiatives to improve the accuracy of the amounts capitalized. We have instituted a detailed supervisory level review of all capitalization data provided by project managers, and we have restructured our accounting code classification to segregate capitalized software from non-capitalized software. We concur with your recommendation to provide training to the software project managers on the applicable generally accepted accounting principals and expect to deliver training this fiscal year.

The SEC has also made improvements over payroll and personnel action processing. We significantly reduced system access privileges to allow only a few people to be able to initiate and approve an action; we improved the approval process for time and attendance certification; and we began work on documenting procedures for payroll and personnel actions. As recommended in your report, we plan to evaluate the effectiveness of the revised processes to determine if any further modifications are necessary or if any new processes are needed.

As Chairman, I remain committed to improving the SEC's financial integrity and operational efficiencies, so that the agency can lead by example when it comes to establishing and maintaining effective internal control over financial reporting. I appreciate your support of these efforts, and look forward to continuing our productive dialogue during the course of this year's audit.

Thank you again for the opportunity to comment on this report. If you have any questions relating to our response, please contact our Chief Financial Officer, Kristine Chadwick, at 202-551-7836.

Sincerely,



Christopher Cox
Chairman

Enclosure III

Details on Audit Scope and Methodology¹

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

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

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

(194648)

¹ For further explanation of our audit scope and methodology, see the financial audit report (GAO-07-134).

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