United States Government Accountability Office
Washington, DC 20548

April 1, 2008

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

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

Dear Mr. Cox:

On November 16, 2007, we issued our report[1] on the U.S. Securities and Exchange Commission's (SEC) fiscal years 2007 and 2006 financial statements and on SEC's internal control as of September 30, 2007. We also reported on the results of our tests of SEC's compliance with selected provisions of laws and regulations during fiscal year 2007.

The purpose of this report is to present areas of SEC's internal controls identified during our fiscal year 2007 audit that could be improved.[2] This report contains 14 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 16, 2007, report concluded that SEC had a material weakness[4] in internal control over its financial reporting process, and therefore did not maintain effective internal

[1] GAO, *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2007 and 2006*, GAO-08-167 (Washington, D.C.: Nov. 16, 2007).
[2] The internal control issues concerning information security are discussed in a separate report: GAO, *Information Security: Securities and Exchange Commission Needs to Continue to Improve Its Program*, GAO-08-280 (Washington, D.C.: Feb. 29, 2008).
[3] We made recommendations in our internal control reports issued as part of our fiscal years 2004, 2005, and 2006 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); *Internal Control: Improvements Needed in SEC's Accounting and Financial Reporting Procedures*, GAO-06-459R (Washington, D.C.: Apr. 21, 2006); and GAO, *Internal Control: Improvements Needed in SEC's Accounting and Operational Procedures*, GAO-07-482R (Washington, D.C.: Apr. 3, 2007).
[4] A material weakness is a significant deficiency or combination of significant deficiencies that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

control over financial reporting as of September 30, 2007. This weakness is comprised of four significant deficiencies,[5] which taken collectively result in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. These significant deficiencies concern (1) the period-end financial reporting process, (2) disgorgements and penalties accounts receivable, (3) accounting for transaction fee revenue, and (4) preparing financial statement disclosures.

In addition to the material weakness discussed above, we identified three significant deficiencies in internal control, which although not material weaknesses, represent significant deficiencies in the design or operation of internal control. These significant deficiencies concern (1) information security controls, (2) property and equipment, and (3) accounting for budgetary resources.

As of January 2008, SEC had taken actions to fully address 3 of the 23 recommendations that remained open as of January 2007 from our audits of the agency's 2004, 2005, and 2006 financial statements.

We also identified one other internal control weakness that although not considered to be a material weakness or significant deficiency, we believe warrants SEC management's consideration as to whether additional actions are warranted. This issue concerns certification of employees' time cards, documentation of monitoring of time card certification, and approval of personnel actions.

Tables 1, 2, and 3 of enclosure I provide summary information on the status of recommendations from our 2004, 2005, and 2006 audits of SEC's financial statements, respectively.[6] Our 14 new recommendations follow the sections in which the corresponding issues are discussed.

In providing written comments on a draft of this report, the SEC Chairman expressed his commitment to remediate the control deficiencies this fiscal year and summarized SEC's corrective action plans to address GAO's recommendations.

Scope and Methodology

As part of our audit of SEC's fiscal years 2007 and 2006 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 2007 and 2006 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

[5] A significant deficiency is a control deficiency, or combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.
[6] GAO-05-691R, GAO-05-693R, GAO-06-459R, and GAO-07-482R.

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 audit of SEC's fiscal years 2007 and 2006 financial statements[7] and are briefly summarized in enclosure III.

Period-End Financial Reporting Process

SEC's financial management system does not conform to the systems requirements of Office of Management and Budget (OMB) Circular No. A-127, *Financial Management Systems*. Specifically, Circular No. A-127 requires that financial management systems be designed to provide for effective and efficient interrelationships between software, hardware, personnel, procedures, controls, and data contained within the systems. Circular No. A-127 further states that financial systems must have common data elements, common transaction processing, consistent internal controls, and efficient transaction entry, and that reports produced by the systems shall provide financial data that can be traced directly to the general ledger accounts.

SEC's period-end financial reporting process for recording transactions, maintaining account balances, and preparing financial statements and disclosures is supported to varying degrees by a collection of automated systems that are not integrated or compatible with its general ledger system. These automated systems' lack of integration and compatibility require that extensive compensating manual and labor-intensive accounting procedures, involving large spreadsheets and numerous posting and routine correcting journal entries, dominate SEC's period-end financial reporting process. Some of SEC's subsidiary systems, such as those for property and equipment and for disgorgements and penalties, do not share common data elements and common transaction processing with the general ledger system. Therefore, intermediary information processing steps, including extensive use of spreadsheets, manipulation of data, and manual journal entries, are needed to process the information in SEC's general ledger. For example, at period end, SEC personnel must extract the period's transactions from each subsidiary system and forward these data, in various formats, to accountants in the Financial Statements Preparation Branch, who use them to develop the journal vouchers (JV) necessary to include these transactions in period-end balances. These JVs are uploaded in batches to the core financial management system and posted to the general ledger. Once the general ledger is thus updated, a trial balance is created from which the accountants prepare the financial statements.

While the accounting staff make extensive use of desktop applications and workstations to perform calculations and to store the data used to prepare JVs and financial statements, little of the data processing that takes place during SEC's financial reporting cycle is fully automated. The information security controls necessary to prevent or recover from any inadvertent data corruption or to permit independent verification of the processing that has taken place have not been established for period-end accounting and reporting. SEC has developed a standard voucher template and a standardized review form for JVs, which were used to prepare the final fiscal 2007 financial statements. However, SEC's current period-end closing process taken as a whole complicates review of the transactions and greatly increases the risk that the transactions are not recorded completely, properly, or consistently, ultimately affecting the reliability of the data presented in the financial statements. Our

[7] GAO-08-167.

identification this year of errors in SEC's calculation of disgorgement and penalty accounts receivable, discussed below, illustrates this risk.

The risk to data reliability is further increased because basic controls over electronic data, such as worksheet and password protection, change history, and controls over data verification, such as control totals and record counts, were not consistently used during the data processing between the source systems and the general ledger. In addition, currently, SEC's general ledger has several unconventional posting models and other limitations that prevent proper recording of certain transactions. As a result, SEC's year-end reporting process requires extensive routine correcting journal entries to correct errors created by incorrectly posted transactions in its general ledger. We also noted that SEC's documentation used to crosswalk individual accounts to the financial statement line items contained an incorrect routing to a line item on SEC's Statement of Budgetary Resources for SEC's year-end financial statement preparation process, which caused a material error in SEC's draft financial statements for 2007.

Also, SEC did not have detailed written documentation of its methodologies and processes for preparing financial statements and disclosures, increasing the risk of inconsistent and improper reporting and the risk that disruptions and error may arise when staff turnover occurs. Specifically, SEC did not have current written policies and procedures for over 15 areas, including investments, property and equipment, accounts receivable, other liabilities, and for the preparation of JV uploads into SEC's financial management system.

Recommendations

We recommend that SEC take the following actions to improve its period-end financial reporting process controls:

1. Integrate subsystems that process significant accounting data with the general ledger.
2. Until subsystems are fully integrated, develop and implement documented data reliability checks for data extracted from nonintegrated subsidiary systems, including spreadsheets. These data reliability checks should include supervisory review.
3. Prepare written procedures which describe explicitly the steps required to accomplish and document each significant activity in the general ledger closing process and in the generation of the financial statements, including related disclosures.

Disgorgements and Penalties Accounts Receivable

As part of its enforcement responsibilities, SEC issues orders and administers judgments ordering, among other things, disgorgements, civil monetary penalties, and interest against violators of federal securities laws.[8] SEC recognizes a receivable when SEC is designated in an order or a final judgment to collect the assessed disgorgements, penalties, and interest. At September 30, 2007, the gross amount of disgorgements and penalties accounts receivable was $330 million, with a corresponding allowance of $266 million resulting in a net receivable of $64 million.

[8] A disgorgement is the repayment of illegally gained profits (or avoided losses) for distribution to harmed investors whenever feasible. A penalty is a monetary payment from a violator of securities law that SEC obtains pursuant to statutory authority. A penalty is fundamentally a punitive measure, although penalties occasionally can be used to compensate harmed investors.

SEC's Phoenix system, which maintains financial data pertaining to disgorgements and penalties, is not integrated with SEC's general ledger system. To determine disgorgement and penalty receivable amounts, SEC downloads the data from Phoenix into a spreadsheet, manipulates selected data, and uses cell formulas to determine balance totals. This manual process for determining disgorgement and penalty balances presents high inherent risk in SEC's financial reporting process and demands effective compensating controls to ensure the accuracy and proper recording of related financial statement amounts, including effective supervisory review.

In our reviews of the interim June 30, 2007, and year-end September 30, 2007, balances of accounts receivable for disgorgements and penalties, we found errors in SEC's spreadsheet formulas resulting in overstatements of these receivable balances for both periods. Specifically, for the interim balance as of June 30, 2007, the spreadsheet formula did not reduce the disgorgement receivable for offset amounts that had already been paid by debtors to a non-SEC entity. SEC subsequently detected and corrected the June 30 errors, but then made different spreadsheet calculation errors in the year-end balances as of September 30, 2007, which we detected as part of our audit and which SEC corrected prior to the issuance of the financial statements. For example, SEC incorrectly included in its disgorgement receivable balance at September 30, 2007, amounts that had been terminated.

The main cause of these errors was the breakdown this year in the manual controls that were intended to compensate for the lack of an integrated accounting system for disgorgements and penalties, as discussed above.

Although SEC reviewed the journal entries posting the amounts to the general ledger, this review did not extend to the preparation of the spreadsheet SEC used to document the accounts receivable calculation at June 30 and September 30, 2007, and therefore, was not sufficient to detect significant spreadsheet formula errors. For example, the review did not include (1) reviewing the detailed manual process of downloading data from Phoenix, (2) determining which Phoenix data elements to use and the rationale used in selecting those data elements, (3) reviewing the manipulation of selected data, and (4) reviewing the accuracy of the spreadsheet cell formulas used in calculating the accounts receivable balance.

Recommendations
We recommend that SEC take the following action to improve its disgorgement and penalties accounts receivable controls:

4. Develop and implement controls over the calculation of disgorgement and penalties accounts receivable, including the reliability of data downloaded from Phoenix and the accuracy of spreadsheet cell formulas and related methodologies.

Accounting for Transaction Fee Revenue

As one of its sources of revenue, SEC collects securities transaction fees paid by self-regulatory organizations (SRO) to SEC for stock transactions. SRO transaction fees are payable to SEC twice a year – in March for the previous months September through December, and in September for the previous months January through August. SEC calculates the fees due and bills the SROs based on actual transaction volume reported on a monthly basis by the SROs to SEC. Since the SROs are not required to report the actual volume of transactions until 10 business days after the end of each month, SEC estimates and records an amount receivable for fees payable by the SROs to SEC for activity during the month of September. At September 30, 2007, SEC estimated this receivable amount at $100.6 million based on previous months' transaction volume. Based on information SEC received from the SROs in mid-October concerning the actual volume of transactions, the amount of claims receivable at September 30, 2007, for activity during the month of September should have been $74.4 million. In addition, also in mid-October, one of the SROs submitted amended transaction volume to SEC for the months March, April, May, and June 2007, reflecting an additional receivable amount of approximately $75,000. In previous years, SEC made adjustments to reflect the actual volume of transactions; however, SEC does not have written procedures to help ensure that these adjustments are made as a routine part of its year-end financial reporting process. We proposed, and SEC posted, the necessary audit adjustments to correct the amount of transaction fee revenue and related receivable for fiscal year 2007.

Statement on Auditing Standards No.1, *Codification of Auditing Standards and Procedures*, which explains the accounting requirements for subsequent events, requires that events or transactions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements should be considered for adjustment to or disclosure in the financial statements through the date that the financial statements are issued. In addition, the concept of consistency in financial reporting provides that accounting methods, including those for determining estimates, once adopted, should be used consistently from period to period unless there is good cause to change.

Recommendations

We recommend that SEC take the following action to improve its accounting for transaction fee revenue controls:

5. Establish and implement detailed written procedures for recording transaction fee revenue and the related receivable, including procedures for recognizing data received after the balance sheet date but prior to issuance of the financial statements.

Preparing Financial Statement Disclosures

In our review of SEC's year-end draft financial statement disclosures, we noted numerous errors including misstated amounts, improper breakout of line items, and amounts from fiscal year-end 2006 incorrectly brought forward as beginning balances for fiscal year 2007. For example, in its disclosure for *Custodial Revenues and Liabilities*, SEC improperly excluded approximately $320 million in collections. In another example, for its disclosure on Fund Balance with Treasury, SEC misclassified approximately $90 million into incorrect line items. Also, in its disclosure for Fiduciary Assets and Liabilities, SEC's beginning balances for *Fund Balance with Treasury* and for *Liability for Fiduciary Activity* were each misstated by $8.9 million due to errors in carrying forward ending balances from September 30, 2006. We also noted numerous instances in which amounts reported in the footnote disclosures were not consistent with amounts presented in the financial statements or Management's Discussion and Analysis. SEC revised the financial statement disclosures to correct the errors that we noted in its final year-end financial statements for fiscal year 2007. However, correction of these errors required multiple revisions before all errors were properly corrected.

We believe that these and numerous other errors in the disclosures were due mainly to the lack of a documented timeline and process for completing the fiscal year 2007 financial statements and disclosures, including review of the disclosures. In addition, the cumbersome and complicated nature of SEC's financial reporting process discussed above did not allow SEC finance staff sufficient time to carry out thorough and complete reviews of the disclosures in light of the November 15 reporting deadline.[9]

Recommendations

We recommend that SEC take the following action to improve its financial statement disclosure preparation controls:

6. Establish and implement detailed written procedures for the preparation and review of the financial statement disclosures, including the comparison of financial statement disclosure amounts to related information presented in the current and previous year financial statements and Management's Discussion and Analysis.

Property and Equipment

SEC's property and equipment consists of 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 and production. SEC acquired approximately $27 million dollars in property and equipment during fiscal year 2007. Similar to our last year's audit, during the course of testing fiscal year 2007 additions, we noted numerous instances of inaccuracies in recorded acquisition dates and costs for property and equipment purchases, as well as unrecorded property and equipment purchases. We also identified an internal control deficiency related to SEC's property receipt function and errors in amounts capitalized and amortized for internal-use software projects.

In 21 of the 53 unique personal property, leasehold improvement, and software items we reviewed, SEC recorded items in subsidiary ledgers or systems with incorrect acquisition dates which affected depreciation calculations. In 12 instances, the incorrect acquisition dates were related to software items SEC recorded on a quarterly basis, rather than in the month of acquisition. SEC has since changed from quarterly to monthly recording of software items. In the remaining 9 instances, SEC recorded items using the incorrect acquisition dates due to administrative errors. In addition to the 21 errors we identified, there were 5 instances for which SEC lacked reliable documentation of receipt date.

Also during our testing, we noted eight instances in which SEC incorrectly recorded property costs. SEC incorrectly recorded costs based on contracts or purchase orders rather than invoices. We also identified approximately $200,000 in unrecorded additions to SEC's telephone system. This omission from SEC's property ledger is in addition to approximately $2.5 million in telephone equipment which we identified in our previous audit and SEC failed to record during fiscal year 2006 or to correct during fiscal year 2007.

Contributing to the cause of these errors is that SEC does not have a formalized, documented process for comparing quantity and type of item received against the corresponding order for property purchases. Seven of the 23 personal property items we reviewed did not have

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[9] OMB directs executive branch agencies to issue their audited financial statements by November 15 for the preceding fiscal year ending on September 30. OMB Circular No. A-136, *Financial Reporting Requirements*, § I.5 (rev. June 27, 2007).

sufficient evidence of this comparison. SEC's draft Property Management Manual, scheduled for implementation during calendar year 2008, calls for the Assistant Property Management Officer to "ensure that receipts are matched against Purchase Orders as a condition of acceptance and payment." However, SEC's guidance does not prescribe a standardized form to document this review. A lack of standardized, documented review procedures increases the risk that SEC will accept, pay for, and record property not yet received.

SEC's property subsidiary system is not integrated with the general ledger. SEC uses a spreadsheet to calculate depreciation and amortization related to additions to existing property items. We found formula errors in these calculations, which we communicated to SEC in September 2007. SEC subsequently corrected these systemic errors, but this situation highlights the risks associated with the lack of an integrated financial management system and the need for additional compensating control procedures.

Overall, these systemic errors 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 2007. However, these conditions evidence a significant deficiency in control over the recording of property and equipment that affects the reliability of its recorded balances for property and equipment. Further, SEC's lack of an integrated financial management system for accounting for property and equipment, as discussed above, requires compensating procedures, which were not effective, to ensure that manual calculations, such as those for depreciation and amortization, are accurate. Until it has a systemic process that incorporates effective controls over receiving, recording, capitalizing, and amortizing property and equipment purchases, SEC will not have sufficient assurance over the accuracy and completeness of its reported balances for property and equipment.

Recommendations
We recommend that SEC, in addition to our previous recommendations in this area which are included in enclosure I, take the following actions to improve its property and equipment controls:

7. Establish and implement controls over invoiced property costs and dates to ensure that property and equipment acquisitions are accurately recorded in the relevant subsidiary ledgers for personal property, leasehold improvement, and software.
8. Establish and implement controls to ensure proper calculation of depreciation and amortization of additions to existing items over the remaining useful lives of the associated items.

Accounting for Budgetary Resources

For fiscal year 2007, SEC incurred $877 million in obligations, which represents legal liabilities against funds available to SEC to pay for goods and services ordered. At September 30, 2007, SEC reported that the amount of budgetary resources obligated for undelivered orders was $255 million, which reflects obligations for goods or services that had not been delivered or received as of that date. In our testing of undelivered order transactions for this year's audit, we identified several concerns over SEC's accounting for obligations and undelivered orders. Specifically, we found numerous instances in which SEC (1) recorded obligations prior to having documentary evidence of a binding agreement for the goods or services, (2) recorded invalid undelivered order transactions due to an incorrect posting configuration in SEC's general ledger, and (3) made errors in recording new obligations and deobligations due to the use of incorrect accounts and by posting incorrect amounts in the general ledger.

During our interim and year-end testing of obligation activity we identified 12 instances in which SEC recorded obligations prior to the signing execution of a written contract. We also found one instance where funds were obligated with the expectation that a contract would be ratified, but the ratification request was later denied. SEC does not have policies or internal controls to prevent recording of obligations that are not valid. Recording obligations prior to having documentary evidence of a binding agreement for the goods and services is a violation of the recording statute,[10] and may result in funds being reserved unnecessarily and therefore made unavailable for other uses should the agreement not materialize. Early recording of obligations also may result in charging incorrect fiscal year funds for an agreement executed in a later fiscal year.

We noted approximately $76 million in general ledger posting errors, including both upward and downward adjustments to prior-year undelivered orders. Due to a system error, deobligations of funds in 1-year Treasury Account Fund Symbols (TAFS) did not process correctly, materially overstating both the upward and downward adjustment accounts. This process results in the need to routinely correct entries. Extensive reviews of the adjusting journal entries are needed to compensate for the system limitations. This process unnecessarily complicated transaction processing and caused SEC to misstate various line items on the Statement of Budgetary Resources. While SEC identified and manually corrected this error for fiscal year 2007, there is a risk that, if the error is not corrected in the financial management system, SEC could materially misstate its Statement of Budgetary Resources in future periods.

In addition to the systemic posting errors, we noted several additional errors impacting SEC's budgetary accounting. SEC incorrectly recorded new obligations by posting incorrect amounts in the general ledger. For example, in 8 of the 147 items we tested, SEC recorded obligations at incorrect amounts, due to either recording obligations early using the requisition amounts instead of the final contract amounts or making administrative errors. In addition, SEC made errors in recording deobligations due to administrative errors in posting amounts to the incorrect accounts. We identified approximately $1 million in net errors in which SEC's financial management system did not properly process downward adjustments of prior-year funds in no-year TAFS. SEC's financial management system improperly treats all budget years maintained in this fund as current-year funds, thereby understating downward adjustments for those years.

Overall, the majority of exceptions related to these issues were corrected by SEC through adjusting journal entries. While the remaining uncorrected amounts did not materially affect the balances on the Statement of Budgetary Resources at September 30, 2007, ineffective processes that caused these errors constitute a significant deficiency in SEC's internal control

[10] An amount shall be recorded as an obligation of the U.S. Government only when supported by documentary evidence of a binding agreement between an agency and another person (including an agency) that is in writing and executed before the end of the period of availability for obligation of the appropriation. 31 U.S.C. § 1501(a)(1). Under the plain terms of the statute, an oral agreement may not be recorded as an obligation. *See* GAO, *Principles of Federal Appropriations Law*, vol. 2, 3rd ed., GAO-06-382SP (Washington, D.C.: February 2006), page 7-15.

over recording and reporting of obligations, and put SEC at risk that the amounts recorded in the general ledger and reported on SEC's Statement of Budgetary Resources are misstated.

Recommendations

We recommend that SEC take the following actions to improve its budgetary accounting controls:

9. Correct general ledger system configurations to properly account for upward and downward adjustments of prior-years' undelivered orders in accordance with the U.S. Standard General Ledger.
10. Establish and implement controls over obligation-related entries (including original obligations, corrections, and deobligations) to ensure the use of correct *U.S. Standard General Ledger* accounts and the recording of correct amounts.
11. Clarify administrative control of funds guidance and document the responsibilities of the staff performing obligation-related activities with regard to recording obligations in accordance with the recording statute.
12. Establish and implement controls to ensure that SEC staff adheres to existing policies and procedures to prevent violations of the recording statute.

Other Issues

Although not considered to be a significant deficiency, the following weaknesses warrant management's consideration.

Certification of Employees' Time Cards, Documentation of Monitoring of Time Card Certification, and Approval of Personnel Actions

We identified three internal control issues with regard to payroll transactions. Specifically, these issues concern the certification of employees' time cards, the documentation of monitoring procedures over time card certification, and the approval of personnel actions.

During our fiscal year 2007 audit, we noted nine instances in which time cards were improperly certified by lower-level employees. We previously noted concerns with administrative officers approving time cards for higher-level employees on a regular basis during fiscal year 2006.

SEC time and attendance (T&A) policies instruct that each organization designate timekeepers who are responsible for initiating time cards and designate supervisors or managers as certifiers who have responsibility for reviewing the accuracy of time cards. The T&A instructions state that administrative officers may certify time cards for higher-level officials for emergency situations only.

As noted above, during our fiscal year 2006 audit, we found cases in which administrative officers improperly certified time cards of higher-level employees on a regular basis. We communicated this finding to SEC officials in August 2006. In response to our finding, SEC's Office of Human Resources (OHR) began to actively monitor the level of employees certifying time cards to determine compliance with its current stated policy. During our fiscal year 2007 audit, we observed SEC's monitoring of time card certifications for a particular pay period. However, SEC did not document when, or what, they were monitoring or the results of what they found. Lack of documentation of these control procedures may delay or prevent SEC management from becoming aware that monitoring of time card certifications has ceased or that there are instances of employees certifying higher-level officials' time cards on an other than emergency basis.

Consistent with GAO's *Standards for Internal Control in the Federal Government*,[11] internal control should be clearly documented, and the documentation readily available for examination. According to SEC's OHR, development of this documentation will be undertaken after determining how best to document its monitoring of time card certifications.

Also, during our interim testing of payroll, we compared selected personnel actions on the employee roster against Standard Form-50 ("Notification of Personnel Action") documentation and identified one employee who approved a valid personnel action for an increase in his own salary without evidence of additional review from another level of management. According to GAO's *Standards for Internal Control in the Federal Government,* "key duties and responsibilities need to be divided or segregated among different people to reduce the risk of error, waste, or fraud." In addition, "no one individual should control all key aspects of a transaction or event." Because one individual performed incompatible duties regarding his own personnel actions, there is a risk of fraud.

<u>Recommendations</u>
We recommend that SEC, in addition to our previous recommendations in this area which are included in enclosure I, take the following actions to improve its payroll controls:

13. Establish and implement procedures for documenting evidence of monitoring of time card certifications and include procedures to document any identified exceptions.
14. Segregate key responsibilities over the approval of personnel actions so that no one individual approves his own personnel action.

Agency Comments

In providing written comments on a draft of this report, the SEC Chairman stated his commitment to remediate the control deficiencies this fiscal year. The SEC Chairman reported several actions SEC has already taken to address financial reporting processes, documentation, and controls, and summarized SEC's Corrective Action Plan (CAP) to address GAO's recommendations. The Chairman cited developing a fully integrated financial management system as the keystone of SEC's CAP to remediate the deficiencies relative to system integration, noncompliance with *U.S. Standard General Ledger (SGL)* at the transaction level, and compensating controls. The Chairman noted that remediation strategies are presented in the CAP in terms of both short-term solutions that are expected to be achieved this fiscal year and long-term solutions that will achieve greater efficiency, effectiveness, and risk mitigation by minimizing reliance on detective controls. Specifically, the short-term strategies are to develop or improve process documentation; overlay manual processes with additional compensating controls as needed; implement SGL-compliant

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

posting models; and implement process improvements to enhance efficiencies and effectiveness of internal controls and monitor performance. The long-term strategies are to automate integration of financial management systems and to comply with the SGL at the transaction level. We will evaluate SEC's actions and initiatives during our fiscal year 2008 audit.

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

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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 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 Chairman 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 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 our 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 2007 and 2006 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

Table 1: Recommendations from 2004 Audit Reported as Open at Conclusion of 2006 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. Implement controls so that the ongoing activities involving disgorgements and penalties are properly, accurately, and timely recorded in the accounting system.		X
3. 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		
4. 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	
5. 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
Property and equipment leases		
6. 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
7. Develop policies and procedures to properly account for future property and equipment leases on an ongoing basis.		X
Closing recommendation to address Federal Managers’ Financial Integrity Act weaknesses		
8. 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.

Table 2: Recommendations from 2005 Audit Reported as Open at Conclusion of 2006 Audit

Audit area/recommendation	Status of recommendation	
	Closed	Open
Financial statement preparation and reporting		
1. 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	
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 2-5):		
2. 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
3. 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
4. The recording of activity by case for fiduciary balances, including monthly reconciliations and management review, to ensure that balances by case are accurate.		X
5. 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)		
6. Clarify guidance regarding policies and procedures (as described in SECR 10-8 and SECR 10-15) 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		
7. Take action to help ensure that its policy on recalculating fee-bearing filing amounts is consistently followed.		X
8. Take action to help ensure that the recalculation of the required filing fees is clearly documented.		X
Compliance with Prompt Payment Act		
9. 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	

Source: GAO.
Note: Recommendations from GAO-06-459R.

Table 3: Recommendations from 2006 Audit

Audit area/recommendation	Status of recommendation: Closed	Status of recommendation: Open
Property and equipment		
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.		X
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.		X
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 Office of Information Technology and Office of Financial Management (OFM) training to software project managers on the requirements of applicable generally accepted accounting principles.		X
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.		X
Payroll system access, approval of time and attendance records, and process documentation		
5. 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.		X
Comparison of furniture and equipment received and ordered		
6. 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.		X

Source: GAO.

Note: Recommendations made in GAO-07-482R.

Enclosure II

Comments from the Securities and Exchange Commission

CHRISTOPHER COX
CHAIRMAN

HEADQUARTERS
100 F STREET, NE
WASHINGTON, DC 20549

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

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SAN FRANCISCO

March 21, 2008

Ms. Jeanette M. Franzel
Director
Financial Management and Assurance
Government Accountability Office
441 G Street N.W.
Washington, DC 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 and Financial Reporting Process*, GAO-08-461R. The report presents recommendations for improvements to internal control as identified in the GAO's financial statement audit of the Securities and Exchange Commission (SEC) for fiscal years 2007 and 2006.

I am pleased that the GAO's FY 2007 audit found that the SEC's financial statements and notes were presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. However, the GAO found that the SEC did not maintain effective internal control over financial reporting as of September 30, 2007. Because no material weakness is acceptable, we are committed to remediating the control deficiencies this fiscal year.

The SEC takes its responsibility for financial reporting very seriously. As the GAO found in the FY 2007 audit report, the SEC improved its controls over the accuracy, timeliness, and completeness of the disgorgement and penalty data and used a much improved database for the initial recording and tracking of these data. The GAO also noted that the SEC continued to make progress in resolving deficiencies in information security. In 2007, the SEC took the opportunity afforded by significant turnover in senior financial positions to fully review and evaluate existing financial reporting policies and procedures. During fiscal year 2007, the SEC committed extensive resources to improving financial reporting proccsses, documentation and controls. The SEC began the evaluation of manual processes and controls used to integrate subsidiary data sources with the General Ledger and initiated systematic improvements to those processes and controls. This review of policies and procedures and completion of related documentation will continue in fiscal year 2008.

In order to fully remediate the control deficiencies this fiscal year, we have prepared a comprehensive Corrective Action Plan (CAP) which builds on the efforts initiated in fiscal year 2007. On February 7, 2008, the SEC provided your office with

CHAIRMANOFFICE@SEC.GOV
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the draft *FY 2008 Corrective Action Plan for Remediation of Internal Control Deficiencies*. Work has already begun on several fronts. The plan specifically addresses the recommendations made by GAO. We welcome your feedback regarding any aspect of this plan and its completeness in addressing the concerns outlined by GAO.

Developing a fully integrated financial management system is the keystone of the SEC's Corrective Action Plan to remediate the deficiencies identified by the GAO. Fully integrated financial management systems and compliance with the U.S. Standard General Ledger (SGL) at the transaction level are fundamental requirements for federal financial management systems. The SEC's lack of automated system integration is the underlying cause of the system non-conformance reported. Currently, data is manually entered at a summary level; however, compliance with SGL is required at the transaction, or detail, level. The deficiencies in internal control over financial reporting are attributable to ineffective compensating controls over the manual processes and spreadsheets supporting financial statement balances that, in the desired state, will be replaced by fully automated integration.

We have developed remediation strategies to address the deficiencies found relative to system integration, non-compliance with SGL at the transaction level, and compensating controls. The strategies are presented in the Corrective Action Plan in terms of both long-term and short-term solutions. The short-term strategies represent improvements that are expected to be achieved this fiscal year. We are confident that these additional compensating controls will be successful in mitigating the risk associated with manual processes. The long-term solution will achieve greater efficiency, effectiveness and risk mitigation by minimizing reliance on detective controls.

The short-term strategies are to develop or improve process documentation; overlay manual processes with additional compensating controls as needed; implement SGL compliant posting models; and implement process improvements to enhance efficiencies and effectiveness of internal controls and monitor performance. In FY 2008, the SEC will continue to take a risk-based approach to ensure that process and procedural documentation is in place, as discussed above. The documentation will be comprehensive enough that management and auditors can clearly ascertain who is performing the control activities, the frequency of the control activities and how they are performed and evidenced. The SEC's first quarter 2008 financial statements were prepared using the newly documented methodologies.

In addition, the SEC is eliminating manual data handling and the use of multiple labor-intensive spreadsheets by automating the generation of financial statements. The implementation of a central data repository for financial statement preparation and analysis will mitigate the risk and the internal control deficiencies identified by the GAO. The automated tool has been run in parallel with the existing process for preparation of the monthly statements since December. The SEC will fully implement the tool beginning with the second quarter statements.

The long-term strategies are to automate integration of financial management systems to eliminate manual processes and comply with SGL at the transaction level. System integration will eliminate the need for the bulk of the manual data manipulation and entry currently required, resulting in enhanced timeliness, accuracy and reliability of the data, while reducing the need to maintain redundant schedules. The ability to fully comply with the SGL at the transaction level is dependent on SEC's ability to integrate or interface all transactional activity with Momentum, which is currently being upgraded to accommodate the necessary integration. Nonetheless, substantial compliance may be demonstrated in the short-term through eliminating use of unconventional posting models and other limitations that prevent proper recordation as discussed above.

As Chairman, I take the SEC's responsibility over financial reporting very seriously. 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 202-551-7840.

Sincerely,

Christopher Cox
Chairman

cc: Diego Ruiz
Kristine Chadwick

Enclosure III

Summary of 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[1]:

• 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 SEC and its operations, including its internal control 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 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 Federal Managers' Financial Integrity Act of 1982.

• Tested 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; the Prompt Payment Act; and the Federal Employees' Retirement System Act of 1986.

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

(194751)

[1] For further, more detailed, explanation of our audit scope and methodology, see the discussion in our related financial audit report (GAO-08-167).

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