United States Government Accountability Office

GAO

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

November 2005

FINANCIAL AUDIT

Securities and Exchange Commission's Financial Statements for Fiscal Years 2005 and 2004

GAO

Accountability * Integrity * Reliability

GAO-06-239

GAO Accountability·Integrity·Reliability

Highlights

Highlights of GAO-06-239, a report to Chairman of the Securities and Exchange Commission

November 2005

FINANCIAL AUDIT

Securities and Exchange Commission's Financial Statements for Fiscal Years 2005 and 2004

Why GAO Did This Study

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

Pursuant to the Accountability of Tax Dollars Act of 2002, the SEC is required to prepare and submit to Congress and the Office of Management and Budget audited financial statements. GAO agreed, under its audit authority, to perform the audit of SEC's financial statements. GAO's audit was done to determine whether, in all material respects, (1) SEC's fiscal year 2005 financial statements were reliable and (2) SEC's management maintained effective internal control over financial reporting and compliance with laws and regulations. We also tested SEC's compliance with certain laws and regulations.

www.gao.gov/cgi-bin/getrpt?GAO-06-239.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Jeanette Franzel at (202) 512-9471 or franzelj@gao.gov.

What GAO Found

In GAO's opinion, SEC's fiscal year 2005 financial statements were fairly presented in all material respects. A notable achievement during fiscal year 2005 was SEC's acceleration of its financial reporting and issuance of its audited financial statements by November 15, 2005. However, because of continued material internal control weaknesses in the areas of preparing financial statements and related disclosures, recording and reporting disgorgements and penalties, and information security, in GAO's opinion, SEC did not maintain effective internal control over financial reporting as of September 30, 2005. Recommendations for corrective actions will be included in a separate report. SEC did maintain in all material respects effective internal control over compliance with laws and regulations we tested as of September 30, 2005, and GAO did not find reportable instances of noncompliance with laws and regulations it tested.

For the preparation of its financial statements, SEC has drafted some policies and procedures, improved communication among SEC divisions, and improved subsidiary ledgers that support financial statement amounts. However, SEC's financial reporting process continues to be largely manual and difficult to follow. The link between the financial statements and the detailed account balances was not supported by an adequate audit trail; support for certain balances was not readily available; and policies for financial reporting were still incomplete. SEC's Office of Financial Management does not have sufficient staff with expertise in financial reporting, resulting in too many responsibilities vested with too few people, causing problems with segregation of duties, achieving quality assurance reviews, and being able to effectively manage the workload.

In the area of disgorgements and penalties, SEC has undertaken a comprehensive review of related financial data and has identified many inaccuracies which it is in the process of correcting. Contributing to SEC's control weakness in this area are limitations in SEC's database used to track disgorgement- and penalty-related activity. The database is not designed to facilitate accounting and financial reporting causing SEC to perform extensive, manual procedures to account for this activity. During our fiscal year 2005 audit, we continued to find inaccuracies in the data that were similar to what we found during the fiscal year 2004 audit.

SEC has taken steps to strengthen its information security by increasing staffing, certifying and accrediting applications, and establishing a backup data center. However, most of the weaknesses identified in our fiscal year 2004 audit persisted, and we identified additional weaknesses, including several important aspects of access control. Key to SEC's weakness in information security control is that it has not fully implemented a comprehensive program for security management. Such a program is fundamental to protecting the integrity, confidentiality, and availability of SEC's sensitive data.

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Abbreviations

FMFIA	Federal Managers' Financial Integrity Act
OMB	Office of Management and Budget
SEC	United States Securities and Exchange Commission

November 15, 2005

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

Dear Mr. Cox:

This report presents our opinion on whether the financial statements of the Securities and Exchange Commission (SEC) are presented fairly for the fiscal years ended September 30, 2005, and 2004. This report also presents (1) our opinion on the effectiveness of SEC's internal control over financial reporting and compliance as of September 30, 2005, including weaknesses in financial reporting controls detected during our 2005 audit; and (2) the results of our tests of SEC's compliance with selected laws and regulations during 2005.

The Accountability of Tax Dollars Act of 2002 requires that SEC prepare and submit to Congress and the Office of Management and Budget (OMB) audited financial statements. GAO agreed, under its audit authority, to perform the audit of SEC's financial statements. GAO conducted this audit in accordance with U.S. generally accepted government auditing standards and OMB audit guidance. This is the second year that SEC has prepared a complete set of financial statements for audit. A notable achievement during fiscal year 2005 was SEC's acceleration of its financial reporting. SEC was able to prepare financial statements that were fairly stated in all material respects for fiscal year 2005 by November 15, 2005, in accordance with OMB timeframes. This due date was met through the tremendous dedication of time and effort from SEC management and staff.

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

This report was prepared under the direction of Jeanette M. Franzel, Director, Financial Management and Assurance, who can be reached at

(202) 512-9471 or franzelj@gao.gov. If I can be of further assistance, please call me at (202) 512-5500.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

Comptroller General of the United States

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

To the Chairman of the United States Securities and Exchange Commission

In our audits of the United States Securities and Exchange Commission (SEC) for fiscal years 2005 and 2004, we found

- the financial statements as of and for the fiscal years ended September 30, 2005, and 2004, including the accompanying notes, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles;
- SEC did not have effective internal control over financial reporting (including safeguarding of assets), but had effective control over compliance with laws and regulations we tested that could have a direct and material effect on the financial statements as of September 30, 2005; and
- no reportable noncompliance with laws and regulations we tested.

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

Opinion on Financial Statements

The SEC's balance sheets as of September 30, 2005, and 2004, and its related statements of net cost, changes in net position, budgetary resources, financing, and custodial activity, with accompanying notes for the fiscal years then ended, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

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

Opinion on Internal Control

This is the second year that SEC has prepared a complete set of financial statements for audit. Despite the specific issues with internal control explained below, SEC was able to prepare financial statements that were fairly stated in all material respects for fiscal years 2005 and 2004. A notable achievement during fiscal year 2005 was SEC's acceleration of its financial reporting. SEC was able to issue financial statements that were fairly stated in all material respects for fiscal year 2005 by November 15, 2005, in accordance with OMB timeframes. This due date was met through the tremendous dedication of time and effort from SEC management and staff.

The acceleration did serve to highlight the difficulties in SEC's financial reporting process and the accounting and reporting for disgorgements that we identified in our fiscal year 2004 audit. In addition, SEC continues to have weaknesses in its information security controls.

Because of the material weaknesses in internal control discussed below, in our opinion, SEC did not maintain effective internal control over financial reporting (including safeguarding of assets) as of September 30, 2005, and thus did not provide reasonable assurance that losses and misstatements material in relation to the financial statements would be prevented or detected on a timely basis. However, SEC maintained in all material respects effective internal control over compliance with laws and regulations as of September 30, 2005, that provided reasonable assurance that noncompliance with laws and regulations that are direct and material in relation to the financial statements would be prevented or detected on a timely basis.[1]

Material Weaknesses

As a result of our fiscal year 2005 audit, we concluded that SEC continues to face the following key issues that we reported as part of our audit of SEC's fiscal year 2004 financial statements, which represent material weaknesses in internal controls:

- weaknesses in controls over the financial reporting process, resulting in SEC not being able to prepare reliable and timely financial statements without extensive and time-consuming manual procedures;

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

- weaknesses in controls over recording and reporting of disgorgement[2] and penalty[3] activity pertaining to those who violate securities laws, resulting in increased risk of incomplete or inaccurate disgorgement and penalty data; and

- weaknesses in information security controls, resulting in increased risk of unauthorized individuals being allowed to access, alter, or abuse proprietary SEC programs and electronic data and assets.

We have reported on these material weaknesses in our prior audit and have provided SEC recommendations to address these issues.[4] SEC has made some progress in resolving these matters; however, these matters remain as material weaknesses as of September 30, 2005. These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audits of SEC's fiscal year 2005 and 2004 financial statements, and our opinion on internal control does not affect our financial audit opinion on the financial statements. The details surrounding these weaknesses are being reported separately to SEC management, along with recommendations for corrective actions. Less significant matters involving SEC's system of internal controls and its operations will also be reported to SEC separately.

Financial Statement Preparation Process

In response to the findings of our fiscal year 2004 audit, SEC has taken some steps to address control weaknesses over preparing financial statements and related disclosures. For example, in August 2005, SEC drafted some policies and procedures for its financial statement preparation process. SEC also established a process to improve communication among other SEC divisions whose work impacts the

[2]A disgorgement is the repayment of illegally gained profits (or avoided losses) that the SEC distributes to harmed investors whenever feasible.

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

[4]GAO, *Information Security: Securities and Exchange Commission Needs to Address Weak Controls over Financial and Sensitive Data*, GAO-05-262 (Washington, D.C.: Mar. 23, 2005); *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Year 2004*, GAO-05-244 (Washington, D.C.: May 26, 2005); and *Material Internal Control Issues Reported in SEC's Fiscal Year 2004 Financial Statement Audit Report*, GAO-05-691R (Washington, D.C.: July 27, 2005).

financial statements, and SEC has improved its ability to produce subsidiary ledgers that support financial statement amounts. At the same time, SEC's financial reporting process continues to be manually intensive and time consuming, with numerous ad hoc procedures. For certain financial statement line items and disclosures, the detailed support for the balances and underlying transactions was not readily available, was difficult to retrieve, and did not easily facilitate an audit trail. In addition, SEC is still lacking policies and procedures for recording many of its activities, such as its process for determining disgorgement and penalty amounts receivable, for recording investment activity, and for reconciling certain account balances such as the fiduciary liability. Many policies and procedures that do exist are still in draft, are complicated and not easy to follow, or in some cases are outdated or not comprehensive. In addition, SEC still does not have an easy-to-follow process for compiling financial statement amounts to enable a cross-walk from the financial statements to the general ledger and supporting subsidiary schedules. Furthermore, certain balances on the financial statements do not readily agree to supporting detail. SEC's Office of Financial Management, the office charged with SEC's financial reporting and financial management, does not have sufficient staff with expertise in financial reporting. As a result, too many responsibilities have been vested with too few people, causing problems such as inadequate segregation of duties, inadequate quality assurance reviews, and difficulties managing the financial reporting workload. Because of these issues, SEC needed to dedicate considerable time and resources from its operating divisions to assist its Office of Financial Management in reconciling the financial statement amounts to its supporting general ledger balances and other supporting detail. SEC's financial reporting process can be strengthened by increased interaction with and input from the program operations' offices responsible for key financial data needed for financial reporting.

Controls over the financial statement preparation process should be designed to provide reasonable assurance regarding the reliability of the balances and disclosures reported in the financial statements and related notes in conformity with generally accepted accounting principles, including the maintenance of detailed support that accurately and fairly reflects the transactions making up the balances in the financial statements and disclosures. GAO's *Standards for Internal Control in the Federal Government*[5] provide an overall framework for establishing and

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

maintaining internal control, including a discussion of control activities, management review, and documentation of processes and transactions. A financial statement preparation process with documented comprehensive policies and procedures, a clear audit trail between the financial statement balances and the detailed support, and quality assurance reviews, if properly designed and implemented, should provide SEC management with reasonable assurance that the balances presented in the financial statements and related disclosures are supported by SEC's underlying accounting records. We believe SEC can use the lessons learned from the fiscal year 2005 financial reporting and audit processes to further formalize and improve its process for developing and reviewing the figures needed to compile and prepare its year-end and interim financial statements.

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.[6] As shown in SEC's Statement of Custodial Activity, SEC collected more than $1.6 billion from federal securities laws violators during fiscal year 2005. Of that total, approximately $302 million was distributed to harmed investors; $207 million was transferred to the Treasury; and approximately $1.1 billion is being held by the SEC for future distribution to harmed investors. In total, SEC held approximately $1.976 billion in such funds at September 30, 2005, for future distribution to harmed investors. These amounts are recorded in the fiduciary liability, investments, and fund balance with Treasury line items, with additional detail provided in note 18 to the financial statements. SEC also has recorded fines and penalties receivable of approximately $1.365 billion, of which it estimates that approximately $96 million will be collectible. These amounts are included in SEC's accounts receivable and custodial liabilities line items, with additional detail provided in note 6 to the financial statements.

[6] 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 these revenues.

Since our fiscal year 2004 audit, SEC has undertaken a comprehensive review of the disgorgement and penalty financial data in its database, which includes data on over 12,000 parties in SEC enforcement issues. SEC's review uncovered a significant amount of financial data inaccuracies which it is still in the process of correcting.

Our audit testing for fiscal year 2005 continued to find similar control weaknesses and data inaccuracies to the problems we noted during our audit of SEC's fiscal year 2004 financial statements. Contributing to SEC's control weaknesses in these areas is that the database SEC uses to record and report disgorgements and penalties data has limitations and is not designed to facilitate accounting for and financial reporting of the data. To compensate for limitations in the disgorgements and penalties database, SEC staff perform extensive manual procedures to compile quarterly subsidiary ledgers to update the accounting system for disgorgement- and penalty-related balances and activity (including cash receipts and disbursements). As we noted in our fiscal year 2004 audit, while SEC has a draft policy covering certain aspects of accounting for disgorgements and penalties, the policy is not comprehensive and does not include the process and controls for determining the amounts to be recorded for disgorgements and penalty activity and for reviewing the entries. In addition, SEC does not have a policy that includes formal procedures to provide assurance that the cash collections have been properly credited to the appropriate cases in the appropriate amounts in the related subsidiary records for investments and fund balance with Treasury. Furthermore, SEC's policies do not include formal procedures to provide assurance that cash disbursements are properly tracked in the related subsidiary ledgers that provide information on the status of each case.

As we have again found during the fiscal year 2005 financial statement audit, not having comprehensive policies and controls increases the risk that disgorgement and penalty transactions will not be completely, accurately, and consistently recorded and reported.

Although we were able to obtain sufficient audit support for SEC's estimated collectible amount of $96 million, we noted significant errors and misstatements in the recorded gross accounts receivable balance of $1.365 billion and the related allowance for loss of $1.269 billion. Specifically, we noted errors and/or inconsistent treatment in recording judgment and interest amounts, terminated debts, waivers, and recording of activity such as amounts paid by defendants. Contributing to these errors is the lack of a clear policy, communication, and coordination between the two key SEC units, both responsible for disgorgement and penalty activity, addressing the supporting documents needed to record the activity, as well as the lack of follow-up procedures to ensure that the activity is being recorded in a timely fashion and in the proper reporting period.[7] In most cases, these errors were offsetting through the allowance for loss account; however, such errors raise concern about the controls over the reliability of the gross accounts receivable and related allowance amounts reported in note 6 to the financial statements.

Establishing proper controls and policies and procedures over the recording of disgorgement and penalty activity and the related collections and adopting a new accounting system to capture the activity for financial reporting purposes are necessary to provide reasonable assurance that disgorgement and penalty transactions are recorded in a complete, accurate, and timely manner for management's use in decision making and tracking of operations, and to facilitate the preparation of financial statements and related disclosures. The process should also include maintaining supporting documentation that, in reasonable detail, supports the transactions that are recorded, and monitoring the data input, data modifications, and the related financial reporting process for reliability. Due to the importance of these activities to SEC's mission and the magnitude of the amounts, it is of critical importance that the internal control weaknesses in this area be addressed.[8]

Information Security

Effective information system controls are essential to providing reasonable assurance that financial information and financial assets are adequately safeguarded from inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction. These controls are part of an entitywide computer security management program that includes access controls, system software, application development and change controls, segregation of duties, and service continuity controls. A comprehensive entitywide security management program must be established in order to ensure effective information security controls and to provide a systemic

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

[8]Material weaknesses and system nonconformance issues concerning data integrity and financial reporting for disgorgements and penalties have been reported in SEC's FMFIA reports since fiscal year 2002.

approach to identifying and addressing security weaknesses. An effective program would include issuing guidance and implementing procedures for assessing risks, establishing policies and related controls, raising awareness of prevailing risks and mitigating controls, evaluating the effectiveness of established controls, and using the results of management's evaluation to continuously improve controls.

SEC relies extensively on computerized information systems to process, account for, and report on its financial activities and make payments. As part of the financial statement audit, we assessed the effectiveness of SEC's information system controls using GAO's *Federal Information System Controls Audit Manual*[9] which contains guidance for reviewing information system controls that affect the integrity, confidentiality, and availability of computerized data.

During fiscal year 2005, SEC took steps to strengthen its information security program by increasing security staffing, certifying and accrediting several major applications, and instituting a backup data center. At the same time, most of the information security controls weaknesses identified in our fiscal year 2004 SEC audit persisted[10] and we identified additional weaknesses. Specifically, SEC had not consistently implemented effective electronic access controls, including user accounts and passwords, access rights and permissions, network security, or audit and monitoring of security-relevant events to limit and detect access to its critical financial and sensitive systems and information. As a result, SEC's financial assets are at risk of loss due to access control weaknesses. In addition, weaknesses in other information security controls, including physical security, segregation of computer functions, application change controls, and service continuity, further increase the risk to SEC's information systems, information, and financial assets. As a result, sensitive data—including payroll and financial transactions, personnel data, regulatory, and other mission-critical information—remained at risk of unauthorized disclosure, modification, or loss. The details surrounding these weaknesses

[9]GAO, *Federal Information System Controls Audit Manual*, *Volume I—Financial Statements Audits*, GAO/AIMD-12.19.6 (Washington, D.C.: January 1999).

[10]Based on our review of SEC's information system general controls for fiscal year 2004, we made 58 recommendations. SEC implemented 9 of the recommendations as of the completion of our review. See GAO, *Information Security: Securities and Exchange Commission Needs to Address Weak Controls Over Financial and Sensitive Data*, GAO-05-262 (Washington, D.C.: March 23, 2005).

will be reported separately to SEC management, along with recommendations for corrective actions.

A key reason for SEC's information security control weaknesses is that SEC has not fully implemented a comprehensive security management program. SEC has taken some actions to improve security management such as defining roles and responsibilities for its central security group. However, it still needs to take additional steps to fully implement all key elements of an information security management program. Such a program is critical to provide SEC with a solid foundation for resolving existing information security problems and continuously managing information security risks. Without effective management of its information security controls, SEC will not be able to provide reasonable assurance that financial information and financial assets are adequately safeguarded from misuse, fraud, improper disclosure, modification, or destruction.

Compliance with Laws and Regulations

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

Consistency of Other Information

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

Objectives, Scope, and Methodology

SEC management is responsible for (1) preparing the financial statements in conformity with U.S. generally accepted accounting principles; (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal

Managers' Financial Integrity Act (FMFIA) are met; and (3) complying with applicable laws and regulations.

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

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

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

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

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

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

- evaluated the overall presentation of the financial statements;

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

- obtained an understanding of the recording, processing, and summarizing of performance measures as reported in Management's Discussion and Analysis;

- tested relevant internal controls over financial reporting and compliance with laws and regulations, and evaluated the design and operating effectiveness of internal control;

- considered SEC's process for evaluating and reporting on internal control and financial management systems under the FMFIA; and

- tested compliance with selected provisions of the following laws and their related regulations:

  - the Securities Exchange Act of 1934, as amended;

  - the Securities Act of 1933, as amended;

  - the Antideficiency Act;

  - laws governing the pay and allowance system for SEC employees; and

  - the Prompt Payment Act.

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

We did not test compliance with all laws and regulations applicable to SEC. We limited our tests of compliance to those required by OMB audit guidance and other laws and regulations that had a direct and material effect on, or that we deemed applicable to, SEC's financial statements for the fiscal year ended September 30, 2005. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

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

SEC Comments and Our Evaluation

In commenting on a draft of this report, the SEC Chairman was pleased to receive an unqualified opinion on SEC's financial statements. The Chairman also acknowledged the material weaknesses in internal control and stated that resolving the weaknesses will be his highest operational priority. The Chairman stated that SEC plans to address the internal control weakness concerning the preparation of financial statements by fully documenting and integrating into agency operations the disciplined procedures and policies needed to complete accurate and timely financial statements. In addition, SEC established a formal financial management review committee to provide advice and to regularly review the agency's financial operations and policies. SEC plans to address the internal control weaknesses related to disgorgements and penalties through the replacement of the financial system it uses to track disgorgement and penalty data. In addition, SEC plans to strengthen controls over the processes for tracking the investment and distribution of funds to harmed investors. To address the internal control weaknesses concerning information technology security that were identified in fiscal year 2004, SEC plans to complete action plans that were put in place following our fiscal year 2004 audit, including finalization of policies and operating procedures and procedures underlying the overall security management program. SEC also plans to begin defining actions and milestones for resolving additional weaknesses identified during this year's audit.

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

David M. Walker
Comptroller General
of the United States

November 10, 2005

SECTION 1

MANAGEMENT'S DISCUSSION AND ANALYSIS

The Securities and Exchange Commission is the federal agency that administers the federal laws governing the U.S. securities markets. As such, the SEC plays a fundamental role in maintaining the integrity and vitality of America's ownership society. The following section outlines the agency's vision, mission, values, and goals to achieve its desired outcomes, as presented in the SEC's five-year strategic plan. In addition, this section highlights the SEC's major accomplishments during fiscal year (FY) 2005, its upcoming challenges, and the results of some of its primary performance measures. This section also includes a discussion of the SEC's management controls and financial highlights.

Vision

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

Mission

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

Values

- *Integrity*
- *Accountability*
- *Fairness*
- *Resourcefulness*
- *Teamwork*
- *Commitment to Excellence*

GOALS

Enforce compliance with federal securities laws

The Commission seeks to detect problems in the securities markets, prevent and deter violations of federal securities laws, and alert investors to possible wrongdoing. When violations occur, the SEC aims to take prompt action to halt the misconduct, sanction wrongdoers effectively, and, where possible, return funds to harmed investors.

Promote healthy capital markets through an effective and flexible regulatory environment

The savings and investments of every American are dependent upon the maintenance of healthy capital markets. The Commission seeks to sustain an effective and flexible regulatory environment that will facilitate innovation, competition, and capital formation to ensure that our economy can continue to grow and to create jobs for our nation's future. Enhancing the productivity of America is a key goal that the SEC works to achieve by increasing investor confidence in the capital markets.

Foster informed investment decision making

An educated investing public ultimately provides the best defense against fraud and costly mistakes. The Commission works to promote informed investment decisions through two main approaches: reviewing disclosures of companies and mutual funds to ensure that clear, complete, and accurate information is available to investors; and implementing a variety of investor education initiatives.

Maximize the use of SEC resources

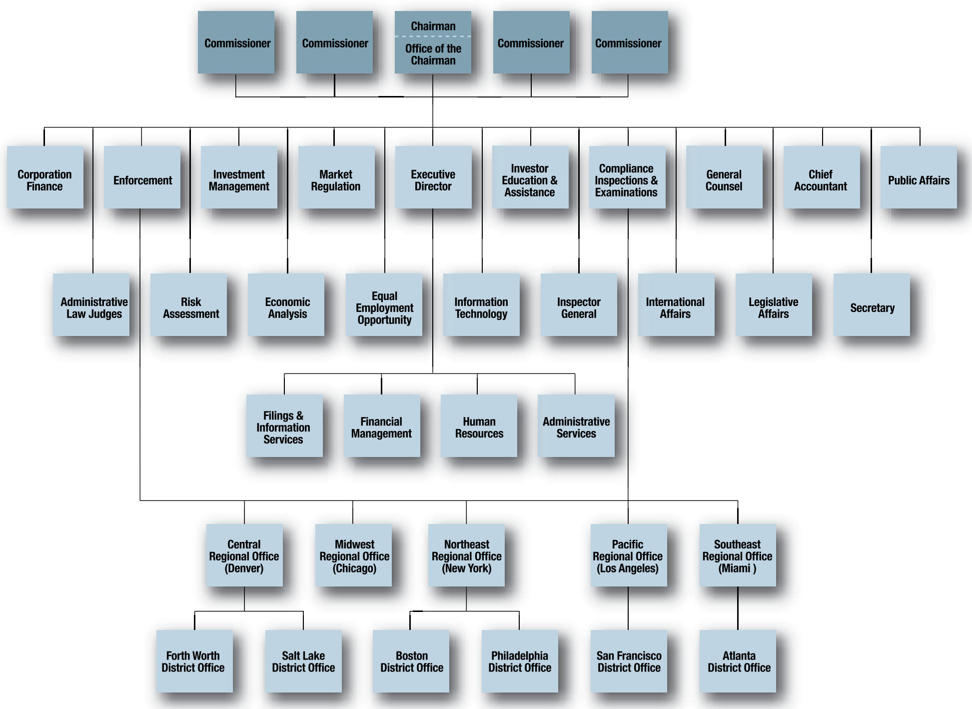
The investing public and the securities markets are best served by an efficient, well-managed, and proactive SEC. The Commission strives to improve its organizational effectiveness by making sound investments in human capital and new technologies, and by enhancing internal controls.

ORGANIZATIONAL STRUCTURE AND RESOURCES

The SEC is an independent federal agency established pursuant to the Securities Exchange Act of 1934. It is headed by a bipartisan five-member Commission, comprised of the Chairman and four Commissioners who are appointed by the President and confirmed by the Senate. The Chairman serves as the chief executive officer. The SEC is organized into four main divisions: Corporation Finance, Market Regulation, Investment Management, and Enforcement. It also has 19 functional offices. The Commission's headquarters are in Washington, D.C., and it has 11 regional and district offices throughout the country. In FY 2005, SEC received authorized funding of $913 million, of which $888 million was available for obligation, with the remainder to be made available in FY 2006. At September 30, 2005, the SEC had 3,865 staff, including 3,759 permanent staff and 106 temporary staff.

EXHIBIT 1.1

SEC Organization Chart



MAJOR ACCOMPLISHMENTS

FY 2005 was a year of tremendous accomplishment for the SEC on many different fronts. The agency's major achievements are discussed below.

Strengthened the SEC's Enforcement and Examination Programs

The SEC continued to improve its efforts to ensure compliance with the federal securities laws through enforcement activities and the ongoing inspection of regulated entities.

Enforcement Program

In FY 2005, the SEC initiated 947 investigations, 335 civil proceedings, and 294 administrative proceedings covering a wide range of issues, including mutual fund and investment adviser fraud, accounting fraud, and failures at self-regulatory organizations. The Commission prevailed in the great majority of the enforcement actions decided by district courts or administrative law judges, and a total of more than $3 billion in disgorgement and penalties was ordered in SEC enforcement cases. Whenever practical, the Commission sought to return funds to harmed investors through the use of disgorgement or the "Fair Funds" provision of the Sarbanes-Oxley Act. Following are some of the notable enforcement actions taken by the SEC in FY 2005.

Actions involving mutual funds and investment advisers

The SEC brought several significant fraud cases in the mutual fund and investment adviser area. For example, the Commission addressed market timing abuses in cases against (i) Canadian Imperial Holdings and CIBC World Markets; (ii) Banc of America Capital Management, BACAP Distributors, and Banc of America Securities; and (iii) Columbia Management Advisors and Columbia Funds Distributor. In those three cases alone, the SEC ordered disgorgement, prejudgment interest, and penalties of $640 million, all of which will be distributed to investors harmed by the conduct.

In another case involving a substantial fraud, the SEC brought an action against two Citigroup subsidiaries: Smith Barney Fund Management and Citigroup Global Markets. In the proceeding, the Commission found that the respondents misrepresented and omitted material facts when recommending to the boards of the mutual funds that the funds change from the third-party transfer agent they previously used to an affiliated Citigroup transfer agent. The respondents agreed to pay $208 million in disgorgement and penalties, which will be returned to investors pursuant to a distribution plan.

Actions involving accounting fraud, disclosure, and auditing failures

The SEC brought a number of cases relating to financial reporting misconduct, including major fraud actions against Time Warner and Qwest Communications International. Both cases involved inflated or improperly recognized revenue, among other violations. Time Warner agreed to pay $300 million in penalties, and Qwest agreed to pay $250 million in penalties, all of which will be distributed to harmed investors.

The SEC addressed disclosures of executive compensation in a case against Tyson Foods and its former CEO, Donald Tyson, alleging that the company made misleading disclosures of perquisites and personal benefits provided to Donald Tyson. Tyson Foods agreed to pay a $1.5 million penalty, and Donald Tyson agreed to pay a $700,000 penalty.

In significant cases relating to audit failures, the SEC charged Deloitte & Touche in connection with its audits of Adelphia Corporation, and KPMG in connection with its audits of Xerox. Deloitte's charges stemmed from its failure to detect a massive fraud perpetrated by Adelphia and certain members of the Rigas family. Deloitte consented to pay a $25 million penalty in the federal court action and $25 million in a separate administrative proceeding. The firm also agreed to undertakings designed to address future audits of high-risk clients. The entire $50 million will be deposited into a fund to compensate victims of Adelphia's fraud.

In the KPMG matter, the SEC charged the firm with permitting Xerox to manipulate its accounting practices to overstate equipment revenues by $3 billion and its true earnings by approximately $1.5 billion during a four-year period. The SEC also found that KPMG violated its obligations to disclose to Xerox illegal acts that came to its attention during the Xerox audits. KPMG consented to pay a total of approximately $22.5 million in disgorgement and penalties.

Actions involving self-regulatory organizations

In an action against the New York Stock Exchange (NYSE), the Commission found that the NYSE failed to adequately monitor and police specialists who engaged in widespread and unlawful trading ahead of customer orders on the floor of the exchange, harming customers by about $158 million from 1999 through 2002. The NYSE agreed to various remedial measures, including spending $20 million to fund audits of its regulatory program every two years through 2011.

The Commission also brought an action against the National Stock Exchange (NSX) and its CEO for similar failures. The NSX case related to the failure to enforce compliance by dealers with certain exchange rules from 1997 through 2003, which resulted in NSX's failure to detect hundreds of thousands of transactions in which NSX dealers engaged in unlawful trading ahead of customer orders.

In another significant action, the Commission issued a report of investigation concerning NASDAQ, as overseen by its parent, the National Association of Securities Dealers (NASD), in connection with an investigation and inspection of wash trades and net capital violations by MarketXT, an NASD member firm. The report finds, among other things, that NASDAQ employees observed suspicious trading by MarketXT and did not communicate their observations to NASD Regulation. In response to the SEC's investigation and the inspection from which it stemmed, the NASD and NASDAQ have implemented a number of remedial steps, all designed to strengthen the self-regulatory oversight of their market.

EXHIBIT 1.2

Distribution of Cases Across Core Enforcement Areas

DESCRIPTION: Effective deterrence of securities fraud requires that the cases filed by the SEC have adequate reach across all core enforcement program areas. The mix and types of cases change from year to year based upon the conditions of the markets and the changes in financial instruments being used. The SEC's enforcement program seeks to maintain a presence and depth so that no single area dominates its case mix, nor is underrepresented. This measure evaluates whether the Commission maintains an effective distribution of cases so that no category exceeds 40 percent of the total.

	PERCENTAGE OF CASES		
CORE ENFORCEMENT PROGRAM AREAS	FY03	FY04	FY05
Financial Disclosure	29%	28%	29%
Investment Advisers/ Investment Companies	11	14	16
Broker-Dealers	20	22	15
Securities Offerings	16	15	9
Insider Trading	7	7	8
Market Manipulation	5	6	7
Other	12	8	16
Total	100%	100%	100%

Examination Program

The SEC's examination program aims to detect fraud and other possible violations of the federal securities laws; foster compliance with these laws; and inform the Commission and its staff of compliance issues. The Office of Compliance Inspections and Examinations (OCIE) uses risk-based techniques to focus resources on those activities that could pose the greatest compliance risk to investors and the integrity of the markets. In FY 2005, OCIE continued to upgrade its risk-assessment techniques, and, given the breadth of its oversight responsibilities, substantially enhanced training for examiners. In addition, OCIE is exploring the use of new technologies that may facilitate the review of large volumes of data and enhance the examination process.

Examinations of investment advisers and investment companies

OCIE focused efforts on identifying the highest risk firms and activities. Specific examination reviews of investment companies and advisers focused on, among other areas: undisclosed arrangements between funds and fund service providers; pricing and valuation practices; accuracy of performance claims; compliance with anti-money laundering requirements; and market timing and late trading. OCIE also concluded an examination sweep of pension consultants and issued a public report outlining conflicts of interest and other concerns. Based on these findings, the SEC and the Department of Labor together published guidance for pension plan trustees that includes questions they can ask pension consultants to aid them in identifying these conflicts of interest.

In FY 2005, using the risk-based examination protocol, the examination staff found significant compliance or operational deficiencies in more than a third of the examinations conducted. Most of these examinations led to remedial action and improved compliance practices by the firms examined. For example, firms voluntarily reimbursed investors over $117 million as a result of examinations, indicating that investors were overcharged, or were owed money. In addition, 11 percent of examinations of funds and advisers found indications of serious problems that were referred to the Division of Enforcement for further investigation.

To help strengthen compliance practices and to assist chief compliance officers in performing their important responsibilities, OCIE and the Division of Investment Management initiated the *"CCOutreach Program,"* which includes regional and national conferences designed to facilitate communications between the SEC staff and the industry about compliance issues, practices, and techniques.

Examinations of broker-dealers

In its FY 2005 examinations of broker-dealers, OCIE focused on areas of significant compliance risk, including: misuse of non-public information concerning trading activities of institutional investors; execution practices in equities and debt, including mark-ups; compliance with net capital and customer reserve obligations; and market timing and late trading in mutual fund shares. OCIE initiated special examinations with respect to: the suitability of recommendations made to retail investors; broker-dealers providing fee-based accounts; revenue-sharing practices; and sales of securities to members of the military. OCIE also assisted in implementing the SEC's program for monitoring consolidated supervised entities and it inspected the internal controls and risk management practices at large broker-dealers. OCIE continued efforts to coordinate examination oversight among regulators.

Also in FY 2005, examinations found compliance or operational deficiencies in more than 80 percent of examinations, and about one third of the examinations found problems that resulted in a referral to the

Division of Enforcement staff or to a self-regulatory organization for further investigation. Importantly, most examinations resulted in remedial action and improved compliance by the firms examined.

Examinations of self-regulatory organizations

OCIE conducted risk-based and routine inspections of the surveillance, examination, disciplinary, arbitration, customer communication, and listing programs of self-regulatory organizations (SROs). In FY 2005, special focus was placed on surveillance for compliance with prohibitions on trading ahead of customer orders and "firm quote" obligations. The SEC began to develop procedures to review and analyze regulatory data that may allow the staff to monitor SRO regulatory activities more effectively and initiate more focused inspections.

Promoted Informed Investor Decision Making and Effective and Flexible Regulation of Reporting Companies

Over the past year, the SEC completed a number of regulatory initiatives to improve disclosure to investors and reform the requirements that apply to the securities offering process. In addition, this year marked the third anniversary of the Sarbanes-Oxley Act, and the Commission took a number of steps to adapt its implementation of the Act and related requirements to sustain an effective and flexible regulatory environment.

Reform of offering and disclosure requirements

Securities offering reform. The Commission adopted amendments to the rules under the Securities Act of 1933 that significantly relax restrictions on communications by issuers and underwriters around the time of securities offerings. The amendments continue the Commission's long-term efforts toward integrating disclosure and processes under the Securities Act and the Securities Exchange Act of 1934. The greatest flexibility in communications is provided to issuers that have a reporting history and are widely followed in the marketplace. In addition, the reforms will facilitate rapid market access for well-known issuers.

Asset-backed securities. The Commission adopted comprehensive registration, disclosure, and reporting requirements under the Securities Act and the Exchange Act for asset-backed securities, an increasingly significant segment of the fixed-income capital markets.

Shell companies. The Commission adopted amendments relating to Form S-8 and Form 8-K filings in order to deter fraud and abuse by reporting shell companies.

Interactive data. The Commission established a voluntary program that permits registrants to furnish financial data required in filings under the Exchange Act and the Investment Company Act of 1940 in eXtensible Business Reporting Language (XBRL) format, which allows investors, analysts, and other market participants, as well as the SEC itself, to manipulate and personalize financial data in ways that are best suited for their purposes.

Effective and flexible implementation of disclosure and internal control requirements

Small businesses. The SEC established the Advisory Committee on Smaller Public Companies to examine the impact of the Sarbanes-Oxley Act and other federal securities laws on those companies. The committee will issue a final report by April 2006, in which it will present recommendations for the Commission's consideration.

Internal control over financial reporting. After evaluating the substantial costs and efforts undertaken by companies to comply with Section 404 of the Sarbanes-Oxley Act and other regulatory requirements, the Commission extended by one year the compliance dates for certain reporting companies to meet the requirements for internal control over financial reporting requirements. The SEC, along with the Public Company Accounting Oversight Board, has also continued to monitor the implementation of Section 404 and provide interpretive guidance as necessary.

Accelerated filers. After considering the concerns expressed by large companies about their ability to file periodic reports under the accelerated filing schedule that would have become effective in 2006, the Commission postponed the final stage of the accelerated filing requirements. In addition, the Commission proposed rules that would limit the final stage of the accelerated filing schedule to only the largest companies and would eliminate for all companies the final stage of the accelerated filing schedule for quarterly reports.

Foreign private issuers. Recognizing that compliance with certain SEC requirements could be difficult and burdensome for foreign private issuers that are transitioning to the use of International Financial Reporting Standards (IFRS), the Commission provided an accommodation for foreign private issuers filing reports with the SEC that include financial statements prepared using IFRS for the first time.

Disclosure review program

The Division of Corporation Finance continued to improve its disclosure review program. Under the Sarbanes-Oxley Act, the SEC is required to review at least once every three years the financial statements of each reporting company and investment company issuer. This year marked the final year of the first three-year cycle, and the Division met the requirement through its review of the financial statements of over 6,000 reporting companies in FY 2005.

The Division's Office of Global Security Risk continued to review the disclosure of companies engaging in activities that raise global security and humanitarian concerns that are material to investors.

The Division of Investment Management continued its review of mutual fund financial statements as required by the Sarbanes-Oxley Act. The Division met the requirement to review all financial statements of investment company issuers during the three-year cycle, reviewing more than 3,000 in FY 2005.

EXHIBIT 1.3

Percentage of Reporting Companies and Investment Companies with Disclosures Reviewed by the SEC

DESCRIPTION: The Sarbanes-Oxley Act requires that the SEC review the disclosures of all reporting companies at least once every three years. These reviews help improve the information available to investors and can uncover serious violations of the securities laws.

	FY03	FY04	FY05
Corporations	23%	22%	51%
Investment Companies	10%	54%	37%

Investor education

The SEC works to assist tens of thousands of investors who complain each year about the mishandling of their investments by securities professionals. In addition, the SEC responds to a wide range of questions from the public on how the securities industry works and where to find information about products, issuers, and securities professionals.

During FY 2005, the SEC's Office of Investor Education and Assistance (OIEA) opened 71,737 new matters resulting from investor complaints and questions, and closed 71,789 pending matters, of which 81 percent were closed within seven days.

OIEA issued numerous investor alerts and publications in response to new scams and emerging products and issues. For example, in the aftermath of Hurricane Katrina, OIEA created a special web page to assist investors and regulated entities. The site includes alternate contact information for Gulf-area investment advisers, guidance on safely using the Internet to check account balances and advice for investors on avoiding scams, protecting credit, and rebuilding banking and other financial records.

OIEA also led workshops and seminars and worked to enhance public awareness of SEC investor resources through outreach to public libraries and participation in public-private partnerships. During FY 2005, the staff distributed 476,000 investor brochures through the General Services Administration's Federal Citizen Information Center. The SEC's investor education web pages received approximately 8.5 million hits.

In addition to carrying out its education and assistance functions, OIEA also provided policy guidance on several key rulemaking initiatives. For example, OIEA collaborated with the Divisions of Investment Management and Market Regulation in using focus groups and in-depth investor interviews to test-market and refine disclosure documents.

Enhanced Transparency and Investor Protection in the Mutual Fund and Investment Advisory Industries

Through several major rulemaking initiatives, the SEC took steps to address abuses and promote transparency and investor protection in the mutual fund and investment advisory industries.

Mutual fund redemption fees. Following significant mutual fund reforms in FY 2004 relating to late trading and market timing scandals, the SEC in FY 2005 adopted a new redemption fee rule, which permits funds to impose a fee of up to 2 percent on the redemption of fund shares. The rule enhances investor protection by requiring that fund boards consider whether they should impose a redemption fee to protect fund shareholders from market timing and other possible abuses. The redemption fee is paid to the fund (rather than to fund management) for the direct benefit of fund shareholders.

Point-of-sale disclosure. As part of a continuing effort to strengthen disclosures to mutual fund investors, the SEC reopened the comment period on proposed rules that would require broker-dealers to disclose to their customers the costs and conflicts of interest that arise from the distribution of mutual fund shares. The proposal would require disclosure at the point of sale and in the confirmation statement.

Hedge fund adviser registration. In FY 2005, the SEC adopted a new rule requiring most hedge fund managers to register as investment advisers. The regulation was prompted by significant recent growth in hedge funds, which are estimated to have $1 trillion in assets. The SEC identified two other concerns that led to the rule's adoption: a growth in hedge fund fraud; and increasing exposure of smaller investors, pensioners, and other market participants, directly or indirectly, to hedge funds. The rule is designed to provide the protections of the Investment Advisers Act of 1940 to hedge fund investors and to enhance the SEC's ability to oversee the securities markets.

Investment adviser/broker-dealer rule. The Commission adopted a new rule addressing the application of the Advisers Act to broker-dealers that offer fee-based accounts. Under the new rule, a broker-dealer is not, by reason of receiving fee-based compensation, subject to the Advisers Act if it provides investment advice in fee-based accounts that is solely incidental to the brokerage services provided to those accounts and if the broker-dealer makes required disclosures. A broker-dealer exercising discretion over customer accounts would be subject to the Advisers Act regardless of the form of compensation received (fixed fees or commissions). In addition, a broker-dealer would be subject to the Advisers Act if it provides investment advice as part of a financial plan and portrays itself to the public or its customers as a financial planner.

Strengthened Market Structure, Governance, and Oversight of Broker-Dealers

In FY 2005, the Division of Market Regulation engaged in rulemaking, reviewed rule filings of self-regulatory organizations, and conducted consolidated supervision of securities firms to strengthen the trading markets, better protect investors, and monitor securities firm financial risk exposure.

Market structure and Regulation NMS. In FY 2005, the SEC addressed important issues of equity market structure that cleared the way for significant market restructuring. In adopting Regulation NMS, the Commission set the terms for competing markets to access and interact with each other. It also resolved issues of minimum quoting increments and allocations of market data. These rule changes are intended to strengthen competition in the national market system for equity securities. Shortly after Regulation NMS was approved, the two largest U.S. equity markets—the NYSE and NASDAQ—announced mergers that, if consummated, will significantly reshape these markets. Other equity markets have also announced restructurings designed to increase their competitiveness.

Governance and structure of self-regulatory organizations. The Commission published two releases discussing the role and operation of self-regulatory organizations (SROs). The first release proposed rules setting governance standards for SROs, in order to increase their independence from member firms and to ensure their effective regulation if publicly owned. The rules would also require greater disclosure by SROs of their finances and structures. The second release requested comment on conflicts affecting SROs, and possible alternative self-regulatory structures to reduce these conflicts.

Short sale pilot program. The Commission implemented a pilot program to examine the impact of removing price restrictions on short sales of securities, while at the same time adopting rule changes requiring closeouts of naked short positions.

Regulation M amendments. The Commission proposed amendments to Regulation M, which governs securities offerings, in order to tighten the regulations governing underwriters' stabilization, after-market solicitations, short covering transactions, penalty bids, and other activities.

Consolidated supervised entities. The SEC continued to review applications from certain broker-dealers and their holding companies and affiliates for group-wide supervision as "consolidated supervised entities." These firms submit to this form of regulatory oversight in exchange for the use of an alternative method to compute net capital. The SEC's reviews involve detailed assessments of the applicants' capacity to manage financial and operational risks, including market, credit, and liquidity risk.

Credit rating agencies. The Commission proposed a new rule to define the term "nationally recognized statistical rating organization" (NRSRO), in order to clarify the recognition criteria and application process. The changes would enhance the agency's ability to ensure that such credit rating agencies continue to meet the minimum standards that led to NRSRO designation.

EXHIBIT 1.4

Milestones for Significant Rulemakings

RULEMAKING	FY 2005 PLAN	FY 2005 ACTUAL
Corporation Finance		
Securities Offering Reform	Final Action	Adopted
Asset-Backed Securities	Final Action	Adopted
Interactive Data-XBRL	Voluntary Rules/Concept Release	Voluntary Rules Adopted/ Concept Release Issued
Transition to IFRS Accounting Standards	Final Action	Adopted
Shell Companies	Final Action	Adopted
Shareholder Nomination Process	Final Action	No Action Taken
Disclosures of Executive Compensation and Related Party Transactions	Propose	No Action Taken
Communications with Beneficial Owners of Securities	Propose/Concept Release	No Action Taken
Investment Management		
Redemption Fees for Mutual Funds	Final Action	Adopted
Hedge Fund Adviser Registration	Final Action	Adopted
Broker-Dealer Exemption	Final Action	Adopted
Address Mutual Fund Late Trading	Final Action	No Action Taken
Reform Fund Disclosure Regime	Propose	No Action Taken
Changes to Adviser Disclosure Regime	Final Action	No Action Taken
Changes to Distribution Fee Rules	Evaluate	No Action Taken
Market Regulation		
National Market System (Regulation NMS)	Final Action	Adopted
Short Sale Regulation (Regulation SHO)	Implement Pilot	Adopted
SRO Governance Rules	Final Action/Concept Release	Proposed/Concept Release Issued
Soft Dollars	Propose	Proposed
Point-of-Sale/Confirmation Disclosure	Final Action	Reopened Comment Period
Regulation B	Final Action	No Action Taken
Net Capital Rule Revisions	Propose	No Action Taken

Improved Operational Effectiveness

The SEC continued to improve its operational effectiveness in FY 2005 through organizational changes and enhancements of its information technology systems.

The agency completed its first full financial statement audit in 2005, consistent with the Accountability of Tax Dollars Act of 2002. The Government Accountability Office (GAO) performed the audit for FY 2004 and delivered an unqualified opinion, finding that the SEC's FY 2004 financial statements were "presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles." However, GAO did identify three material internal control weaknesses in the areas of: recording and reporting disgorgement and penalties; preparing financial statements; and information technology security. As discussed more fully in the *Management Controls and Compliance with Laws and Regulations* section of this report, the agency takes these findings very seriously, particularly given its unique role in monitoring the financial reporting controls of public companies and regulated entities. The SEC continued working aggressively to address these weaknesses and expects to fully resolve them in FY 2006.

The SEC also worked aggressively in FY 2005 to strengthen budget planning for the agency's office facilities. In May 2005, the SEC disclosed to Congress that it had identified unbudgeted costs of approximately $48.7 million associated with the construction of its new facilities in Washington, D.C. and improvements to its new leased facilities in New York and Boston. As discussed in the *Management Controls and Compliance with Laws and Regulations* section of this report, GAO conducted a review of these lapses and recommended certain actions to address them. The SEC has already adopted a number of these recommendations and plans to implement all remaining GAO recommendations during FY 2006.

The SEC began to implement an activity-based costing and performance-based budgeting system, based on the recommendations of a requirements analysis completed in FY 2005. This system, the Budget and Program Performance Analysis System, will be a vital tool for management to strengthen internal controls and to provide a detailed picture of the Commission's operations and their effectiveness.

In FY 2005, the SEC reorganized the procurement and contracting function, recruited additional staff for this area, and selected an automated procurement application. These steps will improve the timeliness and quality of the SEC's acquisition operations and better integrate acquisition planning into the annual budget formulation process.

The agency launched a variety of initiatives to expand the SEC University (SEC-U), the agency's central workforce development program. These efforts included increasing the numbers and types of courses offered, offering options for attorneys and accountants to obtain continuing education credits, completing a comprehensive training needs assessment, and creating a website, which details the SEC-U's human capital development opportunities. The Commission also evaluated and significantly improved its orientation program for new employees.

The SEC continued to use several important human capital programs to retain employees with valuable skills. For example, the agency continued its compensation program that rewards superior performance through a pay-for-performance system. The SEC also offers an expanded benefits package that includes student loan repayment, dental and vision benefits, and other programs to attract and retain talented employees. *Exhibit 1.5* shows the agency's turnover rate in recent years. Although attrition rose in FY 2005, the SEC was recently ranked among the top five places to work in the federal government in a study conducted by the Partnership for Public Service and *U.S. News & World Report.*

EXHIBIT 1.5

Staff Turnover Rate

DESCRIPTION: This measure is determined by dividing the number of employees that leave the agency during the fiscal year by the total number of permanent and term employees on board at the beginning of the fiscal year.

FY 2001	FY 2002	FY 2003	FY 2004	FY 2005
9.1%	5.8%	5.9%	6.3%	7.5%

Adopted New Information Technologies

Finally, the SEC implemented a variety of initiatives to further integrate information technology into its operations (see *Exhibit 1.6*). Some of the major initiatives from FY 2005 are explained in more detail below.

Interactive data. The SEC implemented a voluntary program for registrants to use eXtensible Business Reporting Language (XBRL) in their financial disclosure filings. This format allows financial information to be retrieved from disclosure forms and analyzed automatically. Using interactive data in this way is intended to improve the ability of the public and internal reviewers at the SEC to evaluate and compare data.

Document imaging. The document imaging project, which was initiated in FY 2004 and continued in FY 2005, is intended to reduce the amount of time that Enforcement Division and staff spend searching for documents and protecting the information in case of disaster. The SEC made preparations to prioritize and scan the remaining backlog of investigation-related documents. In addition, the agency expanded imaging services to other offices.

Case tracking. The SEC developed requirements for a fundamental redesign of the Enforcement Division case tracking system. The new system is expected to reduce the costs associated with searches and reports, eliminate duplicative and inaccurate data entry, and help the agency better track funds ordered through enforcement actions.

Forensics capabilities. The agency upgraded the enforcement program's IT forensics capabilities, allowing staff to obtain and analyze data much more quickly from equipment subpoenaed or seized in the course of investigations.

Risk mapping. The SEC piloted a number of new tools to help staff better identify sources of potential risk—whether in disclosure filings, market data, news feeds, evidentiary or examination documents, or elsewhere. For example, the staff piloted a set of tools that will analyze corporate and mutual fund filing information to identify companies most in need of review.

EXHIBIT 1.6

Milestones for Major IT Projects

	FY05 PLAN	FY05 ACTUAL
Electronic Data Gathering Analysis and Retrieval (EDGAR)/Disclosure		
Modify EDGAR to accommodate interactive data in XBRL format for financial reports	Initiate	Initiated
Transition EDGAR system management to new contract	Initiate	Initiated
Enhance SEC.gov to improve EDGAR data searches and accessibility for investors	Initiate	Initiated
Enforcement/Examination Activities		
Image backlog of paper-based discovery documents	Complete	In Progress
Provide fully automated processing of options trade records in support of enforcement investigations	Initiate	In Progress
Redesign the enforcement case management system to improve management of disgorgement and penalties	Initiate	Initiated
Upgrade analytical tools available to examiners	Initiate	Initiated
Internal Productivity		
Implement new systems to support expansion of telework	Initiate	In Progress
Upgrade telecommunications systems in Washington, D.C. metropolitan area	Complete	Completed
Security/Disaster Recovery		
Migrate to alternate data center	Complete	Completed
Certify and accredit major systems for information security risk	Initiate	In Progress
Institute awareness training and incident response programs	Implement	Completed
Implement Homeland Security Presidential Directive 12 for personnel identity verification and access control	Initiate	Initiated
Electronic Government (e-Gov)/Enterprise Architecture and Capital Planning Investment Control		
Redesign organizational structure of IT function	Complete	Completed
Redesign capital planning and project management processes	Implement	In Progress
Institute enterprise architecture program	Implement	In Progress
Implement new procurement and budgeting/performance management systems	Initiate	Initiated
Participate in cross-agency e-Travel project	Initiate	Initiated

CHALLENGES

The SEC undertook a variety of actions in FY 2005 to address the challenges highlighted in last year's Performance and Accountability Report, as well as new issues that have emerged. The following section discusses the SEC's key challenges and the steps the agency is taking to overcome them.

Resolving Material Weaknesses in Controls over Financial Reporting

The SEC's highest operational priority is to remedy the material weaknesses in the agency's internal controls. As discussed more fully in the *Management Controls and Compliance with Laws and Regulations* section of this report, management and the Government Accountability Office (GAO) have identified three material weaknesses for FY 2005 relating to the SEC's controls over: (i) recording and reporting of disgorgement and penalties, (ii) information security, and (iii) preparing financial statements and related disclosures. The SEC takes these weaknesses very seriously, particularly given the agency's unique role in monitoring the internal controls of public companies and regulated entities. The agency is committed to resolving all material weaknesses fully in FY 2006.

Recording and reporting of disgorgement and penalties

The SEC has taken steps to begin the replacement of the financial system for recording disgorgement and penalties. The new system will be integrated into the agency's current central accounting system. The staff is also in the process of implementing the controls necessary to ensure that ongoing activities involving disgorgement are accurately and timely recorded in the accounting system. In addition, new staff resources are being added to strengthen the coordination and communication between the SEC's Division of Enforcement and Office of Financial Management in order to ensure accuracy in recording the agency's disgorgement and penalties data.

Information security

The SEC made significant progress in FY 2005 in developing and implementing an improved information security program. The Office of Information Technology (OIT) certified and accredited 12 major systems and completed 11 SEC regional and district office security risk assessments. In addition, OIT established a security policy framework and reviewed and began documenting its enterprise security architecture. The certification and accreditation of the SEC's IT systems is expected to be completed in FY 2006.

Financial statement preparation process

As with many private companies, the SEC has invested tremendous time and energy in examining and bolstering its financial management practices and internal controls. In addition to improvements made as a result of the GAO audit for FY 2004, an internal senior management team reviewed many of the financial management processes and policies during FY 2005. The team confirmed the acceptability of many of the initial policies applied in FY 2004, and it directed that others be further modified or reviewed. Going forward, a permanent senior management committee will regularly review and assess the agency's financial management and reporting functions. In addition, the SEC is increasing its financial management staff, strengthening documentation of procedures and policies for statement preparation, and continuing to look for ways to apply the best practices of other federal agencies to SEC systems.

Strengthening Controls Over Budget Planning

In May 2005, the SEC disclosed to Congress that it had identified unbudgeted costs of approximately $48.7 million associated with the construction of its new facilities in Washington, D.C. and improvements to its new leased facilities in New York and Boston. At the time, the agency estimated that the impact on its FY 2005 and FY 2006 budgets for construction costs would be $20.2 million and $28.5 million, respectively. In September 2005, Congress approved the SEC's request to reprogram FY 2005 funds to make the necessary funds available for construction-related needs associated with these offices. To address the remaining shortfall, the SEC intends to completely pay for the three facilities projects in FY 2006.

GAO conducted a review of the SEC's building project management and related budget planning and identified the following as the primary causes of the $48.7 million omission: (i) ineffective management controls over budget formulation and review for these projects; (ii) an inadequate administrative infrastructure, and (iii) the particular nature of the facilities projects. In response to GAO's review, the SEC has taken several actions to address the conditions that led to these lapses, including working to enhance its facilities and budget staff in order to strengthen the agency's budget formulation, internal control, and facilities project oversight capabilities. The SEC plans to implement all remaining GAO recommendations during FY 2006.

Improving Fair Funds Administration and Distribution

Another high priority challenge for the SEC is improving the administration and distribution of "Fair Funds" for the benefit of victims of securities law violations. The Fair Funds provision of the Sarbanes-Oxley Act authorizes the SEC, in certain circumstances, to take penalties collected in enforcement cases and add them to disgorgement funds, making it possible to provide greater recovery to victims of securities law violations.

Since the SEC's Fair Funds authority is relatively new, the agency is proceeding deliberately to ensure that it meets its responsibilities to investors. Developing and administering a distribution plan includes determining what classes of investors, during what time period, were harmed; the relative harm to each particular class of investor; and what would constitute an equitable allocation. The SEC expects to learn from its recent experience in addressing these issues in order to expedite the Fair Fund distribution process in future cases.

The SEC has also taken several steps to increase the amounts returned to harmed investors. In particular, in administrative orders, the SEC now generally requires settling respondents to pay the costs of distributions. Another way in which the agency seeks to increase the return to harmed investors is by consolidating individual verdicts and funds in related cases, where appropriate. This can save investors hundreds of thousands of dollars in separate, duplicative distribution actions. Finally, the SEC seeks to ensure that Fair Fund monies awaiting distribution are earning interest. To this end, the SEC has established an agreement with the Bureau of the Public Debt, pursuant to which disgorgement and penalty funds are invested in short-term Treasury securities, pending their distribution to injured investors.

Going forward, the SEC will continue to look for ways to streamline the Fair Fund distribution process so that monies are returned to investors efficiently, effectively, and in a timely manner.

Leveraging Information Technology

The SEC continues working to strengthen IT management. In FY 2005, the Commission improved IT management by leveraging the organizational changes implemented within Office of Information Technology during FY 2004. Specifically, the newly established Project Management Office established a program budgeting framework to plan and account for all IT investments. In addition, OIT implemented processes and established controls that provide investment information necessary to make effective investment funding decisions and to monitor and evaluate the progress of approved investments.

Separately, the Enterprise Architecture (EA) Office made progress in updating its EA repository and modeling capabilities with the procurement of industry standard repository and modeling tools. Moreover, the office continued developing the frameworks and reference models necessary for aligning the agency with the government-wide Federal Enterprise Architecture and for developing, disseminating, and using the EA in the conception, approval, and management of IT investments within the Commission. Finally, OIT also implemented a policy framework that better aligns the SEC's operational controls and policies with the Clinger-Cohen Act and Office of Management and Budget guidance. These efforts will continue in FY 2006 as the SEC continues to strengthen its IT management and governance processes and controls.

Enhancing Risk Assessment

The SEC faces an ongoing challenge of addressing new or resurgent forms of fraudulent, illegal, or questionable conduct or practices before they pose a serious threat to investors. To meet this challenge, the SEC is continuing its aggressive strategy to detect and track emerging risks in their early stages through its risk assessment initiative. In FY 2005, the Commission made progress on a variety of initiatives that span the agency's mission including, for example, the development of a prototype risk tracking and analysis tool for capturing, ranking, reporting, and taking action on various risks. The agency also initiated extensive outreach to private and public sector and other participants, encouraging senior executives to engage in open and active dialogue about pressing issues, key risks, and best practices. In FY 2006, the SEC will expand upon the depth and complexity of risk assessment activities throughout the agency, and develop new technologies that can help SEC staff detect and track sources of potential risks.

Strengthening Human Capital Management

The SEC continues to work in a challenging human capital environment. As the Inspector General's report on serious management challenges facing the Commission indicates, the agency has made significant progress in several areas. For example, in FY 2005 the SEC completed its second cycle under its pay-for-performance system. The agency remains committed to rewarding its employees under this system and will work to ensure that the current system continues to meet its intended merit-based goals. In FY 2006, the SEC's Office of Human Resources (OHR) will complete the agency's first stand-alone Strategic Human Capital Plan. This plan will encompass initiatives and measures that the SEC will accomplish over the next five years and will be built on the Human Capital Assessment and Accountability Framework developed by OMB, the Office of Personnel Management (OPM), and GAO.

Finally, the staff has begun to analyze the results of the Federal Human Capital Survey in which the SEC participated through OPM. According to the findings of the study, the agency is in a strong leadership position in the federal government in terms of employee satisfaction.

MANAGEMENT CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS

SEC management is responsible for the fair presentation of the principal financial statements in conformity with U.S. generally accepted accounting principles for federal government agencies and the requirements of OMB Circular A-136, *Financial Reporting Requirements,* which incorporates and updates OMB Bulletin Number 01-09, *Form and Content of Agency Financial Statements.* Management is also responsible for the fair presentation of the SEC's performance measures in accordance with OMB requirements. The quality of the SEC's internal control rests with management, as does the responsibility for identifying and complying with pertinent laws and regulations.

Federal Managers' Financial Integrity Act

The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires agencies to evaluate annually their system of internal control and report to the President and Congress on whether it complies with the standards and objectives set forth in the Act. If non-compliant, an agency's report must identify the material weaknesses.

Management controls in effect during FY 2005 provided qualified assurance that, taken as a whole, the system of controls is achieving its objectives under Sections 2 and 4 of FMFIA.

This qualified assurance reflects material weaknesses in internal controls over financial reporting, relating to the following three areas:

- Accounting and reporting of disgorgement and penalties collected in enforcement proceedings (Sections 2 and 4);
- Information security (Section 2); and
- Process for preparation of financial statements and related disclosures (Section 2).

These material weaknesses were noted in last year's report and remain pending. In addition, this qualified assurance reflects a material weakness in controls over budget planning, identified by management during FY 2005, relating to:

- Budget planning for office facility improvements (Section 2).

Because the SEC is committed to the effective and efficient management of the resources entrusted to it, the agency takes very seriously these weaknesses in its internal controls and financial management systems. The SEC aims to hold itself to the highest standards, particularly given the agency's unique role in monitoring the internal controls of public companies and regulated entities. Progress was made on resolving each of these weaknesses during FY 2005, and the agency is committed to eliminating all material weaknesses during FY 2006. A discussion of the review process and the corrective actions taken and planned by the SEC to address these matters follows.

FMFIA Management Control Program and Review Process

In accordance with guidance issued by the Commission's Executive Director, 28 office heads conducted reviews of their financial, administrative, and program management controls. The offices range in size from nine to 648 positions, with an average of 146 positions at the end of FY 2005. This segmentation ensures comprehensive coverage of all SEC offices.

Each office head prepared an annual assurance statement that identified any control weaknesses that merit the attention of the Chairman or Executive Director. These statements were based on, among other things:

- Management knowledge gained from the daily operation of the office;
- Management reviews and dashboard reports (which are monthly reports used to track the

progress on operational, budgetary, and staffing objectives, and to adjust processes and resources as necessary);

- GAO or Office of Inspector General reports;
- Self-assessments;
- Annual performance plans and reports;
- Audit of financial statements;
- Reports and other information from Congress, OMB, Office of Personnel Management, General Services Administration, or similar agencies; and
- Other reviews relating to the office's operations.

Upon evaluation of the Section 2 and 4 submissions, recommendations from the Inspector General, and other supplemental sources of information, a committee of agency executives advised the Chairman whether the SEC had any management control deficiencies serious enough to be reported as a material weakness or nonconformance.

Other Reviews

Also during the year, the Office of Inspector General and the Office of Information Technology conducted a combined total of 27 alternative reviews. A majority of Commission offices were reviewed. Several offices underwent multiple reviews.

In addition, GAO completed its audit of the SEC's FY 2004 financial statements and conducted the audit of: the FY 2005 financial statements; the management controls over the financial systems and operating procedures affecting the statements; the agency's compliance with selected provisions of law and regulations applicable to the management of financial resources; and the actions taken in response to prior audit recommendations.

GAO also completed a review of the SEC's building project management and related budget planning, in response to the SEC's disclosure in May 2005 that it had identified unbudgeted costs of approximately $48.7 million associated with the construction of its new facilities in Washington, D.C. and improvements to its new leased facilities in New York and Boston.

Status of Controls over Financial Reporting

The SEC's FY 2004 Performance and Accountability Report disclosed three material weaknesses under Section 2 of the FMFIA, one of which also constituted a material nonconformance under Section 4. While the SEC made significant efforts to remediate these weaknesses during FY 2005, deficiencies remain as outlined below.

The internal control standards for federal agencies established by GAO define material weakness as a significant deficiency in the design or operation of one or more internal controls that result in unacceptable risk that undetected error or fraud could result in a material misstatement in the agency's financial statements. OMB guidance defines nonconformance as "instances in which financial management systems do not substantially conform to financial system requirements."

Reporting and recording of disgorgement and penalties

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

Corrective actions taken. Prior to FY 2005, SEC staff designed and implemented an interim system to record and report on data collected and entered on over 12,000 parties to SEC enforcement actions. During FY 2005, enforcement and financial staff met regularly to reexamine and change certain documentation and data entry procedures and to strengthen coordination and communication among offices. The agency undertook a comprehensive review of all case files to determine whether individual amounts recorded in the interim system were accurate. Work began on a new system to record financial data arising from enforcement actions. This system is designed to be fully integrated with the central accounting system.

Corrective actions planned. During FY 2006, enforcement and financial staff will continue to meet regularly to review and strengthen policies and procedures. The new subsidiary system will be completed by the end of the fiscal year, and business processes, policies and procedures will be redesigned. It is anticipated that consistent application of the internal controls and completion of the new system will improve recording and reporting capabilities and resolve the material weakness in FY 2006.

Information security

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

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

Corrective actions taken. The SEC established a centralized information security program under the Chief Information Officer and Chief Information Security Officer, and put in place a comprehensive information security program that addresses all of the issues associated with the material weakness. The Commission expects to certify and accredit 80 percent of major applications by the end of calendar year 2005, including accreditation of the general support system. The SEC developed information security control documents and all policies, procedures, and guidelines to reflect National Institute of Standards and Technology guidelines as mandated by FISMA.

The SEC continued to promulgate security awareness training internally; and 95 percent of all SEC employees and contractors received annual information security and privacy awareness training in FY 2005. Additionally, 83 percent of all system administrators received specialized security training. The SEC invested in an identity management system to ensure an improved access control system and put new processes in place to mitigate findings by GAO concerning separation of duties and access control.

Corrective actions planned. Both SEC general support systems and financial applications will be fully certified and accredited in FY 2006. Corrective actions for specific control weaknesses identified in the GAO review are being implemented according to a quarterly timeline, and will be completed by June 2006. Meanwhile, the Commission continues to enhance its overall information security program by:

- Clarifying roles and responsibilities for enterprise information security and developing a comprehensive privacy program;
- Developing and implementing security risk assessments for new technology insertions and regional offices;
- Implementing a comprehensive set of information security policies and procedures;
- Providing security awareness and privacy training to employees and contractors; and
- Systematically testing policies and procedures for their appropriateness and effectiveness.

Financial statement preparation process

Description. The SEC prepared its second complete set of financial statements for FY 2005. While enhanced procedures have been formulated or better documented and applied to accumulate the necessary data to complete the financial statements, many changes were implemented late in the fiscal year and therefore have not been fully tested and confirmed. The process to prepare the SEC's financial statements continues to be manually intensive, consumes significant staff resources, and does not include complete documentation of quality control procedures. Additionally, comprehensive documentation of accounting policies and procedures for some major areas remains to be finalized.

Corrective actions taken. The SEC financial reporting staff has been expanded. Staff has drafted, expanded, or completed many accounting policies and procedures; some require further testing and others may require further refinement. More subsidiary records have been reconciled on a monthly basis.

Corrective actions planned. During FY 2006, the SEC's financial reporting staff will formalize additional policies and procedures and assure their consistent application. Monthly reconciliations of subsidiary records will be expanded. New procedures will accelerate year-end and quarterly closings. Efforts to solicit advice from staff experts within the SEC will continue. The organizational structure for assuring regular review by key management of SEC financial reports and operations, policies, and controls will be finalized. Senior management will also address the requirements of the OMB Circular A-123, *Management's Responsibility for Internal Control.*

Status of Controls over Budget Planning

Description. In May 2005, the SEC disclosed that it had identified unbudgeted costs of approximately $48.7 million associated with the construction of its new leased facilities in Washington, D.C. and improvements in its new leased facilities in New York City and Boston. Based on its review, GAO determined that these issues arose because of ineffective management controls, inadequate administrative infrastructure, and the nature of the facilities projects. SEC has taken actions to address these issues and plans to complete its implementation of all GAO recommendations during FY 2006.

Corrective actions taken. The SEC has taken several actions during the year to strengthen controls in this area and resolve this new weakness. The agency has: hired a new official with budgeting and construction experience to head the Office of Administrative Services (OAS); created several new budgeting and project oversight positions in the OAS; improved communications between the Offices of Financial Management and OAS regarding budget formulation; approved and begun planning a new automated budget system to free-up staff for analysis and detect abnormalities; requested that program areas provide more support for their budget estimates; and replaced staff previously involved in managing and overseeing the construction and lease improvement projects. The agency expects to realize approximately $4 million in cost savings associated with the completion of the New York office.

Corrective actions planned. During FY 2006, the SEC will fully rectify this deficiency. In particular, the agency will fully implement GAO's remaining recommendations regarding staff and management accountability for the reasonableness of budget estimates and development of reporting and review procedures related to construction and lease improvement projects. To address the remaining shortfall, the SEC intends to completely pay for the three facilities projects in FY 2006.

Financial Management Systems

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

Federal Information Security Management Act

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

Prompt Payment Act

The Prompt Payment Act requires federal agencies to report on their efforts to make timely payments to vendors, including interest penalties for late payments. In FY 2005, the SEC did not incur interest penalties on 95 percent of the 15,736 vendor invoices processed, representing payments of approximately $226 million. Of the invoices that were not processed in a timely manner, the SEC was required to pay interest penalties on 750 invoices, but was not required to pay interest penalties on 714 invoices where the interest was calculated at less than $1. In FY 2005, the SEC paid approximately $58,000 in interest penalties, or $256 in interest penalties for every million dollars of vendor payments.

Improper Payments Information Act

The Improper Payments Information Act requires federal agencies to review annually all programs and activities they administer, identify those which may be susceptible to significant erroneous payments and the extent of the erroneous payments in its programs, and report the actions it is taking to reduce erroneous payments. During FY 2005, the SEC had controls in place to identify and correct erroneous payments which, in total, did not exceed the $10 million threshold.

Debt Collection Improvement Act

The Debt Collection Improvement Act prescribes standards for the administration, collection, compromise, suspension, and termination of federal agency collection actions and referral to the proper agency for litigation. In FY 2005, the SEC referred approximately $470 million to the Department of the Treasury for collection. Collections of delinquent debt by Treasury for the same period were approximately $458,000.

PERFORMANCE MEASURES SUMMARY

FY 2005 marks the second year that the SEC has reported program performance in its annual Performance and Accountability Report.

The SEC's performance measures were developed by a Government Performance and Results Act team consisting of dedicated staff from throughout the agency. The team strived to craft meaningful performance measures that best reflect the SEC's progress in achieving the goals laid out in its five-year strategic plan.

In general, these measures gauge how much activity the SEC conducts in a given fiscal year, how quickly it accomplishes its tasks, and what effects these activities have on the markets and investors. Of these three components, measuring effectiveness is the most challenging for the SEC, as is the case for many regulatory and law enforcement agencies. In many instances, the agency's impact can only be indirectly assessed. The agency will continue to explore ways to improve these measures, and this effort will be aided by the SEC's new activity-based costing and performance-based budgeting system, which will be implemented in FY 2006.

This fiscal year, the Commission worked diligently to meet or exceed performance targets. Of the 23 performance goals the Commission is reporting on in FY 2005, the SEC met or exceeded 18 goals.

A summary of the SEC's major performance measures, organized by goal, is presented in *Exhibit 1.7.*

EXHIBIT 1.7

Performance Results Summary

GOAL 1 ENFORCE COMPLIANCE WITH THE FEDERAL SECURITIES LAWS	FY05 PERFORMANCE
1. Percentage of first enforcement cases filed within two years	+
2. Enforcement cases successfully resolved	+
3. Number of requests to and by foreign regulators for enforcement assistance	
a. Requests to foreign regulators	+
b. Requests from foreign regulators	–
4. Investment advisers and investment companies examined	+
5. Distribution of cases across core enforcement areas	✓
6. Assets frozen abroad as a result of SEC coordination with foreign regulators (new measure)	

GOAL 2 PROMOTE HEALTHY CAPITAL MARKETS THROUGH AN EFFECTIVE AND FLEXIBLE REGULATORY ENVIRONMENT	FY05 PERFORMANCE
1. Milestones for significant rulemakings	✓
2. Percentage of responses to exemptive, no-action letter, and interpretive requests issued within six months	✓
3. Percentage of SRO rule filings closed in less than 60 days	+
4. Global Access to U.S. markets:	
a. Number of new foreign private issuers registering	+
b. Dollar amount of securities registered by foreign private issuers	+
5. Milestones achieved for international regulatory cooperation	✓

GOAL 3 FOSTER INFORMED INVESTMENT DECISION MAKING	FY05 PERFORMANCE
1. Percentage of reporting corporations and investment companies with disclosures reviewed by the SEC:	
a. Corporations	✓
b. Investment companies	✓
2. Percentage of investment adviser and investment company transactional reviews completed within timeliness goals	+
3. Average time to issue initial comments on Securities Act filings	+
4. Annual number of on-line searches for EDGAR filings	+
5. Percentage of forms and submissions filed electronically and in a structured format	+
6. Number and percentage of investor complaints, questions, and requests completed by the Office of Investor Education and Assistance (OIEA) within seven calendar days	—
7. OIEA publications distributed by the GSA	+

GOAL 4 MAXIMIZE THE USE OF SEC RESOURCES	FY05 PERFORMANCE
1. Staff turnover rate	–
2. Milestones achieved on major human capital initiatives	✓
3. Percentage of IT projects that adhere to the agency's capital planning investment control process	–
4. Milestones for major IT projects	✓
5. Receive an unqualified audit opinion on the agency's audited financial statements with no material weaknesses noted on the agency's internal controls.	
a. Audit opinion	✓
b. Material weaknesses	–

Key: Level of Performance Attained

+ Exceeded Target or Prior Year Level
✓ Achieved Target or Maintained Prior Year Level
– Less than Target or Prior Year Level

FINANCIAL HIGHLIGHTS

The SEC's financial statements present the financial position, net cost of operations, changes in net position, budgetary resources, financing, and custodial and fiduciary activities of the SEC's core business activities as of and for the fiscal years ended September 30, 2005 and 2004.

Overview

The financial statements are presented in conformity with accounting principles generally accepted in the United States for the federal government and OMB Circular No. A-136, *Financial Reporting Requirements.* These financial statements are being presented on a comparative basis for the first time, as this is only the second year that the SEC has undergone an audit pursuant to the Accountability of Tax Dollars Act of 2002.

The financial statements were audited by GAO and received an unqualified opinion. The audit also addressed the SEC's internal controls and compliance with federal laws and regulations that have a direct effect on the financial statements. GAO's findings on those subjects are included in *Section 3: Financial Section.*

During FY 2005, the SEC took steps to better align offices and programs with the agency's strategic plan and performance goals. These preliminary changes were designed to further the SEC's budget and performance integration, and to put the agency in a better position to begin reporting its costs and activities by goal in future years. The agency's six major program areas are: Compliance Inspections and Examinations; Corporation Finance; Enforcement; Investment Management; Market Regulation; and Other Offices. The SEC's financial statements and certain prior year balances were reclassified to conform to current year presentation.

The SEC also moved into its new headquarters building, located at 100 F Street, N.E., Washington, D.C., during FY 2005. This new office space was the culmination of a multi-year construction effort and presented the SEC with logistical and operational challenges in executing the move to the new building.

In addition, the SEC also began investment activity during FY 2005. The SEC records as fiduciary assets any disgorgement, penalty, and interest amounts that are collected from securities law violators and held for future distribution to injured investors. In February 2005, the SEC established a facility with the Bureau of the Public Debt, through which these funds can be invested in short-term Treasury securities, pending their distribution to investors.

The SEC's financial statements, footnotes, required supplementary information, and auditors' opinion appear in *Section 3: Financial Section.* A summary of the SEC's financial activities in FY 2005 and 2004 is presented below.

Balance Sheet

Exhibit 1.8 presents the components of the SEC's balance sheet at September 30, 2005 and 2004.

EXHIBIT 1.8

Balance Sheets at September 30, 2005 and 2004

(DOLLARS IN THOUSANDS)

	FY05	FY04
Cash	$ 9	$ 11
Fund Balance With Treasury	4,348,936	4,202,640
Investments	1,768,024	0
Accounts Receivable (Net)	222,595	326,502
Property and Equipment (Net)	73,309	49,103
Prepayments	657	11
Total Assets	$6,413,530	$4,578,267
Fiduciary Liability	$1,975,553	$ 863,167
Custodial Liability	95,512	279,054
Customer Deposit Accounts	65,934	62,284
Accrued Payroll, Leave, and Benefits	59,682	52,334
Accounts Payable	44,862	24,511
Other Liabilities	28,670	6,316
Commitments & Contingencies	—	—
Total Liabilities	$2,270,213	$1,287,666
Cumulative Results of Operations	$4,133,526	$3,290,288
Unexpended Appropriations	9,791	313
Net Position	$4,143,317	$3,290,601
Total Liabilities & Net Position	$6,413,530	$4,578,267

The major components of the SEC's balance sheet consist of Fund Balance With Treasury; Investments; Accounts Receivable; Property and Equipment; and Liabilities. A brief discussion of each of these components is presented below.

Fund Balance With Treasury

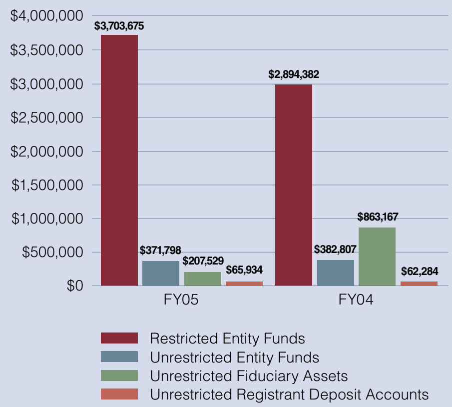
Fund Balance With Treasury includes the following assets: (1) unrestricted balances available to finance expenditures; (2) restricted balances that cannot be used without further authorization by Congress and apportionment by OMB; (3) uninvested fiduciary assets, representing disgorgement, penalties, and interest held by the SEC, pending distribution to injured investors; and (4) registrant deposits, representing excess filing fees remitted by registrants.

At September 30, 2005 and 2004, Fund Balance with Treasury was $4,348.9 million (representing 67.8 percent of total assets) and $4,202.6 million (representing 91.8 percent of total assets), respectively. The change in percentage of total assets reflects the fact that the SEC began investing fiduciary assets during FY 2005. Investments accounted for 27.6 percent of total assets at the end of FY 2005.

The following chart shows the breakdown of FBWT for at September 30, FY 2005 and FY 2004.

EXHIBIT 1.9

Fund Balance With Treasury at September 30
(Dollars in thousands)



As presented above, restricted entity funds are the largest portion of the SEC's Fund Balance with Treasury, and represent primarily the cumulative amount of fees on securities transactions paid to the SEC since 1991 in excess of what the agency was authorized through the Congressional appropriations process to use to fund its annual operations. SEC management is undertaking a multi-year adjustment to fee rates that would bring the amount of fees generated by the SEC more in line with the agency's annual operating budget, and eliminate surplus fees.

Investments

During FY 2005, the SEC initiated a program to invest fiduciary assets in short-term Treasury securities. The SEC records as fiduciary assets any disgorgement, penalty, and interest amounts that are collected from securities law violators and held for future distribution to injured investors. Once these funds are collected, and pending their distribution to investors, they are generally transferred to the SEC's deposit fund account and invested in overnight or other short-term market-based Treasury bills through a facility provided by the Bureau of the Public Debt. At September 30, 2005, the SEC had investments totaling $1,768 million.

Accounts Receivable

At September 30, 2005 and 2004, the SEC's net accounts receivable were $222.6 million and $326.5 million, respectively. The net balance at September 30, 2005 consisted of gross accounts receivable of $1,491.7 million and an estimated allowance for doubtful accounts of $1,269.1 million, as presented below.

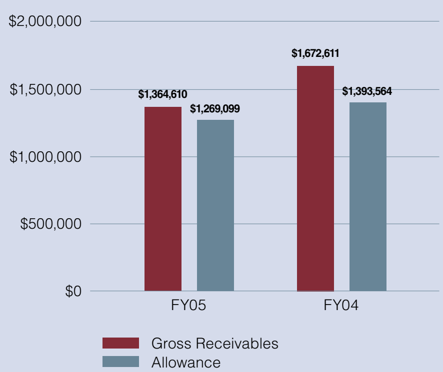
The largest portion of the SEC's accounts receivable relates to enforcement proceedings that result in the assessment of disgorgement, penalties, and interest against violators of federal securities laws. This activity is recognized as non-exchange revenue and presented on the Statement of Custodial Activity. When the SEC collects this revenue, it is either transferred to the general fund of the Treasury or it is held by the SEC in a fiduciary capacity on behalf of harmed investors to whom the SEC intends to return the funds.

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

Exhibit 1.10 shows the gross accounts receivable and related allowance for doubtful accounts for disgorgement and penalty receivables at September 30, 2005 and 2004, respectively.

EXHIBIT 1.10

Accounts Receivable at Year End
(Dollars in thousands)



Property and Equipment

The SEC's property and equipment consists of furniture, general purpose equipment used by the agency, software, internal use software development costs for projects in development, and capital improvements made to buildings leased by the SEC for office space. The acquisition value of SEC's property and equipment is summarized below.

EXHIBIT 1.11

Acquisition Value of Property and Equipment at Year End
(Dollars in thousands)

PROPERTY AND EQUIPMENT	FY05	FY04
Furniture	$ 5,295	$ —
Equipment	36,392	23,939
Software	38,524	36,591
Software in Progress	7,350	3,758
Leasehold Improvements	33,447	17,600
Total Property and Equipment	$121,008	$81,888

Leasehold improvements include costs incurred for two new locations in Washington, D.C. The SEC occupied the first of its new headquarters buildings during FY 2005. The second building is currently under construction, and the SEC expects to occupy that building in FY 2006. Therefore, no depreciation expense has been recognized as of September 30, 2005 for the leasehold improvements to the second building.

Liabilities

The SEC's liabilities consist of routine operating accounts payable, accrued payroll and benefits, registrant deposit accounts, and fiduciary and custodial liabilities associated with monetary sanctions imposed on violators of the securities laws.

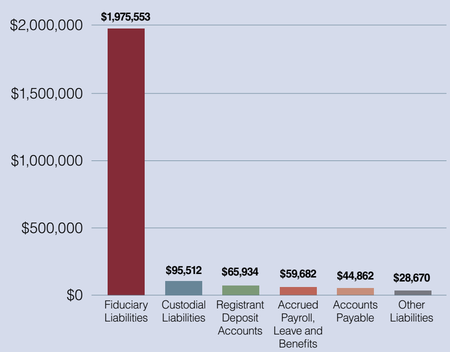
Fiduciary and custodial liabilities represent the largest portion of the agency's liabilities. Fiduciary liabilities arise when the SEC collects disgorgement, penalties, and interest from securities law violators, for the purpose of returning the funds to injured investors. When collected, fiduciary receipts are held in Fund Balance With Treasury or invested in Treasury bills, pending distribution to injured investors, and an equal and offsetting liability for assets held by the SEC at the Treasury is reported as a non-entity liability on the Balance Sheet.

Custodial liabilities arise in respect of accounts receivable for disgorgement, penalties, and interest assessed against securities law violators. The SEC records a custodial liability in respect of the net amount of such receivable, after taking account of the estimated allowance for doubtful accounts. When the SEC collects this revenue, it is either transferred to the General Fund of the Treasury or it is held by the SEC in a fiduciary capacity on behalf of injured investors to whom the SEC intends to return the funds.

Exhibit 1.12 shows the breakdown of the SEC's liabilities at the end of FY 2005.

EXHIBIT 1.12

Liabilities at September 30, 2005
(Dollars in thousands)



Revenues and Costs

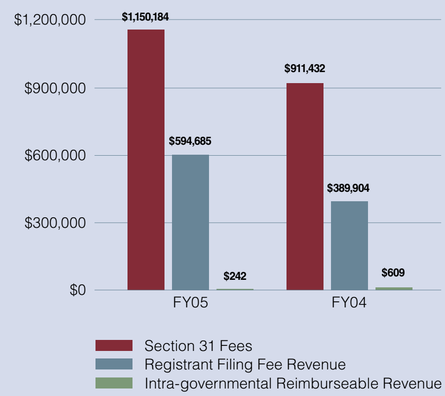
For FY 2005 and FY 2004, the SEC reported net income from operations totaling $827.5 million and $575.9 million, respectively. For FY 2005, net income from operations results from gross revenues totaling $1,745.1 million and cost of operations of $917.6 million. For FY 2004, net income from operations results from gross revenues totaling $1,301.9 million and cost of operations of $726.1 million.

For FY 2005, the Statement of Net Cost and footnote information is being presented to conform to changes in program lines, allocation methods, and the reclassification of personnel costs within each program line. Therefore, certain FY 2004 Statement of Net Cost information is presented differently than in the SEC's FY 2004 Performance and Accountability Report.

The SEC's revenues represent securities transaction fees collected from SROs pursuant to Section 31 of the Securities Exchange Act of 1934, and various registration, tender offer, merger, and other fees collected from registrants. *Exhibit 1.13* shows a breakdown of the SEC's revenues for FY 2005 and FY 2004.

EXHIBIT 1.13

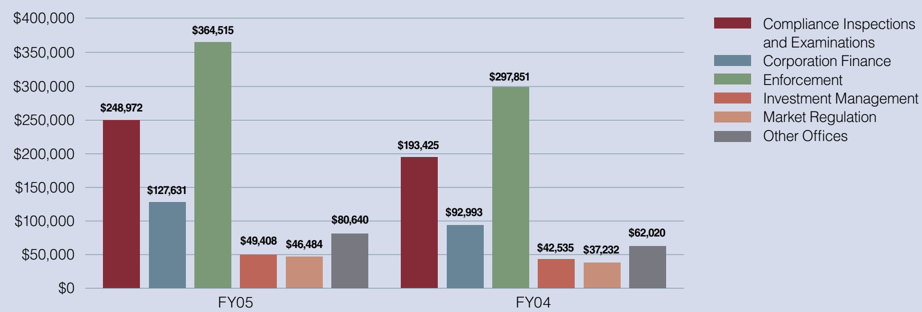
Revenue Summary
(Dollars in thousands)



These fees and assessments support the SEC's six major program areas: Compliance Inspections and Exams; Corporation Finance; Enforcement; Investment Management; Market Regulation; and Other Offices. The gross cost of operations for these six program areas is presented in *Exhibit 1.14.*

EXHIBIT 1.14

Gross Cost of Operations
(Dollars in thousands)



Limitations

The SEC has prepared its FY 2005 financial statements in accordance with the requirements of OMB Circular A-136, Financial Reporting Requirements. This document incorporates the concepts and standards contained in the Statements of Federal Financial Accounting Concepts and the Statements of Federal Financial Accounting Standards (SFFAS) recommended by the Federal Accounting Standards Advisory Board (FASAB) and approved by the Secretary of the Treasury, the Director of the OMB, and the Comptroller General.

In 1999, the American Institute of Certified Public Accountants Council designated the FASAB as the accounting standards-setting body for federal government entities. Therefore, the SFFAS constitute generally accepted accounting principles for the federal government. These concepts and standards have been set by FASAB to help Federal agencies comply with the requirements of the Chief Financial Officers' Act of 1990, as amended by the Government Management Reform Act of 1994. Among other things, these two acts demand financial accountability from federal agencies and require the integration of accounting, financial management, and cost accounting systems.

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

- While the statements are prepared from books and records in accordance with the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.

- The statements should be read with the realization that the SEC is a component of the U.S. Government, a sovereign entity. One implication is that unfunded liabilities cannot be liquidated without legislation that provides resources to do so.

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

Financial Statements

Balance Sheets

U.S. SECURITIES AND EXCHANGE COMMISSION

Balance Sheets

As of September 30, 2005 and 2004

(DOLLARS IN THOUSANDS)	2005	2004
ASSETS		
Intragovernmental:		
Fund Balance with Treasury (Notes 1-K and 2)	$4,348,936	$4,202,640
Investments (Notes 1-L and 5)	1,768,024	—
Accounts Receivable (Notes 1-M and 6)	194	219
Total Intragovernmental	$6,117,154	$4,202,859
Cash (Notes 1-O and 4)	9	11
Accounts Receivable, Net (Notes 1-M and 6)	222,401	326,283
Advances and Prepayments (Note 1-N)	657	11
Property and Equipment, Net (Notes 1-P and 7)	73,309	49,103
Total Assets	$6,413,530	$4,578,267
LIABILITIES		
Intragovernmental:		
Accounts Payable (Notes 1-Q and 8)	$ 16,848	$ 8,055
Employee Benefits (Notes 1-Q, 1-T and 8)	2,702	2,133
Unfunded FECA Liability (Notes 1-Q, 1-R and 8)	1,045	1,120
Total Intragovernmental	$ 20,595	$ 11,308
Accounts Payable (Notes 1-Q and 8)	28,014	16,456
Accrued Payroll and Benefits (Notes 1-Q, 1-T and 8)	18,436	15,236
Accrued Leave (Notes 1-Q, 1-S and 8)	32,024	28,705
Registrant Deposit Accounts (Notes 1-Q, 3 and 8)	65,934	62,284
Actuarial FECA Liability (Notes 1-Q, 1-R, 8 and 9)	5,475	5,140
Fiduciary Liability (Notes 1-Q, 1-W, 3, 8 and 18)	1,975,553	863,167
Custodial Liability (Notes 1-Q, 1-V, 3, 8 and 17)	95,512	279,054
Other Accrued Liabilities (Notes 1-Q, 8 and 10)	28,670	6,316
Total Liabilities	$2,270,213	$1,287,666
Commitments and Contingencies (Notes 8 and 19)		
NET POSITION		
Unexpended Appropriations	$ 9,791	$ 313
Cumulative Results of Operations	4,133,526	3,290,288
Total Net Position	$4,143,317	$3,290,601
Total Liabilities and Net Position	$6,413,530	$4,578,267

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

Statements of Net Cost

U.S. SECURITIES AND EXCHANGE COMMISSION

Statements of Net Cost

For the years ended September 30, 2005 and 2004

(DOLLARS IN THOUSANDS)	2005	2004
PROGRAM COSTS (Notes 1-E, 12 and 13)		
Compliance Inspections and Exams		
Gross Cost	$ 248,972	$ 193,425
Corporation Finance		
Gross Cost	127,631	92,993
Enforcement		
Gross Cost	364,515	297,851
Investment Management		
Gross Cost	49,408	42,535
Market Regulation		
Gross Cost	46,484	37,232
Other Offices		
Gross Cost	80,640	62,020
Total Entity		
Total Gross Program Cost	$ 917,650	$ 726,056
Less: Earned Revenue Not Attributed to Programs (Note 14)	(1,745,111)	(1,301,945)
Net (Income) from Operations	$ (827,461)	$ (575,889)

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

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FINANCIAL SECTION

Statements of Net Position

U.S. SECURITIES AND EXCHANGE COMMISSION

Statements of Changes in Net Position

For the years ended September 30, 2005 and 2004

	2005		2004	
(DOLLARS IN THOUSANDS)	CUMULATIVE RESULTS OF OPERATIONS	UNEXPENDED APPROPRIATIONS	CUMULATIVE RESULTS OF OPERATIONS	UNEXPENDED APPROPRIATIONS
Net Position, Beginning of Period	$3,290,288	$ 313	$2,684,949	$313
Budgetary Financing Sources:				
Appropriations Not Available	(10,055)	9,478	(994)	—
Other Financing Sources:				
Imputed Financing (Note 11)	25,832	—	30,444	—
Total Financing Sources	$ 15,777	$9,478	$ 29,450	$ —
Net Income from Operations	827,461	—	575,889	—
Net Change	$ 843,238	$9,478	$ 605,339	$ —
Net Position, End of Period	$4,133,526	$9,791	$3,290,288	$313

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

Statements of Budgetary Resources

U.S. SECURITIES AND EXCHANGE COMMISSION

Statements of Budgetary Resources

For the years ended September 30, 2005 and 2004

(DOLLARS IN THOUSANDS)	2005	2004
BUDGETARY RESOURCES		
Budget Authority:		
Net Transfers (Note 15)	$ —	$ —
Unobligated Balance:		
Beginning of Period	3,049,337	2,409,706
Net Transfers, Actual (Note 15)	—	—
Spending Authority from Offsetting Collections:		
Earned		
Collected	1,665,560	1,392,878
Customer Receivables and Refund Payables	(24)	39
Change in Unfilled Customer Orders		
Without Advance Received	—	182
Subtotal	$ 1,665,536	$ 1,393,099
Actual Recoveries of Prior Year Obligations	87,609	75,327
Permanently Not Available	(576)	(994)
Total Budgetary Resources	$ 4,801,906	$ 3,877,138
STATUS OF BUDGETARY RESOURCES		
Obligations Incurred: (Note 16)		
Direct	$ 961,333	$ 827,619
Reimbursable	—	—
Subtotal	$ 961,333	$ 827,619
Unobligated Balance Available:		
Realized and Apportioned for Current Period	39,224	56,020
Exempt From Apportionment	—	600
Unobligated Balance Not Available		
Restricted Funds	3,703,675	2,894,382
Expired Funds	97,674	98,517
Total Status of Budgetary Resources	$ 4,801,906	$ 3,877,138
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS		
Obligated Balance, Net, Beginning of Period	$ 228,280	$ 183,787
Accounts Receivable	(194)	(219)
Change in Unfilled Customer Orders Without Advance Received	—	(182)
Undelivered Orders	162,080	179,886
Accounts Payable (Note 19)	73,622	48,795
Obligated Balance, Net, End of Period	$ 235,508	$ 228,280
Outlays:		
Disbursements	$ 866,702	$ 707,578
Collections	(1,665,560)	(1,392,878)
Subtotal Outlays:	$ (798,858)	$ (685,300)
Offsetting Receipts:	—	—
Net Outlays	$ (798,858)	$ (685,300)

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

Statements of Financing

U.S. SECURITIES AND EXCHANGE COMMISSION

Statements of Financing

For the years ended September 30, 2005 and 2004

(DOLLARS IN THOUSANDS)	2005	2004
RESOURCES USED TO FINANCE ACTIVITIES		
Budgetary Resources Obligated: (Note 16)		
Obligations Incurred	$ 961,333	$ 827,619
Less: Spending Authority from Offsetting Collections and Recoveries	(1,753,144)	(1,468,426)
Net Obligations	$ (791,811)	$ (640,807)
Other Resources:		
Imputed Financing from Cost Absorbed by Others (Note 11)	25,832	30,444
Total Resources Used to Finance Activities	$ (765,979)	$ (610,363)
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS		
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but Not Yet Provided	$ 17,161	$ (48,328)
Resources that Finance the Acquisition of Assets Capitalized on the Balance Sheet	(42,081)	(30,816)
Net Decrease in Revenue Receivables Not Generating Resources until Collected	—	90,876
Total Resources Used to Finance Items not Part of the Net Cost of Operations	$ (24,920)	$ 11,732
Total Resources Used to Finance the Net Cost of Operations	$ (790,899)	$ (598,631)
COMPONENTS OF NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Components Requiring or Generating Resources in Future Periods:		
Costs That Will Be Funded by Resources in Future Periods	$ 3,318	$ 5,729
Net Increase in Revenue Receivables Not Generating Resources until Collected	(79,667)	—
Recognition of Lease Liability (Note 10)	21,647	—
Increase in Unfunded FECA Liability	259	89
Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods	$ (54,443)	$ 5,818
Components Not Requiring or Generating Resources:		
Depreciation and Amortization	$ 17,574	$ 14,050
Revaluation of Assets or Liabilities	300	2,624
Other Costs That Will Not Require Resources	7	250
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	$ 17,881	$ 16,924
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	$ (36,562)	$ 22,742
Net (Income)/Cost from Operations	$ (827,461)	$ (575,889)

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

Statements of Custodial Activity

U.S. SECURITIES AND EXCHANGE COMMISSION

Statements of Custodial Activity

For the years ended September 30, 2005 and 2004

(DOLLARS IN THOUSANDS)	2005	2004
REVENUE ACTIVITY		
Sources of Cash Collections:		
Disgorgement and Penalties	$1,606,274	$216,255
Other	270	98
Net Collections	$1,606,544	$216,353
Accrual Adjustments	(183,542)	213,164
Total Custodial Revenue (Notes 1-V and 17)	$1,423,002	$429,517
DISPOSITION OF COLLECTIONS		
Amounts Transferred to:		
Department of the Treasury	$ 206,984	$216,353
Fiduciary Fund	1,097,608	—
Public	301,952	—
Net Disbursements	$1,606,544	$216,353
Change in Liability Accounts	(183,542)	213,164
Total Disposition of Collections (Notes 1-V and 17)	$1,423,002	$429,517
NET CUSTODIAL ACTIVITY	$ —	$ —

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

Notes to the Financial Statements

NOTES TO FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

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

These financial statements report on the SEC's six major program areas: Compliance Inspections and Examinations; Corporation Finance; Enforcement; Investment Management; Market Regulation; and Other Offices. These programs are intended to promote the public interest by protecting investors and preserving the integrity and efficiency of the securities markets; encouraging international regulatory and enforcement cooperation; educating and assisting investors; overseeing the operations of the nation's securities markets and participants; regulating investment companies and investment advisors; and ensuring compliance through inspection, examination, and full disclosure.

B. Fund Accounting Structure

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

- ***Special Fund Receipts*** (X0100) include the appropriated general funds used to carry out the SEC's missions and functions for fiscal year (FY) 2005 and revenues collected by the SEC in excess of appropriated funds (See *Note 2. Fund Balance With Treasury*).

- ***Salaries and Expenses*** (0100) include the appropriated general funds used to carry out the SEC's missions and functions for FY 2000 to 2004.

- ***Deposit Funds*** (X6563, F3875 and F3880) account for disgorged ill-gotten gains, penalties, and interest thereon collected and held on behalf of harmed investors, registrant monies held temporarily until earned by the SEC, and collections awaiting disposition or reclassification.

- ***Miscellaneous Receipt Accounts*** (1099 and 3220) hold non-entity receipts and accounts receivable from SEC custodial activities that cannot be deposited into funds under SEC control.

The SEC does not have lending or borrowing authority, except as discussed in *Note 19. Commitments and Contingencies.* The SEC does have custodial and fiduciary responsibilities, as described in *Note 17. Custodial Revenues and Liabilities* and *Note 18. Fiduciary Assets and Liabilities.*

C. Intra- and Inter-Agency Relationships

The SEC does not transact business among its own operating units, and therefore, intra-entity eliminations are not necessary. The SEC does have certain oversight responsibilities with respect to the Financial Accounting Standards Board (FASB); the Securities Investor Protection Corporation (See *Note 19. Commitments and Contingencies*); and the Public Company Accounting Oversight Board. These entities have been excluded from the SEC reporting unit and the accompanying financial statements.

D. Basis of Presentation

The accompanying financial statements present the financial position, net cost of operations, changes in net position, budgetary resources, financing, and custodial and fiduciary activities of the SEC's core business activities in conformity with accounting principles generally accepted in the United States for the federal government and Office of Management and Budget (OMB) Circular No. A-136, Financial Reporting Requirements (A-136). Therefore, they may differ from other financial reports submitted pursuant to OMB directives for the purpose of monitoring and controlling the use of SEC budgetary resources. The SEC's books and records serve as the source of the information presented in the accompanying financial statements. Assets, liabilities, revenues, and costs have been classified in these financial statements according to the type of entity associated with the transactions. Intragovernmental assets and liabilities are those from or to other federal entities. Intragovernmental earned revenues are collections or accruals of revenue from other federal entities, and intragovernmental costs are payments or accruals to other federal entities.

E. Reorganization of Program Elements and Reclassification of Costs

In its FY 2006 budget submission, the SEC began to reorganize its responsibility segments into program lines that better align with the agency's strategic plan and performance goals. These preliminary changes were designed to further the SEC's budget and performance integration and to put the SEC in a better position to begin reporting its costs and activities by goal.

During FY 2005, the SEC also revised its method to allocate personnel and allocable costs to its program lines. In addition, the SEC reclassified $56.6 million of fiscal year 2004 personnel benefit costs from public costs to intragovernmental costs to conform to FY 2005 classifications. This reclassification changed the amounts reported as intragovernmental and public costs within each program line, but it did not change total costs reported on the Statements of Net Cost.

The Statements of Net Cost and information in *Note 12. Intragovernmental Costs and Exchange Revenue* and *Note 13. Program Costs by Category* are being presented to conform to the changes in program lines, allocation methods, the reclassification of personnel benefit costs, and new reporting requirements of OMB A-136. Therefore, certain information is presented differently than in the SEC's FY 2004 Performance and Accountability Report.

F. Basis of Accounting

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

The accompanying financial statements are presented in conformity with United States generally accepted accounting principles for federal entities. The accounting principles and standards applied in preparing these financial statements are in accordance with the accounting policies and practices summarized in this note and the following hierarchy of accounting principles:

- Federal Accounting Standards Advisory Board (FASAB) Statements and Interpretations plus American Institute of Certified Public Accountants (AICPA) and FASB pronouncements if made applicable to federal governmental entities by a FASAB Statement or Interpretation;

- FASAB Technical Bulletins and the following pronouncements if specifically made applicable to federal government entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position;

- AICPA Accounting Standards Executive Committee Practice Bulletins if specifically made applicable to federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB;

- Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the federal government; and

- Other accounting literature published by authoritative standard-setting bodies and other authoritative sources (a) in the absence of other guidance in the first four parts of this hierarchy, and (b) if the use of such accounting principles improves the meaningfulness of the financial statements.

G. Budgets and Budgetary Accounting

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

The SEC is subject to certain restrictions on its use of statutory fees. All fee revenues are deposited in a special fund receipt account at the United States Department of the Treasury (Treasury). However, the SEC may use funds from this account only as authorized by the United States Congress, made available by OMB apportionment, and upon issuance of a Treasury warrant. Revenue collected in excess of appropriated amounts is restricted for use by the SEC.

Fees other than the restricted excess fees can be used for SEC operations subject to an annual congressional limitation of $913.6 million and $812.1 million for the budget fiscal years 2005 and 2004, respectively. Funds appropriated but not used in a given fiscal year are held in the special fund receipt account for use in future periods, as appropriated by the United States Congress.

Each fiscal year, the SEC receives its appropriation through Category A apportionments, which are quarterly distributions of budgetary resources made by the OMB. The SEC also receives a small amount of Category B funds, or those funds that are exempt from quarterly apportionment.

H. Use of Estimates

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

I. Revenue and Other Financing Sources

The SEC's revenue and financing sources include exchange revenues, which mainly consist of fees collected from self-regulatory organizations (SROs) and registrants, and non-exchange revenues, which include amounts collected in enforcement proceedings from violators of the securities laws.

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

The SEC also recognizes revenue from enforcement proceedings that result in the assessment of disgorgement, penalties, and interest thereon against violators of federal securities laws. This activity is recognized as non-exchange revenue and presented on the Statements of Custodial Activity. When the SEC collects this revenue, it is either transferred to the Treasury or it is held by the SEC in a fiduciary capacity on behalf of injured investors to whom the SEC intends to return the funds. An equal and offsetting liability for the fiduciary assets held by the SEC is reported on the Balance Sheets. The SEC does not record fiduciary assessments collected and held by another federal entity, such as a court registry, or a non-federal government entity, such as a receiver.

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

J. Entity/Non-Entity Assets

Assets that an entity is authorized to use in its operations are titled entity assets, while assets held by an entity and not available for the entity's use are termed non-entity assets. The SEC's assets are entity assets available to carry out its mission, except (i) restricted special fund receipts, representing fees collected in excess of appropriated amounts; (ii) registrant deposits, representing excess filing fees remitted by registrants; (iii) custodial accounts receivable in respect of disgorgement, penalties, and interest owed by securities law violators; and (iv) fiduciary assets, representing disgorgement, penalties, and interest collected and held or invested by the SEC pending distribution to injured investors.

K. Fund Balance With Treasury

Fund Balance With Treasury includes unrestricted balances that are available to finance the SEC's expenditures and restricted balances that cannot be used without further authorization by the United States Congress and apportionment by OMB.

Fund Balance With Treasury also includes certain funds held on behalf of third parties. These include registrant deposits, representing excess filing fees remitted by registrants, and uninvested fiduciary assets, representing disgorgement, penalties, and interest held by the SEC pending distribution to injured investors.

All SEC banking activity is conducted in accordance with directives issued by the Treasury, Financial Management Service (FMS). All revenue and receipts are deposited in commercial bank accounts maintained by the FMS or wired directly to a Federal Reserve Bank. The Treasury processes all disbursements made by the SEC. All moneys maintained in commercial bank accounts are transferred to the Federal Reserve Bank on the next business day following the day of deposit.

L. Investments

During FY 2005, the SEC initiated a program to invest fiduciary assets in short-term Treasury securities. The SEC records as fiduciary assets any disgorgement, penalty, and interest amounts that are collected from securities law violators and held for future distribution to injured investors. Once these funds are collected, they are generally transferred to the SEC's deposit fund and invested in overnight or other short-term market-based Treasury bills through a facility provided by the Bureau of the Public Debt, pending their distribution to investors.

M. Accounts Receivable and Allowance for Uncollectible Accounts

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

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

Non-entity accounts receivable comprise disgorgement, penalties, and interest thereon assessed against violators of federal securities laws. The SEC maintains a custodial responsibility over these non-entity accounts receivable, which are recognized when the SEC has been designated in authorized judgments or orders to collect the assessed disgorgement, penalties and interest. When collected, these funds are either returned to the Treasury, or they are held for future distribution to injured investors.

In cases where the SEC collects disgorgement, penalties, and interest thereon from securities law violators for the benefit of injured investors, these funds constitute a fiduciary responsibility of the SEC. When collected, fiduciary receipts are held in Fund Balance With Treasury or invested in Treasury bills, pending distribution to injured investors, and an equal and offsetting liability for assets held by the SEC at the Treasury is reported as a non-entity liability on the Balance Sheets.

At September 30, 2005 and 2004, the SEC recorded $1,269.1 million and $1,393.6 million in allowances for uncollectible amounts, respectively, to reduce the gross amount of its non-entity accounts receivable to its estimated net realizable value, as summarized in *Note 6. Accounts Receivable, Net.* A provision for estimated losses for uncollectible amounts of $124.5 million as an increase and $466.3 million as a reduction of non-exchange revenue has been recorded in FY 2005 and 2004, respectively. The allowance for uncollectible amounts and the related provision for estimated losses for disgorgement and penalties, and FOIA accounts receivable are based on reserving 100 percent of amounts over two years old; an analysis of the collectibility of individual account balances for the largest debts; and on historical collection data to determine on a percentage basis the value of gross accounts receivable that are likely to be collected by the SEC. This percentage is applied to the remaining disgorgement and penalties and FOIA accounts receivable to reflect the balances at their estimated net realizable value. The allowance for uncollectible amounts and the related provision for estimated losses for Filing Fees and Other is based on historical collection data to determine on a percentage basis the value of gross accounts receivable that are likely to be collected by the SEC; and no allowance for uncollectible amounts and the related provision for estimated losses has been established for Due for Reimbursable Agreements and Exchange Fees, as these gross accounts receivable are deemed to represent their net realizable value. In addition, unless a court or administrative order specifies the amount of pre- and post-judgment interest, the SEC does not recognize such interest as accounts receivable.

N. Advances and Prepayments

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

O. Cash

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

P. Property and Equipment, Net

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

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

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

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

Q. Liabilities

The SEC records liabilities for amounts that are likely to be paid as the result of events that have occurred as of September 30, 2005 and 2004. The SEC's liabilities consist of routine operating accounts payable, accrued payroll and benefits, registrant deposit accounts, and fiduciary and custodial liabilities associated with monetary sanctions imposed on violators of securities laws.

Fiduciary and custodial liabilities represent the largest portion of the SEC's liabilities. Fiduciary liabilities arise when the SEC collects disgorgement, penalties, and interest from securities law violators for the purpose of returning the funds to injured investors. When collected, fiduciary receipts are held in Fund Balance With Treasury or invested in Treasury securities, pending distribution to injured investors, and an equal and offsetting liability for assets held by the SEC at the Treasury is reported as a non-entity liability on the balance sheet.

Custodial liabilities arise in respect of accounts receivable for disgorgement, penalties, and interest assessed against securities law violators. The SEC records a custodial liability in respect of the net amount of such receivables, after taking into account the estimated allowance for doubtful accounts. When the SEC collects this revenue, it is either transferred to the Treasury or it is held by the SEC in a fiduciary capacity on behalf of injured investors to whom the SEC intends to return the funds.

The SEC considers liabilities covered by three types of resources: realized budgetary resources; unrealized budgetary resources that become available without further Congressional action; and cash and amounts held in Fund Balance With Treasury that do not require the use of a budgetary resource. Realized budgetary resources include obligated balances that fund existing liabilities and unobligated balances at September 30, 2005 and 2004. Unrealized budgetary resources represent fee collections in excess of amounts appropriated for current fiscal year spending. These resources are used to cover liabilities when appropriation language makes these unrealized budgetary resources available in the fiscal year without further Congressional action.

Fund Balance With Treasury, Investments, and cash includes amounts for liabilities that will never require the use of a budgetary resource. These liabilities consist of registrant deposit accounts; accounts receivable for disgorgement, penalties, and interest assessed against securities laws violators; and uninvested fiduciary assets held by the SEC on behalf of injured investors.

R. Injury and Post-employment Compensation

Claims brought by SEC employees for on-the-job injuries fall under the Federal Employees' Compensation Act (FECA) administered by the United States Department of Labor (DOL). The DOL bills each agency annually as its claims are paid, but payment on these bills is deferred for two years to allow for funding through the budget process. At September 30, 2005 and 2004, the SEC recorded liabilities of $471 thousand and $482 thousand for claims paid on its behalf during the benefit periods October 1, 2004 through September 30, 2005 and October 1, 2003 through September 30, 2004, respectively.

Similarly, SEC employees who are terminated without cause may receive unemployment compensation benefits under the unemployment insurance program also administered by the DOL. The DOL bills each agency quarterly for paid claims. For FY 2005 and 2004, the SEC paid $79 thousand and $30 thousand, respectively, for claims paid by the DOL on behalf of former SEC employees.

S. Annual, Sick, and Other Leave

Annual leave and compensatory time are accrued as earned, and the accrual is reduced when leave is taken. Each fiscal quarter, an adjustment is made so that the balances in the accrued leave accounts reflect current leave balances and pay rates. Accrued leave at September 30, 2005 and 2004 was $32.0 million and $28.7 million, respectively. No portion of this liability has been obligated. Funding will be obtained from future financing sources to the extent that current or prior year funding is not available to pay for leave earned but not taken. Sick leave and other types of non-vested leave are expensed as used.

T. Employee Retirement Systems and Benefits

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

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

Instead, the financial statements of the SEC recognize an imputed financing source and corresponding expense that represent the SEC's share of the cost to the federal government of providing pension, post-retirement health, and life insurance benefits to all eligible SEC employees. For FY 2005, the SEC made contributions based on OPM cost factors equivalent to approximately 6.79 percent and 10.85 percent of the employee's basic pay for those employees covered by CSRS and FERS, respectively. For FY 2004, the SEC made contributions based on OPM cost factors equivalent to approximately 6.81 percent and 10.39 percent of the employee's basic pay for those employees covered by CSRS and FERS, respectively.

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

For FY 2005, the SEC's retirement plan contributions for CSRS and FERS participants were $45.1 million and the SEC also contributed to the Social Security Administration for FICA benefits totaling $24.5 million. For FY 2004, the SEC's retirement plan contributions for CSRS and FERS participants were $36.9 million, and its contributions to the Social Security Administration for FICA benefits totaled $21.4 million.

U. Environmental Cleanup

The SEC does not have any liabilities for environmental cleanup.

V. Custodial Activities

The Statements of Custodial Activity presents the sources and disposition of SEC custodial activity that consists of primarily disgorgement, penalties, and interest thereon assessed against violators of securities laws. When collected, the funds are either returned to the Treasury or they are held for future distribution to injured investors, as discussed in *Note 1. M. Accounts Receivable and Allowance for Uncollectible Accounts.*

W. Fiduciary Activities

Fiduciary activities represent the receipt, management, accounting, and disposition by the SEC of cash or other assets in which injured investors have an ownership interest that the SEC must uphold. The SEC also recognizes an equal and offsetting liability for these assets.

The SEC's fiduciary assets consist of disgorgement, penalties, and interest thereon assessed against securities laws violators where the Commission, an administrative law judge, or, in some cases, a court has determined that the SEC should return such funds to injured investors. The funds are held as fiduciary assets by the SEC, pending distribution to injured investors pursuant to an approved distribution plan. The SEC does not record fiduciary assessments collected and held by another federal entity, such as a court, or a non-federal government entity, such as a receiver.

Note 2. Fund Balance With Treasury

At September 30, 2005, Fund Balance With Treasury consisted of the following:

(DOLLARS IN THOUSANDS)	UNRESTRICTED FUNDS	RESTRICTED FUNDS	TOTAL
Funds Obligated But Not Disbursed	$ 235,499	$ —	$ 235,499
Funds Not Obligated	136,299	3,703,675	3,839,974
Subtotal Entity Funds	$ 371,798	$3,703,675	$4,075,473
Registrant Deposit Accounts	65,934	—	65,934
Uninvested Fiduciary Assets	207,529	—	207,529
Subtotal Non-Entity Funds	$ 273,463	$ —	$ 273,463
Total Fund Balance With Treasury	$ 645,261	$3,703,675	$4,348,936

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

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

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

Registrant deposit accounts are for filers who maintain a deposit account at the SEC to facilitate the filing process. These funds are drawn down when filers submit filings, and filers can replenish their deposit account as desired. Account balances with no activity for six months are returned to the registrant. Funds maintained in registrant deposit accounts are not available for SEC use until a filing has been submitted to the SEC, and then the funds are reclassified to entity funds.

Fiduciary assets are funds collected and held on behalf of injured investors for distribution at some later date pursuant to a court ordered or SEC-approved distribution plan. At September 30, 2004, uninvested fiduciary assets represented the total amount of fiduciary assets because the SEC had not initiated its investment program.

Note 3. Non-Entity Assets

At September 30, 2005 and 2004, non-entity assets consisted of the following:

(DOLLARS IN THOUSANDS)	FY 2005	FY 2004
Registrant Deposit Accounts	$ 65,934	$ 62,284
Fiduciary Assets	1,975,553	863,167
Custodial Assets	95,512	279,054
Total Non-Entity Assets	$2,136,999	$1,204,505

Note 4. Cash

At September 30, 2005 and 2004, cash and other monetary assets included petty cash balances of $9 thousand and $11 thousand, respectively.

Note 5. Investments

At September 30, 2005, investments consisted of Treasury Special Overnight Certificates of Indebtedness and Market-Based Treasury Bills, are summarized as the follows:

(DOLLARS IN THOUSANDS)

COST	AMORTIZATION METHOD	UNAMORTIZED DISCOUNT	INVESTMENTS, NET
$1,768,866	S/L	$(842)	$1,768,024

As discussed in *Note 1. L. Investments* and *Note 18. Fiduciary Assets and Liabilities,* the investments represent disgorgement, penalties, and interest thereon collected from securities law violators on behalf of injured investors. Invested funds are held by the SEC, pending distribution to harmed investors. The SEC invests these funds in overnight and short-term market-based treasury bills through a facility provided by the Bureau of the Public Debt. The market value for these investments is the same as the net value stated above. Prior to FY 2005, the SEC did not invest in marketable securities.

Note 6. Accounts Receivable, Net

At September 30, 2005, accounts receivable consisted of the following:

(DOLLARS IN THOUSANDS)	GROSS RECEIVABLES	ALLOWANCE	NET RECEIVABLES
Due for Reimbursable Agreements	$ 194	$ —	$ 194
Subtotal Entity Intragovernmental Assets	$ 194	$ —	$ 194
Exchange Fees	126,589	—	126,589
Filing Fees	26	—	26
Other	281	7	274
Subtotal Entity Assets	$ 127,090	$ 7	$127,083
Disgorgement and Penalties	1,364,610	1,269,099	95,511
FOIA Fees	1	—	1
Subtotal Non-Entity Assets	$1,364,611	$1,269,099	$ 95,512
Total	$1,491,701	$1,269,106	$222,595

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

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

Note 7. Property and Equipment, Net

At September 30, 2005, property and equipment consisted of the following:

CLASS OF PROPERTY (DOLLARS IN THOUSANDS)	DEPRECIATION/ AMORTIZATION METHOD	SERVICE LIFE (YEARS)	ACQUISITION VALUE	ACCUMLATED DEPRECIATION/ AMORTIZATION	BOOK VALUE
Furniture	S/L	5	$ 5,295	$ 508	$ 4,787
Equipment	S/L	3	36,392	17,565	18,827
Software	S/L	3-5	38,524	28,691	9,833
Software in Progress	N/A	N/A	7,350	—	7,350
Leasehold Improvements	S/L	10	33,447	935	32,512
Total			$121,008	$47,699	$73,309

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

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

Leasehold improvements include costs incurred for two new locations in Washington, D.C. The SEC occupied the first of its new headquarters buildings during FY 2005. The second building is currently under construction, and the SEC expects to occupy that building in FY 2006. Therefore, no depreciation expense has been recognized at September 30, 2005 for the leasehold improvements to the second building.

Note 8. Liabilities

At September 30, 2005 and 2004, liabilities consisted of the following:

(DOLLARS IN THOUSANDS)	FY 2005	FY 2004
Liabilities Covered by Resources		
Intragovernmental		
Accounts Payable	$ 16,848	$ 8,055
Employee Benefits	2,702	2,133
Total Intragovernmental Liabilities	$ 19,550	$ 10,188
Accounts Payable	28,014	16,456
Accrued Payroll and Benefits	18,436	15,236
Registrant Deposit Accounts	65,934	62,284
Custodial Liability	95,512	279,054
Fiduciary Liability	1,975,553	863,167
Commitments and Contingencies	700	500
Other	6,323	5,816
Total Liabilities Covered by Resources	$2,210,022	$1,252,701
Liabilities Not Covered by Resources		
Intragovernmental		
Unfunded FECA Liability	$ 1,045	$ 1,120
Total Intragovernmental Liabilities	$ 1,045	$ 1,120
Recognition of Lease Liability	21,647	—
Accrued Leave	32,024	28,705
Actuarial FECA Liability	5,475	5,140
Total Liabilities Not Covered by Resources	$ 60,191	$ 34,965
Total Liabilities	$2,270,213	$1,287,666

Note 9. Actuarial FECA Liability

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

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

LBP CATEGORY	MEDICAL	COMPENSATION
Highest	9.10 %	13.40 %
Overall Average	8.00 %	12.30 %
Lowest	7.00 %	11.40 %

For FY 2005 and 2004, the SEC used the Overall Average LBP ratios to calculate the $5.5 million and $5.1 million FECA actuarial liabilities for those years, respectively.

Note 10. Leases

The SEC has the authority to negotiate long-term leases for office space. At September 30, 2005, the SEC leased office space at 19 locations under operating lease agreements that expire between 2006 and 2021. The SEC paid $66,538 thousand and $51,869 thousand for rent for FY 2005 and 2004, respectively. Under existing commitments, the minimum lease payments through FY 2010 and thereafter are as follows:

FISCAL YEAR *(DOLLARS IN THOUSANDS)*	MINIMUM LEASE PAYMENTS
2006	$ 77,615
2007	81,745
2008	78,416
2009	76,411
2010	74,718
2011 and Thereafter	541,195
Total Future Minimum Lease Payments	$930,100

During FY 2005, the SEC entered into a lease agreement for new office space in New York. With respect to its prior New York office space, the SEC and U.S. General Services Administration (GSA) entered into separate agreements with the lessor. The GSA has agreed to rent the office space from the lessor for the next five years of the SEC's lease. At that time, the GSA has the option to renew the agreement for the remaining 15 months of the SEC's lease. As part of the SEC's agreement with the lessor, the SEC is responsible for the estimated $18 million difference between its annual lease liability and the annual lease liability negotiated by the GSA with the lessor, summarized as follows:

FISCAL YEAR *(DOLLARS IN THOUSANDS)*	REQUIRED LEASE PAYMENTS
2006	$ 3,583
2007	2,603
2008	2,722
2009	2,722
2010	2,722
2011	2,469
2012	1,192
Total Future Estimated Lease Payments	$18,013

In addition, during FY 2005, the SEC moved into temporary office space in New York because the new office space is under renovation. This temporary office space is being provided to the SEC for only the lessor's operating costs, and therefore, the SEC did not pay rent expense for its New York office for five months of the fiscal year. The SEC has attributed rent expense on a straight-line basis over the life of its new lease, and recorded rent expense estimated at $3.6 million. At September 30, 2005, the SEC recognized a liability of $21.6 million to cover both obligations (See *Note 8. Liabilities and Commitments and Contingencies*).

Note 11. Imputed Financing

The SEC recognizes an imputed financing source and corresponding expense to represent its share of the cost to the federal government of providing pension and post-retirement health and life insurance benefits (Pension/Other Retirements Benefits (ORB)) to all eligible SEC employees. For FY 2005 and 2004, the components of the imputed financing sources and corresponding expenses were as follows:

PENSION/ORB CATEGORY (DOLLARS IN THOUSANDS)	FY 2005	FY 2004
CSRS	$ 6,999	$ 6,727
FERS	1,416	9,822
FEHB	17,320	13,813
FEGLI	88	75
Other	9	7
Total Pension/ORB	$25,832	$30,444

Note 12. Intragovernmental Costs and Exchange Revenue

Program costs are accumulated by responsibility segment and consist of costs related directly to the individual program lines and overall support costs allocated to the program lines. All costs incurred during FY 2005 and 2004 were assigned to specific program lines, but exchange revenue is not directly assignable to a specific program, and is presented in total. For FY 2005 and 2004, total intragovernmental and public program operating costs, are summarized in the tables on the following page.

PROGRAM COSTS (DOLLARS IN THOUSANDS)	FY 2005 AMOUNT	FY 2004 AMOUNT
Compliance Inspections and Exams		
Intragovernmental Costs	$ 46,367	$ 39,429
Public Costs	202,605	153,996
Subtotal—Compliance Inspections and Exams	$ 248,972	$ 193,425
Corporation Finance		
Intragovernmental Costs	24,772	19,398
Public Costs	102,859	73,595
Subtotal—Corporation Finance	$ 127,631	$ 92,993
Enforcement		
Intragovernmental Costs	72,502	61,741
Public Costs	292,013	236,110
Subtotal—Enforcement	$ 364,515	$ 297,851
Investment Management		
Intragovernmental Costs	9,438	8,242
Public Costs	39,970	34,293
Subtotal—Investment Management	$ 49,408	$ 42,535
Market Regulation		
Intragovernmental Costs	8,739	7,459
Public Costs	37,745	29,773
Subtotal—Market Regulation	$ 46,484	$ 37,232
Other Offices		
Intragovernmental Costs	15,028	12,611
Public Costs	65,612	49,409
Subtotal—Other Offices	$ 80,640	$ 62,020
Total Entity		
Intragovernmental Costs	176,846	148,880
Public Costs	740,804	577,176
Total Costs	$ 917,650	$ 726,056
Less Exchange Revenues	$(1,745,111)	$(1,301,945)
Net (Income)/Cost from Operations	$ (827,461)	$ (575,889)

Note 13. Program Costs by Category

For FY 2005, program costs by cost category were as follows:

COST CATEGORY (DOLLARS IN THOUSANDS)	COMPLIANCE INSPECTIONS AND EXAMS	CORPORATION FINANCE	ENFORCEMENT	INVESTMENT MANAGEMENT	MARKET REGULATION	OTHER OFFICES	TOTAL
Direct Costs							
Personnel Services and Benefits	$124,020	$ 73,097	$187,003	$29,547	$26,159	$45,599	$485,425
Compensation and Benefits	6,615	3,673	8,277	1,285	1,264	2,531	23,645
Travel and Transportation	810	144	1,698	131	634	955	4,372
Rent, Communications, and Utilities	29	4	—	—	—	12	45
Printing and Reproduction	—	—	3,210	—	—	—	3,210
Contractual Services	—	230	12,869	—	39	974	14,112
Abandonment of Software in Development Project	—	—	—	—	—	—	—
Training	—	—	—	—	—	—	—
Maintenance and Repairs	—	—	—	—	—	—	—
Supplies and Materials	—	—	—	—	—	—	—
Equipment Not Capitalized	—	—	—	—	—	—	—
Insurance Claims and Indemnities	—	—	—	—	—	—	—
Depreciation and Amortization	—	12	812	566	154	290	1,834
Loss on Asset Disposition	—	1	1	1	—	1	4
Subtotal Direct Costs	$131,474	$ 77,161	$213,870	$31,530	$28,250	$50,362	$532,647
Allocated Costs							
Personnel Services and Benefits	$ 23,353	$ 9,186	$ 30,870	$ 3,463	$ 3,326	$ 5,675	$ 75,873
Compensation and Benefits	1,705	678	2,201	256	245	420	5,505
Unfunded Personnel Services and Benefits	227	119	300	44	43	72	805
Travel and Transportation	3,152	126	3,395	47	46	110	6,876
Rent, Communications, and Utilities	34,381	13,337	40,774	4,329	4,813	7,644	105,278
Printing and Reproduction	4,816	2,516	6,390	936	908	1,526	17,092
Contractual Services	22,183	9,875	29,301	3,692	3,569	6,120	74,740
Abandonment of Software in Development Project	47	24	68	9	9	15	172
Training	467	245	620	91	89	148	1,660
Maintenance and Repairs	429	132	515	49	47	81	1,253
Supplies and Materials	984	326	1,233	122	118	204	2,987
Equipment Not Capitalized	21,735	11,015	28,703	4,096	3,976	6,703	76,228
Insurance Claims and Indemnities	188	99	250	37	36	60	670
Depreciation and Amortization	3,795	2,775	5,976	701	1,003	1,490	15,740
Loss on Asset Disposition	36	17	49	6	6	10	124
Subtotal Allocated Costs	$117,498	$ 50,470	$150,645	$17,878	$18,234	$30,278	$385,003
Total Program Costs	$248,972	$127,631	$364,515	$49,408	$46,484	$80,640	$917,650

For FY 2004, program costs by cost category were as follows:

COST CATEGORY (DOLLARS IN THOUSANDS)	COMPLIANCE INSPECTIONS AND EXAMS	CORPORATION FINANCE	ENFORCEMENT	INVESTMENT MANAGEMENT	MARKET REGULATION	OTHER OFFICES	TOTAL
Direct Costs							
Personnel Services and Benefits	$107,089	$57,083	$165,125	$26,650	$23,043	$37,841	$416,831
Compensation and Benefits	8,674	4,148	11,445	1,804	1,516	2,977	30,564
Travel and Transportation	710	88	1,887	103	536	909	4,233
Rent, Communications, and Utilities	3	—	—	—	—	12	15
Printing and Reproduction	—	—	—	—	—	—	—
Contractual Services	—	15	11,364	2	1	364	11,746
Abandonment of Software in Development Project	—	—	2,266	—	—	—	2,266
Training	—	—	—	—	—	—	—
Maintenance and Repairs	—	—	—	—	—	—	—
Supplies and Materials	—	—	—	—	—	—	—
Equipment Not Capitalized	—	—	—	—	—	—	—
Insurance Claims and Indemnities	—	—	—	—	—	—	—
Depreciation and Amortization	—	—	1,479	1,132	2	5	2,618
Loss on Asset Disposition	—	—	—	—	—	1	1
Subtotal Direct Costs	$116,476	$61,334	$193,566	$29,691	$25,098	$42,109	$468,274
Allocated Costs							
Personnel Services and Benefits	$ 20,600	$ 7,052	$ 27,804	$ 2,895	$ 2,736	$ 4,482	$ 65,569
Compensation and Benefits	1,642	678	2,321	277	263	429	5,610
Unfunded Personnel Services and Benefits	25	13	35	5	5	8	91
Travel and Transportation	3,214	113	3,558	46	44	90	7,065
Rent, Communications, and Utilities	16,988	8,850	23,260	3,786	3,364	5,630	61,878
Printing and Reproduction	3,944	1,970	5,502	754	750	1,206	14,126
Contractual Services	15,622	6,594	21,527	2,587	2,527	4,114	52,971
Training	309	156	430	59	59	95	1,108
Maintenance and Repairs	424	110	532	42	42	68	1,218
Supplies and Materials	995	226	1,229	88	87	143	2,768
Equipment Not Capitalized	9,628	4,300	13,061	1,651	1,638	2,636	32,914
Insurance Claims and Indemnities	188	95	261	36	36	58	674
Depreciation and Amortization	3,261	1,458	4,621	601	566	925	11,432
Loss on Asset Disposition	109	44	144	17	17	27	358
Subtotal Allocated Costs	$ 76,949	$31,659	$104,285	$12,844	$12,134	$19,911	$257,782
Total Program Costs	$193,425	$92,993	$297,851	$42,535	$37,232	$62,020	$726,056

Note 14. Exchange Revenues

For FY 2005 and 2004, exchange revenues consisted of the following:

(DOLLARS IN THOUSANDS)	FY 2005	FY 2004
Securities transactions fees	$1,150,184	$ 911,432
Securities registration, tender offer, and merger fees	594,685	389,904
Other	242	609
Total Exchange Revenues	$1,745,111	$1,301,945

As discussed in *Note 1. I. Revenue and Other Financing Sources,* the SEC is funded by securities transaction fees from SROs, and by securities registration, and tender offer, merger, and other fees collected from registrants. In 2002, the Investor and Capital Markets Fee Relief Act was signed into law, and set fee rates for FY 2002. The Act also requires the SEC to adjust the fee rates for FY 2003 through FY 2011, and make a final adjustment to fix the fee rates for FY 2012 and beyond. The SEC's fee rates are applied to volumes of activity reported by self-regulatory organizations or to filings submitted by registrants. The SEC is permitted by law to include these amounts in its obligational authority or to offset its expenditures and liabilities upon collection up to authorized limits for budgetary purposes. When earned, these fees are recognized as exchange revenue for purposes of these financial statements.

Note 15. Transfers Without Reimbursement

For FY 2005, transfers of budgetary authority (from) to other SEC funds consisted of the following:

		INTRA-AGENCY TRANSFERS	
(DOLLARS IN THOUSANDS)	INDEFINITE AUTHORITY	GENERAL FUND	NET TRANSFERS
To Fund Current Year Operations	$57,000	$(57,000)	$—
To Transfer Cancelling Authority	5,232	(5,232)	—
Net Transfers	$62,232	$(62,232)	$—

For FY 2004, transfers of budgetary authority (from) to other SEC funds consisted of the following:

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

Intra-agency transfers represent funding from prior years unobligated balances to fund the current year appropriation level.

NOTE 16. Status of Budgetary Resources

A. Apportionment Categories of Obligations Incurred

For FY 2005 and 2004, obligations incurred as reported on the Statements of Budgetary Resources consisted of the following:

OBLIGATIONS INCURRED (DOLLARS IN THOUSANDS)	FY 2005	FY 2004
Direct Obligations		
Category A	$961,333	$827,619
Category B	—	—
Total Direct Obligations	$961,333	$827,619
Reimbursable Obligations		
Category A	$ —	$ —
Category B	—	—
Total Reimbursable Obligations	$ —	$ —
Total Obligations Incurred	$961,333	$827,619

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

The distinction between Category A and B funds is that Category A funds are subject to quarterly apportionment by the OMB, while category B funds are available for use by the agency without being subject to apportionment. At September 30, 2004, there were no material differences between the Statements of Budgetary Resources and the Budget of the United States Government. In addition, a comparison between the Statements of Budgetary Resources and the actual FY 2005 data in the President's Budget cannot be performed as the FY 2007 President's Budget is not yet available.

Note 17. Custodial Revenues and Liabilities

For FY 2005, the source of custodial revenues consisted of the following:

(DOLLARS IN THOUSANDS)	DISGORGEMENT AND PENALTIES	OTHER	TOTAL
Cash Collections	$1,606,274	$270	$1,606,544
Less: Refunds	—	—	—
Net Cash Collections	$1,606,274	$270	$1,606,544
Increase/(Decrease) in Amounts to be Collected	(183,535)	(7)	(183,542)
Total Non-Exchange Revenues	$1,422,739	$263	$1,423,002

For FY 2005, the source of custodial liabilities consisted of the following:

(DOLLARS IN THOUSANDS)	DISGORGEMENT AND PENALTIES	FOIA	TOTAL
Gross Custodial Accounts Receivable	$1,364,610	$ 1	$1,364,611
Less: Allowance for Doubtful Accounts	1,269,099	—	1,269,099
Net Custodial Liability	$ 95,511	$ 1	$ 95,512

For FY 2004, the source of custodial revenues consisted of the following:

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

For FY 2004, the source of custodial liabilities consisted of the following:

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

Note 18. Fiduciary Assets and Liabilities

As a civil law enforcement agency, the SEC has broad regulatory and enforcement powers and judicial and administrative remedies available to enforce federal securities laws. The principal laws that grant the SEC its authority include the: Securities Act of 1933; Securities Exchange Act of 1934; Public Utility Holding Company Act of 1935; Trust Indenture Act of 1939; Investment Company Act of 1940; Investment Advisers Act of 1940; Securities Investor Protection Act of 1970; Insider Trading Sanctions Act of 1984; Government Securities Act of 1986; Insider Trading and Securities Fraud Enforcement Act of 1988; Securities Enforcement Remedies and Penny Stock Reform Act of 1990; Market Reform Act of 1990;

Unlisted Trading Privileges Act of 1994; Private Securities Litigation Reform Act of 1995; Philanthropy Protection Act of 1995; National Securities Markets Improvement Act of 1996; International Anti-Bribery and Fair Competition Act of 1998; Securities Litigation Uniform Standards Act of 1998; Gramm-Leach-Bliley Act of 1999; Commodity Futures Modernization Act of 2000; Investor and Capital Markets Fee Relief Act of 2001; and Sarbanes-Oxley Act of 2002.

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

The SEC's fiduciary activities arise from orders issued by the Commission, administrative law judges or, in some cases, federal courts granting monetary relief to injured investors using disgorgement, penalties, and interest thereon against securities law violators. The funds are held in the name of the SEC and generally invested in market-based Treasury securities pending distribution to injured investors pursuant to an approved distribution plan. In FY 2005 these investments earned $28.6 million in interest.

At September 30, 2005 and 2004, the assets held by the SEC in a fiduciary capacity and its offsetting liability consisted of the following:

FIDUCIARY ACTIVITIES *(DOLLARS IN THOUSANDS)*	FY 2005	FY 2004
Assets		
Fund Balance With Treasury	$ 207,529	$863,167
Investments	$1,768,024	—
Total Assets	$1,975,553	$863,167
Liabilities		
Liability for Fiduciary Activity	$1,975,553	$863,167
Total Liabilities	$1,975,553	$863,167

For FY 2005 and 2004, the source and disposition of the SEC's fiduciary activities consisted of the following:

FIDUCIARY ACTIVITIES *(DOLLARS IN THOUSANDS)*	FY 2005	FY 2004
Fund Balance With Treasury		
Beginning Balance	$ 863,167	$134,915
Disgorgement and Penalties	1,112,386	728,252
Transfer to Investments	(1,768,024)	—
Total Fund Balance With Treasury	$ 207,529	$863,167
Investments		
Beginning Balance	$ —	$ —
Net Investments Activity— Disgorgement and Penalties	1,768,024	—
Total Investments	$ 1,768,024	$ —
Total Assets	$ 1,975,553	$863,167
Liability for Fiduciary Activity		
Beginning Balance	$ 863,167	$134,915
Disgorgement and Penalties	1,112,386	728,252
Total Liabilities	$ 1,975,553	$863,167

NOTE 19. Commitments and Contingencies

A. Commitments

The Securities Investor Protection Act of 1970, as amended (SIPA) created the Securities Investor Protection Corporation (SIPC) to provide certain financial protections to customers of insolvent registered securities brokers, dealers, firms, and members of national securities exchanges for up to $500,000 per customer. The SIPA authorizes the SIPC to create a fund to maintain all moneys received and disbursed by the SIPC. The SIPA also gives the SIPC the authority to borrow funds from the SEC in an amount not to exceed in the aggregate $1 billion in the event that the SIPC fund is or may appear insufficient for purposes of the SIPA. If necessary, these funds would be made available to the SEC through the purchase by the Treasury of notes or other obligating instruments issued by the SEC. Such notes or other obligating instruments would bear interest at a rate determined by the Secretary of the Treasury. As of September 30, 2005 and 2004, the SEC had not loaned any funds to the SIPC, and there are no outstanding notes or other obligating instruments issued by the SEC.

In addition to the future lease commitments discussed in Note 10. Leases, the SEC is obligated for the purchase of goods and services that have been ordered, but not yet received. For FY 2005, net obligations for all of the SEC's activities were $235,508 thousand and of this amount $73,622 thousand were delivered and unpaid. For FY 2004, net obligations for all of the SEC's activities were $228,280 thousand and of this amount $48,795 thousand were delivered and unpaid.

B. Contingencies

The SEC is party to various routine administrative proceedings, legal actions, and claims brought by or against it, including threatened or pending litigation involving labor relations claims, some of which may ultimately result in settlements or decisions against the federal government. As of September 30, 2005, SEC management expects that it is probable that approximately $700 thousand may be owed for Equal Access to Justice matters. As of September 30, 2004, SEC management expected that it was probable that approximately $500 thousand would have been owed for a settlement involving an Equal Access to Justice application. In FY 2005, this application was settled for $272.5 thousand.

Required Supplemental Information

U.S. SECURITIES AND EXCHANGE COMMISSION

Required Supplemental Information

As of September 30, 2005

Intragovernmental Assets:

(DOLLARS IN THOUSANDS)

	2005				2004
TRADING PARTNER	FUND BALANCE WITH TREASURY	ACCOUNTS RECEIVABLE, NET	INVESTMENTS, NET	TOTAL	TOTAL
20 Department of the Treasury	$4,348,936	$ —	$1,768,024	$6,116,960	$4,202,640
72 Agency for International Development	—	194	—	194	219
Total	$4,348,936	$194	$1,768,024	$6,117,154	$4,202,859

Intragovernmental Liabilities:

(DOLLARS IN THOUSANDS)

	2005			2004
TRADING PARTNER	ACCOUNTS PAYABLE	ACCRUED PAYROLL AND BENEFITS	TOTAL	TOTAL
04 Government Printing Office	$ 672	$ —	$ 672	$ 24
05 General Accounting Office	233	—	233	849
12 Department of Agriculture	1	—	1	3
14 Department of Interior	8	—	8	1
15 Department of Justice	3,637	—	3,637	2,378
16 Department of Labor	76	1,045	1,121	1,120
18 U.S. Postal Services	70	—	70	70
20 Department of the Treasury	2,058	—	2,058	815
24 Office of Personnel Management	68	2,702	2,770	2,210
29 Federal Trade Commission	19	—	19	—
47 General Services Administration	9,481	—	9,481	1,209
69 Department of Transportation	50	—	50	2,346
75 Department of Health and Human Services	385	—	385	253
88 National Archives and Records Administration	90	—	90	28
95 Independent Agencies	—	—	—	2
Total	$16,848	$3,747	$20,595	$11,308

Intragovernmental Earned Revenues:

(DOLLARS IN THOUSANDS)

TRADING PARTNER	2005	2004
72 Agency for International Development	$242	$609
Total	$242	$609

Gross Costs that Generated Intragovernmental Earned Revenues:

(DOLLARS IN THOUSANDS)

BUDGET FUNCTIONAL CLASSIFICATION	2005	2004
Prevention & Suppression of Fraud	$242	$609
Total	$242	$609

The SEC has not deferred to a future period maintenance on the property and equipment presented on the Balance Sheet as of September 30, 2005.
The SEC has not deferred to a future period maintenance on the property and equipment presented on the Balance Sheet as of September 30, 2004.

Comments from the Securities and Exchange Commission

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

OFFICE OF
THE CHAIRMAN

November 14, 2005

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

Dear Mr. Walker:

Thank you for the opportunity to respond to the draft report of the Government Accountability Office (GAO) entitled "Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2005 and 2004". I would like to personally acknowledge and commend the efforts and dedication by you and the GAO staff in working with the Securities and Exchange Commission (SEC) to meet the November 15 deadline for reporting our audited financial statements.

I am pleased that the audit found that the statements and notes are presented fairly, in all material respects, and in conformity with U.S. generally accepted accounting principles for federal government agencies, and that it found no instances of reportable noncompliance with laws and regulations tested.

The opinion on internal controls cites three material weaknesses in the same areas where GAO found controls to be inadequate in the audit of the fiscal 2004 financial statements. As you know from our meetings on this subject, since my arrival at the SEC in August 2005 I have made resolution of these weaknesses my highest operational priority as Chairman. I have redoubled the efforts of the agency and our staff to this end. We intend to remediate all three material weaknesses before the end of fiscal 2006.

We will resolve the control weaknesses in the system for preparing financial statements and related disclosures by fully documenting and integrating into agency operations the disciplined procedures and policies needed to complete accurate and timely financial statements. As you know, I have directed accounting and financial experts on the professional staff of the Office of the Chief Accountant to assist the Office of Financial Management with the development of these measures. Additionally, we have established a Financial Management Review Committee to provide advice and to regularly review the agency's financial operations and policies. This committee will also help ensure SEC compliance with the requirements of OMB Circular-A 123 on Management's Responsibility for Internal Control.

The Honorable David M. Walker
November 14, 2005
Page Two

With respect to identified weaknesses in controls over information technology security, the audit confirmed many of the findings reported previously through the SEC's Federal Managers' Financial Integrity Act (FMFIA) and audit programs. The draft audit report specifically cites electronic access controls over sensitive financial data. The SEC intends, with respect to weaknesses in this area, to complete implementation of the plans that were put in place following last year's information security audit. We intend to finalize policies and operating procedures to better manage access to computer systems, and to control the types of changes that are introduced into the information technology environment. In addition, we will continue to define the detailed procedures underlying our overall security management program, to ensure that the agency is effectively identifying, assessing, and mitigating sources of information security risk on a continuous basis. As indicated in the comments on last year's audit, we anticipate that all weaknesses identified at that point will be resolved by June 2006. We will also be defining plans of action and milestones for resolving any additional specific weaknesses emerging from this year's audit.

The final material weakness, related to documentation and reporting of disgorgement and penalties, also confirms findings reported previously through the SEC's FMFIA program. During fiscal 2005, the SEC completed a comprehensive review of disgorgement and penalty financial data aimed at correcting any erroneous data. Nonetheless, as the draft audit report properly recognizes, there are continuing problems. A key to resolving this material weakness is the replacement of the financial system in which the data are stored, and our plans call for completion of the new system during the current fiscal year. The SEC will also move aggressively to strengthen controls over the processes for tracking the investment and distribution of funds to harmed investors. We anticipate that strengthened internal controls and replacement of the program's financial management information system will be adequate to resolve this material weakness in fiscal 2006.

As Chairman, I am committed to enhancing the SEC's financial and operational effectiveness. It is my firm belief that the SEC must lead by example when it comes to compliance with the internal controls requirements of the private and federal sectors. I appreciate your support of those efforts, and look forward to continuing our productive dialogue on the issues addressed in the fiscal 2005 audit.

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

Sincerely,

Chris Cox

Christopher Cox
Chairman

The Honorable David M. Walker
November 14, 2005
Page Three

cc: Jeanette M. Franzel
Director, Financial Management and Assurance
Government Accountability Office

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