Testimony on Securities and Exchange Commission's Audited Financial Statements and Facilities Budgeting

By:

James M. McConnell

Executive Director, Securities and Exchange Commission

Before the Subcommittee on Federal Financial Management, Government Information, and International Security

Committee on Homeland Security and Governmental Affairs

United States Senate

July 27, 2005

Chairman Coburn, Ranking Member Carper, and Members of the Subcommittee:

My name is Jim McConnell and I am the Executive Director of the SEC. The views expressed below and the views I express today are my individual views, and do not necessarily reflect the views of the Commission or the Commissioners, including the Acting Chairman. Thank you for the opportunity to testify today about the SEC's audited financial statements and facilities budget estimates. Given the SEC's regulatory responsibilities, it is critical that the agency maintain strong financial management practices and that we use taxpayer funds efficiently and effectively.

Like many private companies, the SEC has invested tremendous time and energy on examining and bolstering our financial management practices and internal controls. As the regulator overseeing the financial markets and the accounting industry, it is entirely appropriate that we do so. As you know, these efforts have uncovered some weaknesses that we are working aggressively to resolve. Although the audit and internal controls program have presented challenges, we believe that the process will pay dividends in the form of stronger and more effective financial management at the SEC and is an important government-wide initiative.

Audited Financial Statements

I would like to begin by discussing the first-ever audit of the SEC's financial statements, conducted under the Accountability of Tax Dollars Act of 2002. Because of the SEC's regulatory responsibilities, we selected the Government Accountability Office (GAO) as our auditor. The release of our fiscal 2004 Performance and Accountability Report in May was the culmination of two years of hard work by Commission staff and our GAO auditors. I want to thank them all for their efforts.

The good news is that the GAO found that our financial statements were "presented fairly, in all material respects, in conformance with U.S. generally accepted accounting principles." Clean financial statements are quite an achievement for a first-time audit. When the 24 major federal agencies began issuing audited financial statements in 1996, only six received unqualified opinions on their first audit, and many agencies still have not achieved unqualified opinions.

The GAO also performed an audit of the SEC's internal controls over financial reporting, and their report concluded that our controls in three areas were not fully effective. Specifically, their report identified material weaknesses in the areas of recording and reporting of disgorgements and penalties, preparing financial statements, and information technology (IT) security. Two of the three issues—IT security controls and disgorgements and penalties—are weaknesses that the agency has been working on for some time and that have been reported previously under the Federal Managers' Financial Integrity Act (FMFIA).

Let me now discuss each of these three areas, and add some general comments.

Disgorgements and Penalties

The first material weakness relates to the controls over our accounting for disgorgements and penalties ordered by courts as a result of SEC enforcement actions. While the judgments awarded by the courts are for specific amounts, the collection is frequently uncertain and requires efforts over a period of years. Let me emphasize that all fines and penalties are accounted for and no payments have been lost. Instead, the GAO found that the SEC did not have a sufficiently comprehensive policy governing the accounting for these amounts, and found inadequate internal controls in the procedures and systems for recording of judgments and the allowance for uncollectible accounts.

This is an issue that the SEC has been working on for several years, and we appreciate that the GAO audit report indicated that the SEC has made significant progress in this area. We are currently performing a comprehensive review of our case files and data, and finalizing relevant accounting policies and internal control procedures. We anticipate that consistent application of strengthened internal controls and potentially some limited redesign of the current case tracking system will resolve the material weakness in fiscal 2006. In addition, we are developing plans to implement a multi-year initiative beginning in 2006 to replace the current tracking system. The financial components of the new system will be integrated with our central accounting system to improve the timeliness and accuracy of our financial reporting in this area.

Financial Statement Preparation Process

The GAO found a second material weakness related to the SEC's internal controls over the process for preparation of financial statements. This was the SEC's first audit, and the procedures used to prepare our statements involved significant manual effort by SEC staff. As a result, the policies, practices, and procedures had not been fully documented and integrated into the agency's operations.

This spring an internal senior management team reviewed many of our financial management processes and policies. The team confirmed the acceptability of many of the initial policies applied in 2004 and directed that others be further modified or reviewed. Going forward, a permanent senior management committee will regularly review our financial management and reporting functions and review our progress. 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 into our own systems. Through these efforts, we expect to be able to resolve this material weakness in fiscal 2006.

Information Technology Security

Finally, GAO's audit confirmed weaknesses in the SEC's information technology security that have been reported in prior years through our FMFIA program. These weaknesses include insufficient access controls, network security, and monitoring of security-related events. However, I should also note that the GAO found we had taken the right set of initial steps to address the weaknesses, including hiring a new Chief Information Security Officer and establishing a centralized security management program. In response, the SEC has developed a detailed inventory and timeline for correcting each of the specific weaknesses identified, such as through a certification and accreditation project and revisions to the agency's policies and procedures in this area. We have continued to build out our information security program and address specific issues over the several months since the conclusion of the audit, and while our timeline is ambitious, we plan to complete the remediation efforts by June 2006.

General Comments

Let me take a moment for some general comments. Because of the SEC's regulatory role, we believe the agency must lead by example through our handling of internal control weaknesses. Just as with private companies, we believe it is critical to forthrightly disclose our weaknesses and work to mitigate them as completely and quickly as possible. Full disclosure is entirely appropriate for the federal sector, as it is for the private sector. While we have worked to resolve and reported two of these weaknesses previously, the additional focus that comes with an audit has brought renewed energy and aggressiveness to our efforts to resolve them. We look forward to continuing this process in 2005, and believe that the SEC, as well as the investors we serve, will only benefit as a result.

I would also like to advise the Subcommittee of the many new initiatives that the agency has implemented during the past two years that improve the management and oversight of its operations. First, the SEC has implemented monthly management "dashboards" designed to present regular snapshots of the divisions’ and offices’ progress in meeting budget, staffing, and performance objectives. Rather than motivating staff to simply “hit the numbers,” our dashboards are designed to identify emerging problems, promote the discussion of solutions, and reinforce each executive's accountability for staff, performance and key initiatives. In conjunction with our other efforts, the dashboards will help the agency proactively adjust operations and resources as environmental changes require. Second, the SEC has strengthened its human capital planning activities by creating a new Human Capital Review Board that meets on a regular basis to ensure that the agency’s staff are appropriately deployed to those parts of the agency with the highest need. In addition, the agency has spent considerable energy “breaking down silos” to increase the level of communication and coordination across the agency’s offices and divisions, and has worked to use its policy expertise to assist the agency in addressing a number of its current audit and operational challenges.

I now would like to turn to addressing the SEC’s facilities budget estimates.

Facilities Budgeting

As you know, the SEC recently discovered that it had underestimated tenant build-out costs for new agency facilities in Washington, New York, and Boston by about $48 million over the next three years. These errors are serious, and revealed the need to improve our facilities management and budget planning functions. However, I should note that there have been no cost overruns on existing contracts; these mistakes pertain to estimates of future costs. Also, the SEC will be able to deal with these costs within existing funding levels and has submitted a reprogramming request that will correct our budget allocations. As you know, Representative Wolf has asked the GAO over the next few weeks to review the actions that led to this change in estimates and the actions the SEC has taken in response, and we welcome their involvement.

I will now discuss in more detail the nature of the costs for each of these projects, and the vigorous actions the SEC is taking to ensure that this type of mistake does not occur again in the future.

Station Place Buildings One and Two

The SEC first entered into a lease for a new Washington-area headquarters facility at Station Place Building One in May 2001. To select this site, the SEC conducted a full and open competition, in partnership with the General Services Administration (GSA). Station Place was the lowest bid in the competition, with the flat base rental rate of $43.63 per square foot for the duration of the lease. Then, because of substantial increases in the SEC's staff approved by Congress, the agency exercised its option to lease Building Two of Station Place in November 2002.

When the SEC developed its cost estimates for both Station Place buildings, the agency estimated a total tenant build-out cost of roughly $97 million over several years. Of this amount, the SEC was to pay $47 million in appropriated funds, and the remainder was to be covered through tenant allowances provided by the building owner. In its fiscal 2006 Congressional budget request, the SEC estimated the agency's fiscal 2005 needs for both buildings at about $15 million. This estimate was based on assumptions related to construction costs provided by our facilities staff. This spring, it became clear that these assumptions, and the originally projected multi-year cost, were no longer accurate and had increased substantially.

As a result, the SEC now estimates that the cost of completing the build-out for both buildings is roughly $19 million more than originally anticipated, almost all of which is needed for Building Two. This $19 million increase falls into two categories. First, $6 million is due to security enhancements for Building Two. With the benefit of lessons learned from Building One, the SEC determined that its security-related costs have increased. For example, among other items, the cost of hardening the multi-level parking garage has proven much more expensive than originally projected, due to its structural design.

The remainder of the Building Two needs stem from base construction and interior build-out costs. The original estimates for these costs in Building Two were made in the spring of 2004. Our recent experience and estimates indicate that there will be higher actual costs for construction materials and labor than those projected. Additionally, some of the functional requirements for Building Two, such as a Voice Over Internet Protocol (VOIP) telecommunications system, an emergency communications antenna, and augmented data and telephone cabling have led to higher interior build-out costs. Finally, this current cost estimate better anticipates that we will encounter unforeseen site conditions, as we did with Building One.

To cover the majority of these costs, the SEC has the option under the lease to pay a lump-sum to the landlord up to a year after completion of the building, in which case the SEC would seek this funding in our budget request for fiscal 2007. Alternatively, the lease allows the SEC to amortize up to $12.3 million into our lease payments. If the costs were amortized, then the SEC would need to accommodate roughly $1.5 million more into its annual budgets over the next 14 years, starting with fiscal 2006.

Northeast Regional Office

Now I would like to discuss the new facility for our New York Office at Three World Financial Center, for which we signed the lease in March 2005. This location provides the SEC with the additional space needed to accommodate the staffing increases the agency has received over the last several years. The new space also was obtained at a more favorable lease rate than the SEC's prior location. Most important, this move enabled the SEC to vacate a substandard office that it had to find quickly in response to the destruction of our building on September 11th.

While the SEC did not yet have a lease for new space in New York when it was formulating its fiscal 2005 budget, the agency had been developing plans to move to an alternate location. Unfortunately, no funds were included to build out this new facility, and instead the agency only requested enough resources to cover the costs of returning certain tenant improvement credits received under the prior lease in the Woolworth Building. As a result, the SEC currently estimates that it will cost an additional $28 million to fully address our New York build-out needs. Of this amount, about $6 million is associated with the acquisition of temporary swing space, and the remaining $22 million is attributable to the build-out of permanent space.

The agency does not anticipate facing any significant additional build-out expenses in New York in 2007 or beyond, as this project will be completed in fiscal 2006. Separately, the SEC currently intends to cover a portion of the costs of this build-out through amortizing these costs into our lease payments in accordance with a revised lease agreement with the landlord, and to fund the remainder through our currently pending reprogramming request.

Boston District Office

Lastly, the SEC is in the process of completing the Boston district office's relocation to its new address at 33 Arch Street. When the SEC first estimated the costs of this space, the staff assumed a build-out cost of $90 per square foot. Recently, the SEC determined that this price is not obtainable given the rising costs of construction materials, labor, and the agency's space-related requirements. For these reasons, the SEC faces an estimated shortfall of about $1.4 million. While the SEC will not be moving to this location until next spring, this cost must be funded in fiscal 2005. As with the New York Office, the SEC does not expect to require additional funding for build-out beyond 2006.

Project Management and Budgetary Controls

Now let me say a few words about the actions the SEC has taken to rectify the conditions that led to these project management and budget planning failures, and ensure that they do not recur.

During the course of the development of the SEC's spending plans for fiscal years 2005 and 2006, our facilities staff in the Office of Administrative Services (OAS) had been asked multiple times to provide accurate and complete cost information on these projects. However, OAS staff provided no new information that reflected the agency's need for additional build-out funds. The SEC's budget oversight staff then learned of the possibility of these budgetary shortfalls and omissions in the course of reviewing the SEC's fiscal 2005 operating budget this spring. The SEC then advised our appropriations subcommittee and submitted a reprogramming request that will allow us to shift funds from other areas to pay for our 2005 needs, as outlined above.

The SEC has removed several staff from these projects and is working to strengthen our budgetary formulation internal controls and oversight capabilities. Among other improvements, the SEC recently created several new budgeting and project oversight positions in OAS and added budget formulation staff in our Office of Financial Management (OFM). The SEC also is planning a new budget formulation and activity-based costing systems that will greatly enhance the quality and timeliness of the data related to our administrative and operational costs.

Conclusion

In conclusion, I would like to thank the subcommittee for your interest in these important topics. We believe that strengthening our internal controls and financial management practices will have significant benefits for the SEC, and will allow us to be more effective in fulfilling our mission to protect investors. We look forward to sharing with you the results of these efforts.

I would be happy to answer any of your questions.