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WHO'S WATCHING THE WATCHDOG? EXAMINING FINANCIAL MANAGEMENT AT THE SEC

HEARING

BEFORE THE

FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE

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WHO'S WATCHING THE WATCHDOG? EXAMINING FINANCIAL MANAGEMENT AT THE SEC

WEDNESDAY, JULY 27, 2005

U.S. SENATE,
SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT,
GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY,
COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:32 p.m., in room 562, Dirksen Senate Office Building, Hon. Tom Coburn, Chairman of the Subcommittee, presiding.

Present: Senators Coburn, and Carper.

OPENING STATEMENT OF CHAIRMAN COBURN

Senator COBURN. The hearing will come to order. This is a hearing of the Federal Financial Management Oversight Subcommittee of the Homeland Security and Governmental Affairs Committee.

The Securities and Exchange Commission (SEC) plays a crucial role in ensuring the continued health of the U.S. capital markets by administering the Federal laws that govern U.S. securities markets. In 2004, the Commission took an aggressive agenda, with the implementation of rulemaking projects under the Sarbanes-Oxley Act, including supervision of the Public Company Accounting Oversight Board and its regulation of auditors of public companies, such as the former Arthur Anderson, PricewaterhouseCoopers, and other auditing firms.

The Commission is expanding its role. For instance, we have seen increased promulgation of regulation to identify abuses in the mutual fund industry and requiring hedge funds to register. These rules have shown the agency's commitment to maintaining integrity in the U.S. markets and, more importantly, investor confidence within the United States. Without a doubt, the Securities and Exchange Commission has a difficult job, but also a very vital role in the U.S. economy.

I would reference a poster which is their vision statement. It would read and note that, in its own words, the Commission "aims to be the standard against which Federal agencies are measured." If this is the vision, we have a long way to go.

Similarly, its rigorous reform agenda, coupled with its ability to continue expanding its regulatory role, raises the question of SEC's ability to maintain effective examination and enforcement of the se-

curities industry while making necessary internal control changes. These goals deserve candid discussion.

The Accountability for Tax Dollars Act of 2002 expanded the requirement to conduct annual audits of agencies' finances from the original 24 CFO Act agencies to all Executive Branch agencies in the Federal Government. Since then, the SEC has been required to prepare and submit to Congress and the Office of Management and Budget (OMB) audited financial statements. Fiscal year 2004 was the first year SEC prepared its first complete set of financial statements.

GAO performed this initial audit, and though the SEC received a clean audit opinion on its financial statements, GAO found three very significant material weaknesses in the areas of appropriately preparing financial statements, keeping track of penalties owed to the government and to harmed investors, and finally, an insecure information system which makes sensitive data vulnerable. Such disturbing audit results are inexcusable for the financial watchdog of corporate America.

I am reminded of the unique indignation you feel when you are passed on the highway by a trooper or policeman who doesn't have his lights on and is just going home, or the outrage that America felt when a longtime Federal forest ranger started a forest fire that destroyed 30 homes and 100,000 acres in Colorado. What I am getting at here is that those most entrusted with enforcement authority cannot be above their own standards. Americans will not and should not tolerate that sort of hypocrisy.

In addition, due to poor budgeting, the Commission understated by $50 million the cost for new buildings in New York City, Boston, and Washington, DC. The original cost estimate for these three new buildings, which was estimated in fiscal year 2005, was approximately $22 million. In fewer than 3 years, the cost has more than tripled. I am also aware that rather than absorbing the cost of this budgeting problem, in fiscal year 2006, SEC plans to heap the financing burden on these buildings on generations down the road.

Four years ago, the Global Research Analysts Settlement required the firms involved to pay $875 million in penalties and disgorgement, including $80 million dedicated to investor education. Fifty-two-point-five million of this was supposed to establish an investor education fund to develop and support programs designed to equip investors. While $27.5 million of these monies were directed to State securities regulators for investor education, the transfer of $52.5 million to the NASD Foundation has raised legal questions and I anticipate solid explanations for this decision.

I look forward in this hearing to find the progress that the SEC has already made with regard to strengthening internal controls this year. I also look forward to discussing their intent for reform of an agency that must maintain shining standards of financial reporting, given the important role that it plays in regulating public companies and the U.S. securities market.

I want to thank our witnesses, the Hon. David Walker, Comptroller General of the United States, and James McConnell, for being with us.

David M. Walker has been Comptroller General of the United States since November 1998. He serves as the Nation's chief accountability officer and head of the U.S. Government Accountability Office. Mr. Walker has extensive executive-level experience in both government and private industry. He is a Certified Public Accountant, has a degree in accounting from Jacksonville University and a Senior Management in Government Certificate in Public Policy from the John F. Kennedy School of Government at Harvard University, as well as honorary degrees in both business and public service.

Jim McConnell, Executive Director of the Securities and Exchange Commission, is our second witness. Mr. McConnell was appointed Executive Director of the U.S. Securities and Exchange Commission in October 1990. Prior to his role as Executive Director, Mr. McConnell served as the Commission's Chief Management Analyst, where he was primarily responsible for preparation of the agency's budget and authorization request, as well as the agency's internal control program. Today, as Executive Director, he is responsible for achieving efficiency and economy in the Commission's operations as well as for developing and executing overall management policies within the policy framework established by the Chairman. In 1991, Mr. McConnell received the Chairman's Award of Excellence, recognizing his performance in improving the management and budget operations of the SEC. Prior to joining the Commission, Mr. McConnell worked at the Department of Labor, where he received a Distinguished Career Service Award, that agency's highest honor. He holds a B.S. in business administration from Virginia Tech.

I would like to thank each of you for being here. General Walker, if you would start. Your written testimony will be made a part of the record and we won't have any time limits.

TESTIMONY OF HON. DAVID M. WALKER,[1] COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. WALKER. Thank you, Mr. Chairman. It is good to be back before this Subcommittee today to talk about the results of our first audit of the Securities and Exchange Commission for the fiscal year ended 2004.

As you noted in your opening statement, this was the first ever audit of the Securities and Exchange Commission, which resulted from recent legislation that expanded the audit requirements that previously applied to most major Federal Government agencies. I think it is important to note that our report was issued on May 26, 2005. It has been made available to you as well as to the public.

There were mixed results from that initial audit. First, the SEC did earn a clean opinion on its financial statements. That is quite an accomplishment. The fact of the matter is that most of the agencies in the Federal Government who undertook their first audit did not earn a clean opinion the first time out.

At the same point in time, as you properly pointed out, the SEC plays a critically important role with regard to the securities mar-

[1] The prepared statement of Mr. Walker appears in the Appendix on page 25.

kets and also with regard to overseeing the public accounting profession through the Public Company Accounting Oversight Board (PCAOB). Therefore, it is important that the SEC lead by example with regard to its own financial management activities.

While the SEC received a clean opinion on its financial statements, it received an adverse opinion on internal control. There were three material control weaknesses which we highlighted, the first dealing with preparing financial statements and related disclosures; the second dealing with recording and reporting of disgorgements and civil penalties; and the third dealing with information security.

It is important to note that these weaknesses were as of the date of our opinion. SEC management and leadership has agreed with the vast majority of our recommendations, and they have taken a number of steps to try to address these recommendations. Furthermore, it is also important to note that there are a number of other Federal agencies that have similar material control weaknesses, especially with regard to information security.

But as you pointed out in your opening statement, the SEC has a very visible and prominent role in promoting and enforcing accountability for corporations whose equity and debt instruments are traded on our securities markets, and therefore, it is critically important that it lead by example.

In its 2004 Performance and Accountability Report, SEC leadership noted its intention to do so and to try to serve as a model for other Federal agencies. I believe that they were sincere when they made that commitment. I know that they are taking steps to try to deliver on that. But that is not going to be accomplished overnight.

Mr. Chairman, it is important for the SEC to lead by example for a variety of reasons, not just to make sure that we have proper accountability over these funds, but also to maintain the credibility of the agency, given its mission, and to make sure that its regulatory enforcement activities have full force and effect not only in law, but also in substance and as they are viewed by those that they regulate to.

Last thing, there are two issues that I would like to raise for your attention that I think are noteworthy, one of which is the fact that if you look at the SEC's financial statements, which I am sure you have, you will see there is about a $4 billion balance with the Treasury. Of that $4 billion balance with the Treasury, about $3 billion of that represents the accumulated positive results of operations for the SEC throughout its history. This is shown as a restricted asset on the balance sheet of the SEC. It is eliminated in consolidation when you come up with the consolidated financial statements of the U.S. Government, but as you probably noted, Mr. Chairman, those funds are not available for use by the SEC unless the Congress appropriates such funds. It has done so on occasion in the past. I believe at least once in the past. This amount also serves to note that these has been a self-sustaining organization over many years. However, there are ongoing discussions and debate about whether and to what extent the current accounting treatment should be continued in the future.

Second, I would also note that of the roughly $4 billion that was held by the Treasury as of the end of last fiscal year, that $863 million represented two fiduciary funds from disgorgements that were being held for the benefit of others. Up until November 2004, those funds were not earning any interest. They were not invested actively. They were just in an account of the Treasury. While reasonable people can debate about who should invest it and how they should be invested, I believe that since these are fiduciary funds, it is important that they be invested for the benefit of those who would ultimately receive payment.

I thank you, Mr. Chairman. I look forward to hearing from my colleague here today at the panel and answering your questions thereafter.

Senator COBURN. Thank you, General Walker. Mr. McConnell.

TESTIMONY OF JAMES M. McCONNELL,[1] EXECUTIVE DIRECTOR, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. MCCONNELL. Thank you, Chairman Coburn. My name is Jim McConnell. I am the Executive Director of the SEC. 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.

I appreciate 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 our funds efficiently and effectively.

Like many private companies, the SEC has invested tremendous time and energy on 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 as an important government-wide initiative.

I would like to begin by discussing the first ever audit of the SEC's financial statements. The release of our fiscal year 2004 Performance and Accountability Report in May was the culmination of 2 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 the report concluded that our controls

[1] The prepared statement of Mr. McConnell appears in the Appendix on page 43.

in three areas were not fully effective. Specifically, the report identified material weaknesses in the areas of recording and reporting of disgorgements and penalties, preparing financial statements, and information technology security. Two of these weaknesses, IT security 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.

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.

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.

Finally, GAO's audit confirmed weaknesses in the SEC's information technology security that had 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 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.

Because of the SEC's regulatory role, we believe the agency must lead by example through 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.

With respect to our facilities budget estimates, and as you know, the SEC recently discovered it had underestimated tenant buildout costs for new agency facilities in Washington, New York, and Boston by about $48 million over the next 3 years. These areas are serious and reveal 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 cost. 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 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.

The SEC has taken action to rectify the conditions that led to these project management and budget planning failures and ensure they do not recur. The agency has removed several staff from these projects, added new project staff, 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 administrative services and added budget formulation staff in our Office of Financial Management. The SEC is also planning a new budget formulation activity-based costing system that will greatly enhance the quality and timeliness of the data related to our administrative and operational costs.

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.

I would like to thank the Subcommittee for your interest in and commitment to these important topics. I would be happy to answer any questions.

Senator COBURN. Thank you very much for your testimony.

General Walker, are there specifics outside what Mr. McConnell mentioned in terms of the recording and reporting disgorgements? I mean, how is it that you don't account for those? How is it possible that you don't have a system to properly account for that?

Mr. WALKER. I think what is fair to say, Mr. Chairman, is that the amount of disgorgements has increased dramatically in the recent years because of some of the failures in the private sector. One of the things that we found in this and a couple of the other areas which resulted in material control weaknesses was that there was a lack of comprehensive and documented policies and procedures with regard to how to handle these matters.

There were also issues with regard to our dated and non-integrated information systems that need to be addressed, and part of this was exacerbated by the fact that, due to the increased activity with regard to disgorgements in the last several years, it was quite a challenge for the SEC staff to deal with that increased volume——

Senator COBURN. But what you are really saying is they didn't have good systems and control to begin with, because had they had the systems in, even with increased volume, if you have a system in, you are going to be able to handle it.

Mr. WALKER. That is correct, and they are taking steps to document their policies and procedures, deal with the staffing issues, and provide for enhanced responsibility and accountability. Ultimately, they are going to have to do some more on the systems side, but that is going to take more time.

Senator COBURN. In your testimony, you listed 13 actions that the SEC could take in order to improve controls over the financial reporting process. In their response to your statement, the SEC stated they plan to increase their financial reporting staff and formalize policies and procedures, much as what you had recommended. Are you aware of the progress the SEC has made on any of these recommendations?

Mr. WALKER. They have made some progress. I think one of the SEC's biggest challenges right now, is the agency is in a time of transition. As you know, Chairman Donaldson has now left the SEC. We have the pending confirmation of Congressman Cox as the President's nominee to serve as Chairman. I think one of the biggest challenges with regard to a number of these recommendations is to make sure that the SEC's leadership continues to be committed to these types of changes and continues to hold people responsible and accountable for making progress on these various recommendations. So yes, they are making progress, but it is this transition in leadership that is probably the biggest risk at the present point in time.

Senator COBURN. Should the SEC, given the onus of their responsibility in terms of all the other markets, all the other people whose debt and equity trade in this country who have to have outside audited financial statements, should they be subjected to the same groups that audit their customers? In other words, why wouldn't we want a PricewaterhouseCoopers doing the audit at SEC?

Mr. WALKER. With all due respect, Mr. Chairman, I would suggest several things. First, we do as good or better of an audit than one might be able to obtain from one of the private sector firms.

Second, there are certain potential conflicts that would exist if one of the major private sector firms were to do the audit for the Securities and Exchange Commission. As you know, the SEC has to oversee the PCAOB, the Public Company Accounting Oversight Board, which has the responsibility to oversee the major accounting firms, and so the SEC was rightly concerned about a potential conflict of interest.

I also would note, Mr. Chairman, that to the SEC's credit, while they are not required under current law to obtain an opinion on their internal accounting control system dealing with financial reporting, that is a standard practice we perform for the entities we audit, even though it is not required by law. We conferred with SEC management and they agreed that would be an appropriate thing to do for the SEC. Frankly, not just because it passes a cost-benefit test, but because of the issue that you talked about before, to lead by example and to demonstrate that they are subjecting themselves to the same type of audit procedures that those they oversee and regulate are subjected to.

Senator COBURN. Mr. Walker, are you aware of a time estimate that SEC has given to implement a new system as far as the disgorgements and the control of those? In the meantime, what can SEC senior management do to mitigate the risks related to the systems and data and penalties for payments and disgorgements?

Mr. WALKER. We have made a number of specific recommendations, Mr. Chairman, as to things that we think they should do, many of which are outlined in my detailed testimony. Several relate to interim steps recognizing that building this new integrated system is going to take some time. Therefore, there are interim steps that need to be taken to provide for enhanced controls in the interim.

Mr. McConnell may have a better answer on when they expect to be done.

Mr. MCCONNELL. We expect to have each of these internal control weaknesses fixed in 2006, for that audit.

Senator COBURN. So that is the audit for fiscal year 2006?

Mr. MCCONNELL. That is the audit for fiscal year 2006.

Senator COBURN. So it won't be fixed when you are audited this year?

Mr. MCCONNELL. That is correct.

Senator COBURN. OK. I think you should be congratulated for the accomplishment of getting a clean audit as far as your numbers. That is a hard thing to do.

Describe for me the sources of SEC's funding and what happens to the surplus. General Walker talked about the $4 billion surplus that you paid into the Treasury, of which 25 percent is roughly money waiting to go back out in terms of penalties or disgorgement. What is the source of the funds?

Mr. MCCONNELL. We are an appropriated agency. Our appropriation, however, is entirely offset by the fees that we collect. Let me give you an example, for fiscal year 2006, the budget that we are working on now, we estimate that we will collect $2.1 billion in fees. Those fees go to the general fund of the Treasury and are accumulated in an account in our name. We are then appropriated through the regular, normal appropriations process, and our appropriations for 2006 is right now intended to be $888 million.

Senator COBURN. Eight-hundred-and-eighty-eight million.

Mr. MCCONNELL. So the remainder of that $2.1 billion is then available for—it offsets the entire CJS appropriation and is available, then, to use elsewhere. But the money that we get is actually subtracted from the amount and the remainder is held in that account.

Senator COBURN. Right.

Mr. WALKER. They reduced the deficit, Mr. Chairman.

Mr. MCCONNELL. Yes.

Mr. WALKER. Last year, they reduced the consolidated deficit of the U.S. Government by, on an accrual basis, by about $575 million.

Senator COBURN. And if they are more transparent, more results oriented, more competitive oriented, more priority setting oriented, more responsive and more spending discipline, they can increase that. That is what I am after. It is great that they are there, but they are in a position with which they collect a lot of money based on the fact that people aren't doing the right things.

The interesting thing would be is what would your budget be net of appropriations if we had 100 percent compliance and we didn't see the fines and penalties that were coming.

Mr. MCCONNELL. What would our budget be in——

Senator COBURN. In other words, there wouldn't be any net difference. In other words, you would be appropriated what you needed if there, in fact, were not compliance fines and penalties.

Mr. MCCONNELL. I think maybe I have confused things here. The fees that we collect I am talking about are transaction fees on exchanges and the registration of securities. That $2.1 billion has nothing to do with fines and disgorgements. That is a total separate amount.

Senator COBURN. Right. But there are penalties, though, that go into that, is that not correct?

Mr. MCCONNELL. Well, yes. Those are the result of enforcement actions. None of those monies are available to the SEC or to the Federal Government at all for the purpose of appropriations.

Senator COBURN. So when we talk about you are going to collect through fines, penalties, assessments, and fees in excess of $2.1 billion——

Mr. MCCONNELL. It is actually more than that.

Senator COBURN. OK.

Mr. MCCONNELL. The $2.1 billion is strictly the amount we collect in fees placed upon transactions on exchanges or public companies registering securities.

Senator COBURN. OK. The penalties and fines——

Mr. MCCONNELL. The fines, penalties, and disgorgements, you can't anticipate exactly what they are going to be, but $800 million, let us say, is a number that I think is currently in the Treasury accounts. So that is a totally separate amount. They are not additive for purposes of appropriation——

Senator COBURN. Right, and they are set aside.

Mr. MCCONNELL. Yes.

Senator COBURN. All right.

Mr. WALKER. Basically, Mr. Chairman, just to reiterate, the fines and penalties go directly to the Treasury and, therefore, they don't affect the appropriated amounts for the SEC. These amounts serve to directly reduce the Federal deficit and related public debt needs.

Senator COBURN. Transaction fees, the tax on every time I buy a stock——

Mr. WALKER. That is exactly right.

Senator COBURN [continuing]. Comes in at $2.1 billion.

Mr. WALKER. When you get your confirmation statement, you oftentimes see a little SEC——

Senator COBURN. I have seen it. I have seen it. [Laughter.]

Senator COBURN. Let me defer to Senator Carper, our Ranking Member, for a statement and I will let you ask questions.

OPENING STATEMENT OF SENATOR CARPER

Senator CARPER. Thanks very much. Gentlemen, welcome. How are you?

Mr. WALKER. It is good to see you, Senator.

Senator CARPER. It is good to be here. First, I will just start with a short statement.

In addition to the responsibilities that I share here with Dr. Coburn, I also serve on the Senate Banking Committee and I know fairly well, then, that we have given the SEC a big job, a couple of big jobs to do in the last several years in trying to make sure that firms in the private sector are more accountable and live up to the standards that we have established in a wide variety of areas.

I am really pleased that given that role—and the hearing today is to hold the SEC accountable—but also to recognize that you are holding yourselves accountable, and GAO's audit of you would seem to suggest that is the case.

Based on what I have been able to learn so far, it appears that the SEC is doing about as well as could be expected at this point in time. I think we passed the law in 2002 that added the SEC to the list of agencies that had to be audited and I think you went through your first one in 2004 and came away with a qualified audit. I think you are to be commended for that. I think I heard Dr. Coburn commending you all already.

I would just note that I think that some other agencies—every now and then, you hold a hearing and the idea is to put a spotlight on folks that aren't doing their job very well and that could do a whole lot better. In this case, this hearing is really more akin to putting a spotlight on folks who have done a good thing and to, rather than to say, get on the stick, just to say we are glad that you are providing a good model for others. Everything we do, we can always do better, but I think what you have done is certainly commendable.

We have actually had some discussion on the issue of improper payments at an earlier hearing. I think General Walker was here for the discussion on one of those. I think it is about $45 million, is the number that we have heard, mostly in overpayments, in some cases underpayments, but that is what we are told at least is the magnitude of the problem. I would like to learn, maybe before we leave today, from the SEC about how you feel you have benefited from GAO's audit of your internal controls and, if possible, to explore whether other agencies might benefit from a similar kind of audit.

Agencies need to have the internal capability to detect and to prevent improper payments before they happen, but it is my understanding that most don't receive audited opinions of their internal controls, and as a result, they don't have maybe as good a sense of how well they are doing on that score.

As far as I can tell, the SEC doesn't have a problem with respect to improper payments, but I would just note for the record again that every dollar that is spent unwisely, whether it is accidentally or fraudulently misspent, is one more dollar that is taken away from a worthwhile program or that could go back to our taxpayers.

With that having been said, let me just ask a couple of questions, maybe one or two for General Walker and then maybe a question or two for you, Mr. McConnell.

Let us talk about the scope of the audit that was done at the SEC, if we could. The scope of the audit included internal controls, and as I said earlier, as far as I know, neither the SEC nor other agencies are required under the law to have an independent audit of their internal controls. In fact, I think the only major problem that you found at the SEC may have centered on internal controls.

How could the kind of internal control audits that you conducted at the SEC help other agencies to detect and to prevent improper payments?

Mr. WALKER. Senator, you are correct in noting that the SEC is not required by law to have an audit dealing with its system of internal accounting control and to have an opinion expressed by its external auditor. In our case, we do that on every entity that we audit. We proposed that when the SEC approached us about doing their audit. We helped them understand what we felt the benefit

was, including reducing the possibility of improper payments, but in addition to that, to provide reasonable but not absolute assurance to help facilitate economy, efficiency, and effectiveness as well as the fair reporting of financial information. The SEC agreed.

My personal view is that requiring an audit on the system of internal accounting control is not something that makes sense for every government audit. However, I think there are circumstances based upon value and risk, and one of the factors that might be considered is the possibility of improper payments where it does make sense to have an audit of the system internal accounting controls. But I believe that should be something that should be done on a facts and circumstances basis rather than saying every government agency should automatically have to do that.

Senator CARPER. I think you said on the basis of facts and risks? Talk a little bit about that——

Mr. WALKER. Value and risk.

Senator CARPER. Value and risk?

Mr. WALKER. In other words, how much money is involved? What is the potential for abuse? To what extent has work been done to ascertain the likelihood of improper payments or other types of activities that one could seek to effectively avoid through having a stronger system of internal accounting controls?

This is an element that needs to be more directly considered, and one of the things that I have asked for the Joint Financial Management Improvement Program Principals to address, namely the Secretary of the Treasury, that Director of OMB, myself, and the head of OPM. Specifically, that group will discuss whether and under what circumstances Federal Government agencies should be required to have an opinion on their system of internal accounting controls. This is an active topic and I hope that we can gain some consensus among that group.

It could be done, arguably, without legislation if OMB decided that it was something that should be done. We can report back to you on what the progress is on that if you would like.

Senator CARPER. Give me some idea what the time line might be for doing that.

Mr. WALKER. I have asked for a meeting of the principals to be held within the next 2 months. I don't know if it has been scheduled or not yet. From a practical standpoint, if this was going to be required, it would be for next year's audit, not this year's audit, if a consensus can be reached.

Senator CARPER. Sure.

Senator COBURN. Are the firms that the SEC oversees, are they not required to have in their audit opinion their internal controls?

Mr. WALKER. Sarbanes-Oxley requires public companies to undergo an audit of their system of internal accounting controls relating to their financial reporting requirements, and so, yes, public companies are required to obtain such an opinion. However, private companies are not, not-for-profit entities are not, and government agencies are not at the present point in time.

Senator CARPER. A follow up to this issue of internal controls. With respect to the recommendations and your findings at the SEC and any recommendations that you may have made, how were they received by the SEC, and I would ask both of you to answer.

Mr. WALKER. I would echo the comments that were made earlier. Specifically, there was a serious and sustained undertaking for 2 years to achieve the results for this first audit by the SEC staff as well as the GAO staff. Top management at the SEC took this very seriously, and that goes right up to former Chairman Donaldson. He understood that this was an important issue and there was a need for the SEC to lead by example in this regard. I believe he took it very seriously.

The SEC's response to our recommendations has generally been very positive. The key now is to make sure that continues through the transition in leadership. As you know, there is a pending transition in leadership at the SEC. My understanding is, under the statute, it is the chairman who has the responsibility and authority for these types of matters. So the chairman's commitment is key to continued progress in this area.

Senator CARPER. Mr. McConnell, do you want to add anything to that?

Mr. MCCONNELL. Yes. It is really part of the fiber of the SEC to have undertaken an internal control audit. We would never have considered doing otherwise. In speaking with GAO at the outset of this undertaking, it sounds trite, but we really do want to be the gold standard. We want to have all these boxes checked and we expected their audit to treat us as if we should be the gold standard and we wanted them to give us everything. We view the findings that they submitted to the SEC as a way in which we can achieve that and we intend to do so.

We think it has been an incredibly valuable experience. Personally, I have just been very pleased with the response throughout the agency to a recognition that these material weaknesses and the financial audit that we undertook is among the highest priorities the agency has.

Senator CARPER. One last question, if I could, for you, Mr. McConnell, and the question is about your budgeting related to the construction of your new headquarters. If you all have already gotten into this, just tell me, but I appreciate your honesty about it and your efforts to address the cause of these concerns.

It seems to me that the problem is related to what may be a communications breakdown almost. What I am told is that may have occurred. Let me just ask, what steps have been taken to ensure that the lines of communication between folks on your staff, the SEC staff who are working on projects like this, and those in your budget office, to make sure that those lines of communication are open?

Mr. MCCONNELL. We have done a number of things already and additional items are planned. Basically—and communications is a good way to put it. It is absolutely essential that the needs that we provide funds for throughout the agency, the administrative needs, the support and management needs, start with good communications from the programs so that we know exactly—and we are working in that area—what the programs need, so that in enforcement, in market regulation, in investment management, we have dedicated people—and we are dedicating those people now—to identifying their needs. And then they come to administrative services and we have the people there that will understand their needs,

work with them, and turn them into budget estimates for supplies, materials, buildings, whatever it is they need.

Then the administrative services people have to have the ability to analyze budgets. They haven't had that in the past and they are going to have that now. We have put a branch together that will. So it is not just an accumulation function of everybody's wants and needs. It is communication and gathering information, but then it is analyzing and understanding it.

And we also intend to have our Financial Management office beefed up to have similar oversight capabilities. So it is an iterative process of asking questions about budget estimates, what they need, and are these meeting their needs.

And then when it comes to the top of the agency, we will have the ability to really see the record, know who did what, who was responsible, and that they, in fact, did the job and will understand fully the entire process from beginning to end for how those budget estimates were developed.

Senator CARPER. Could I ask maybe one more?

Senator COBURN. Sure.

Senator CARPER. Thanks. I understand that the Secretary has known for some time about some of the information security problems at the agency that GAO has, I believe, now highlighted. I also understand that you hired someone fairly high-ranking with the responsibility of tackling those problems and developing some, I guess, agency-wide security guidelines. What I would like to ask is, why has the problem been such a difficult one to tackle and can you just give us some idea what this new person, this new official is supposed to do to assure that the secure financial information is protected from tampering or from some other kind of potential problems?

Mr. MCCONNELL. Information system security is, I think as Mr. Walker indicated, a government-wide problem. Every agency is grappling with how to make sure its systems meet the test that has currently been established for information security. That is part of the issue. This has been a developing area. It is not a science, but it is a developing sort of a regimen for how security ought to be employed in each agency.

So each year, it has improved. We understand better how to make things secure, what level of security you ought to achieve. So it has been very hard to keep up with that. I think that now we have had a maturation of sort of the security posture that agencies ought to be and we really know very well what we have to achieve and how to get there.

The new person we have brought in, we are very enthusiastic about. She knows how to do it. She has done it in the private sector and we are very enthusiastic that we have both the people now, we have the resources. As a member of the Banking Committee, you know fully well that we have had substantial funding increases, in large part due to Sarbanes-Oxley. So we have had the resources to apply to this problem and I think we have the right kind of plans in place to get there. We are confident that in 2006, we can achieve eliminating this as a material weakness.

Senator CARPER. Mr. Walker, do you want to add anything?

Mr. WALKER. Yes, if I can, Senator, just to reinforce, this is a government-wide high-risk area. It is an area that we believe the SEC is taking seriously. I would note that there are a number of major departments and agencies that have a similar challenge, including some of the largest ones in government, like the Department of Defense, the Department of Homeland Security, etc. But I believe that they are on the case.

Senator CARPER. Great. Gentlemen, thank you very much.

Senator COBURN. Mr. McConnell, I want to go back for a minute to a couple of things. I am trying to figure out the relationship between your office and the Chairman. You have been there since 1990, 15 years. You have had administrative responsibility for this agency that entire time. How is it that you can have a $50 million overrun on buildings and you not be aware it has happened? How does that happen? Chairman Donaldson had his performance dashboards in there. Are they not working? They don't work? Is somebody not talking to anybody?

Either this system was gamed or somebody is totally incompetent. It is one of those two. You can't be $29 million off on a $5 million building. You can't be $17 million off on a $14 million building. And you can't be $8 million off on a $2 million building. How does something like that happen?

Mr. MCCONNELL. Well, first, maybe I should deal with the numbers first. We have been interacting with your staff on these and it is a fairly complicated situation. We are talking about four different sites over multi-year periods. It actually started in 2002 and extends out to 2007. The costs that you are identifying here are actually those that are mostly associated with what we are trying to achieve with respect to our reprogramming in 2005 and some of the actions we need to take in 2006 to finish up these projects.

Senator COBURN. Well, but reprogramming is another word for taking money from somewhere else to use in a different direction. Is that true, that the original 2005 estimate on the New York City building was $5 million?

Mr. MCCONNELL. That is not correct.

Senator COBURN. What was the original estimate?

Mr. MCCONNELL. Well, there actually was no original estimate for the New York City build-out.

Senator COBURN. So we built a building without an estimate?

Mr. MCCONNELL. We obtained a new leasehold in New York that was going to require a build-out, but there was a mistake made, and competency is clearly an issue here.

Senator COBURN. What was the mistake?

Mr. MCCONNELL. A mistake was made that—it was an omission in developing estimates for how much money we needed to build out new leaseholds in New York City. We were moving from one building to another. During that transition, that cost was not estimated. The $5 million cost is, in fact, what was needed to repay our former tenant for build-out work that we were going to be doing there.

Senator COBURN. So what was the 2005 true estimate for the New York City building?

Mr. MCCONNELL. At the time that the 2005 budget submission was made, there was no estimate for the build-out——

Senator COBURN. When you all made the decision to go ahead and said, we are going to do this, what was the estimate?

Mr. MCCONNELL. Well, that is the point. The decisions were made to go ahead, but the lease wasn't actually signed until March and these budget estimates were done in February. At the time these budget estimates were done in December—excuse me—no number was put in for tenant improvement work for the new lease for our new space in New York. It was an omission.

Senator COBURN. OK. Did somebody know a number at some time before now?

Mr. MCCONNELL. We only this spring have developed numbers, and those numbers are what is reflected in our reprogramming request and the budget estimates we are currently working on.

Senator COBURN. Would you tolerate that from somebody you regulate?

Mr. MCCONNELL. I am not tolerating it from the SEC at all.

Senator COBURN. Let me ask you about the reprogramming, because you are financing this at 9 percent?

Mr. MCCONNELL. Well, there are two items here. Any time you do tenant improvement work for your leaseholds, you have a build-out, you can do that either of two ways. You can amortize it with your rent, which is the common practice, or you can pay for it up front in a one-time payment.

The SEC generally tries to do a combination because it does lower your out-year costs and it is somewhat more efficient. You do borrow that money essentially at 9 percent from a building owner to have that tenant improvement allowance as part of your lease. You also borrow it from the government when you initially make an up-front payment. That is right now about 5.5 percent. So it is somewhat more expensive to extend those costs out. That is the common practice——

Senator COBURN. But why would we spend more money to do that, especially when you all have reserve funds that you could come to the Congress and say, we would like to use these—you are talking 3.5 percent on $69 million in total, which over the life of the lease is a lot of money. Why would we not opt to save that money for the American taxpayer?

Mr. MCCONNELL. Well, it is two questions. We did approach our appropriations staff about the possibility of adding monies for our 2005 budget. That was not possible at the time. In the reprogramming, we clearly identified two different options, either do it up front or we can do it through an amortization, which is the normal way of doing it. It is a standard practice to have as part of your lease the costs of tenant improvement, because then you pay for those tenant improvements over the course of the life of the lease.

Senator COBURN. Is that standard practice in GSA?

Mr. MCCONNELL. It is. In fact, GSA has the clauses for these types of——

Senator COBURN. So it is standard practice when we have money sitting in the Treasury or we can borrow from ourselves at, right now, 30-year notes under 6 percent—it is five-point-some-odd percent——

Mr. MCCONNELL. Correct.

Senator COBURN [continuing]. For a 30-year note. So we would go and pay 9 percent rather than borrow at 5 percent what we can borrow, and that difference, that 3.75 percent, we are just going to let the American taxpayer pay, and that is standard practice. That is what you are telling me, government-wide——

Mr. MCCONNELL. It is entirely normal practice for us to use in leases, and it is throughout government and in the commercial sector.

Senator COBURN. Let me go back. Mr. Walker, do you find anything wrong with that picture?

Mr. WALKER. Mr. Chairman, part of the issue is how the government keeps score. You are correct in noting that to the extent that the government ends up financing it, the cost of capital is less. We can borrow from the public at much less than 9+ percent.

What ends up happening is when the government ends up spending the money up front, and therefore de facto financing it through the cost of capital for the Federal Government, it means that the Federal deficit goes up. In addition, the amount of money that is at the Treasury in the X account for the SEC is not readily available to the Securities and Exchange Commission. What would have to happen is they would have to make a business case, which I think is what you are saying they should make——

Senator COBURN. It wouldn't have to come to that, because they are going to have an excess this year. It would be just a difference in their allocation from the appropriations bill.

Mr. WALKER. Well, there are two ways you could do it, Mr. Chairman. One way you could do it is to seek a reprogramming request from the appropriators to be able to use funds that otherwise would be excess funds. If you did not have enough money in your current year appropriation, then theoretically you could seek authority from the appropriators to be able to tap into that X account, which is the accumulated surplus, to be able to use that in lieu of building it into the lease.

Candidly, I believe this is symptomatic and symbolic of a bigger problem that government has. The Federal Government makes decisions based upon cash flows rather than discounted present values on sound economic concepts. We need to rethink that.

Senator COBURN. Yes, because borrowing that money at 5 percent and paying it back 30 years from now, the real value of the cost to you is actually going to go down, versus a 9 percent loan. You are going to lose some of that time value of money advantage by paying it ahead of time. In other words, financing at the lower rate, borrowing from ourselves, is cheaper than financing it through your lender at 9 percent.

Mr. WALKER. There are many decisions that the Federal Government makes that do not make economic sense. They are made primarily because of the way we keep score. For budget purposes, it is largely a cash basis rather than an accrual basis.

Senator COBURN. I wonder if you might be willing to look at that government-wide for us in terms of the cost of financing when we are doing it this way and what that total cost is to the Federal Government in terms of build-out leases and everything else where we are financing through a landlord building improvements.

Mr. WALKER. I would be happy to talk to our staff about whether or not we are doing anything and what might make sense there.

Senator COBURN. OK. I want to go back to, did we sign a lease without knowing what the cost was going to be?

Mr. MCCONNELL. We signed a lease in March, and then subsequent to that, you work on how much you are going to spend and how much the budget will be for the actual tenant improvement work associated with that lease.

Senator COBURN. Why would we not wait to sign a lease until we knew what something was going to cost?

Mr. MCCONNELL. Well, that would be the much preferred way of doing it.

Senator COBURN. Well, I am saying, why wouldn't we? I would never sign a lease until I knew what it was going to cost me. Why would the government sign a lease when it doesn't know what it is going to cost them?

Mr. MCCONNELL. We know what the lease is going to cost in terms of the rental payment.

Senator COBURN. I am talking the cost. There is no difference. Our grandchildren are going to pay for this one way or the other. The total cost, what is it going to cost in terms of financing the leasehold improvements, which we are going to pay for, the landlord is going to get the benefit. Why would we sign a lease if we didn't know what it was going to cost?

Mr. MCCONNELL. We generally do know what it is going to cost, or we have very good estimates as to what it is going to cost. You don't really know finally what it is going to cost until you execute the lease, you select your build-out, you do the construction drawings, you bid it out to the trades, and then you get the final cost.

Senator COBURN. Well, I want to tell you, I do a lot of commercial real estate and I am the owner of the buildings and I never will sign a lease until I have presented to them what it is going to cost and what my return is. And I can't believe that we think it is common practice, nor financially sound, to sign a lease without knowing what the cost is. I mean, where was the time pressure to sign leases on this without knowing what it is going to cost?

Maybe somebody made a mistake in terms of the follow-through on this. That can happen. I am not critical of that. I am critical that we didn't know it was happening because the dashboard obviously—this is happening and nobody knows it is happening until it has already ballooned on you. You have a degree in accounting. I have a degree in accounting. If you look at cost accounting, or financial controls, you would never do it. Why is that standard policy in the SEC?

Mr. MCCONNELL. This issue is not standard policy. This was a failure on our part, and I readily admit that. We had a serious breakdown in our budget estimating process for tenant improvement work. That is what this is.

Senator COBURN. Do we have the option on these leases to prepay that leasehold improvement?

Mr. MCCONNELL. We do. When we exercise our lease, we have the ability to either take that tenant improvement work from it or pay it up front. We still have that option.

Senator COBURN. Do you know what the difference in cost is going to be if we pay it up front, and based on these numbers?

Mr. MCCONNELL. I would have to——

Senator COBURN. Can you give that to us?

Mr. MCCONNELL. Yes, we could.

Senator COBURN. If you take $50 million versus, let us say $45 million, and the difference is 3.75 percent over 30 years on $45 million, that is $50 million. That is the difference in cost that we are going to ask our grandchildren to pay back. That is the difference just on the interest rate differential. So if you can take a 30-year note and borrow the money from the public and pay them at 5 percent and pay this thing off, why would we not want to save that $50 million over the next 30 years?

Mr. MCCONNELL. I would much prefer to have these payments paid for up front. It is much efficient. It is a better way of doing business.

Senator COBURN. Do you have to do this process through GSA?

Mr. MCCONNELL. We have independent leasing authority, but we work in coordination with GSA, usually through a Memorandum of Understanding.

Senator COBURN. You would have had an interesting time at our hearing yesterday with the GSA.

Mr. MCCONNELL. Is that right?

Senator COBURN. Yes. The same problems.

Let us go back to the money that you have for the disgorgement accounts. Why is it not earning interest?

Mr. MCCONNELL. I actually believe that you are not well served, Mr. Chairman, by me answering that because it is really an issue that the Enforcement Program is leading, but my understanding is that we have moved that over to interest-bearing accounts.

Senator COBURN. OK. That is great news.

Mr. WALKER. Mr. Chairman, it is my understanding that as of the financial statement date, which was September 30, 2004, that it was part of the X account at the Treasury. It was not earning interest. However, it is also my understanding that subsequent to that date, that General Counsel within the SEC determined that the SEC had the authority to invest those funds and now has moved those funds out of Treasury and, I think, are now actively investing them in some way.

Mr. MCCONNELL. That is my understanding, as well.

Mr. WALKER. I am trying to follow up on that. I do believe that since those funds are held in a fiduciary capacity, that it is important that they be invested.

Mr. MCCONNELL. There is a fiduciary obligation that goes along with that.

Mr. WALKER. Correct. It is one thing to not give credit to the X fund that deals with the accumulated results of operations of the SEC because that is part of the consolidated government and ultimately, the taxpayers are going to bear the related cost. But in this particular case, it is somebody else's money.

Senator COBURN. Let me go back to Mr. McConnell for a minute. I want to understand the relationship between your position and the SEC Chairman, and you tell me if I am wrong. You are the hands-on management guy for the SEC, is that correct?

Mr. MCCONNELL. That is correct.

Senator COBURN. And so the leadership role is in terms of true leading to make sure the direction is the direction that the chairman and the Commission want the SEC to go, and you are submissive to their direction, is that correct?

Mr. MCCONNELL. I work for the chairman. The chairman is effectively the CEO of the agency. I am essentially the principal management official.

Senator COBURN. So with an acting chairman now, without a permanent chairman, you have the ability to continue all these reforms that you are wanting to put forward even if we don't have another chairman for another year, is that correct?

Mr. MCCONNELL. That is correct.

Senator COBURN. And that is in process.

Mr. MCCONNELL. That is correct.

Senator COBURN. And is that going to happen?

Mr. MCCONNELL. I intend for it to happen, yes.

Senator COBURN. I know you intend to. I am asking you, is it going to happen? If you are sitting in the board room of a corporation and you give that answer, nobody is going to accept it. They are going to say, are you going to get it done or are you not going to get it done? And what I want to know for everybody's grandchildren in this country, is it going to happen?

Mr. MCCONNELL. Well, I fully expect it to happen. Again, we are in a transition period and I have every reason to believe that a new chairman will follow through on these. They make sense. They are the right thing for the SEC and government to do. They are the right thing for the agency. I believe very strongly that we will continue this aggressively.

Senator COBURN. With a $1.3 billion excess this year, or close to excess in fees over costs, are the fees and charges, too high? I mean, it is a tax, right? The fee is a tax.

Mr. MCCONNELL. Well, the best way for me to answer that is there has been lots of discussion both within the SEC and on the Hill with respect to making the fees more closely associated directly with the amount of money the SEC needs. So that is being discussed. It has been discussed. And I fully expect that issue will be dealt with in the 2007 budget discussions. It is an issue, I think, that is important, and I think it makes a lot of sense to try and move in the direction of making sure the SEC presents a budget that is sound, is exactly what it needs, and that then the Congress would fund it with fees that are matched to those needs.

Senator COBURN. And that is as it should be, right?

Mr. MCCONNELL. I think that is a good way to go.

Senator COBURN. When was the last time a committee of Congress had a true oversight hearing on the SEC? Was that associated with the Sarbanes-Oxley reform or——

Mr. MCCONNELL. I can't directly answer that.

Senator COBURN. Does any of your staff know that? Does anybody know?

Mr. MCCONNELL. Because I really don't deal with the oversight committees that much. I deal with the appropriators personally, but——

Senator COBURN. I have some questions I am going to send you, I am going to give to your staff, and it has to do with the Global Research Analysts settlement. I know that is in litigation, but I would appreciate very much if you would answer those the best you can for us to look at that.

The only question I have is how did we ever let it get to where a court had to tell you to do that?

Mr. MCCONNELL. That is a good thing to put in the letter, Mr. Chairman.

Senator COBURN. All right. Fair enough.

I want to thank each of you for being here. There isn't one area of the government in the next 6 years, if I am Chairman of this Subcommittee, that we are not going to look at, and we are going to be back talking about this in 6 to 9 months, after the first of the year to see where we are, after we get this next report from General Walker. You are well intentioned, we know you are, we want to help you get there, and transparency is a very key thing. I want people to be able to get on a computer and find out where you spend your money, any citizen in this country, and you ought to want that, too.

Mr. MCCONNELL. We do.

Senator COBURN. All right. General Walker and Mr. McConnell, thank you very much.

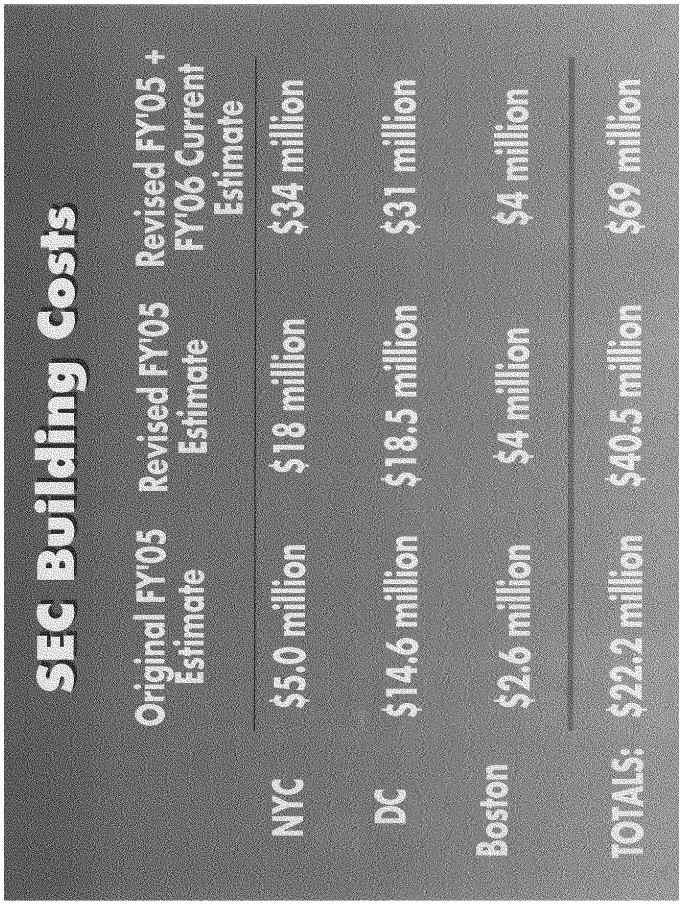
Mr. WALKER. Thank you, Mr. Chairman.

Mr. MCCONNELL. Thank you, Mr. Chairman.

Senator COBURN. The Subcommittee is adjourned.

[Whereupon, at 3:34 p.m., the Subcommittee adjourned.]

APPENDIX



SEC Building Costs	Original FY'05 Estimate	Revised FY'05 Estimate	Revised FY'05 + FY'06 Current Estimate
NYC	$5.0 million	$18 million	$34 million
DC	$14.6 million	$18.5 million	$31 million
Boston	$2.6 million	$4 million	$4 million
TOTALS:	$22.2 million	$40.5 million	$69 million

U.S. SECURITIES AND EXCHANGE COMMISSION

Vision

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

U.S. Securities and Exchange Commission
2004 Performance and Accountability Report
Available on the web at: www.sec.gov/about/secpar.shtml

United States Government Accountability Office

GAO

Testimony

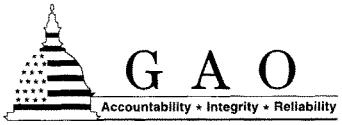
Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

For Release on Delivery
Expected at 2:00 p.m. EST
Wednesday, July 27, 2005

SECURITIES AND EXCHANGE COMMISSION

Results of Fiscal Year 2004 Financial Audit

Statement of David M. Walker
Comptroller General of the United States



GAO-05-880T

May 2005

GAO
Accountability·Integrity·Reliability
Highlights

Highlights of GAO-05-880T, testimony before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

SECURITIES AND EXCHANGE COMMISSION

Results of Fiscal Year 2004 Financial Audit

Why GAO Did This Study

Pursuant to the Accountability for Tax Dollars Act of 2002, the Securities and Exchange Commission (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 initial audit of SEC's financial statements. GAO's audit was done to determine whether, in all material respects, (1) SEC's fiscal year 2004 financial statements were reliable, (2) SEC's management maintained effective internal control over financial reporting and compliance with laws and regulations, and (3) SEC's management complied with applicable laws and regulations.

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

GAO was asked by the Chairman of the Senate Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, to present the results of its May 26, 2005, report, *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Year 2004* (GAO-05-244).

www.gao.gov/cgi-bin/getrpt?GAO-05-880T.

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

What GAO Found

The SEC's first ever financial audit was performed by GAO for fiscal year 2004. In reporting on the results of the audit, GAO issued an unqualified, or clean, opinion on the financial statements of the SEC. This means that SEC's financial statements presented fairly, in all material respects, its financial position as of September 30, 2004, and the results of operations for the year then ended. However, because of material internal control weaknesses in the areas of preparing financial statements and related disclosures, recording and reporting disgorgements and penalties, and information security, GAO issued an adverse opinion on internal controls, concluding that SEC did not maintain effective internal control over financial reporting as of September 30, 2004. However, SEC did maintain, in all material respects, effective internal control over compliance with laws and regulations material in relation to the financial statements as of September 30, 2004. In addition, GAO did not find reportable instances of noncompliance with laws and regulations it tested. It is important to remember that GAO's opinions on SEC's financial statements and internal controls reflect a point in time.

SEC prepared its first complete set of financial statements for fiscal year 2004 and made significant progress during the year in building a financial reporting structure for preparing financial statements for audit. However, GAO identified inadequate controls over SEC's financial statement preparation process including a lack of sufficient documented policies and procedures, support, and quality assurance reviews, increasing the risk that SEC management will not have reasonable assurance that the balances presented in the financial statements and related disclosures are supported by SEC's underlying accounting records. In addition, GAO identified inadequate controls over SEC's disgorgements and civil penalties activities, increasing the risk that such activities will not be completely, accurately, and properly recorded and reported for management's use in its decision making.

GAO also found that SEC has not effectively implemented information system controls to protect the integrity, confidentiality, and availability of its financial and sensitive data, increasing the risk of unauthorized disclosure, modification, or loss of the data, possibly without detection. The risks created by these information security weaknesses are compounded because the SEC does not have a comprehensive monitoring program to identify unusual or suspicious access activities.

SEC agreed with our findings and is currently working to improve controls in all these areas.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the results of our audit of the Securities and Exchange Commission's (SEC) fiscal year 2004 financial statements, the first complete set of financial statements SEC has prepared and has subjected to an independent audit.[1] Our recent report,[2] issued on May 26, 2005, presents the results of that audit. Today, I will discuss those results and the steps we believe SEC needs to take to improve its ability to produce timely and reliable financial statements, and to produce them efficiently and with reasonable assurance that they are fairly presented. These steps will also help SEC to produce complete and reliable information for internal management who make decisions about SEC operations and expenditures, and congressional stakeholders who provide oversight of SEC operations and make decisions about SEC funding.

The results of our audit were mixed—a clean opinion on the financial statements and an adverse opinion on internal control. Because we detected three material weaknesses in internal control, we concluded that SEC's internal control did not reduce to a relatively low level the risk of misstatements material to the financial statements. In other words, mistakes may occur and either go undetected by employees in the normal course of their work or be detected too late to prevent errors or fraud. The material weaknesses we found relate to SEC's internal control over (1) preparing financial statements and the related disclosures, (2) recording and reporting of disgorgements[3] and civil penalties,[4] and (3) information security. It is important to remember that our opinions on SEC's financial statements and internal controls reflect a point in time. SEC has stated its commitment to enhancing its financial and operational effectiveness. We and others have made recommendations, which if successfully implemented, would help SEC to generate timely, reliable, and useful financial information with which to make informed decisions, manage daily operations, and ensure accountability on an ongoing basis.

[1]The Accountability of Tax Dollars Act of 2002 requires certain agencies, including SEC, to prepare financial statements and have them audited.

[2]*Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Year 2004*, GAO-05-244 (Washington, D.C.: May 26, 2005).

[3]Disgorgement is the repayment of illegally earned profits.

[4]A penalty is a monetary sum that is to be paid by the registrant to SEC as a result of a security law violation.

SEC has a very visible and prominent leadership role in promoting and enforcing accountability for corporations whose equity and debt securities are traded in the securities markets. Recently, this role has also encompassed helping to ensure the effective implementation of the Sarbanes-Oxley Act, with its emphasis on internal control and corporate governance for the companies it regulates. At a time when many corporations are striving to strengthen internal controls and improve financial reporting, SEC has the opportunity and responsibility to serve as a model of good practice. In that regard, SEC stated in its *2004 Performance and Accountability Report*, issued in May 2005, that SEC must lead by example with respect to the internal control requirements demanded of the private and federal sectors, and also articulated management's vision that SEC serve as the standard against which other federal agencies are measured. A higher standard of accountability is appropriate for SEC as a government regulatory agency; moreover, it is important to the success of SEC's programs, activities, and leadership in the business community and as a government regulator.

Audit Results

In our audit of the fiscal year 2004 financial statements for SEC, we found

- the financial statements as of and for the fiscal year ended September 30, 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 that could have a material effect on the financial statements as of September 30, 2004; and
- no reportable noncompliance with laws and regulations we tested.

We issued an unqualified, or clean, opinion on the SEC's financial statements. This means that the financial statements and accompanying notes present fairly, in all material respects, SEC's financial position as of September 30, 2004, and, as well, certain other financial information that the statements must provide: net cost, changes in net position, budgetary resources, financing, and custodial activities for the year then ended. We also found that the statements conform to U.S. generally accepted accounting principles. In order to reach our conclusions about the financial statements, we (1) tested evidence supporting the amounts and disclosures

in the financial statements, (2) assessed the accounting principles used and significant estimates made by management, and (3) evaluated the presentation of the financial statements.

We found three material weaknesses in internal control and thus issued an adverse opinion on internal control—stating that SEC management did not maintain effective internal control over financial reporting and the safeguarding of assets as of September 30, 2004. Internal control over financial reporting consists of an entity's policies and procedures that are designed and operated to provide reasonable assurance about the reliability of that entity's financial reporting and its process for preparing and fairly presenting financial statements in accordance with generally accepted accounting principles. It includes policies and procedures for maintaining accounting records, authorizing receipts and disbursements, and the safeguarding of assets. Because SEC makes extensive use of computer systems for recording and processing transactions, SEC's financial reporting controls also include controls over computer operations and access to data and computing resources.

Our opinion on SEC's internal control means that SEC's internal control did not reduce to a relatively low level the risk that misstatements material to the financial statements may occur and go undetected by employees in the normal course of their work. This conclusion on SEC's internal controls did not affect our opinion on SEC's financial statements. This is because during the audit process SEC made the adjustments identified during the audit as necessary for the fair presentation of its financial statements. However, the weaknesses we found could affect other, unaudited information used by SEC for decision making. Our evaluation of internal control covered SEC's financial reporting controls which also cover certain operational activities that result in SEC's financial transactions, such as activities pertaining to stock exchange transaction fees, public-filing fees, maintaining disgorgements and penalties receivable, payroll-related transactions, and others.

We also tested SEC's compliance with selected provisions of laws and regulations that have a direct and material impact on the financial statements. For example, we tested for compliance with sections of the Securities Exchange Act of 1934, as amended, that requires SEC to collect fees from the national securities exchanges and the National Association of Securities Dealers based on volume of stock transactions, and sections of the Securities Act of 1933, as amended, that requires SEC to collect fees from registrants for public filings. Our tests found no instances of

noncompliance that are reportable. We also found that SEC maintained, in all material respects, effective internal control over compliance.

I would now like to discuss in detail the three material internal control weaknesses we found during our audit.

Material Internal Control Weaknesses

SEC Needs to Improve Its Controls over Financial Statement Preparation and Reporting

We found that SEC did not have formalized processes or documentation for the procedures, systems, analysis of accounts, and personnel involved in developing key balances and preparing the financial statements and related disclosures. As I will discuss later, this issue is compounded by SEC's limitations with its financial management system. Also, SEC did not have formalized quality control or review procedures. As a result, we identified errors in the beginning asset and liability balances and in the September 30, 2004, draft financial statements prepared by SEC management, that if had not been corrected, would have resulted in materially misleading operating results for fiscal year 2004.

SEC's lack of formalized processes, documented procedures, and quality assurance checks, significantly delayed the reporting of fiscal year 2004 financial results, consumed significant staff resources, caused audit inefficiencies, and resulted in higher financial statement preparation and audit costs. I would like to highlight the following items we found:

- SEC did not have documentation providing an explanation or a crosswalk between the financial statements and the source systems, general ledger accounts, account queries, and account analyses.
- SEC did not maintain a subsidiary ledger for certain activities, such as customer deposit amounts pertaining to filing fees.
- Accounting staff had difficulty in retrieving support for certain account balances, such as undelivered-order amounts, and for certain property and equipment leases.
- Reconciliations of detail and summary account balances were not prepared for certain financial statement line items, such as for the

customer deposit liability relating to filing fees and the associated earned filing fee revenue; the accounts receivable related to exchange fees and the related amount of earned exchange fee revenue; and the budgetary accounts related to undelivered and delivered orders, thus requiring SEC staff to create an audit trail after the fact.

- There also was no consistent evidence of supervisory review of journal entries, including closing and adjusting journal entries made in connection with preparing quarterly and year-end financial statements.

- Comprehensive accounting policies and procedures were still in draft or had not yet been developed for several major areas related to financial statements, including disgorgements and penalties, filing fees, exchange fees, and fixed asset capitalization.

GAO's *Standards for Internal Control in the Federal Government*[5] requires that controls over the financial statement preparation process be designed to provide reasonable assurance regarding the reliability of the balances and disclosures reported in the financial statements and related notes in conformity with generally accepted accounting principles, including the maintenance of detailed support that accurately and fairly reflect the transactions making up the balances in the financial statements and disclosures. In addition, an effective financial management system includes policies and procedures related to the processing of accounting entries.

SEC's difficulties in the area of financial statement preparation are exacerbated because SEC's financial management system is not set up to generate the user reports needed to perform analyses of accounts and activity on a real-time basis leading to SEC's staff-intensive and time-consuming efforts to prepare financial statements. Because SEC does not maintain standard schedules for producing certain basic reports of account detail for analysis, users have to request reports generated on an ad hoc basis by a software application whose operations are known only to some SEC staff. Also, as I will discuss in more detail later, not all of SEC's systems used for tracking and recording financial data are integrated with the accounting system.

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

Federal agencies preparing financial statements are required to develop a financial management system to prepare a complete set of statements on a timely basis in accordance with generally accepted accounting principles. The financial statements should be the product of an accounting system that is an integral part of an overall financial management system with structure, internal control, and reliable data. Office of Management and Budget Circular No. A-127, *Financial Management Systems*, requires that each agency establish and maintain a single integrated financial management system—basically a unified set of financial systems electronically linked for agencywide support. Integration means that the user is able to obtain needed information efficiently and effectively from any level of use or access point. (This does not necessarily mean having only one software application covering all financial management system needs or storing all information in the same database.) Interfaces between systems are acceptable as long as the information needed to enable reconciliation between the systems is accessible to managers. Interface linkages should be electronic unless the number of transactions is so small that it is not cost beneficial to automate the interface. Reconciliations between systems, where interface linkages are appropriate, should be maintained to ensure data accuracy.

To support its financial management functions, SEC relies on several different systems to process and track financial transactions that include filing and exchange fees, disgorgements and penalties, property and equipment, administrative items pertaining to payroll and travel, and others. Not all of these systems are integrated with the accounting system. For example, the case-tracking system and the spreadsheet application used to account for significant disgorgement and penalty transactions and the system used to account for property and equipment are not integrated with the accounting system. Without a fully integrated financial management system, SEC decision makers run the risk of delays in attaining relevant data or using inaccurate information inadvertently while at the same time dedicating scarce resources toward the basic collection of information.

A properly designed and implemented financial statement preparation and reporting process (which encompasses the financial management system) should provide SEC management with reasonable assurance that the balances presented in the financial statements and related disclosures are materially correct and supported by the underlying accounting records. To address the issues related to SEC's financial statement preparation and

reporting processes, we recommended that SEC take the following 13 actions to improve controls over the process.

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

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

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

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

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

6. Perform a formal closing of all accounts at an interim date or dates to reduce the level of accounting activity and analysis required at year-end. The formal closing entails procedures to ensure that all transactions are recorded in the proper period through the closing date, and then closing the accounting records so that no new entries can be posted during that period.

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

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

9. Establish milestones for preparing and reviewing the financial statements by setting dates for critical phases such as closing the

general ledger; preparing financial statements, footnotes, and the performance and accountability report; and performing specific quality control review procedures.

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

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

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

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

In response to our audit findings, SEC plans to increase its financial reporting staff this fiscal year, formalize its policies and procedures, and solicit advice from corporate financial reporting experts within SEC. SEC senior management has reviewed and endorsed certain initial policies applied in the first year of financial reporting, and has modified or recommended others for further review. In addition, SEC plans to establish a formal audit committee to provide for regular review by key management officials and advise on policies and controls. SEC is undertaking a multiyear project to replace the existing case-tracking system with a system that is better designed for financial reporting purposes.

Now I would like to shift to the second material internal control weakness.

SEC Has Control Weaknesses over Disgorgements and Civil Penalties

As part of its enforcement responsibilities, SEC issues and administers judgments that order disgorgements and civil penalties against violators of federal securities laws. The resulting transactions for fiscal year 2004 involved collections of about $945 million, and recording and reporting of fiduciary and custodial balances on the financial statements.[6] SEC records and tracks information on over 12,000 parties in SEC enforcement cases involving disgorgements and penalties through a case-tracking system. However, the case-tracking system is not designed for financial reporting and is not integrated with SEC's general ledger accounting system, which accumulates, tracks, and summarizes SEC's financial transactions.

To compensate for limitations in the system, SEC staff compiles quarterly subsidiary ledgers using extensive and time-consuming procedures. After downloading financial information on disgorgements and penalties from the case-tracking system to a spreadsheet with thousands of cases and defendants with a magnitude of approximately 1 million data elements, SEC staff performs numerous calculations using the data in the spreadsheet to compile the disgorgement and penalty balances as of the end of each quarter. Such a process is inherently inefficient and prone to error. Further, since the source of the data included on the spreadsheet is from the case-tracking system, whose data reliability has been reported as a problem by SEC for the past three years,[7] it is imperative that specific control procedures be put in place to provide reasonable assurance over the completeness and reliability of the data in the case-tracking system. In addition, control procedures are needed to reduce the risk of errors in the spreadsheet and ultimately the reported financial statement information. Finally, when reviewing case files we noted instances in which the supporting documentation in the files contained notations by the case managers indicating that potential activities or transactions related to the case had occurred. However, there was not adequate supporting

[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 General Fund of the Treasury, as nonfederal individuals or entities do not have an ownership interest in these revenues.

[7]The Federal Managers' Financial Integrity Act (FMFIA) of 1982 (31 U.S.C. § 3512 (c)(d)) requires the head of each agency to annually prepare a statement that identifies material weaknesses in the agency's systems of internal accounting and administrative control and its plans and schedule for correcting them. SEC reported material weaknesses and related system nonconformance issues concerning data integrity and financial reporting for disgorgements and penalties in its 2002, 2003, and 2004 FMFIA reports.

documentation to support an entry to the case-tracking system. These instances raised questions about whether SEC's accounting and financial reporting information related to penalties and disgorgements was potentially incomplete or out-of-date.

As a result of the issues I have described, we concluded that SEC did not have adequate control procedures in place to provide adequate assurance over the reliability of financial information related to this area. Thus, our auditors performed additional testing over SEC's financial statement balances related to penalties and disgorgements. GAO's *Standards for Internal Control in the Federal Government* requires that agencies establish controls to ensure that transactions are recorded in a complete, accurate, and timely manner. Although SEC has a draft policy that covers certain aspects of accounting for disgorgements and penalties, it is not comprehensive. For example, the policy does not define who is responsible for recording disgorgement and penalty data or the documentation that should be maintained to support the amounts recorded. Of even greater importance, the policy does not identify controls that are critical for determining the amounts to be recorded and for reviewing entries for completeness and accuracy, including the specific types of controls needed for the quarterly downloading of data and use of the spreadsheets for arriving at the accounting entries. Nor does the policy address supervisory review necessary to ensure consistent application of the procedures.

A lack of comprehensive policies and controls over disgorgement and penalty transactions increases the risk that the transactions will not be completely, accurately, and consistently recorded and reported. In our audit of the estimated net amounts receivable from disgorgements and penalties, we did find errors in the recorded balances for the related gross accounts receivable and allowance for loss. Specifically, we noted errors where SEC had made entries to the accounting system that conflicted with information in the files. We also noted inconsistent treatment in recording judgments, interest amounts, terminated debts, and collection fees imposed by Treasury. We believe that these errors and inconsistencies occurred because of the control weaknesses we found. While, in most cases, these errors and inconsistencies were offsetting, such errors raise concern about the reliability of the $1.673 billion gross accounts receivable for disgorgements and penalties and the related allowance amounts of $1.394 billion reported in footnote 3 to SEC's financial statements.

To address internal control weaknesses over disgorgements and penalties, we recommended that SEC

1. implement a system that is integrated with the accounting system or that provides the necessary input to the accounting system to facilitate timely, accurate, and efficient recording and reporting of disgorgement and penalty activity;

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

3. implement controls so that the ongoing activity involving disgorgements and penalties is properly, accurately, and timely recorded in the case-tracking system and the accounting system;

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

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

SEC agrees with our findings in this area and has begun efforts to strengthen internal controls. For example, SEC plans to complete a comprehensive review of files and data and review and strengthen policies and procedures for recording and updating amounts receivable for disgorgements and penalties. SEC anticipates that consistent application of strengthened internal controls and potentially some limited redesign of the existing management information system will be adequate to resolve the material weaknesses in fiscal year 2006. However, SEC acknowledges that a replacement of the current case-tracking system and a more thorough reexamination of the relevant business process would provide more effective assurance. Accordingly, in fiscal year 2006, SEC plans to complete a requirements analysis as the first phase of the multiyear project to replace the case-tracking system.

Now I would like to shift to the discussion of the material internal control weakness pertaining to information security.

SEC Needs to Address Weak Controls over Financial and Sensitive Data

Information system controls are essential for any organization that depends on computer systems and networks to carry out its mission or business and maintain key records and accountability information. Without proper safeguards, organizations run the risk that intruders may obtain sensitive information, commit fraud, disrupt operations, or launch attacks against other computer systems and networks.

SEC—which relies extensively on computer systems to support its operations—needs a comprehensive program of general controls[8] to monitor and manage information security risks. Our review[9] of SEC's information system general controls found that the commission did not effectively implement controls to protect the integrity, confidentiality, and availability of its financial and sensitive information.

In March 2005, we reported weaknesses in electronic access controls, including controls designed to prevent, limit, and detect access to SEC's critical financial and sensitive systems.[10] We found these weaknesses in user accounts and passwords, access rights and permissions, network security, and the audit and monitoring of security-related events. These weaknesses were heightened because SEC had not fully established a comprehensive monitoring program.

We identified the following electronic access control weaknesses:

- SEC operating personnel did not consistently set password parameters—such as a minimum of six digits including both numbers and letters—to ensure a level of difficulty for an intruder trying to guess a password, and users sometimes did create easy-to-guess passwords.

[8]Information system general controls affect the overall effectiveness and security of computer operations as opposed to being unique to any specific computer application. These controls include security management, operating procedures, software security features, and physical protection designed to ensure that access to data is appropriately restricted, computer security functions are segregated, only authorized changes to computer programs are made, and back-up and recovery plans are adequate to ensure the continuity of essential operations.

[9]GAO-05-244.

[10]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).

- All 4,100 network users were inadvertently granted access that would allow them to circumvent the audit controls in the commission's main financial systems.

- Key network devices were not configured to prevent unauthorized individuals from gaining access to detailed network system policy settings and lists of users or user groups.

- SEC did not have a comprehensive monitoring program for routine review, audit, or monitoring of system user-access activities. For example, audit logging, which is typically used to track certain types of activity on a system, was not consistently implemented on network services and there was no real-time capability to target unusual or suspicious network events for review. In addition, SEC had not fully implemented a network intrusion-detection system. The commission did, however, have several initiatives under way to monitor user access activity.

We also identified weaknesses in other information system controls—including physical security, segregation of computer functions, application change controls, and service continuity. For instance:

- At the time of our review, 300 employees and contractors had physical access to SEC's data center. Persons with access included an undetermined number of application programmers, budget analysts, administrative staff, and customer support staff. Typically, persons serving these functions do not need access to the data center for their work.

- SEC had not sufficiently separated incompatible[11] system administration and security administration functions on its key financial applications.

- Although a change control board at SEC was responsible for authorizing all application changes, none of the software modifications reviewed had documentation to show that such authorizations had been obtained.

[11]Incompatible functions are those that cause a conflict or risk if they are under the responsibility of the same person. For example, authorizing access and using that access are incompatible functions.

- SEC had not implemented a service-continuity plan to ensure that the system and its major applications could continue to function after a major disruption, such as a loss of electricity.

As a result of these weaknesses, sensitive SEC data—including payroll and financial transactions, personnel data, regulatory, and other mission-critical information—were at increased risk of unauthorized disclosure, modification, or loss.

A key reason for weaknesses in SEC's information system general controls is that the commission has not fully developed and implemented a comprehensive agency information security program. The Federal Information Security Management Act (FISMA) requires each agency to develop, document, and implement an agencywide information security program to provide security for the information and systems that support the operations and assets of the agency. Agencies are required to use a risk-based approach to information security management. FISMA also requires an agency's information security program to include these key elements:

- periodic assessments of risk and the magnitude of harm that could result from unauthorized access, use, or disruption of information systems;

- policies and procedures that are based on risk assessments and risk reductions to ensure that information security is addressed throughout the life cycle of each system and that applicable requirements are met;

- security awareness training to inform all users of information security risks and users' responsibilities in complying with information security policies and procedures; and

- periodic tests and evaluations of the effectiveness of information security policies, procedures, and practices related to management, operational, and technical controls of every major system.

Although SEC has taken some actions to improve security management—including establishing a central security management group and appointing a senior information security officer to manage the information security program—further efforts are needed. For example, we found that the commission had not clearly defined roles and responsibilities for the central security group it had established. In addition, SEC had not fully (1) assessed its risks, (2) established or implemented security policies,

(3) promoted security awareness, or (4) tested and evaluated the effectiveness of its information system controls.

SEC and its Office of Inspector General (OIG) have recognized weaknesses in the commission's information security program. Since 2002, SEC has reported information security as a material weakness in its FMFIA reports. In its fiscal year 2004 FISMA report, SEC's OIG reported that the commission had several weaknesses in information security and was not substantially in compliance with information security requirements contained in FISMA.

Without proper safeguards for its information systems, SEC is at risk from malicious intruders entering inadequately protected systems. It is at risk that intruders will use this access to obtain sensitive information, commit fraud, disrupt operations, or launch attacks against other computer systems and networks. We believe the primary cause of these weaknesses has been the lack of a fully developed and implemented entitywide information security program. In our March 2005 report,[12] we recommended 6 actions to fully develop and implement an effective security program. In addition, we made 52 recommendations to correct specific information security weaknesses related to electronic access control and other information system controls. Due to their sensitivity, these recommendations were included in a separate report designated for "Limited Official Use Only." A fully developed, documented, and implemented agency information security program would provide the commission with a solid foundation for resolving its information security problems and for ongoing management of its information security risks.

We believe that if our recommendations and SEC's planned actions are carried out effectively, SEC can make considerable progress toward its declared vision as "the standard against which federal agencies are measured"[13] and will be in a stronger position to manage its daily operations and accomplish its mission.

This testimony is based on our recent audit of SEC's fiscal year 2004 financial statements, which was conducted in accordance with U.S. generally accepted government auditing standards.

[12]GAO-05-262.

[13]U.S. Securities and Exchange Commission, *2004 Performance and Accountability Report*.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or the other members of the Subcommittee may have.

Contacts and Staff Acknowledgements

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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.

Questions for David Walker from Chairman Coburn for the Record (7/27/2005)

1. In your testimony, you list 13 actions the SEC should take in order to improve controls over the financial reporting process. These are 13 substantive actions. In their response letter to GAO, SEC stated its plans to "increase their financial reporting staff and formalize policies and procedures."

A. Is GAO aware of any progress the SEC has made on these recommendations?

SEC has begun to take some actions to improve its financial reporting process. For example, SEC is in the process of hiring additional financial reporting staff and has drafted policies and procedures for preparing financial statements. In addition, SEC has established a Financial Management Review Committee to provide advice and to regularly review the agency's financial operations and policies. However, as we reported on November 15, 2005, as of September 30, 2005, SEC still had material 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. See our report *Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2005 and 2004*, GAO-06-239, dated November 15, 2005, for a more detailed discussion of SEC's weaknesses in controls over its financial statement preparation process.

B. What types of actions are crucial on the part of the top management of the SEC in order to successfully correct the weaknesses in financial reporting?

In order to correct its financial reporting weaknesses, SEC needs to build a foundation for financial reporting and accountability that includes (1) providing strong top management leadership and support for the financial management function including instituting accountability mechanisms to help ensure timely and reliable financial reporting; (2) fully staff the financial management team with the right knowledge, skills, and experience; (3) fully develop integrated financial reporting systems to produce reliable and supportable financial information and minimize manual processes; and (4) develop and implement appropriate, cost-effective internal controls over financial reporting that include a well-defined documentation process containing an audit trail and verifiable results so that someone not connected with the procedures can understand the processes over financial reporting.

2. The SEC Inspector General has cited information systems security as a problem since 1996, and GAO reported in March of this year that the SEC needs to address weak controls over financial and other sensitive data. The Federal Information Security Management Act (FISMA) requires each agency to develop, document, and implement an agency-wide information security program to provide security for the information and systems that support the operations and assets of the agency. Under FISMA, agencies are required to use a risk based approach to information security management.

A. What progress has the SEC made thus far in developing this program?

SEC has made some progress in developing an information security program, but additional steps are needed to develop a program that effectively addresses its information security problems. During fiscal year 2004, we noted that SEC had established a central security management function and appointed a senior information security officer to manage the program as steps towards strengthening its information security program. In our fiscal year 2005 review, we also observed additional progress in SEC's security program development such as an increase in security staffing, the certification and accreditation of several major applications, and the implementation of a backup data center for service continuity. In September 2005, SEC Office of Inspector General's FISMA report showed other security program improvements including better remediation action tracking, completed and tested contingency plans for several major applications, and an inventory of SEC systems. However, SEC must continue to make progress in its security program in order to address weaknesses in electronic access controls, including user accounts and passwords, access rights and permissions, network security, or audit and monitoring of security-relevant. The program must also address weaknesses in other information security controls, including physical security, segregation of computer functions, application change controls, and service continuity. Additional efforts are needed for SEC to develop and implement an information security program that resolves existing information security problems and continuously manages information security risks.

B. Could you give the Subcommittee an example of the threats this security weakness poses?

A former SEC employee could access its systems and sensitive information for malicious purposes because SEC lacks a process to remove network access for separated employees. Similarly, SEC's systems are under threat of unauthorized access and attack due to access control weaknesses such as weak passwords, insecure hardware configurations, and insufficient guidance and testing program for wireless devices. Further, SEC's systems remain vulnerable to infiltration as a result of SEC's lack of a policy to install and maintain up-to-date security and software patches. Such unauthorized access and attack could occur with little likelihood of detection until SEC fully implements intrusion detection systems on its networks. Additional opportunities to compromise SEC's information security exist because of other security weaknesses such as excessive file and system permissions, incompatible job functions, and inadequately protected databases provide. Overall, the security vulnerabilities that have been identified at SEC leave sensitive data—including payroll and financial transactions, personnel data, regulatory, and other mission critical information—under threat of unauthorized disclosure, modification, or loss.

C. Does this mean an outsider could hack into the SEC's system?

Yes. As a result of the existing security weaknesses, unauthorized access to SEC's systems is possible and could occur without immediate notice. In particular, SEC has a

number of access control weaknesses that could allow an outsider to gain unauthorized access to SEC's information systems. SEC's password storage and settings issues, excessive permissions and privileges, insecure configuration of network devices and other access control weaknesses increase the risk of system compromise whether the threats are external or internal.

3. All of the new initiatives for improved oversight of mutual funds, hedge funds, along with numerous other regulatory initiatives initiated under Chairman Donaldson will obviously create greater demands for impeccable financial management and accountability and careful allocation of resources at the SEC. These initiatives have required new staff and additional resources. Accordingly, these new initiatives demand heightened oversight and accountability as does the strategic five year plan developed by the SEC to address the material weaknesses identified by GAO. The Inspector General's Office at SEC currently has 10 employees, and has stated that they have been provided with the staff resources they need over the last 15 years.

Does GAO have any comments regarding the size of the Inspector General's Office, and whether or not their investigatory role should be increased?

We don't have any specific comments regarding whether or not the IG's investigatory role should be increased, although we have had discussions with the IG concerning its need to hire additional employees if the IG ever assumes responsibility for auditing the SEC's financial statements. However, at this time, GAO plans to continue to audit SEC's financial statements for the foreseeable future.

4. Can you please share generally how financing decisions are made across government, specifically the decisions made by agencies for construction versus lease-purchase, purchase, etc.?

Our work in the federal government shows that, often, lease financing decisions are made based on appropriations, cash flow, and "how we keep score" rather than on the best long-term economic value for the government. Dependence on costly leasing was one of the reasons we designated federal real property as high risk.

As a general rule, building ownership options through construction or purchase are the least expensive ways to meet agencies' long-term requirements. Lease-purchases—where payments are spread out over time and ownership of the asset is eventually transferred to the government—are generally more expensive than purchase or construction but are generally less costly than using ordinary operating leases to meet long-term space needs. However, over the last decade we have reported that GSA—as the central leasing agent for most agencies—relies heavily on operating leases to meet new long-term needs because it lacks funds to pursue ownership.

Operating leases—in which periodic lease payments are made over the specified length of the lease—have become an attractive option in part because they generally look

cheaper in any given year. Pursuant to the scoring rules adopted as a result of the Budget Enforcement Act of 1990, the budget authority to meet the government's real property needs is to be scored—meaning recorded in the budget—in an amount equal to the government's total legal commitment. For example, for lease-purchase arrangements, the net present value of the government's legal obligations over the life of the contract is to be scored in the budget in the first year. For construction or purchase, the budget authority for the full construction costs or purchase price is to be scored in the first year. However, for many of the government's operating leases, only the budget authority to cover the government's commitment for an annual lease payment is required to be scored in the budget. Given this, while operating leases are generally more costly over time, compared with other options, they add much less to a single year's appropriation total than these other arrangements, making this choice a more attractive option from an annual budget perspective, particularly when funds for ownership are not available. While the requirement for "up-front funding" permits disclosure of the full costs to which the government is being committed, the budget scorekeeping rules allow costly operating leases to "look cheaper" in the short term and have encouraged an over reliance on them for satisfying long-term space needs. Decision makers have struggled with this matter since the scoring rules were established and the tendency for agencies to choose operating leases instead of ownership became apparent.

For more information, see *Federal Real Property: Reliance on Costly Leasing to Meet New Space Needs is an Ongoing Problem (*GAO-06-136T, *October 6, 2005); High Risk Series: An Update* (GAO-05-207, January 2005); and *High Risk Series: Federal Real Property.* (GAO-03-122, January 2003)

5. **Have the Joint Financial Management Improvement Program Principals met yet to discuss whether and under what circumstances federal government agencies should be required to have an outside opinion on their system's internal accounting controls? If so, what were the general outcomes of that discussion?**

The Joint Financial Management Improvement Program (JFMIP) Principals met on October 24th, 2005 and continue to discuss and follow the issue of internal controls in the federal government. There have been many developments over the past year and ongoing developments during fiscal year 2006 in the area of internal control management, assessment, and reporting in the federal government. The JFMIP Principals will continue to follow these developments closely and use the information and experience gained through these initiatives to consider the issue of, whether and under what circumstances, auditor opinions on internal control should be encouraged or required.

In December 2004, OMB issued revisions to its Circular A-123, *Management's Responsibility for Internal Control.* The revised Circular, is effective for fiscal year 2006, and provides guidance to Federal managers on improving the accountability and effectiveness of Federal programs and operations through establishing, assessing, correcting, and reporting on internal control. In addition, Appendix A to the Circular applies to the CFO Act Agencies, and requires a management assessment process specifically over the

effectiveness of internal control over financial reporting. In July 2005, the Chief Financial Officer's Council issued an implementation guide to specifically address the additional requirements of Appendix A to OMB Circular A-123. Agencies are currently in the process of implementing these new requirements during fiscal year 2006. Separately, on September 27, 2005, The Chief Financial Officers Council and the President's Council on Integrity and Efficiency issued a joint study on the potential costs and benefits of requiring the CFO Act agencies to obtain audit opinions on internal control over financial reporting. This study recommends that agencies be given the opportunity to implement the revised OMB Circular A-123 and obtain an internal control audit only where particular circumstances warrant. The Department of Homeland Security Financial Accountability Act required the study and also requires GAO to perform an analysis of the study, which is in process.

CHRISTOPHER COX
CHAIRMAN

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SECURITIES AND EXCHANGE COMMISSION

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January 12, 2006

The Honorable Tom Coburn
Chairman
Subcommittee on Federal Financial Management,
Government Information, and International Security
United States Senate
439 Hart Senate Office Building
Washington, DC 20510

Dear Chairman Coburn:

Enclosed, please find written responses to your questions for the record from the Subcommittee on Federal Financial Management, Government Information, and International Security's hearing entitled "Examining Financial Management at the SEC" held July 27, 2005.

As you know, my highest operational priority as Chairman is to resolve the material weaknesses in the agency's internal controls that were documented in your hearing and in the SEC's FY 2005 Performance and Accountability Report. Given the agency's unique role in monitoring the internal controls of public companies and regulated entities, it is unacceptable for the SEC to have these material weaknesses, and the Commission is committed to resolving them fully in FY 2006. I am also pleased to report that the SEC has taken steps to fully fund the completion of its three real estate projects without amortizing any amounts into the agency's future lease payments. By working to fully cover these costs in 2005, through a reprogramming, and in 2006, as part of our current operating budget, the Commission will save taxpayers an estimated $24 million in unnecessary interest payments over the next 14 years.

I hope that the attached responses from SEC Executive Director Jim McConnell are helpful to the Subcommittee. As with other issues involving the Commission's responsibilities, we welcome the opportunity to share our views on these matters. If the Subcommittee has additional questions or requires additional materials to complete its hearing record, please do not hesitate to contact our Director of Legislative Affairs, Jane Cobb, at (202) 551-2010.

Sincerely,

Christopher Cox
Chairman

Enclosure

Chairman Tom Coburn

Questions for Mr. McConnell for the Record (7/27/05):

1. In May 2005, GAO reported three material internal control weaknesses in the areas of recording and reporting disgorgements and penalties; preparing financial statements and related disclosures; and information security. These conclusions were as of September 30, 2004. Since then, the SEC has begun a number of key initiatives to eliminate these material weaknesses and strengthen internal controls.

A. Please summarize the major ongoing initiatives to deal with these three internal control weaknesses.

B. Please explain the management and governance issues that allowed for these weaknesses to occur.

C. What is your plan to solve internal control problems, and protect interests of the US Taxpayers? Please provide a schedule of your plan that includes initiatives and their respective expected dates of implementation.

Answer:
The SEC's FY 2005 Performance and Accountability Report (PAR), which was completed by November 15 in accordance with the Office and Management and Budget's (OMB) required deadline, provides an update on the SEC's initiatives to resolve the three material weaknesses previously identified in last year's PAR. The SEC expects to have remediated fully these three weaknesses by the end of FY 2006. The following excerpts from our FY 2005 PAR highlights our progress in these areas over the last year, in addition to summarizing our remaining tasks.

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.

Chairman Tom Coburn

2. With all of the new initiatives for improved oversight of mutual funds, hedge funds, and numerous other regulations initiated under Chairman Donaldson, there is obviously an even greater demand for impeccable financial management and accountability and careful allocation of resources at the SEC. These initiatives have required new staff and additional resources.

A. How do you plan to manage all of these initiatives, in addition to keeping up with enforcement and examination demands given the probability of a slimmer budget?

B. How will the Commission keep up with its increased enforcement and examination demands while fulfilling the aggressive five-year strategic plan to reform current weaknesses and management issues?

Answer:
The Chairman has expressed his unstinting support for the SEC's enforcement program and examination responsibilities. Since his arrival at the Commission, the Chairman has worked diligently to ensure that the agency can operate successfully within its constrained FY 2006 funding level.

As noted above, the SEC expects to resolve fully its three previously identified material weaknesses by the end of FY 2006. These efforts are not expected to compromise at all the agency's ability to fulfill its mission or any other agency's other ongoing initiatives.

With respect to the SEC's five-year strategic plan, the agency is slated to complete a revised version by next fall. This plan, which will be voted on by the Commission, will be used to guide the activities and initiatives of the agency of the next several years.

3. The SEC Inspector General has sighted information systems security as a problem since 1996, and GAO reported in March of this year that SEC needs to address weak controls over financial and sensitive data. The Federal Information Security Management Act (FISMA) requires each agency to develop, document, and implement an agency-wide information security program to provide security for the information and systems that support the operations and assets of the agency. Under FISMA, agencies are required to use a risk based approach to information security management.

A. What progress has SEC made thus far in developing this program?

Answer:
In the March 2005 GAO report, the auditors acknowledged that we had made initial progress in developing an information security program, including hiring a Chief Information Security Officer (CISO), instituting a centralized security management function under the CISO, and putting in place an action plan to remediate the specific weaknesses identified. This plan lays out a comprehensive approach for implementing the risk-based security management requirements of FISMA, including the finalization of policies and operating procedures, and the implementation of new technologies designed to improve monitoring, managing, and restricting access to computer systems. Once completed, these new security activities will help SEC control the types of changes that are introduced into its IT environment and ensure that the agency effectively identifies, assesses, and mitigates sources of information security risk on a continuous basis.

One of the cornerstones of the FISMA guidelines is a process to "certify and accredit" major IT systems based on a detailed analysis of the sensitivity of the information and the system's sources of information security risk. Since the GAO report's release, and as reported to OMB during the most recent annual reporting period, the SEC has certified and accredited 80% of our major applications and general support systems as required by FISMA. The SEC's four remaining systems will be completed by March 2006. The SEC also instituted a computer security awareness training program that was completed by over 95% of staff and contractors during 2005.

B. Could you give the Subcommittee an example of the threats this security weakness poses?

Answer:
Many of the issues identified by GAO relate to insufficient internal controls. Typically, the perceived threats posed by these security weaknesses are risks associated from internal users accessing and/or modifying sensitive information. A hallmark principle of information security best practices is known as "least privilege"; under this principle, a user of a system should not have access to any information beyond that needed for his or her role. Without consistent enforcement and awareness of security policies, users may have access to information for which they may not have a business need, or users may not understand the sensitivity of the data as defined by the business owners. An

employee with malicious intent could also theoretically abuse his or her access to the information.

On page 15 of their testimony, GAO says, "without proper safeguards for its information systems, SEC is at risk from malicious intruders entering inadequately protected systems. It is at risk that intruders will use this access to obtain sensitive information, commit fraud, disrupt operations, or launch attacks against other computer systems and networks."

C. Does this mean an outsider could hack SEC's system?

Answer:
The SEC has historically focused its information security efforts on protecting the agency from intrusion attempts coming from outside the agency – as a result, we have a "defense in depth" posture that provides layers of protection for our IT systems and assets. To verify that these layers of defense provide adequate protection and are effectively implemented, the SEC contracted with security industry vendors to conduct external penetration tests earlier this year. No significant weaknesses were identified as a result of these tests. Nevertheless, no IT network or system that is connected to the Internet is 100% safe from being compromised. However, the SEC believes that our network and systems have sufficient operational, technical, and management controls to reduce the risk of attack from an outside intruder to a low level.

4. Under Chairman Donaldson's leadership, he instituted "performance dashboards," designed to present regular snapshots of the divisions' and offices' progress in meeting budget, staffing, and performance objectives. As stated in your testimony before the House Government Reform Subcommittee on Efficiency and Financial Management, Committee on Government Reform on April 20, 2004, "dashboards are designed to identify emerging problems, promote the discussion of solutions, and reinforce each executive's accountability for staff, performance and key initiatives."

A. Have the dashboards been successfully implemented at all levels and in all offices at the Commission?

B. If indeed the performance dashboards are still being utilized, how have you kept up the momentum with the new Chairman?

C. What ingredients did the "dashboards" lack that strained accountability between each executive and their staffs? In other words, how do you reconcile this aggressive initiative with GAO's reports of weaknesses?

Answer:
As you know, the dashboards were instituted by former Chairman Donaldson in FY 2004. These monthly management reports contain a variety of performance measures and other data that gauge the agency's success in meeting its operational, staffing, and budgetary objectives.

By design, the dashboards were meant to be dynamic, and the SEC has worked to expand the range of offices covered by the reports and refine the measures for each area. The reports now focus on nine of the SEC's major divisions and offices: the enforcement program, the examination program, the Division of Corporation Finance, the Division of Market Regulation, the Division of Investment Management, the Office of the General Counsel, the Office of Economic Analysis, the Office of Investor Education and Assistance, and the Office of the Executive Director. Although certain smaller offices remain to be added, these nine components represent 92% of the SEC's permanent staff.

Through these efforts, the dashboards have yielded significant positive results. Not only have they improved the operational information available to senior managers and enhanced the dialogues among divisions and offices, but the dashboards have directly contributed to shorter turnaround times and reduced backlogs, in areas such as no-action letter requests, SRO exams, and open investigations.

Chairman Cox remains committed to these valuable tools and under his leadership, the SEC is working to implement further improvements. Since the dashboards' inception, the SEC has added new measures and improved others as the agency has gained experience with these reports and as the agency's needs have evolved. Currently, the SEC is undergoing another review of the dashboard measures to ensure they remain appropriate and also plans to automate the reports.

With respect to the material weaknesses reported by GAO, the dashboard reports were never designed to capture such internal control weaknesses. The dashboards were conceived to gauge the agency's progress against a variety of predetermined performance measures; they would not reveal whether the internal controls underlying the performance data or other management information have weaknesses. That is why it is critical that agencies also conduct self-assessments and outside audits of their internal controls. However, the dashboards have served as a useful tool for senior managers to track the agency's progress in preparing its first financial statements and addressing internal control weaknesses once they have been identified. Separately, the SEC also plans to integrate the dashboards with the upcoming Activity-Based Costing/Performance-Based Budgeting system, which will help enhance the internal controls over budget formulation.

5. $52.5 million of the settlement money from the Global Research Analyst Settlement was supposed to establish an Investor Education Fund to develop and support programs designed to equip investors. While $27.5 million of these monies were directed to state securities regulators for investor education, the transfer of $52.5 million to the NASD Foundation has raised legal questions. How did the SEC go about selecting the NASD Foundation to be the sole recipient of the Global Settlement investor education funds?

A. Did the SEC provide any public notice that it would be considering private sector recipients for managing the investor education funds?

The SEC's plan to distribute the investor education funds to the NASD Foundation was publicly filed and approved after a public hearing, in accordance with Court Orders governing the Global Research Analyst Settlement. The $55 million in federal investor education funds is the result of the settlement between the SEC, NASD, the New York Stock Exchange and defendants. The NASD and NYSE authorized the federal investor education funds to be paid into the federal action pending before the Honorable William H. Pauley, III, Southern District of New York, subject to a plan to be submitted to the Court by the SEC. It was the intention of the parties to the settlement that the SEC and the Court have oversight of the funds. In submitting the investor education plan providing for the transfer of the funds to the NASD Foundation, the SEC acted in conformance with the terms of the settlement and Court Orders. The SEC made its plan public in a filing with the Court. Third parties were permitted to comment on the plan, including parties who desired to manage the funds. After a public hearing, the Court approved the SEC's plan, and in fact rejected arguments by certain parties that other entities would be more suitable recipients for the funds.

B. Were any other potential recipients contacted?

No, although consideration was given to other potential recipients. In crafting the new investor education plan, the SEC relied on its Office of Investor Education and Assistance. The SEC confirmed that the NASD Foundation is an independent investor education entity that is nation-wide in scope and not funded by individual financial services companies or their trade associations. In addition to the independent nature of the NASD Foundation, and its pledge to have a majority of public board members, the guidelines, procedures, and focus of the NASD Foundation are compatible with the Court's Orders regarding the use of investor education funds. The SEC has a good working relationship with the NASD Foundation. The NASD Foundation's mission is investor education, not the broader goal of financial education. The NASD Foundation publicly discloses, via its website, all grants made, the purpose of each grant, and the recipient of each grant. Such transparency is very important when disbursing public funds. Further, the NASD Foundation's agreement to work within the terms of the Court's Orders regarding investor education will permit sufficient SEC and Court oversight. Given these facts, and the SEC's determination that other entities were not as attractive in terms of complying with the Court's Orders, no other potential recipients were contacted.

C. What recourse, if any, will the SEC have if the NASD Foundation does not adequately manage these funds?

The NASD Foundation is subject to detailed terms in a Court Order for the handling of the funds. The Court Order directs how the funds are to be distributed, contains restrictions on who may receive funds, requires quarterly and annual reports to the SEC and the Court, and requires an annual audit by an independent third party. The Court has retained jurisdiction for the purposes of ensuring compliance with the terms of the Order. Should the NASD Foundation not adequately manage the funds, or fail to comply with the Order, the SEC can seek appropriate relief from the Court. The SEC also has the right to submit a new plan for the use of the funds, including distribution to a different entity, should such action be necessary. The Court can also take action on its own should such action be necessary to enforce the terms of the Order.

D. Whose money is this?

See Response to Question A. In sum, the funds are under the jurisdiction of the federal court overseeing the settlement, and applicable Orders give the SEC the authority to submit plans for the use of the funds.

6. Please provide the Subcommittee with a comparison of the difference in the total SEC building costs (for the new New York, Boston, and Washington, D.C. offices) if they were to have been paid for up front, vs. the option that was chosen.

Since the July hearing, the SEC has taken steps to fully fund the completion of its three real estate projects without amortizing any amounts into the agency's future lease payments. By the SEC's working to fully cover these costs in 2005, through a reprogramming, and in 2006, as part of our current operating budget, the agency will save taxpayers an estimated $24 million in unnecessary interest payments over the next 14 years.

In addition to extinguishing these build-out costs completely in 2006, the SEC has taken steps to reduce the costs of these projects through value engineering their completion. We currently estimate that these design changes, which will have no negative effects on employee efficiency, will result in approximately $4 million in cost savings associated with the completion of our Northeast Regional Office.

Sen. Lautenberg's Questions for Mr. McConnell for the Record (7/27/05):

Question #1: What sorts of confidential data does the SEC store? Is personal data stored as well as confidential business data?

The SEC manages a wide range of data, both internally generated and received from external parties. Confidential data would include information such as:

- Evidentiary information obtained during the course of enforcement investigations, which is mostly stored in electronic format
- "Bluesheet" data on trading activity obtained from broker-dealers, usually in support of enforcement requirements
- Information obtained from regulated broker-dealers, mutual funds, and other entities during compliance inspections and examinations
- Other confidential information submitted to the SEC according to agency requirements; for example, correspondence with registrants which is covered by a confidential treatment request
- Internal personnel records

Information sources such as the above items can include personal information such as names, addresses, social security numbers, records of personal securities transactions, and other data. All such information is retained within Commission information systems that are fully subject to Commission information security and privacy policies.

Question #2: Has the SEC ever inadvertently released confidential data?

To our knowledge, the SEC has not inadvertently released confidential or personal information to the public, with the exception of a few isolated cases where documents not intended for public release have been disseminated. For example, the Inspector General issued an audit memorandum in March 2004 examining instances where internal memoranda related to no-action letters in the Division of Investment Management were inadvertently categorized as documents for public release. These incidents would have resulted in the release of non-public Commission work product, but not personal information.

The SEC has also on occasion served as a conduit for the inadvertent release of confidential information via the EDGAR system. Filers have on occasion included personal information in their filings with the Commission, which the SEC has then automatically disseminated to the public. Filers are aware that the documents that they file with SEC through the EDGAR system are disseminated to the public immediately upon their arrival and it is their responsibility to ensure that the information that they send in their filings is public information. In unusual cases where this type of disclosure does happen, the SEC can issue a correction to the filing to expunge the personal information, which eliminates the information from the system of record.

Question #3: Has the SEC ever had a security breach that resulted in data being lost?

To our knowledge, the SEC has not had a security breach that resulted in data being lost or corrupted. The SEC has over the past year instituted a comprehensive program for monitoring suspicious activity and responding to information security-related incidents. For example, the agency's 2005 FISMA report listed four recorded security incidents, all of which were quickly contained and mitigated, and none of which involved the release of confidential information or loss of data.

Question #4: How much extra staff time is spent at the SEC due to the agency's failure to integrate its financial systems?

Since 2003 the SEC has increased its financial management staff by 20% to meet the new requirements for preparation and audit of financial statements. The Enforcement Division also added staff to meet the need to better track penalties and disgorgements. These resources contributed to the SEC's success in issuing 2004 and 2005 financial statements with clean opinions from the GAO auditors.

The process of preparing financial statements also has triggered some changes and improvements to financial systems which will continue into the future. Currently there are automated linkages between some of the larger subsidiary accounts and the SEC's central accounting systems, but there remain other subsidiary systems that require manual intervention to transfer data for preparation of financial statements. As new financial systems and subsidiary accounts are implemented or existing systems are upgraded, automated interfaces with the central accounting system will be put in place. We believe, however, that more automation and integration of systems are not likely to significantly reduce the staffing requirements for this activity because of the continued need to meet challenging reporting deadlines with high quality financial data.

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