REVIEW OF PERIODIC REPORTS

EXECUTIVE SUMMARY

The Division of Corporation Finance (CF) was reasonably effective in achieving its goal to review the financial and operating information for 33% of reporting issuers each year. The percentages reported in the Commission's budget submissions did not fully reflect this because they omitted significant aspects of CF's review activities. These percentages would better reflect the effectiveness of CF's review activities if more of these review activities, such as initial public offering registrations, were included.

Also, CF used the number of annual reports filed to estimate the number of reporting issuers for these percentages. We recommend that CF instead use an appropriate version of the list of registrants it provides on the SEC Internet site.

Other recommendations include: provide more information in its internal and external tracking and budget reports related to its review goals; include a performance measure based on its goals in the performance plan required by the Government Performance and Results Act; develop review goals related to filing monitors; and separate quarterly reports (10-Qs) and current reports (8-Ks) in the Commission budget.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objective was to determine whether review coverage of reporting issuers through the review of periodic reports was effective. During our audit, Division managers indicated that they also considered reviews of repeat registration statements, certain post-effective amendments and certain proxy statements in determining reporting issuer review coverage. Consequently, we included these filings in our analysis. We analyzed Commission budget information from fiscal years 1994-1998 and Division workload reports for 1998. CF's budget and workload information we reviewed were derived primarily from its Filing Activity and Tracking System (FACTS). We reviewed this system in a previous audit and found management controls to be generally adequate[1]. We also interviewed Division staff.

[1] OIG Audit Report No. 213, December 12, 1994.

The audit was performed between April and September 1999, in accordance with generally accepted government auditing standards.

BACKGROUND

Public companies registered with the Commission must file periodic reports under the Exchange Act of 1934, which include annual (10-K) and quarterly (10-Q) reports. These reports provide the securities markets with updated financial and operating information. CF refers to companies with these filing obligations as "reporting issuers."

If a periodic report is selected for review, CF may assign it either a "full review" (examination of the accounting, business, and legal information in a filing and related amendments), "financial review" (analysis of financial statements and management's discussion and analysis), or a "monitor" (analysis of specific disclosure issues). CF considers a full or financial review of an annual report, repeat securities registration, post-effective amendment to a securities registration, or going private and merger proxy solicitation a "reporting issuer review."

"Reporting issuer reviews" do not include reviews of 1933 Act initial public offering registrations (IPOs). CF does not view an issuer as a reporting issuer until it incurs the periodic reporting obligation, generally after the IPO is declared effective. Also, CF does not include reviews of quarterly reports in its determination of reporting issuer review coverage because they generally do not include audited financial statements.

CF's goal is to provide at least a financial review to all reporting issuers at least once every three years (33% each year). Other Division goals include 100% review of IPOs, Regulation A exemptive filings of small business issuers, new issuer 1934 Act registration statements, third-party tender offers, going-private transactions, and contested proxy statements. Because of resource constraints and the higher priority of other work (*e.g.*, IPOs), CF only reviewed an average of 20% per year of reporting issuers for the three-year period from 1996 to 1998 through review of periodic reports. The shortfall from its goal is somewhat mitigated by CF's review of other securities registrations, post-effective amendments, and proxy statements, which also contain financial and operating information.

A recent NASDAQ rule change[2] now requires issuers that wish to continue to trade their securities on the over-the-counter bulletin board (OTCBB) to file registration statements (and periodic reports) with the SEC. Managers in CF and the Office of Filings and Information Services (OFIS) estimate that this rule change will result in an additional 3,000 small businesses (an increase of approximately 20%) filing new registration statements with the Commission by the year 2001. These new registrations will be subject to full reviews by Division staff.

[2] SEC Adopting Release 34-40878 (January 4, 1999), National Association of Securities Dealers (NASD) and NASDAQ proposal SR-NASD-98-51 (submitted to SEC October 7, 1998).

AUDIT RESULTS

CF was reasonably effective in achieving its goal to review 33% of reporting issuers each year. The reported percentages would better reflect the effectiveness of CF's review activities if more of CF's review activities were included.

We are making several recommendations that could enhance CF's measurement and reporting of its review performance. These are described below.

REVISE CALCULATION OF PERCENTAGE OF ISSUERS REVIEWED

To calculate the percentage of reporting issuers reviewed, CF divides an adjusted number of reporting issuer filings reviewed by the number of 10-Ks filed. Both the numerator and denominator of this fraction can be adjusted to more accurately reflect CF's work.

The numerator of this fraction, reporting issuer filings reviewed, includes reviews of repeat registration statements; post-effective amendments; going private and merger proxies; and 10-Ks. CF adjusts the number of 10-Ks to recognize those reviewed in connection with other filings. CF does not include reviews of IPOs, which all receive full reviews and are currently one of CF's highest review priorities.

As a consequence, CF's percentages for review coverage appear understated. Using CF's current methodology, a summary table in the Commission's fiscal year 2000 budget estimate indicated that CF reviewed 21% of reporting issuers in 1998. We estimated that if IPOs were included in the number of reviews, the review percentage would increase to 28% for that year (closer to CF's goal).

The denominator of the fraction is the number of reporting issuers. For this number, CF uses the number of 10-Ks filed because all reporting issuers are required to file 10-K reports annually. The number of 10-Ks filed in a year may not represent all reporting issuers because a new reporting issuer may not file a 10-K in the same year its IPO is declared effective, or occasionally a company may file multiple 10-Ks (10-Ks filed late).

CF published a list of companies in April 1998 to assist issuers in locating the Corporation Finance group responsible for reviewing its filings. This list, with updates, might be a more reliable determinant of the number of issuers than the number of 10-Ks filed. We identified 13,070 registrants on the April 1998 list (compared to 13,577 10-Ks in 1998).

Recommendation A

The Division of Corporation Finance should include the number of IPOs reviewed in its calculation of reporting issuer reviews for the budget.

Recommendation B

The Division of Corporation Finance should use the actual number of registrants to represent reporting issuers in budget submissions and its internal workload reports.

REPORTS OF GOAL OUTCOMES

CF should improve its reporting of progress toward its goals to review 33% of reporting issuers and 100% of IPOs in its budget information, internal workload reports, and in the GPRA (Government Performance and Results Act) performance plan.

CF indicated in the "1998 Program Evaluation" section of the FY 2000 budget that it reviewed 80% of the going-private, merger, or other proxies that included audited financial statements. This section lacked information on progress towards the goals identified above.

CF's primary internal workload report tracks the number of filings reviewed and compares it to monthly and annual targets. Like the budget, it does not relate the number of filings reviewed to progress toward CF's goals.

One of CF's GPRA performance plan measures describes the number of issuers reviewed. The plan also needs performance measures relating to CF's percentage goals for review of reporting issuers, IPO's, tender offers, etc.

Recommendation C

The Division of Corporation Finance should include descriptions of its review goals and progress toward achieving them in its Commission budget submission, Division workload reports, and GPRA performance plan.

GOALS FOR MONITORS

CF performed approximately 2225 monitors of 10-Ks, 10-Qs, repeat 1933 Act registrations, and post-effective amendments in FY 1998. Recent monitoring efforts included evaluations of issuers' compliance with new disclosure requirements for derivatives, Year 2000 conversions, and Plain English. These monitors contributed directly to CF's mission to provide investors with material information and prevent fraud.

While the Commission's budget discusses monitors, CF did not develop review goals for monitors for the budget or internal workload reports, or count them toward the industry groups' production.

Division staff indicated that developing goals for monitors would be difficult. A filing must be screened to identify the need for a monitor, and they can not predict the outcome of a filing screening.

CF estimated the annual number of full and financial reviews for repeat 1933 Act registrations and annual reports, which are also screened, by using the previous year's total number of reviews adjusted to consider available resources and Division priorities. CF could use a similar approach as a starting point for developing goals for monitors.

Recommendation D

The Division of Corporation Finance should develop review goals for monitors and track progress toward those goals.

BUDGET REPORTING OF 8-KS AND 10-QS

The budget combines current reports (Forms 8-K) with quarterly reports (Forms 10-Q). As a result, it is difficult to determine from the budget information the number of each of these reports filed and reviewed.

These filings serve different purposes. Issuers file 8-Ks to report specific, significant events shortly after their occurrence. On the other hand, 10-Qs provide a broader range of company information, and must be filed after the end of each quarterly reporting period.

Recommendation E

The Division of Corporation Finance should report Form 8-K reports as a separate line item in the Commission budget.