

PRELIMINARY REVIEW OF FILINGS

EXECUTIVE SUMMARY

The Division of Corporation Finance (Division) conducts preliminary reviews of filings under the securities laws. These preliminary reviews identify disclosure issues and help determine whether further review of filings is warranted and the type of further review. We evaluated the Division's preliminary review process.

We found that the Division has made some revisions to enhance its preliminary reviews over the last three years and that further improvements are planned. Most significantly, the Division plans to focus to a greater degree on the quality of the filing company, as well as the quality of the disclosure in a filing. We concur with this proposed change of focus and commend the Division for its efforts.

We are making several recommendations to assist the Division as it continues to improve the preliminary review process. These include: enhancing consideration of company risk factors in the preliminary review process, maintaining surveillance of large companies, and continuing efforts to manage workloads better.

The Division provided comments on earlier drafts of this report. We have reflected the Division's comments as appropriate in our report. The Division did not provide comments on the final version of the report.

SCOPE AND OBJECTIVES

Our audit objective was to determine if improvements could be made to the Division's preliminary review process. During the audit, we interviewed and surveyed Division and other Commission staff. We also analyzed filing review data, relevant guidance, and other documentation.

The audit was performed from January to October 2005 in accordance with generally accepted government auditing standards, with one exception. Because of time and resource constraints, we did not evaluate the validity and reliability of data from three automated systems used by the Division: the Electronic Data Gathering Analysis and Retrieval (EDGAR) system, ADHOC (not an acronym), and the Filing Activity Tracking System (FACTS). We are unaware of any material errors involving EDGAR, ADHOC, or FACTS, or any effect on the results of the audit from not testing the systems.

EDGAR is used by public companies to submit their filings and contains documentation related to filing reviews. ADHOC is a database program which extracts information from EDGAR. FACTS contains data on filing reviews (*i.e.*, which filings were reviewed, and the date and type of review).

BACKGROUND

Specific information on the preliminary review process is non-public, according to the Division. As a consequence, we present below only some general information about the Division and the review process.

The Division has approximately 515 staff (mainly attorneys and accountants), of which approximately 80% are assigned to one of eleven industry groups (*e.g.*, the Office of Telecommunications, the Office of Financial Services). The industry groups are primarily responsible for reviewing filings received from public companies. The Division also has several support offices, including the Office of the Chief Counsel and the Office of Mergers and Acquisitions.

Filings are submitted pursuant to the securities laws, including the Securities Act of 1933, the Securities Exchange Act of 1934, and the Trust Indenture Act of 1939. Some types of filings are usually reviewed, while other types are usually not reviewed. The main review types are full review (legal and accounting); financial statement (accounting); legal; targeted (focused on specific issues - also referred to as a monitor); and preliminary review (the subject of this audit).

The Division normally conducts full reviews on filings representing a company's initial entry into the federal disclosure system (*i.e.*, initial public offerings of securities). Contested proxy solicitations, tender offers, and going private filings are also normally reviewed because they can have a material effect on the interests of investors.

The preliminary review is the initial review of a filing. It may lead to a more comprehensive review (such as a legal or accounting review), depending on the review results. Annual reports from large companies are given a preliminary review to determine whether further review is warranted. According to the Division, this review is primarily focused on the company's financial statements and related disclosure.

The Division noted that, since 2002, it has replaced what it described as a very mechanical screening process with a much more substantive preliminary review process. The Division indicated that, as a result, it has made very substantial changes in the manner in which it selects companies for further review. Each industry group has been given more independence in deciding what level of review to assign to a company filing. According to the Division, this allows the group to balance its workload effectively and focus on material issues in a greater number of filings.

Once the preliminary review is completed, the Division's further review of selected filings is primarily focused on the full disclosure of material information and corrections of material deviations from its rules and regulations and generally

accepted accounting principles. The review seeks to ensure that investors are provided with accurate and material information, and to deter fraud and misrepresentation in the public offering, trading, voting, and tendering of securities. These objectives are designed to allow investors to make well-informed decisions regarding their security transactions.

The work of the Division has been impacted by passage of the Sarbanes-Oxley Act (SOX), which contained numerous provisions designed to improve the reliability of financial statements. SOX increased the Division's budget, while also imposing additional requirements on the Division's review of filings, as discussed below.

AUDIT RESULTS

We found that the Division has been making changes to improve the preliminary review process. The Division has already implemented several improvements, and further steps are planned.

The Division has in the past used financial analysis of company performance in its screening process. It has more recently been testing the usefulness of reports prepared by a number of vendors. These private reports attempt to identify potentially problematic companies.

A pilot program in the EDGAR system concerns use of Extensible Business Reporting Language (XBRL) in filings. This data-tagging technology, if implemented, should allow the Division to undertake financial analyses and to determine trends across companies.

As stated in the Background, the Division has replaced what it described as a mechanical screening process with a more substantive preliminary review process. The Division intends to enhance this process by focusing to a greater degree on company quality (in addition to disclosure quality). In our opinion, this broadened focus should improve the preliminary review process. We commend the Division for its initiative.

Our recommendations below are designed to help the Division further improve the preliminary review process. Overall, the recommendations should help the Division make better-informed decisions during that process regarding what type of further review, if any, is appropriate.

COMPANY RISK FACTORS

To focus on company quality, the Division will need to consider several risks involving companies. These include the risk that a company's financial statements may need to be restated. To help it analyze company risks effectively, the Division will need to provide additional guidance on this issue to its staff.

We identified and shared with the Division certain risk-based information that could enhance the preliminary review process. This information includes financial ratios and analyses, trading data, and other information.

The Division agreed that this kind of information could be useful and is taking steps to further incorporate it in the preliminary review process. Obtaining some of this material may require enhancements to the information technology available to the Division.

Recommendation A

The Division of Corporation Finance should enhance its consideration of company risk factors and other risk-based information during the preliminary review process, as discussed above. It should consult with other Commission offices (*e.g.*, the Office of Information Technology, the Office of the Chief Accountant, and the Office of Risk Assessment), and provide guidance to its staff, as appropriate (*e.g.*, by including company risk factors on the Division's preliminary review sheets).

SCHEDULING REVIEWS

Section 408(b) of the Sarbanes-Oxley Act (SOX) requires the Division to consider certain factors in scheduling reviews, as follows:

- 1) issuers that have issued material restatements of financial results;
- 2) issuers that experience significant volatility in their stock price as compared to other issuers;
- 3) issuers with the largest market capitalization;
- 4) emerging companies with disparities in price to earning ratios;
- 5) issuers whose operations significantly affect any material sector of the economy; and
- 6) any other factors that the Commission may consider relevant.

We found that the Division generally only used the third factor above (issuers with the largest market capitalization) in determining the timing of filing reviews. A senior member of the Division indicated that incorporating all of the risk factors has been difficult, for a variety of reasons (including delays in hiring and training new staff, a lack of the necessary information technology, and difficulties in initially developing a methodology for some factors).

The Division indicated, however, that it considers these factors in determining whether to review a company in a given year. It views the factors as assisting it in making review decisions over a three-year review cycle, not a one-year period.

The Division further indicated that it has finalized work with the Office of Economic Analysis on developing a methodology for identifying companies that experience significant volatility in their stock price. The Division also believes that its industry specialization allows it to focus on companies in material sectors of the economy.

The Division's focus on company quality should help it to further implement the factors listed in Section 408(b) of SOX, since these factors relate to companies, not individual filings.

Recommendation B

As it continues its focus on company quality, the Division should further incorporate the factors in Section 408(b) of SOX into its timing of filing reviews, and issue appropriate guidance to its staff.

REVIEW REQUIREMENTS

The Sarbanes-Oxley Act, Section 408(c) states that “In no event shall an issuer required to file reports under section 13(a) or 15(d) of the Securities Act of 1934 be reviewed under this section less frequently than once every 3 years.”

During its first review cycle under Sarbanes-Oxley, the Division excluded certain companies from review. These included, but were not limited to, some companies not required to file periodic reports after the first year (because they registered only debt securities under a certain amount), and some companies that could deregister at any time due to a small number of shareholders or a limited asset size. However, the Division indicated that it did review a number of companies meeting these criteria during the first three year cycle.

The Division determined that its approach of excluding certain companies was the best way to carry out Congress’ intent, given its limited resources at the time. With the possible exception of the excluded companies, the Division stated that it complied with the three-year review cycle in the Sarbanes-Oxley Act. As resources permit, the Division plans to review some or all of the excluded companies in the future.

Recommendation C

In the future, the Division of Corporation Finance should review all companies subject to Section 408(c) of SOX. If it excludes certain companies from review (as discussed above), it should seek a formal legal opinion from the Office of General Counsel to determine whether the exclusion is permissible under the Sarbanes-Oxley Act. The Division should then take appropriate action to comply with that opinion.

SURVEILLANCE OF LARGE COMPANIES

The Compliance Inspection and Examination Program (Program) recently implemented a new examination approach. On an experimental basis, the Program assigned staff to monitor continuously developments at the largest investment advisory groups. A similar approach involving large capitalized companies could help the Division improve its focus on company quality.

For instance, the companies in the Standard and Poor’s 500 Index represent approximately 80% of the total market capitalization in the United States. The Division could assign staff to maintain continuous surveillance of developments (*e.g.*, corporate press releases, trading data, and 8-K filings) at these companies. Because of their enhanced knowledge of large companies, the staff assigned to surveillance

would be better able to identify timely material issues affecting the companies when they perform preliminary reviews of filings.

Recommendation D

The Division of Corporation Finance should consider implementing a surveillance program for large capitalized companies, as outlined above.

WORKLOAD MANAGEMENT

Based on our analysis, approximately two-thirds of issuers have a December 31 fiscal year-end. These companies are required to submit their 10-K filings by mid-March of the following year. The influx of filings from these companies creates a workload management issue for the Division.

Some industry groups in the Division believe that the large influx of 10-K filings in mid-March adversely affects the review process. They indicated that companies with fiscal year-ends other than December 31 may be reviewed more often and more comprehensively than their risk level would normally warrant (a large workload peak could also lead to a lesser level of review than warranted for filings made during the peak).

Our analysis supported the view of the industry groups. Using data from the FACTS system on 2,750 10-K filing reviews in calendar years 2003-2004, we found that companies not having a December 31 fiscal year-end received a financial statement or full review approximately 15% more often than companies with a December 31 fiscal year-end.

According to many industry groups, the 10-K peak season also influences the timing of registration and proxy statement filings. However, they do not generally believe that preliminary reviews of registration and proxy statements are significantly affected.

The Sarbanes-Oxley Act requires that the Division review each reporting company at least once every three years. Some industry groups believe that this requirement also creates a workload peak season because the Commission reports Sarbanes-Oxley statistics as of September 30, the end of the Commission's fiscal year.

The Division indicated that the cyclical nature of the Division's workload due to difference in fiscal year ends can create pressure on its staff to complete company reviews quickly. It believes that the workload peak created by the Sarbanes-Oxley Act review cycle will improve now that the first three-year cycle under SOX has been completed.

Also, the Commission issued a rule in December 2005 requiring that 10-K filings from the largest companies be filed about two weeks sooner than before (Release Nos. 33-8644, 34-52989). This rule should help mitigate the workload peak.

The Division indicated that it believes our concerns will be ameliorated now that it has completed the first SOX three-year cycle and has established procedures to meet the review mandate.

Recommendation E

The Division of Corporation Finance should monitor its workload situation and identify ways to manage its workload peaks, if those peaks continue.