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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

DIVISION OF FINANCIAL AND
GENERAL MANAGEMENT STUDIES

SEPTEMBER 2, 1980

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The Honorable Harold M. Williams
Chairman, Securities and Exchange Commission

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Dear Mr. Williams:

Subject: Opportunities for Improving the Quality and Efficiency of the Securities and Exchange Commission's Process for Reviewing Reports (FGMSD-80-81)

This report discusses the results of our review of the Commission's administrative procedures used in reviewing company reports to determine whether they are complying with the Securities Act of 1933 and the Securities Exchange Act of 1934. These acts require companies to send periodic financial disclosure reports to the Commission. For those companies not complying with these reporting requirements, the Commission must determine appropriate enforcement actions and/or sanctions which will ensure that adequate disclosures are made.

We believe that you can increase the efficiency and improve the quality of your process for reviewing reports and following up on delinquent reports. Your staff has also recognized the potential for improvement and has already taken significant action on the areas discussed in this report. If fully carried out, these positive steps should improve Commission disclosure reviews.

We are well aware that the number of statements and reports filed with the Commission has increased dramatically over the last 10 years. And while filings have increased from about 27,000 to 77,000 between 1968 and 1979, the number of people reviewing the reports has been reduced. Consequently, the Commission has decreased the number of thorough reviews and resorted to abbreviated reviews despite evidence that greater--rather than less--scrutiny of the reports is called for. Particularly subject to the shorter review are the annual 10K and quarterly 10Q reports, which are the key source for data with which to assess a firm's financial condition. We focused our attention on the Commission's review of these reports, because of their importance and the workload they represent.

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In addition to shortening many reviews, the Commission had to devote increased staff time and computer resources to identifying and following up on firms which either did not file required reports or failed to file them on time. Altogether, the increased workload reduced the Commission's ability to detect possible corporate improprieties and preserve a well-informed securities market.

## THE EFFICIENCY AND QUALITY OF ANNUAL AND QUARTERLY REPORTS CAN BE IMPROVED

Faced with a growing number of filings, the Commission is in a predicament that is best illustrated by the situation existing in its Division of Corporation Finance.

With primary responsibility for reviewing annual 10K and quarterly 10Q reports, the Division's workload more than tripled and its staff decreased between 1968 and 1979. The Division was forced to abbreviate reviews it normally would have done more thoroughly. We could not determine from Division records the adequacy of the reviews or of the resulting analyses. Compounding the problem, the staff was given little written guidance for reviewing reports.

A number of relatively inexpensive measures could be taken to increase the efficiency and help assure the quality of reviews made by the staff. These are:

- Prepare more detailed guidelines for what staff should look for in reviewing reports and the analysis they should make.

- Establish a quality control program to check the adequacy of staff reviews and identify the possible obsolescence of existing data and analysis as well as the need for new data and analysis.

- Use computer assistance for financial analysis, particularly for abbreviated reviews.

- Promote specialization by assigning staff to review reports on the basis of industry classification.

These measures are discussed in the following paragraphs. As the preparation of our report has been delayed because of higher priority work, significant actions have already been taken by the Commission staff to correct the problems we noted. If fully carried out these actions should lead to more efficient and comprehensive reviews of the reports filed by companies.

<u>Provide guidance on how and what to review in reports</u>

To guide them in their reviews, Corporation Finance Division staff were given memorandums that described responsibilities and suggested items to review. The memorandums did not, however, answer questions about how and what to review--such as what ratios to compute or what comparisons to make. When questioned about the need for more specific guidance, Division officials said there was no substitute for professional judgment and a rigid pro forma checklist would not provide the latitude necessary to effectively review periodic reports.

We agree that professional judgment is essential. But we believe specific guidance on how and what to review can help reviewers use their professional judgment more effectively. Specific guidance would help assure Commission management that at least certain minimal steps are taken during the reviews.

Such guidance should incorporate the Commission's experience of what analyses are important and have proven effective. This may keep new or inexperienced reviewers from wasting time on analyses that are not useful and may keep them from overlooking analyses that are important. Judgment could then be exercised in making analyses beyond those proven by Commission experience and in deciding what the results mean and what action should be taken.

Accordingly, we believe you should assign a team to identify those elements that staff should look for in reports and direct attention to those analyses that have proven useful through institutional experience. The team findings should be used to create appropriate guidelines for reviewers.

<u>Establish a process to check quality of staff reviews</u>

In addition to providing guidance, we believe you would benefit from establishing a quality control check to monitor the adequacy of staff reviews. When we made our review we noted that little time or emphasis was given to checking the adequacy of these reviews, even by supervisors. Supervisors normally reconsidered questions or problems that arose during a review by the professional staff. They generally did not, however, thoroughly review what was or was not done, or the reasonableness of the reviewer's judgment about what merited further investigation. The philosophy behind this approach, as communicated to us, was that the individuals reviewing the reports were professionals who assumed the responsibility of doing an adequate review.

It was difficult to ascertain the quality of staff reviews because records of work done were incomplete. However, both our limited work and a review by Commission staff indicated that better control was needed.

Guidelines issued by the Corporation Finance Division directed reviewers to include in the company file a clearance memorandum for each report reviewed, indicating what action they took. This instruction was neither fully followed nor enforced. In case files we reviewed, the memorandums were sometimes incomplete or absent, and seldom indicated the type of review made. In a test analysis of reports from 12 corporations, we identified 4 reports with fluctuations and erratic financial patterns that appeared significant enough to need clarification. As best we could determine, however, the Commission staff either did not identify three of these fluctuations or did not seek to have them clarified. The staff did seek additional information in the fourth case, but no response was ever received from the corporation and no followup action was taken.

The same problems with clearance memorandums were noted in a recent analysis of a sample of 150 annual 10K reports. Commission supervisory accountants considered the quality of reviews and in a few cases also questioned whether actions indicated necessary were taken.

An ad hoc quality evaluation was also made by a Commission team to assess the work done by the staff in reviewing reports. As pointed out by the Commission team, quality review can help identify training needs and ensure consistency in dealing with companies of a given industry. It can also serve management in an important way by identifying common problems as well as the need for new analysis and information to replace that which is obsolete.

For these reasons, we think you should consider making this quality review process a recurring procedure. At a minimum, you should instruct supervisors to see that staff follow established guidelines. Without the documentation called for by the guidelines, the extent of review and analysis cannot be fully verified by Commission management.

<u>Use the computer for financial analysis</u>

Two of the most useful techniques for analyzing both financial data and a firm's financial condition are ratios and comparisons. Ratios demonstrate a significant connection between two important elements of a company's financial statements. Comparisons and ratios can be applied both to the financial information about one entity and to equivalent information about many firms in the same industry.

To the extent such analyses were made, Commission staff members did them manually. We learned from staff members that they did not make more use of these analytical review techniques because they did not have the time.

We believe that computers could be effectively used in making financial analyses. Two things that computers can do well are performing mathematical computations and making comparisons. They can do them incredibly fast and virtually without error. Accordingly, it would seem that a computer could be readily used to perform the basic ratios and comparisons normally made for firms in particular industries. A computer might also be used to screen reports and identify those warranting a more thorough review. The Internal Revenue Service effectively uses computers to screen tax returns.

This use of computers has the potential both to make more analyses than staff are currently making and to free staff time. This time could be used to make any special analysis that may be indicated and to give more 10K and 10Q reports a thorough review.

Accordingly, we believe that in conjunction with deciding what criteria should be included in reviewers' guidelines, you should assess the feasibility of using computers to make analyses and thereby free staff time.

Promote efficiency by specialization

At the time of our review, the Corporation Finance Division policy for reviewing annual 10K and quarterly 10Q reports was to assign the workload evenly among branches without much regard for the type of industry concerned. In accordance with this policy, staff accountants were responsible for reviewing accountants' reports, examining financial statements, and analyzing summaries of operations included in periodic reports. A tremendous amount of current knowledge was required to meet these accounting responsibilities for the oil and gas, public utility, insurance, and other registered companies in some 50 specialized industries. It was difficult to keep current on the complexities of all the industries and their special accounting requirements and operating problems.

We believe that specialization of staff would promote efficiency. The complexities facing a reviewer would be limited to those issues arising in the particular industry or segment. Staff expertise could be concentrated in one area of responsibility and the staff could more efficiently carry out its assignments whether it be on full or abbreviated reviews.

The concept of specialization is not new. It has been discussed previously by the Commission. It has also been applied to industries considered to be potential problems, such as oil and gas firms and bank holding companies. Commission management has assigned reports of these industries to special groups for review during certain periods.

Since our work was completed, a plan for reorganizing the disclosure operations of the Corporation Finance Division has been implemented. Commission staff told us that the concept of specialization has been adopted as part of the reorganization. This positive step, which addresses our suggestion, should enable the Commission to make more efficient and comprehensive reviews of filed reports.

## DELINQUENT REPORT PROGRAM NEEDS REFINEMENT

In 1974 the Commission started a special delinquent report program. Its purpose was to identify companies failing to file required reports, persuade delinquent companies to file missing reports, and when appropriate, take remedial enforcement action. At the heart of this program was a computerized information file containing data on reports missing, periods covered, and brief comments on why companies had not submitted required reports. Information could also be obtained directly from the computer file by using a computer terminal.

This program was not working as well as it might. Opportunities exist for improvement, such as

--eliminating errors in the computer files as well as errors and unnecessary information in listings of delinquent reports,

--establishing better procedures for following up on delinquent reports, and

--reevaluating the effectiveness of the delinquent reports program in getting companies to file reports on time.

### Improve accuracy and usefulness of delinquent report listings

The Office of Data Processing was responsible for operating the computer system. It entered data on reports received and monthly prepared three different listings of companies delinquent in filing reports. These listings had many errors, primarily because the computer data file contained inaccurate data. The lists also contained unneeded information.

The Commission staff acknowledged that the computer data files contained incorrect information and that delinquency reports were not up to date. As a result, the listings were not fully relied on, and when they were, followup action was often made to companies who had filed the required reports. Substantiating this, we found that of 94 companies which had been sent letters notifying them they were delinquent, 20 (21 percent) actually had filed their reports on time.

As an alternative to relying on the listings, users checked with outside sources. These sources included information from the major exchanges and the National Association of Securities Dealers. Commission staff also accessed the computer file directly, using terminals. But since the files contained inaccurate information, the information obtained in this way was sometimes inaccurate too.

Another problem with the delinquent report listings is that they contained unneeded information. For example, one listing showed companies to be delinquent that were inactive, in bankruptcy, or otherwise exempt from the Commission's reporting requirements. Commission staff agreed that since no followup action was taken on such companies, no useful purpose was served by continuing to list them as delinquent. One official estimated that as many as 1,800 companies could be segregated from the delinquency listing and shown only on a separate listing as needed.

It also appeared that the three different monthly listings contained essentially the same information. One of the listings was used by the Office of Reports and Information Service for following up on delinquent reports and the other two listings were sent to the Corporation Finance Division and the Enforcement Division. Operating personnel of these divisions said they made little or no use of the listings. They agreed that the listings could be discontinued since more useful and accurate information could be obtained, if needed, from docket files and directly from the computer. Discontinuance of two of the three monthly listings--which were issued in triplicate and averaged about 500 pages in length--would result in elimination of approximately 36,000 pages of unneeded data annually

Improve efficiency and effectiveness of followup actions

Responsibility for following up on delinquent reports was not clearly defined. As a result, three different staffs spent time identifying delinquent reports and sending follow-up letters, sometimes to the same companies. The three staffs were the Office of Reports and Information Services, the Division of Enforcement, and the Division of Corporation Finance.

While there may be legitimate need for some overlap between organizations in following up with delinquent companies, duplication of effort would be minimized if the responsibility for followup were assigned to one organization. The Office of Reports and Information Services seems to be the logical office with which to place this responsibility.

Potential also existed for reducing the cost of preparing followup letters. Commission organizations currently send typewritten letters to delinquent companies. The Documents Control Branch, Office of Reports and Information Services, for example, sends about 10,000 typewritten letters annually with copies made for distribution. Since the letters are reasonably standard, we believe they could be prepared more quickly and economically by using the computer. The National Association of Securities Dealers uses this technique in communicating with delinquent members.

Evaluate effectiveness of actions against delinquent companies

A considerable amount of resources was spent by the Commission, the National Association of Securities Dealers, and the major stock exchanges in following up on the large number of companies failing to file required reports. However, the number of delinquent companies had not dropped appreciably. According to Commission records, about 2,600 of the 9,400 companies registered with the Commission failed to file reports, or to file them on time.

The Commission is on record as stating that the timely filing of reports is essential to the preservation of a well-informed securities market. We were unable, however, to find what criteria the Commission uses to measure its progress in getting companies to file reports on time. Commission representatives agreed that they have no way of knowing the effectiveness of the delinquency followup program and that such knowledge would be useful in plotting future followup action.

The most important issue to be addressed is what more can the Commission do to insure that companies file timely reports which the public can use to make informed investment decisions. To find the answer, we believe the following questions should be asked:

--Are the same companies consistently late in filing delinquent reports? If so, why?

--Should more stringent punitive actions be taken against delinquent companies, especially those who are habitually late in filing required reports?

--Should the program be more closely coordinated with those of the major stock exchanges and the National Association of Securities Dealers to reduce duplication and costs?

The answers to these questions should be considered in any effort to improve the delinquent report program.

## COMMISSION'S CREATION OF AN INTERNAL AUDIT FUNCTION IS COMMENDABLE

The Commission's decision to seek funding for the establishment of an internal audit function in 1979, and the appointment of a director in April 1980, are commendable. We in GAO have long advocated the benefits of effective internal audit to good management. Internal auditors can act as management's eyes and ears by doing the things executives and managers would do if they had the time. We are confident the Commission will find the internal audit function to be an asset to management as it provides information and suggests corrective actions to solve problems like those facing the agency at the time of our review.

## RECOMMENDATIONS

In summary we recommend that you consider taking the following actions to improve the efficiency and effectiveness of Commission efforts to monitor whether companies filing reports under the securities acts are meeting disclosure requirements.

--Prepare more detailed guidelines telling the reviewing staff what vulnerabilities they should look for and what analysis they should make in reviewing reports.

--Establish a quality review process to (1) check the adequacy of staff reviews, (2) see that staff follow Commission guidelines, and (3) identify the need for new data and analysis and possible obsolescence of present data and analysis.

--Investigate the benefits of using computers to assist in making financial analyses.

--Improve the accuracy of computer files and delinquent report listings and eliminate unnecessary information from these listings.

--Establish better procedures for following up on delinquent reports to minimize duplication.

--Evaluate the effectiveness of the delinquent reports program and the remedial action the Commission is taking against delinquent companies.

## ACTIONS TAKEN BY COMMISSION STAFF

We discussed our findings and recommendations with members of your staff. Significant action has been taken by them on the areas discussed in this report. A reorganization of the disclosure operations of the Division of Corporation Finance has resulted in the adoption of the specialization concept for reviewing reports and the establishment of a quality control unit. One of this unit's responsibilities is the issuance of detailed review guidelines for use by the staff. The hiring of a contractor to provide computer analysis of report data is also being reviewed by the Commission's Executive Director. In addition, a study to improve the delinquency report program is underway. These actions parallel and address the problems facing the Commission at the time of our review. If fully carried out, the actions should improve the Commission's ability to monitor disclosures made by reporting companies for the benefit of investors.

## SCOPE OF REVIEW

Our review effort was directed toward examining the Commission's procedures for monitoring the disclosure requirements which Regulation S-X prescribed for financial reporting, and other requirements for periodic reports under the Securities Act of 1933 and the Securities Exchange Act of 1934. We examined legislation, policies, procedures, documents, and reports. We reviewed records in the Offices of the Chief Accountant and Reports and Information Services, also in the Divisions of Enforcement and Corporation Finance, and in branch offices in Boston, Miami, Fort Worth, and Los Angeles.

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As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations. You must send the statement to the House Committee on Government Operations and to the Senate Committee on Governmental Affairs within 60 days of the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made over 60 days after the date of the report.

We are sending copies of this report to the Director of the Office of Management and Budget, the three Committees mentioned above, the Senate and House Banking Committees, the House Interstate and Foreign Commerce Committee, and the Governmental Efficiency and District of Columbia Subcommittee of the Senate Governmental Affairs Committee.

We would appreciate receiving your comments on any actions you take or plan to take on the matters discussed in this report.

Sincerely yours,

D L Scantlebury

D. L. Scantlebury
Director