Bloomberg Law

The SEC Is Scrutinizing 'Earnings Management Practices'
Bloomberg Law
Jina Choi and Andre Fontana
October 6, 2021
[Link]

The SEC continues to crack down on companies that manipulate earnings data to meet forecasts, and are using data analysis to detect suspicious activity, say Morrison & Foerster partner Jina Choi, a former regional director of the SEC, and associate Andre Fontana. They urge companies to pay close attention to their accounting controls.

The Securities and Exchange Commission continues to scrutinize and investigate public companies for "earnings management practices." Under its data-driven Earnings Per Share (EPS) Initiative, the SEC has filed charges against three companies and four individuals since September 2020, levying a total of over $12 million in civil penalties. Three executive officers have agreed to be suspended from appearing and practicing before the SEC as accountants because of the charges.

Companies should be aware that the SEC will not simply wait for issuers to announce restatements or self-report conduct to initiate investigations. In addition to fielding tips from whistleblowers, the SEC has been monitoring and analyzing data through its EPS Initiative to open investigations into potential accounting and disclosure violations stemming from earnings management practices—violations that are otherwise often difficult to detect.

Three EPS Actions to Date

In September 2020, the SEC first set forth its EPS Initiative at the same time it announced settling separate actions against two public companies. Both settlements alleged violations that resulted in improper reporting of quarterly EPS that met or exceeded analyst consensus EPS estimates.

In one case, the SEC issued an order finding that Interface, a Georgia-based designer and manufacturer of modular carpet, made a series of unsupported, manual accounting adjustments in several quarters. From Q2 2015 to Q2 2016, the SEC found that Interface's then-corporate controller and chief accounting officer and its then-CFO directed or otherwise caused others to book unsupported, manual accounting adjustments to Interface's management bonus accruals, expenses related to an independent consultant, and stock-based compensation expenses.

These adjustments were often made when Interface's internal forecasts indicated that the company would likely fall short of consensus EPS estimates. These quarterly adjustments, however, boosted the company's income and made it possible for the company to meet or exceed the consensus estimates for these five consecutive quarters.

Finding these actions violated federal securities laws, the SEC fined Interface $5 million, its chief accounting officer $70,000, and its CFO $45,000. The former officers also agreed to be suspended from appearing and practicing before the SEC as accountants.

The SEC also issued an order finding that Fulton, a Pennsylvania-based financial services company, inaccurately described in its public filings the process it used to value its mortgage servicing rights (MSR). The SEC found that for two quarters, Fulton stated that it was on track to meet or beat consensus EPS estimates.

During these quarters, however, Fulton deviated from its publicly stated valuation method for its MSR: instead of following its valuation method, which would have led to a $3 million allowance reversal, Fulton chose to

Reproduced with permission. Published Oct. 6, 2021. Copyright 2021 The Bureau of National Affairs, Inc. 800-372-1033. For further use, please visit http://www.bna.com/copyright-permission-request/

selectively reverse $1.7 million but maintain $1.3 million MSR valuation allowance. With this valuation allowance still on the books, Fulton was able to just beat consensus EPS estimates for the quarter.

Fulton then belatedly reversed the $1.3 million allowance in the following quarter, which allowed Fulton to meet consensus expectations of which it otherwise would have fallen short. The SEC alleged that Fulton's disclosures gave the misleading impression that the reversal of the valuation allowance was timely when it was two quarters late. Finding that these actions violated federal securities laws, the SEC fined Fulton $1.5 million.

More recently, in August 2021, the SEC issued an order that charged Healthcare Services Group (HCSG)—a Pennsylvania-based provider of housekeeping, dining, and other services to healthcare facilities—with failing to properly record loss contingencies in several quarters over two years. At the end of 2013, HCSG was facing eight pending labor and employment class or collective actions by current or former employees.

Starting in 2014, HCSG negotiated and ultimately sought approval for settlement of the eight actions, triggering an obligation for HCSG to account for the litigation in a manner consistent with the status of the negotiated settlements. The SEC's order found that the company and its CFO failed to timely accrue for and disclose material loss contingencies related to the pending settlements in accordance with GAAP.

The SEC fined HCSG $6 million, its former CFO $50,000, and its former controller $10,000. The former CFO also agreed to be suspended from appearing and practicing before the SEC as an accountant.

Common Elements and Takeaways

Although the SEC has not set forth what in an issuer's data may raise red flags in the EPS Initiative, there are certain common elements among the three actions:

The companies met or exceeded analyst consensus EPS estimates for several consecutive quarters, often by as little as a penny. Despite meeting or exceeding estimates for several consecutive quarters, each company experienced significant drops in EPS.

The SEC alleged that each company would not have been able to meet quarterly EPS estimates had they not engaged in practices that the SEC seemed to find manipulative or disingenuous, including making manual adjustments without documentary support and not following established and disclosed valuation methodology. The SEC accused each company of failing to maintain sufficient internal accounting controls or failing to ensure compliance with its internal accounting controls.

Considering these actions under the EPS Initiative, public companies should pay attention to the data, metrics, and communications they disclose; document accounting judgments contemporaneously; maintain robust internal accounting controls; and ensure and oversee compliance with those accounting controls.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owner.

Author Information

Jina Choi is a partner of Morrison & Foerster and previously served as director of the San Francisco Regional Office of the SEC.

Andre Fontana is an associate in the Litigation Department of Morrison & Foerster's San Francisco office.

Reproduced with permission. Published Oct. 6, 2021. Copyright 2021 The Bureau of National Affairs, Inc. 800-372-1033. For further use, please visit http://www.bna.com/copyright-permission-request/