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SEC Continues to Scrutinize Earnings Management Through Its EPS Initiative

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On August 24, 2021, the SEC announced a settled enforcement action against Pennsylvania-based Healthcare Services Group, Inc. (HCSG) and its former CFO for accounting and disclosure violations that resulted in the company reporting inflated earnings per share (EPS) that met research analysts' consensus estimates for multiple quarters. The SEC also charged HCSG with failing to keep accurate books and records and sufficient internal accounting controls, and charged its former controller with causing those violations.

Following two cases from last year, the action against HCSG is the third enforcement action—and likely not the last—resulting from the SEC's EPS Initiative, which was created to use data analytics to uncover potential accounting and disclosure violations caused by earnings management practices. In the three cases brought under the EPS Initiative, each issuer had patterns of meeting or slightly exceeding consensus EPS estimates for consecutive quarters, followed by significant drops in EPS. The consequences have not been mild: the three companies caught in the crosshairs of the EPS Initiative paid a total of over $12 million in penalties and charges were brought against individual officers who agreed to pay significant fines as well as to be denied the privilege of appearing or practicing before the Commission as an accountant, with permission to reapply after one to three years.

As the SEC continues to scrutinize earnings management practices, issuers should:

- **pay close attention to the data and metrics they disclose;**
- **document their accounting judgments; and**
- **ensure compliance with their disclosure controls and procedures.**

Case Background

According to the SEC's Order, HCSG, a provider of housekeeping, dining, and other services to healthcare facilities, had been facing at least 10 labor and employment class or collective actions by current or former employees in 2013. By year's end, two cases had settled, while the remaining eight were pending. Starting in 2014, HCSG negotiated and ultimately sought approval for settlement of the remaining cases, 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 describes the company and its CFO as failing to timely accrue for and disclose material loss contingencies related to the settlement of the remaining private litigation against the company in accordance with GAAP.

The SEC alleged that, had HCSG properly recorded the financial impact of the loss contingencies when they were probable and reasonably estimable (in accordance with GAAP), the company would have reported lower EPS and missed research analysts' estimates in several quarters—some by as little as a penny. Instead, HCSG ended up accruing for the loss contingencies in quarters when it would report missing estimated EPS by wide margins. By seemingly picking and choosing when to accrue for the loss contingencies, HCSG was able to report multiple quarters of EPS growth, including "record-high" EPS. Therefore, the SEC alleged, HCSG's financial statements filed with the Commission were materially misleading during these periods.

HCGS paid $6 million to settle negligence, financial reporting, books and records, and internal controls violations. The former CFO paid a $50,000 penalty and agreed to be suspended from appearing and practicing before the SEC as an accountant, with the right to apply for reinstatement after two years, for negligent disclosure violations and causing HCSG's violations. The former controller was charged with causing the company's books and records and internal controls violations and agreed to pay a $10,000 penalty.

Takeaways

The question we receive from clients time and time again is when does responsible financial and operational management cross the line to inappropriate earnings management and what is the risk that the SEC will come knocking. The cases coming out of the SEC's EPS Initiative show that if issuers are seen to be "managing" or manipulating their earnings to give an overly positive view of their operations and finances, the SEC may investigate and if a company is found to have engaged in improper accounting and disclosure practices, the SEC will not hesitate to bring an action.

Given that rooting out accounting and disclosure fraud in the context of earnings management is a clear priority for the SEC, here are a few takeaways for issuers when it comes to the EPS Initiative and earnings management cases:

- **To assess your risk, pay attention to your data.** The EPS Initiative uses risk-based data analytics to uncover potential accounting and disclosure violations. In the three cases brought by the SEC under its EPS Initiative, each issuer had patterns of meeting or slightly exceeding consensus EPS estimates for consecutive quarters, followed by significant drops in EPS. The issuers also touted record-high or record-setting EPS. Issuers should review and examine their own data, metrics, and communications to assess the risk of being swept up in the EPS Initiative.
- **Materiality: The adjustment amounts need not be huge to look manipulative.** The cases in the EPS Initiative don't involve massive adjustments. Rather, these cases generally involve smaller adjustments made consistently over multiple quarters that affected the company's EPS, often by pennies. The SEC appears to have concluded that these adjustments are qualitatively material.
- **Document accounting judgments.** The HCSG case serves as an example where adjustments were made without adequate documentation. Whether in the quarter-end closing process or in its analysis of a litigation loss contingency, HCSG did not document why it made particular adjustments. The SEC pointed out that HCSG's finance staff regularly recorded manual journal entries with no or inadequate documentation. And the SEC's case against HCSG's controller seems rooted in the fact that she was responsible

for ensuring that all accounting entries were supported by adequate documentation. Without contemporaneous documentation, adjustments and manual journal entries made at quarter-end—that also happen to guarantee meeting analyst expectations—will appear self-serving and manipulative.

- **Pay attention to your policies and procedures and make sure they are being followed.** HCSG actually had policies and procedures requiring that accounting entries have adequate supporting documentation. The company also had a Disclosure Control Committee that met each quarter to ensure that adequate disclosure controls and procedures (DCPs) were developed, documented, and implemented; in turn, these DCPs were made to ensure that the company's financial statements and disclosures were complete and accurate. But the SEC accused the company of failing to follow its own policies and procedures, and its controls did not seem to have caught those instances of non-compliance. It is important that companies develop appropriate DCPs, follow them, and have some sort of mechanism or audit trail to verify and document that they are being followed.