LATHAM & WATKINS

Client Alert Commentary

Latham & Watkins Securities Litigation & Professional Liability Practice

October 14, 2020 | Number 2805

SEC Announces First "EPS Initiative" Enforcement Actions

The enforcement actions provide early clues on how the SEC's "risk-based data analytics" may flag public companies for investigation.

Key Points:

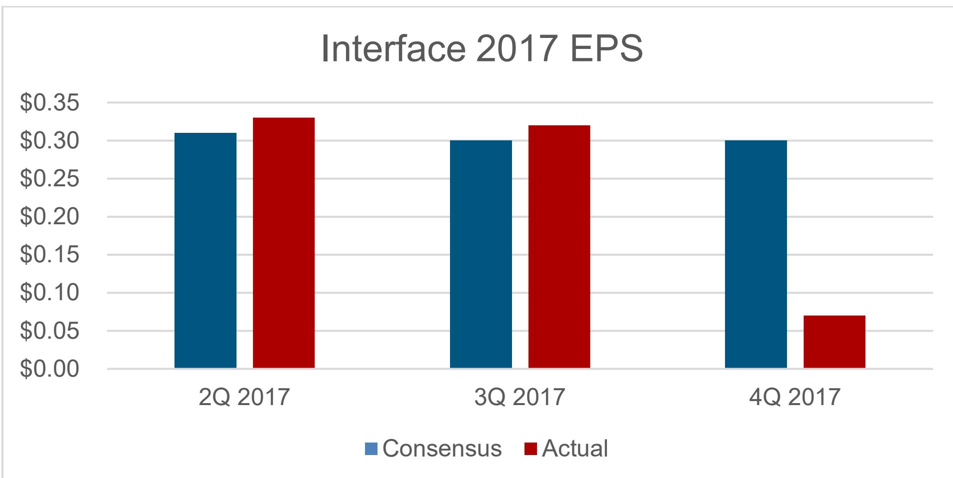
- On September 28, 2020, the US Securities and Exchange Commission (SEC or Commission) announced the first two settled actions arising from the Division of Enforcement's EPS Initiative, which applies data analytics to detect earnings management practices that may expose potential accounting and disclosure violations.
- Both settling issuers had patterns of meeting or slightly exceeding consensus EPS estimates for consecutive quarters, followed by significant drops in EPS, suggesting similar patterns may trip the SEC's data-monitoring protocol.
- The small misstatements at issue in the settled orders suggest the SEC is using the EPS Initiative to develop cases under a theory of materiality based on qualitative factors.
- Issuers that are flagged for investigation may face scrutiny for conduct unrelated to the EPS patterns or drops that triggered the investigation.
- Issuers should look carefully at EPS reporting that could make the difference between meeting or missing EPS consensus estimates, even if the difference is not quantitatively significant.

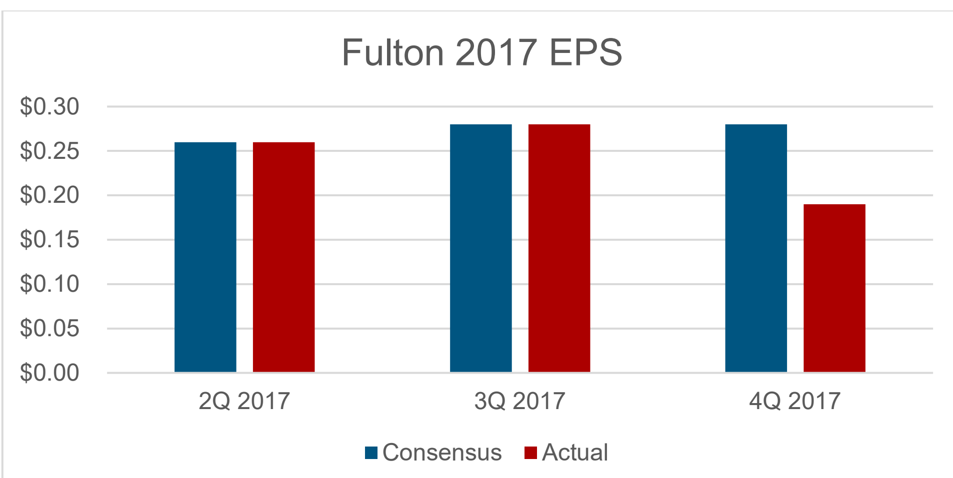
On September 28, 2020, the SEC announced settled actions against Fulton Financial Corporation (Fulton) and Interface Inc. (Interface) along with Interface's CFO and Controller, touting the actions as the first generated through its EPS Initiative.[1] Although the SEC had not previously publicized the EPS Initiative, in 2018, news outlets reported that the SEC staff had requested information from issuers related to accounting adjustments that could be used to inflate EPS.[2] Speculation at the time suggested the SEC had keyed into a trend identified in academic literature of statistical anomalies in disclosed EPS figures across public companies. The *Wall Street Journal* reported in 2018 that an academic paper identifying these anomalies was "widely read within the SEC."[3]

Whether or not the academic literature prompted the Enforcement Division to undertake the EPS Initiative or informed its analytical framework, the Commission's press release echoes the conclusion reached in the literature: the Enforcement Division has in its sights potential improper earnings management practices and is trying to identify them through analysis of a broader set of EPS data. In the SEC's press release, an Associate Director in the Enforcement Division, acknowledged that improper quarterly adjustments may be "difficult to detect" but "can have a material impact on reported EPS and how investors view a company's reported financial results."[4] The EPS Initiative is in line with the Enforcement

Division's broader shift to data-driven case identification processes. Enforcement Division Co-Director Stephanie Avakian noted in a September 17, 2020, speech that the Enforcement Division is taking "proactive efforts to identify cases," utilizing "internal and external tools" and "other information sets" to identify potential misconduct.[5]

So what types of data may appear on the EPS Initiative's radar? While reverse-engineering requires a sample size greater than two issuers, trends do emerge from these two settled actions. Fulton's and Interface's reported EPS figures show a multiple-year pattern of meeting or exceeding consensus EPS estimates over several quarters, followed by a sudden and substantial drop far below consensus estimates. In 2017, for example, as shown in the charts below, Interface and Fulton each met or exceeded consensus EPS in the second and third quarters, before posting below-consensus, five-year lows for EPS in the fourth quarter.[6]





The Enforcement Division may view these substantial misses as corrective "true-ups" resulting from prior improper inflationary adjustments. In that sense, sudden EPS drops following periods of meeting or exceeding consensus estimates could be the canaries in the coal mine flagging small but improper adjustments taken by an issuer in prior periods to meet or exceed consensus estimates. This suggests the Enforcement Division may be using the EPS initiative to combat EPS smoothing — a practice by which issuers manipulate earnings to portray to the market consistent growth rather than quarterly ups and downs[7] — and as a means (ironically) of using *quantitative* analysis to build cases predicated on a *qualitative* materiality theory.[8] Accordingly, issuers with similar patterns of sudden drop-offs in EPS following sustained streaks of meeting or exceeding consensus estimates should be mindful of potential regulatory scrutiny and take proactive steps to ensure the soundness of their internal reporting processes.

Fulton Financial Corporation

Fulton is a financial holding company that operates regional banks in the mid-Atlantic. The SEC's order found that Fulton deviated from the process described in its public filings to value assets in its mortgage servicing rights (MSR) business, and thereby misstated quarterly EPS from late 2016 through mid-2017. The Commission found that Fulton violated Exchange Act Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B), and Exchange Act Rules 12b-20, 13a-1, and 13a-13.

Fulton's stated policy for valuing its MSR assets involved performing internal valuations and relying on an independent valuation expert to assess the need for valuation allowances in the event the assets became impaired. Fulton followed that policy through the third quarter of 2016. As of 4Q 2016, Fulton carried a valuation allowance of $3 million against its internal valuation of the MSR assets. In November 2016, Fulton asked its independent expert to prepare an interim report on the MSR assets. That report indicated a significant increase in value of the MSR portfolio and, assuming Fulton incorporated the expert's valuation in line with its stated procedures, justified the reversal of the entire $3 million allowance. A reversal of $3 million would have increased Fulton's EPS by slightly more than a penny. With the valuation allowance intact, Fulton would have met consensus EPS estimates for the quarter, whereas removing the allowance would have increased EPS above the quarterly consensus estimate.

The SEC's order found that Fulton deviated from its standard process for incorporating the expert's valuation, and elected to reverse only $1.7 million of the total $3 million allowance, leaving a $1.3 million allowance on the books. The SEC also found that Fulton persuaded the expert to modify its final report to show a lower valuation than the expert originally reported. The lower valuation allowed Fulton to memorialize a smaller proposed, but unrecorded, allowance adjustment. In a subsequent internal memorandum, Fulton omitted any mention of the original valuation in the expert's final report and Fulton's communications with the expert about lowering the valuation.

The expert's 1Q 2017 valuation report showed a further increase in the value of Fulton's MSR portfolio, which, according to Fulton's written policies, justified the reversal of the remaining $1.3 million allowance. Fulton again opted not to execute the reversal, and kept the full $1.3 million allowance intact. Fulton beat consensus EPS estimates by two cents that quarter.

In 2Q 2017, Fulton elected to reverse the remaining valuation allowance — a reversal that was, once again, supported by the expert's quarterly valuation. Absent the reversal in 2Q, Fulton would have missed consensus EPS estimates by a penny.

Ultimately, the SEC found that Fulton's selective adherence to its written valuation policy "created the appearance of consistent earnings trends across reporting periods and deprived investors of the ability to understand management's involvement in fair value calculations."

Interface Inc. et al.

Interface is a Georgia corporation that designs and manufactures modular carpet. The SEC's order found that Interface's CFO and Controller booked or directed others to book unsupported manual accounting adjustments to Interface's management bonus accruals, the valuation of the cash surrender value of a consultant's life insurance policy (the CSV Asset), and stock-based compensation expenses for the purpose of manipulating Interface's reported EPS. The misstatements occurred between 2Q 2015 and 2Q 2016. The Commission found that: Interface violated Securities Act Sections 17(a)(2) and (3); Exchange Act Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B); and Exchange Act Rules 12b-20, 13a-1, 13a-11, and 13a-13; the Controller willfully violated Securities Act Sections 17(a)(2) and (3) and Exchange Act Rule 13b2-1, and caused Interface's Exchange Act violations; and that the CFO willfully violated Exchange Act Rule 13b2-1 and caused Interface's Exchange Act violations.

In 2Q 2015, Interface reported EPS of $0.33, which, according to its earnings release, was the highest the company had ever reported. It was also a 65% increase over 2Q 2014. The SEC found that Interface overstated EPS for 2Q 2015 by $0.02 based on the Controller's manipulation of the management bonus accrual. This was the third consecutive quarter that Interface met or exceeded analyst consensus EPS.

In 3Q 2015, Interface reported EPS of $0.31, which met analyst consensus EPS. The SEC found that Interface overstated EPS by $0.04 based on the Controller's failure to write down sufficiently the value of the CSV Asset, the Controller's improper accounting for stock-based compensation expenses, and because the CFO and Controller understated separate bonus accruals for management and a consultant. The improper write-down and understated stock-based compensation expense each increased EPS by almost $0.01. The understated bonus accruals increased EPS by $0.016 and $0.002, respectively.

In 4Q 2015, Interface reported quarterly EPS of $0.28 and annual EPS of $1.10. The annual EPS beat consensus estimates by $0.02, but the quarterly EPS missed consensus by $0.02. Interface's earnings release described a "phenomenal year" and noted that the annual EPS number was an "all-time record." The SEC found that the Controller continued to overstate the value of the CSV Asset, which inflated EPS by $0.01, and understated accruals and expenses related to bonuses, which inflated EPS by an additional $0.01. Interface's Form 10-K disclosed that the company had approximately $24.8 million of company-owned life insurance, which was measured on readily determinable cash surrender value on a recurring basis. The CSV Asset made up a portion of this figure.

In 1Q 2016, Interface reported EPS of $0.20, which met consensus estimates, according to the SEC's order.[9] The order also noted that this represented a "quarter-over-quarter increase of $0.01." The SEC found that Interstate overstated quarterly EPS by $0.03, which the order points out would have been "a $0.02 quarter-over-quarter decline and a $0.02 miss of consensus." The SEC found that the CFO and Controller continued to make increasingly egregious manual entries that did not comply with GAAP in the same accounts in order to inflate EPS.

In 2Q 2016, Interface reported EPS of $0.32, which Interface described in its earnings release and earnings call as "strong," the "second best quarterly earnings ever," and "just a penny short of the all-time record." The report exceeded consensus estimates by $0.03. The SEC found that the CFO and Controller continued to even more blatantly manipulate the same accounts, including leaving the CSV Asset on Interface's books when its value had reached zero, which had the effect of inflating quarterly EPS by $0.02.

The SEC's order also noted that Interface employees produced falsified or newly created documents during the investigation.

Though not mentioned in the SEC's order, in 4Q 2016 Interface reported quarterly EPS of $0.07 EPS, which was $0.17 lower than consensus estimates and $0.21 lower than 4Q 2015. Interface again reported EPS significantly below consensus estimates in 4Q 2017, 3Q 2018, and 4Q 2018.

Key Takeaways

EPS Initiative Risk Factors

The SEC has publicized new tools it will use to hunt for earnings management. Issuers should not manage earnings, and should be mindful of even small adjustments that could give the appearance of earnings management.

Extended periods of barely meeting or exceeding consensus EPS estimates — streaks that are viewed as improbable in the long run unless material non-public information is shared to the market or earnings numbers are manipulated — may flag the EPS Initiative's data analytics, particularly if those streaks of meeting or exceeding consensus end with a sharp drop in EPS.

Scrutiny of the Commission's orders and the settling issuers' financials and press releases reveals several other commonalities that may function as risk factors drawing Commission scrutiny:

- Both actions involved issuers that incorporated manual adjustments to accounting estimates requiring significant managerial judgment.
- Both actions involved findings that internal controls over those accounting estimates were deficient to safeguard against management manipulating EPS.
- Both actions involved issuers whose quarterly earnings releases called out record-setting EPS figures.

Issuers Should Mind the Little Items

Besides showing that the SEC's data analytics can uncover latent misconduct, the Fulton and Interface actions reaffirm the SEC's commitment to pursuing accounting and disclosure actions even when the alleged misstatements are not quantitatively significant. Both cases involved small quarterly inflations that would not generally meet the commonly cited 5% rule of thumb for quantitative significance, but both issuers were able to meet or exceed the EPS consensus (a factor supportive of finding materiality based on *qualitative* factors) by making small adjustments in discrete financial statement items. Issuers reviewing their own disclosures and accounting should flag even modest adjustments that could be the difference between exceeding EPS consensus or disappointing the market.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

John J. Sikora Jr.
john.sikora@lw.com
+1.312.876.6580
Chicago

Eric R. Swibel
eric.swibel@lw.com
+1.312.777.7185
Chicago

Heather A. Waller
heather.waller@lw.com
+1.312.876.6554
Chicago

Jack M. McNeily
jack.mcneily@lw.com
+1.312.876.6520
Chicago

Adam L. Rosenbloom
adam.rosenbloom@lw.com
+1.312.876.6563
Chicago

You Might Also Be Interested In

Securities Litigation Trends During Covid-19

US Supreme Court Upholds SEC's Authority to Seek Disgorgement

SDNY: Syndicated Loans Are Not Securities

The SEC Continues Its Enforcement Streak Against Unregistered Token Offerings

Endnotes

[1] SEC Charges Companies, Former Executives As Part of Risk-based Initiative, SEC Release No. 20-226 (Sept. 28, 2020); *In the Matter of Fulton Fin. Corp.*, SEC. Release No. 4174 (Sept. 28, 2020); *In the Matter of Interface, Inc., Gregory J. Bauer, Cpa, & Patrick C. Lynch, Cpa*, SEC. Release No. 4175 (Sept. 28, 2020).

[2] *See*, *e.g.*, Dave Michaels, *SEC Probes Whether Companies Rounded Up Earnings Per Share*, Wall St. J., Jun. 22, 2018, https://www.wsj.com/articles/sec-probes-whether-companies-rounded-up-earnings-1529699702?mod=hp_lead_pos1.

[3] *Id*.; *see also* Nadya Malenko et al., *Quadrophobia: Strategic Rounding of EPS Data*, Sept. 28, 2009. Rock Center for Corporate Governance at Stanford University Working Paper No. 65, Stanford Law and Economics Olin Working Paper No. 388, Available at SSRN: https://ssrn.com/abstract=1474668.

[4] SEC. Release No. 20-226 (Sept. 28, 2020).

[5] Stephanie Avakian, Protecting Everyday Investors and Preserving Market Integrity: The SEC's Division of Enforcement, Remarks at the Institute for Law and Economics, University of Pennsylvania Carey Law School Virtual Program (Sept. 17, 2020).

[6] Consensus EPS estimates are as reported by Seeking Alpha.

[7] *See* Dan Seligman, *The Crusade Against Smoothing*, Forbes, Jun. 12, 2000, https://www.forbes.com/forbes/2000/0612/6514338a.html (commenting on the SEC's scrutiny of earnings smoothing, a "practice that mainly involves smoothing [earnings] out to show steady progress, rather than a lot of quarterly ups and downs").

[8] Staff Accounting Bulletin No. 99, SEC. Release No. 99 (Aug. 12, 1999) (noting the factors that "may well render material a quantitatively small misstatement" include "whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise").

[9] According to Seeking Alpha, consensus EPS for 1Q 2016 was $0.21.