Data Analytics Gives SEC Enforcement Edge On Earnings

By **Elisha Kobre** (September 1, 2021)

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In a sign that the U.S. Securities and Exchange Commission continues to ramp up its enforcement efforts, the SEC last week in In re: Healthcare Services Group Inc. charged a health care services company and its chief financial officer and controller as part of the Division of Enforcement's Earnings Per Share, or EPS, Initiative.

A Sept. 28, 2020, SEC press release described the initiative as "utiliz[ing] risk-based data analytics to uncover potential accounting and disclosure violations caused by, among other things, earnings management practices."[1] Including last week's action, the SEC has now charged three issuers under the EPS Initiative.

The SEC has never formally announced its EPS Initiative but has referred to it in press releases as a data analytics program focused on earnings per share reporting.

What is the EPS Initiative and what does it mean for issuers? The three charges brought to date under the program show that the SEC is now more than ever closely scrutinizing patterns in reported earnings per share as a means to uncover accounting and other potential securities violations.

The Healthcare Services Group case is a prime example of the EPS Initiative's use and efficacy in detecting accounting failures or financial misreporting and is a call for issuers to take active steps to head off potential inquiries and enforcement actions

Healthcare Services Group, or HCSG — a Nasdaq-traded company in the business of providing provides various services to health care facilities — had a consecutive four quarter streak of reporting EPS that either barely met, exceeded or fell just below analyst expectations.[2]

Then suddenly, in the following quarter, HCSG reported EPS that missed the consensus estimate by 100%. This pattern — extended period of just attaining or just missing consensus EPS estimates followed by a sudden sharp drop — was flagged by the EPS Initiative as suggestive of financial misreporting.

The theory is that the drop in EPS was, in essence, the unmasking of improper accounting or reporting used the prior quarters to maintain a consistent EPS in line with analyst expectations.

The SEC investigation that followed — initiated based on data analytics through the EPS Initiative — revealed that HCSG had, indeed, only managed to maintain a consistent EPS in line with consensus expectations by failing to properly accrue for or disclose loss contingencies relating to pending civil litigation in violation of generally accepted accounting principles.

In particular, HCSG failed to properly account for out-of-court settlements reached in a series of costly lawsuits. One the settlements were finalized, HCSG could no longer hide them from the company's auditors resulting in the sudden drop in EPS.

As a result of the investigation, HCSG and its CFO and controller faced substantial sanctions, including a $6 million civil penalty imposed on the company.

Key Takeaways From HCSG and the EPS Initiative

- Consecutive periods of closely meeting or exceeding consensus EPS estimates — which may indicate accounting practices designed to manipulate EPS — are likely to be detected by the EPS Initiative's data analytics, particularly if those periods end with a sharp drop in EPS.

- SEC follow-up investigations stemming from the EPS Initiative often result in serious sanctions against the company and charges against individual members of management found to have directed the improper accounting adjustments.

- Issuers should conduct periodic reviews of historical EPS data as a compliance tool and review their accounting and disclosures to ensure that no questionable practices result in the company's closely meeting or exceeding EPS estimates.

- To the extent an accounting practice or adjustment makes the difference between exceeding EPS consensus or disappointing the market, those practices should be fully and robustly disclosed in the Issuer's filings to head off SEC and other regulatory scrutiny.

September 2020 Charges Under the EPS Initiative

The SEC first publicly acknowledged the EPS Initiative in September 2020 when it brought its initial charges under the initiative against two publicly traded companies, Interface Inc. and Fulton Financial Corp.[3]

The common denominator of these cases and HCSG is that all three companies had, for several quarters, announced earnings that consistently met or exceeded consensus expectations followed by a sudden substantial drop in EPS. While the nature of the underlying accounting failures or financial misreporting differed in these cases, all were detected through the EPS Initiative's data analytics.

Interface, a Nasdaq traded manufacturer of modular carpet, had a year-long pattern of consistently just meeting or slightly exceeding analyst expectations for several quarters followed by a sudden steep drop in EPS.[4]

Apparently detected by the EPS Initiative, the SEC investigated. That investigation revealed that Interface's EPS figures during the period when earnings per share just met or slightly exceeded expectations were inflated as a result of unsupported, manual accounting adjustments to Interface's management bonus accruals, expenses and stock based compensation that did not comply with generally accepted accounting principles.

The subsequent sudden drop in EPS occurred following reversal of these manipulations. While HCSG had manipulated its EPS by failing to accrue litigation costs, Interface did so through improper manual adjustments.

Another variation is exemplified by yet another EPS Initiative case against Fulton Financial, also a Nasdaq traded financial holding firm. Fulton, like HCSG and Interface, reported a pattern of consistent earnings trends across reporting periods that was in reality, as later determined by the SEC, the result of management's intentional deviation from the company's stated valuation policy for particular assets.[5]

Unlike HCSG and Interface, however, Fulton used these deviations to intentionally lower, rather than inflate, its EPS just enough so that it would barely exceed analyst consensus expectations by a penny or two, presumably to provide a small but consistent outperformance of analyst expectations.

The intention appears to have been to reserve the EPS bump that would have resulted from a proper valuation for a future quarter when Fulton's EPS would otherwise fall below expectations.

Indeed, Fulton only applied the proper valuation policy — one that resulted in increased EPS — the following quarter, a period when the company would otherwise have missed consensus expectations.

The SEC's investigation concluded that Fulton's selective adherence to its 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."

Peloton?

One can speculate that the EPS Initiative may have played a role in the recent disclosure by Peloton Interactive Inc. of an SEC investigation concerning the company's public disclosures.

In its fiscal year 2021 Form 10-K filed this past Friday, Peloton announced that the U.S. Department of Justice and the U.S. Department of Homeland Security have subpoenaed the company related to Peloton's reporting of injuries associated with the Tread+ treadmill "and the SEC is also investigating our public disclosures concerning these matters."

Notably, Peloton's EPS reports throughout 2021 fit a pattern not dissimilar as the three EPS Initiative cases described above. In each of the first three quarters of 2021, Peloton reported EPS that beat estimates, though by large margins between 74% and 106% but announced last Thursday fourth quarter EPS that fell short of estimates by 74%.

Whether Peloton's announcement the very next day of the SEC investigation is, at least at this point, pure speculation. Many other factors could have caused the SEC to investigate Peloton's disclosures relating to the treadmill injuries.

But Peloton's EPS disclosures are a good example of the pattern the SEC appears to be looking for through the EPS Initiative.

Conclusion

Armed with the knowledge that the SEC is closely studying historical EPS data, issuers can

and should take several proactive steps to head off potential regulatory scrutiny or at least to be prepared to respond to inquiries.

These include: (1) conducting periodic quantitative self-audits of EPS data and other key financial statistics to identify patterns that might attract regulatory scrutiny; (2) using consistent accounting and other measures across reporting periods robustly disclosing, in advance, any changes that could be viewed as an effort to manipulate key financial statistics; and (3) ensuring that accounting and financial reporting policies, particularly those that may make the difference between meeting analyst expectations or not, are properly justified and fully and robustly reported.

While the EPS Initiative's focus on earnings reports is new, the SEC has, of course, long used data analytics to detect violations of the securities laws. Perhaps the best-known example is ARTEMIS, the Advanced Relational Trading Enforcement Metrics Investigation System used to detect insider trading.

According to the SEC, ARTEMIS "analyzes suspicious trading patterns and relationships among multiple traders."[6] Another example is the Exchange-Traded Products Initiative, which, like the EPS Initiative, "use[s] trading data analytics to uncover unsuitable trades of complex exchange-traded products in retail investor accounts."[7]

And the SEC's Division of Economic and Risk Analysis is a lesser-known division which, among other things, "develop[s] customized, analytic tools and analyses to proactively detect market risks indicative of possible violations of the Federal securities laws."[8]

It has been suggested that the SEC's recent focus on EPS through a quantitative lens may stem from academic literature describing the phenomenon of quadrophobia, or the under-representation of the number four in the first post-decimal digit of EPS.

The theory is that the rarity of a 4 in the first post-decimal digit is a result of management's incentives to round up reported EPS. At least one paper has concluded that "[q]uadrophobia is pervasive and persistent, and successfully predicts future restatements, SEC enforcement actions, and class action litigation."[9]

Significantly, quadrophobia was found to increase as firms gain analyst coverage and is especially strong when the result of rounding allows firms to meet analyst expectations.

It is likely that these and similar findings led the SEC to look at how other suspicious EPS patterns might be used to identify underlying accounting violations or disclosure issues ripe for further investigation.

Whatever the background of the program, it is likely a sign of more SEC's aggressive use of data analytics in aid of enforcement in the months to come.

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[1] https://www.sec.gov/news/press-release/2020-226.

[2] Healthcare Services Group, Inc., Securities Act Release No. 10967, Exchange Act Release No. 92735, Accounting and Auditing Enforcement Release No. 4244 (August 24, 2021). HCSG's streak was actually longer the four quarters but, as reflected in the SEC's Order, in one of the intervening quarters, HCSG took a large unrelated loss. The SEC Order concluded that Interface intentionally recorded a liability that should have been reported in a prior quarter instead in a quarter when the company reported a substantial net loss and loss per share and was in any event going to show a loss. Had HCSG accrued the liability in the prior period, which it was required to do, HCSG would likely have missed consensus EPS estimates for that quarter.

[3] Id.

[4] Interface, Inc., Securities Act Release No. 10854, Exchange Act Release No. 90018, Accounting and Auditing Enforcement Release No. 4175 (September 28, 2020).

[5] Fulton Financial Corp., Exchange Act Release No. 90017, Accounting and Auditing Enforcement Release No. 4174 (September 28, 2020).

[6] Chair Mary Jo. White, Opening Remarks at the 21st Annual International Institute for Securities Enforcement and Market Oversight https://www.sec.gov/news/statement/remarks-21st-international-institute-for-securities-enforcement.html (November 2, 2015).

[7] https://www.sec.gov/enforce/selected-division-enforcement-accomplishments-december-2016-december-2020. The ETP Initiative has resulted in six charges, most recently in July 2021 against UBS.

[8] https://www.sec.gov/dera/about.

[9] Malenko, Nadya and Grundfest, Joseph A. and Shen, Yao, Quadrophobia: Strategic Rounding of EPS Data (August 9, 2020). 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 or http://dx.doi.org/10.2139/ssrn.1474668.