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SEC Targets Small Accounting Adjustments in First Enforcement Actions Under Earnings-Per-Share Initiative

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White Collar Defense and Investigations

Last week, the SEC announced settled enforcement actions against two public companies and two former senior executives based on small allegedly improper quarterly accounting adjustments that cumulatively overstated the companies' reported earnings per share (EPS) by as little as one penny.[1] These actions arise from the agency's ongoing EPS initiative, which applies risk-based analytics to accounting and financial disclosure data to identify and investigate potentially improper accounting adjustments.

One of the actions announced last week involved allegedly improper accounting that increased a company's EPS by a single penny, enabling it to meet analyst consensus expectations for one quarter. According to the SEC, in public filings for two quarters in 2016 and 2017, Fulton Financial Corp. maintained a $1.3 million mortgage service rights (MSR) valuation allowance that was not supported by its publicly disclosed MSR valuation process.[2] The SEC found that, in the following quarter, Fulton belatedly reversed the allowance, which increased its EPS by one cent.[3] Although the SEC did not find that Fulton's conduct was fraudulent, it charged the company with reporting, internal accounting controls, and books-and-records violations.[4] Fulton agreed to pay a $1.5 million penalty, without admitting or denying the SEC's findings.[5]

The SEC also brought a settled action against Interface, Inc., a carpet manufacturer, which agreed to pay a $5 million penalty. In its order, the SEC found that in five consecutive quarters in 2015 and 2016, Interface booked "unsupported, manual adjustments" to its management

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[1] SEC Press Release 2020-226 (Sept. 28, 2020), https://www.sec.gov/news/press-release/2020-226.

[2] *See In re Fulton Financial Corp.*, Exchange Act Rel. No. 90017 (Sept. 28, 2020), https://www.sec.gov/litigation/admin/2020/34-90017.pdf.

[3] *Id.* at 2, 10.

[4] *Id.* at 11–12.

[5] *See id.* at 12.

bonus accruals, independent consultant expenses, and stock-based compensation.[6] According to the SEC, the adjustments, which did not comply with GAAP, artificially increased the company's EPS by between $0.02 and $0.04 per quarter, enabling it to meet or beat consensus EPS estimates and show earnings growth.[7] Interface was charged with negligence-based securities fraud, reporting, and internal controls violations, and did not admit or deny the SEC's findings.[8]

Notably, the SEC also charged two former senior Interface executives, both of whom settled. The company's former Controller and Chief Accounting Officer was charged with negligence-based fraud and other violations, fined $45,000, and suspended from appearing or practicing before the agency as an accountant for at least three years.[9] Interface's former Chief Financial Officer, who avoided the fraud charge, was fined $70,000 and received a suspension of at least one year.

These actions demonstrate that the SEC is using sophisticated technology to ferret out earnings management practices at public companies that improperly boost earnings, even by what would otherwise appear to be small amounts, to hide losses or meet prior earnings guidance or analyst expectations. Companies should guard against the risk of a burdensome and expensive SEC investigation, and potential enforcement action, by ensuring that their accounting and disclosure controls are sufficient to provide reasonable assurance that quarter-end adjustments comply with GAAP and do not hide weaker-than-expected performance.[10]

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6 *In re Interface, Inc., et al.*, Exchange Act Rel. No. 90018, 3 (Sept. 28, 2020), https://www.sec.gov/litigation/admin/2020/33-10854.pdf.

7 *See id.* at 3–9.

8 *Id.* at 10–11.

9 *Id.* at 12–16.

10 *See* SEC Press Release 2020-226, *supra* note 1.