4 Enforcement Actions Highlight SEC's Focus On Earnings

By Lori Echavarria (October 13, 2020)


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In the last three days of the U.S. Securities and Exchange Commission's fiscal year, the SEC announced four corporate settlements involving alleged improper earnings management. The SEC's Division of Enforcement also disclosed that two of these settlements arose out of an Earnings Per Share Initiative — a risk-based data analytics initiative designed to discover accounting and disclosure violations related to earnings management.

This flurry of activity makes clear that the Division of Enforcement continued to focus on earnings management in 2020 and will continue to do so next year.

What can we learn from these recent settlements? These four cases, announced on Sept. 28, 29 and 30, exemplify three different scenarios where the SEC concluded an issuer's efforts to meet earnings targets exceeded legal bounds.

The conduct charged ranges from disclosure failures of known trends regarding real sales and earned revenues, to accounting misstatements and errors, and on into outright fraudulent conduct involving false invoices and fake financing arrangements.

As these cases show, the SEC is watching issuers that meet or beat analyst consensus estimates and may investigate issuers if it determines investors are unaware of how the issuer's successful outcomes are achieved.

Disclosure Failures

In the first scenario, the SEC charged HP Inc. with negligence-based anti-fraud violations of the securities laws for pure disclosure failures without citing any accompanying accounting misstatements or errors at all.[1] Specifically, the SEC alleged HP failed to disclose "the impact of sales practices undertaken in an effort to meet quarterly sales and earnings targets."

The SEC found that HP used quarter-end discounts to accelerate or "pull in" sales of printing supplies that they otherwise expected to sell in subsequent quarters.[2] The SEC further found that HP sold printing supplies to distributors involved in selling supplies outside of their territory in order to meet sales targets — cannibalizing future HP sales in those regions and pressuring margins.[3]

HP announced that it would change its business model in part to address these sales practices and anticipated this change would reduce net revenue by $450 million during the third and fourth quarters of 2016.[4] HP's stock price dropped by 6% on that news.[5]

Here, the SEC alleged that the sales practices engaged in by HP created a known trend reasonably expected to have a material impact on net revenues, creating an obligation to disclose pursuant to the requirements of Regulation S-K, Item 303.[6] The issuer's failure to do so led to the SEC's action.

HP settled without admitting or denying the allegations to violations of non-scienter-based fraud, reporting, and disclosure controls provisions of the securities laws and agreed to pay a $6 million penalty.[7]

Accounting Misstatements and Mistaken Disclosures

Two settlements jointly announced on Sept. 28 exemplify the second scenario of earnings management cases — those involving erroneous or flawed accounting practices resulting in financial statement misstatements.

In a single press release, the SEC announced charges against two issuers arising out of improper reporting of quarterly earnings per share that met or exceeded analyst consensus estimates.

In a further shot across the bow, the SEC stated that these two actions were the first to arise out of investigations generated by the Division of Enforcement's EPS Initiative.[8] Both actions involved alleged improper quarterly accounting adjustments resulting in violative earnings management practices, without alleging outright false sales, fake documents, or sham transactions.[9]

In the first of these two Sept. 28 actions, the SEC found that Interface Inc., a Georgia-based modular carpet manufacturer, reported inaccurate earnings per share from the second quarter of 2015 through the second quarter of 2016.[10] The SEC stated that the former corporate controller and former chief financial officer directed a variety of unsupported manual accounting adjustments that did not comply with generally accepted accounting principles.[11]

These unsupported and noncompliant accounting adjustments "artificially inflated Interface's income and EPS, which resulted in Interface meeting or beating consensus estimates for EPS and showing earnings growth."[12] The SEC further concluded that without these adjustments, Interface's earnings would have been more volatile than reported, and in two quarters, Interface would have missed earnings instead of meeting consensus estimates.[13]

For these allegations, Interface settled, without admitting or denying the allegations, to non-scienter fraud, books and records, internal controls and reporting violations and paid a $5 million penalty.[14] The former officers also settled with the SEC to a suite of negligence-based securities violations and accepted suspensions from practicing as accountants before the commission.[15]

In the second action announced on Sept. 28, the SEC alleged that Fulton Financial Corporation, a Pennsylvania-based financial services company, had inaccurately presented its financial performance in late 2016 and early 2017.[16]

According to the order, in late 2016 through mid-2017, Fulton maintained a $1.3 million mortgage servicing rights valuation allowance, which was inconsistent with its public disclosures.[17]

When Fulton corrected the accounting, and reversed the improperly valued allowance in the second quarter of 2017, the net result increased pre-tax income, and allowed Fulton to avoid missing analyst consensus estimates by a penny.[18]

Although the 2017 allowance reversal was consistent with both Fulton's accounting policy and the opinion of a valuation expert retained by Fulton, the SEC found the reversal to have occurred two quarters too late and with the self-serving effect of the reversal occurring when Fulton risked missing estimates without it.[19]

Unlike in the Interface settlement, the SEC did not charge Fulton with anti-fraud violations, but rather alleged negligence-based disclosure, books and records and internal controls violations, and imposed a $1.5 million penalty.[20]

Fake Shipping Documents and Fake Companies

Finally, in the seemingly most clear instance of alleged improper earnings management, the SEC charged Illinois-based Manitex International Inc., a crane manufacturer and distributor, and three of its officers with engaging in what the SEC found to be two distinct, fraudulent schemes involving fraudulent accounting practices.[21]

In the first alleged scheme, the SEC's order recounts efforts by Manitex's former chief operating officer and the former general manager of its Crane & Machinery subsidiary to create "false inventory lists and shipping documents provided to Manitex's outside auditor to cover up a $1.39 million inventory shortfall."[22]

The second alleged scheme involved the recognition of $12 million in revenue in purported "bill and hold" sales of cranes to another company.[23] The problem here? The purchasing company "had no operations, revenue, or significant assets, and did not have the financial ability to obtain financing or otherwise pay for or store the cranes purchased from Manitex."[24]

Simply put, Manitex purported to have sold $12 million of cranes to a defunct company. In order to receive payment for the cranes, the former chief operating officer and Manitex general manager set up and guaranteed financing for these sales from Manitex.[25]

But, since Manitex had to avoid having its auditors see the company as paying for its own equipment, the former general manager and former COO created a fake financing subsidiary and used false and fraudulent invoices to create the impression that this purported subsidiary was actually financing the payments.[26]

The SEC's order even alleges that the former COO "sarcastically suggested the possibility of calling the purported subsidiary 'Vandalay Industries,'" after a fake company referenced in the "Seinfeld" television show.[27] Manitex's former chief financial officer approved the payments although he knew that the invoices were "not genuine."[28]

Clearly, fake inventory lists, false shipping documents, fake companies and round-trip financing transactions used to report false revenue and inventory and to allow an issuer to meet earnings targets violates the securities laws.

Accordingly, and no surprise, Manitex and the responsible executives settled with the SEC without admitting or denying the allegations for violations of the anti-fraud, books and records and internal accounting provisions of the federal securities laws, agreeing to pay civil penalties that totaled among them $485,000.[29]

The former COO, former CFO and former general manager each accepted a bar from serving as an officer or director of a public company, and the former COO and former CFO were suspended from appearing or practicing before the SEC as accountants.[30]

What Can Be Learned?

Four takeaways emerge from these late September cases.

First, the commission and the Division of Enforcement staff have a renewed focus on earnings management and financial reporting and disclosure cases. The newly announced EPS Initiative has already borne fruit in two cases and portends a continuing effort based on data analytics in order to identify additional cases.

Second, the SEC will charge issuers for violations of disclosure rules and standards even where the underlying sales activity resulted in genuine third-party transactions for which the issuer ultimately received payment. Nowhere in the HP order did the SEC allege any improper accounting or financial statement misstatements — yet failure to highlight internal business decisions resulting in a material known trend in disclosures to investors led to a fraud charge.

Third, materiality matters. Materiality is a required element for charges under the anti-fraud provisions of the securities laws and for allegations of violations of the disclosure requirements under Regulation S-K, Item 303. In the scenarios involving either fraudulent conduct or erroneous accounting, the SEC quantified the impact of the misconduct to establish materiality.[31]

Even more notably, in the pure disclosure scenario against HP, the SEC also alleged quantifiable facts establishing materiality.[32] Here, the SEC alleged that HP's stock price dropped by 6% causing a market capitalization drop of more than $1 billion on the news that HP would cease the sales practices at issue and take a net revenue hit.[33]

Finally, companies should be wary of being too focused in setting internal performance targets to the expectations of the analyst community. Most companies are quite aware of the expectations of analysts.

However, issuers that place too much emphasis on meeting those estimates can create pressure on executives and managers to just do whatever it takes to meet those targets.

And even where the issuer's sales practices generated legitimate transactions, the SEC may still focus on the issuer's disclosures to determine whether investors were provided enough information to understand the overall health of the company and any material trends relevant to the issuer's earnings performance.

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[1] SEC Charges HP Inc. With Disclosure Violations and Control Failures, Press Release 2020-241, (Sept. 30, 2020) https://www.sec.gov/news/press-release/2020-241; In the Matter of HP, Inc. Sec. Act Rel. No. 10868, Exchg. Act Rel. No. 90060, AAER No. 4183, AP File No. 3-20112 (Sept. 30, 2020) ("HP Order").

[2] HP Order at 5, ¶¶ 16-23.

[3] HP Order at 6, ¶¶ 24-29.

[4] HP Order at 8, ¶38.

[5] Id.

[6] HP Order at 8, ¶41-45.

[7] HP Order at 10-11.

[8] SEC Charges Companies, Former Executives as Part of Risk-Based Initiative, Press Rel. 2020-226, Sept. 28, 2020, https://www.sec.gov/news/press-release/2020-226 ("EPS Initiative Press Release").

[9] In the Matter of Interface, Inc., et.al., Sec. Act Rel. No. 10854, Exchg. Act Rel. No. 90018, AAER No. 4175, AP File No. 3-20085 (Sept. 28, 2020) ("Interface Order") at 10, ¶43; In the Matter of Fulton Financial Corporation, Exchg. Act Rel. No. 90017, AAER No. 4174, AP File No. 3-20084 (Sept. 28, 2020) ("Fulton Order") at 11-12, ¶¶66-68.

[10] Interface Order at 2-3, ¶1.

[11] Interface Order at 3, ¶1.

[12] Id.

[13] Id.

[14] Interface Order at 11-14.

[15] Interface Order at 12-14.

[16] SEC Charges Companies, Former Executives as Part of Risk-Based Initiative, September 28, 2020, Press Release 2020-226, https://www.sec.gov/news/press-release/2020-226.

[17] Fulton Order at 2, ¶2 and 10-11, ¶ ¶58-61.

[18] Fulton Order at 2, ¶2.

[19] Fulton Order at 10, ¶54 -57.

[20] Fulton Order at 12.

[21] In the Matter of Manitex International, Inc., Sec. Act Rel. No. 10860, Exchg. Act Rel. No. 90042, AAER No. 4177, AP File No. 3-20099 (September 29, 2020) at 1, ¶1 (the "Manitex Order").

[22] Manitex Order at 2, ¶2.

[23] Manitex Order at 2, ¶3.

[24] Id.

[25] Id.

[26] Manitex Order at 2, ¶3.

[27] Manitex Order at 6, ¶31.

[28] Manitex Order at 2-3, ¶3.

[29] SEC Charges Manitex International and Three Former Executives With Accounting Fraud, Press Rel No. 2020-237, Sept. 29, 2020, https://www.sec.gov/news/press-release/2020-237 ("Manitex Press Release").

[30] Manitex Press Release at 1.

[31] Manitex Order at 5, ¶23, 8, ¶ 44; Interface Order at 4, ¶13, 6, ¶20, 7, ¶25, 8, ¶30, 9, ¶35; Fulton Order at 2 ¶2, 10, ¶54.

[32] HP Order at 8, 38 (announcement of $450 million net revenue reduction due to ceased sales practices led to 6% stock price reduction).

[33] HP Order at 8, ¶38.