ALERT MEMORANDUM

Potential SEC Inquiry: Improper Rounding Up Of Earnings Per Share

June 25, 2018

A recent report in the Wall Street Journal, drawing on a source "familiar with the matter", indicates that the Securities and Exchange Commission's ("SEC") Division of Enforcement has launched a probe into whether certain issuers may have improperly rounded up their earnings per share to the next higher cent in quarterly reports.[1] While the SEC has neither confirmed the report nor otherwise disclosed the existence of any such investigation, the Journal reports that the SEC has sent inquiries to at least 10 companies requesting information about such accounting adjustments that could have inflated reported earnings. The targeted companies have not yet been identified. Whether the reported inquiries amount to a broad-based sweep of issuer accounting practices remains to be seen. However, such an investigation would be consistent with SEC Chairman Jay Clayton's announced enforcement priorities, which include a focus on public-company accounting practices and the protection of retail investors.[2]

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[1] Dave Michaels, *SEC Probes Whether Companies Rounded Up Earnings Per Share*, WALL STREET JOURNAL, June 22, 2018, https://www.wsj.com/articles/sec-probes-whether-companies-rounded-up-earnings-1529699702?mod=hp_lead_pos1.

[2] Testimony of Jay Clayton before the U.S. Senate Banking Committee, Sept. 26, 2017, https://www.sec.gov/news/testimony/testimony-clayton-2017-09-26.

The Journal reports that the investigation was prompted by a four-year old academic paper that found that the number four is significantly underrepresented in the first post-decimal digit of reported earnings per share figures leading to a hypothesis that companies may be incentivized to report earnings with a five or higher in the tenths decimal place to allow them to round up to the next penny.[3] The authors, Professors Nadya Malenko and Joseph A. Grundfest (a former SEC Commissioner), base their findings on an assumption that every number zero to nine should appear in the tenths decimal place about 10% of the time. But what they found, after reviewing quarterly results for over 25,000 companies from 1980 to 2013, was that the number four appeared only 8.6% of the time. The authors conclude that the low prevalence of a .4 may be an indicator of accounting fraud or earnings management. Though Professors Malenko and Grundfest's research was first issued back in 2014, the Journal reports that economists from the SEC have since replicated aspects of the study and found similar results, which apparently have driven the issuance of the recently reported requests.

Possible Implications

As noted, the existence of the SEC's investigation into inflated earnings per share has not been officially confirmed. Thus, the scope and extent of any investigation remains unclear. While such a probe would be consistent with the SEC's stated priority of protecting retail investors through greater scrutiny of potentially fraudulent accounting practices,[4] the SEC under Chairman Clayton has also appeared to be less enthusiastic with respect to using industry-wide sweeps than in the past. Moreover, it is worth noting that, previously, such data-driven initiatives have met with mixed results. For example, in *SEC v. Yorkville Advisors, LLC et al.*, a case investigated by the SEC's Asset Management Unit, the SEC just last month voluntarily dismissed all remaining charges against two former private equity executives[5] on the heels of a summary judgment decision that dismissed a number of the charges in the case.[6] That case arose from the Aberrational Performance Inquiry, a 2012 enforcement initiative that used an internally-developed risks analytics tool to identify suspicious outsized investment adviser performance for further investigation.[7]

Nonetheless, there are reasons to take note of this potential sweep. *First*, as discussed above, the conduct at issue is consistent with announced Commission enforcement priorities. *Second*, despite some expectations to the contrary, the SEC has, in recent months, undertaken certain broad-based investigations where retail investors were deemed to be at risk. For example, the SEC recently charged several investment advisers for failing to ascertain the eligibility of their retail retirement account customers for less expensive mutual fund share classes, and separately sanctioned 13 private fund advisers for repeated failure to file a Form PF informing the SEC about the private funds they advise.[8] *Third*, potential actions stemming from the reported investigation—which could range from scienter-based fraud to failure to maintain effective controls—are serious and may be costly to investigate and remediate. It is also worth noting that the Commission has faced criticism in the years following the financial crisis for its alleged insufficient focus on public company accounting, so it is perhaps not surprising that SEC Staff is using

3 Nadya Malenko and Joseph A. Grundfest, *Quadrophobia: Strategic Rounding of EPS Data*, July 2014, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1474668&mod=article_inline.

4 U.S. Securities and Exchange Commission Division of Enforcement, "Annual Report: A Look Back at Fiscal Year 2017," https://www.sec.gov/files/enforcement-annual-report-2017.pdf.

5 Stipulation of Voluntary Dismissal with Prejudice, *SEC v. Yorkville Advisors, LLC, et al.*, 12-cv-07728 (S.D.N.Y. May 18, 2018) (D.E. 228).

6 *See SEC v. Yorkville Advisors, LLC*, 12 Civ. 7728 (GBD), 2018 WL 1725555, at *38 (S.D.N.Y., March 29, 2018).

7 *See* Commission PR 2012-209 (Oct. 17, 2012), https://www.sec.gov/news/press-release/2012-2012-209htm.

8 *See e.g.*, Commission PR 2018-100 (June 1, 2018), https://www.sec.gov/news/press-release/2018-100; Commission PR 2018-26 (Feb. 28, 2018), https://www.sec.gov/news/press-release/2018-26.

academic literature as a potential means to identify new cases in this area.

In light of this apparent interest by the SEC, now may be good a time for issuers to review their reporting practices around earnings with their audit committee and external auditors and take stock of their own controls environment around the reporting of quarterly and annual earnings numbers, for example by:

— Assessing whether the existing controls around the generation and publication of quarterly earnings would serve to prevent, or defend against, the kind of scrutiny the SEC appears to be placing on those public companies that have already received information requests.
— Reviewing controls surrounding financial reporting practices generally. For example, reviewing which individual or group of individuals is vested with discretion on how to make judgment calls that may impact reported numbers, and any controls over how that discretion is exercised.
— Focusing on the attention given to earnings guidance and to analyst consensus estimates. The SEC and certain institutional investors periodically have bemoaned what they consider to be the excessive focus of certain companies on quarterly earnings and meeting analyst estimates.[9] For companies that consistently have avoided the .4 and also met analyst estimates, the SEC should be expected to ask whether the coincidence of those two facts is an accident or a function of potential accounting fraud or manipulation.
— If controls are found to be insufficient, companies should consider steps to strengthen them, and ultimately evaluate whether any material weaknesses occurred and what, if any impact they may have had on reported results and how to address them. Such efforts are not only good practice, but, will likely be considered favorably by the SEC in the event of an investigation.

It is likely early days in this reported SEC inquiry, and it may end up being quite limited in scope and focus. But it is a reminder that the SEC continues to use data analytics—including those produced by academics—to attempt to re-invigorate a pipeline of issuer accounting cases that has apparently shrunk over the last decade. Now is as good a time as any for public companies to take a measure of their accounting controls environment to place themselves in the best possible position in the event of future regulatory scrutiny.

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[9] Remarks by Arthur Levitt, The Numbers Game, Sept. 28, 1998, https://www.sec.gov/news/speech/speecharchive/1998/spch220.txt.

In fact, Warren Buffet and Jamie Dimon have been calling for the end to quarterly guidance by companies. Dimon explained that the pressure of executives to meet quarterly forecasts may cause them to "do things that they wouldn't otherwise have done." Liz Moyer, *Warren Buffett and Jamie Dimon Join Forces To Convince CEOS To End Quarterly Profit Forecasts*, CNBC, June 6, 2018, https://www.cnbc.com/2018/06/06/warren-buffett-and-jamie-dimon-join-forces-to-convince-ceos-to-end-quarterly-profit-forecasts.html.