SEC Targets Defense Contractor on Violation of Books-and-Records Requirements

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Government Contracts

Contractors are used to the Defense Contract Audit Agency scrutinizing their internal accounting practices, but in a recent cautionary tale a contractor found itself in the crosshairs of another federal law enforcement agency: the Securities and Exchange Commission (SEC). In a settlement recently made public, defense contractor L3 Technologies, Inc. (L3) agreed to pay $1.6 million to settle charges it had violated SEC recordkeeping requirements.

The trouble for L3 began in 2013, when it allegedly found itself losing money on a five-year aircraft maintenance contract with the Army. According to the SEC, L3 executives grew concerned they would not meet the year-end profitability target of their division's operating plan and thus initiated a "Revenue Recovery Initiative" to identify unbilled work on the contract. After months of review, L3 allegedly concluded it had performed approximately $50 million in work on the contract for which it had not billed. Settlement Order ¶ 6. It appears L3 then tried to negotiate payment of the unbilled work, but was unable to reach an agreement with the Army by the end of 2015. *Id*. Facing a year-end loss with $50 million still in flux, the division's VP of Finance allegedly directed staff to create invoices for performed but unbilled work, but to not deliver those invoices to the Army for payment. *Id.* ¶ 8. L3 then recognized "an additional $17.9 million in revenue . . . based on the undelivered invoices, enabling ASD to barely satisfy the target required in order to qualify for management incentive bonuses." *Id.*

The SEC concluded that this revenue recognition violated L3 policies and Generally Accepted Accounting Principles (GAAP), which require that revenue be recognized only when "collectability is reasonably assured." According to the SEC, that was not the case here, and L3's move to recognize the revenue thus violated two provisions of the Securities Exchange Act of 1934: the requirements that public companies keep books and records that "accurately and fairly reflect their transactions and dispositions of their assets" (§13(b)(2)(A)), and that they maintain "internal accounting controls sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles" (§13(b)(2)(B)).

It is difficult to gauge just how aggressive L3 was in recognizing the revenue because the details of L3's negotiations with the Army are not public. L3 may have believed from those discussions that it was highly likely to recover far more than the $17.9 million it recognized at year's end.

It also appears, however, that L3 may have been plagued by a series of breakdowns in its organizational oversight. According to the SEC, L3's internal controls failed to flag a potential problem arising from the fact it had incurred costs for which invoices were prepared but never submitted for payment. *Id.* ¶ 12. The SEC also claims L3 missed a second chance to catch the issue when the company's internal ethics office received multiple complaints in late 2013 regarding the accounting practices in question. According to the SEC, the ethics investigators that conducted the ensuing internal investigation "failed to identify the improper revenue recognition issue because they did not adequately understand the billing process" for the contract. *Id.* ¶ 14. The SEC claims L3 recognized it had erred only after it conducted a second internal investigation in 2014 (this time using outside investigators), which concluded that L3 had violated its accounting procedures by recognizing the revenue. *Id.* ¶ 15. This prompted L3 to make amended filings disclosing improper deferred cost overruns and overstatements of net sales, as well as material weaknesses concerning its Internal Control Over Financial Reporting. The settlement states that the civil penalty was "limited" to $1.6 million in recognition of L3's cooperation with the SEC's own ensuing investigation.

Contractors that are public companies should take heed from L3's tangle with the SEC. Accounting for revenue for which there is not a clearly documented and uncontested basis of recovery can be tricky. This dilemma presents itself fairly often for government contractors, whether due to unbilled work, as was the case with L3, or because of a contract dispute or modification that entitles the contractor to additional compensation but which has not yet formally been resolved and finalized. The L3 case underscores the need for companies to make sure they follow GAAP and carefully document the basis for any conclusion that collection of such revenue is "reasonably assured." If the SEC's characterization is accurate, the case also underscores the need for companies to conduct internal audits and investigations with personnel that have a sophisticated understanding of government contract requirements and, if necessary, to consult with government contracts counsel. Once the SEC becomes involved, companies should consult counsel experienced in SEC enforcement matters.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Government Contracts and Securities Enforcement practices:

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