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NEWSLETTER

Warning for Public Company Defense Contractors: DCAA is Not the Only Accountant Examining Your Books

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Government Contracts Issue Update

It happens at the end of the fiscal year at many companies. In order to meet bonus targets, employees scramble to find innovative ways to recognize revenues before the end of the period. A recent Securities and Exchange Commission (SEC) settlement with L3 Technologies, Inc. (L3) offers a cautionary tale if these efforts are not appropriately policed and addressed. The settlement resolved an accounting issue that L3 self-reported to the SEC relating to its Army Sustainment Division (ASD).

Background

On January 11, 2017, In *In the Matter of L3 Techs., Inc.*, Rel. No. 3844 (Jan. 11, 2017) (Order Instituting Cease and Desist Proceedings) (Order), L3 agreed to pay a $1.6 million penalty to the SEC for violating Sections 13(b)(2)(A)-(B) of the of the Securities Exchange Act of 1934 (Exchange Act). Section 13(b)(2)(A) requires that publically held companies "make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets." Section 13(b)(2)(B) requires publically held companies to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that . . . transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles [(GAAP)] . . . ."

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According to the Order, ASD had a contract for the maintenance of 100 fixed-wing C-12 airplanes for the U.S. Army from June 2010 through January 2015 (C-12 Contract). Beginning in 2013, ASD's management team learned that the C-12 Contract was projected to lose money, putting their annual operating plan and incentive bonuses at risk. Hoping to address this shortfall, the ASD management team created a "Revenue Recovery Initiative" under which ASD employees identified work completed on the C-12 Contract, but not yet billed to the Army as of the end of 2013. The initiative identified approximately $50 million in unbilled work. Employees were then directed by a Vice-President of Finance to generate 69 invoices for that work, but were told not to send them to the Army.

Despite the fact that the invoices were not delivered to the Army in 2013, ASD recognized $17.9 million in revenue upon the generation of the invoices, which enabled ASD to "barely satisfy the target required in order to qualify for management incentive bonuses."

Consistent with GAAP, L3's revenue recognition policy set forth four standards that had to be met before revenue could be realized and earned: "(1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the seller's price to the buyer is fixed or determinable; and (4) collectability is reasonably assured." Since the Army had not, as of the end of 2013, reviewed or agreed to pay the invoices, the SEC found the collectability of payment for those invoices was not reasonably assured, and therefore the revenue related to the C-12 Contract could not be recognized.

In addition to improperly recognizing revenue, L3 also failed to have adequate controls in place to detect and prevent the improper revenue recognition, which is a separate violation. Even though two employees filed internal ethics complaints about the C-12 Contract (one of which specifically mentioned the 69 invoices), "L3's internal ethics department" investigators "failed to identify the improper revenue recognition because they did not understand the billing process." When the undelivered invoices were later discovered, L3 commenced a second investigation utilizing outside advisors.

Based on the findings by the outside advisors, L3 was forced to issue a press release indicating it had improperly overstated sales; and ultimately amend its 2013 and 2014 SEC filings because it "identified material weaknesses in the company's ICFR (Internal Control Over Financial Reporting) . . . ." The amended filings specifically noted that "[c]ompany personnel did not perform reviews of certain employee concerns regarding violations of our accounting policies and ICFR in a sufficient and effective manner."

As a result of the accounting and internal control failures, the SEC found L3 in violation of §13(b)(2)(A) and §13 (b)(2)(B). L3 settled the action, agreeing to pay $1.6 million in penalties.

Lessons All Government Contractors Should Take From the L3 Settlement

The SEC report is a cautionary tale for publicly traded government contractors, and highlights yet another potential regulatory and enforcement risk:

Having an ethics hotline is no defense if the subsequent investigation fails. All government contractors, regardless of public company status, must have sufficiently trained employees conducting internal investigations. As the Order notes, L3 had an ethics hotline into which a complaint was filed about the bogus invoices, but the initial investigation missed the issue completely. Using experienced in-house investigators is a first step to confront internal allegations of fraud but, in the long run where accounting or fraud issues arise, having experienced outside advisors conduct the investigation may prove to be more effective and efficient. Especially where sophisticated allegations may be at issue, in-house resources should recognize when they need to augment their expertise.

Serious remedial actions matter as a mitigating factor. The SEC's acceptance of L3's offer of settlement was based on the "extensive remedial acts promptly undertaken by [L3], which included an internal investigation, terminating a number of employees associated with the conduct in question, and self-reporting the matter to the Commission; and the cooperation afforded the Commission staff." Whether to self-report to the Government and how to remediate are some of the most critical decisions made in any internal investigation because they are factors both the Department of Justice (DOJ) and SEC consider when making charging and penalty determinations. The Order confirms that companies may receive valuable credit for making hard decisions about how to respond to wrongdoing.

Consider whistleblower risks and protections. Publically held government contractors need to be aware of the SEC's Dodd-Frank whistleblower program. Since 2012, the program has paid $149 million in awards to 41 whistleblowers. When an internal complaint like the one in the L3 case arises, it is critical that those complaints be addressed quickly and correctly. Employees that first report internally have 120 days during which time they keep their place in line for reporting to the SEC and a possible whistleblower award. Addressing internal whistleblower concerns in that time period is critical to both discouraging outside reporting and getting ahead of SEC and DOJ investigations. While there is no indication that an SEC whistleblower was involved here, L3's failed initial internal investigation put the company at a greater risk of receiving an SEC or DOJ subpoena, enduring a much costlier enforcement investigation, and receiving no credit for self-reporting.

Investigations must be structured to preserve cooperation opportunities. Finally, the SEC's press release notes that the investigation is continuing, which suggests there could be further action against the involved individuals. In an era when both the DOJ and SEC are focused on charging individuals, entities have an incentive to identify bad actors to the Government in order to receive cooperation credit. Now more than ever, internal investigations need to be properly structured to present the best possible case to the Government and to preserve the ability to obtain cooperation credit, as L3 was able to receive here.

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