

Too much advocacy can mislead financial reporting judgments

By: [Joseph J. Floyd](#) July 6, 2017



Imagine that you represent a company with a fixed-fee government contract and your client realizes that it may incur a loss on the contract. The client asks you, as legal counsel, to help find ways to charge the government more so that the company can avoid reporting a loss.

You review the contract, work with the company's finance team, craft legal arguments, and prepare a draft claim for additional amounts owed from the government. You also advise your client regarding the probability of success for each claim based on the company's history with similar government contract disputes.

While you use the phrase "legal entitlement" when describing the claims with your client, you have no responsibility for the financial reporting process and the judgments about the probability of collection and revenue recognition for the possible contract claim recoveries.

A similar scenario appears in a recent accounting and auditing enforcement release issued by the U.S. Securities and Exchange Commission concerning L3 Technologies' improper recording of revenue in its Army Sustainment Division.

L3 is a contractor for government agencies, including the Department of Defense. The improperly recorded revenue arose from a fixed-price aircraft maintenance contract between L3's Army Sustainment Division and the U.S. Army, which is referred to as the C-12 contract. Per the release, L3 recognized revenue for the C-12 contract in excess of the contractual amount, and before any commitment to pay additional amounts from the Army was received.

Following an investigation, L3 settled with the SEC and accepted the entry of an order instituting cease-and-desist proceedings, as well as payment of a monetary penalty for internal control violations underlying the financial statement misstatement.

Importantly, L3's cooperation and remediation favorably impacted the SEC's actions. In addition, the SEC took action against management and finance individuals involved in

the improper recording of revenue. No action appears to have been taken with regard to legal counsel's involvement.

Understandably, it's not legal counsel's role to serve as an expert in revenue recognition. However, awareness of the rules and general requirements can help clients avoid similar problems, especially on matters for which counsel provides assistance.

Background facts

Note that the following is a brief overview of the information contained in the release; a thorough reading of the release is recommended to appreciate the full context of the facts.

Starting in mid-2013, the Army Sustainment Division's finance team, the general counsel of ASD, and the general counsel of ASD's business segment worked together to estimate that they were "likely to recover" approximately \$30 million of the total potential claims, which totaled approximately \$50.6 million.

The recovery process would involve a request for equitable adjustment under the contract, and possibly a dispute with the Army if matters could not be resolved amicably.

Per the release, the "likely to recover" estimate was based on the results of the company's historical negotiations with the government, indicating the company had a history of revisiting contract terms and interpretations.

In December 2013, ASD produced a document titled "Army C-12 Contract Dispute Summary," which included a table containing 10 rows with separate claims categories adding up to the \$50.6 million. A column on the table was titled "legal entitlement" and applied a discount of either 50 or 60 percent to each claim value comprising the \$50.6 million. The presentation acknowledged that ASD planned to meet with the government to reach a resolution and that, "[a]fter the negotiations with the government, L3 is postured to immediately invoice and bill the government."

Before receiving approval for additional payments from the Army, a member of ASD management requested that invoices be generated in L3's accounting system for certain amounts among the potential claims categories, but not be delivered to the Army. Needless to say, withholding the invoices produced from and recorded in the L3 accounting system was a significant internal control violation. As a result of generating the invoices, ASD recognized an additional \$17.9 million in revenue. Of significance and raising management integrity concerns, that amount allowed ASD to meet management incentive bonus targets.

In fact, L3 never collected for the undelivered invoice amounts and never should have recognized revenue for them. To correct for the misstatement, on Oct. 10, 2014, L3 restated its financial statements for the fiscal year ended Dec. 31, 2013, and for the first quarter of 2014. Among other things, L3 disclosed that it was revising its financial statements to reverse amounts improperly recognized as revenue related to the C-12 contract.



The improperly recorded revenue arose from a fixed-price aircraft maintenance contract between L3 Technologies and the U.S. Army.



Legal entitlement

The phrase “legal entitlement” is worthy of vetting for the financial reporting confusion it may cause when evaluating the revenue recognition standards.

Importantly, legal entitlement appears to be a misnomer when applied to the facts described in the release. An entitlement is defined generally as “the fact of having a right to something.” Prefaced with “legal,” the word “entitlement” implies the existence of a statutory or other right under the law. When dealing with contract recoveries and interpretations, especially a fixed-fee government contract, that creates a potentially misleading situation.

In contrast to the certainty the phrase portrays and its potential misunderstanding, the very existence of counsel’s judgments on the probability of success for each claim would seem to negate the certainty of the amounts presented as legal conclusions regarding collectability when using the phrase “legal entitlement.”

Based on the limited information in the release, the extent to which this phrase was relied on when making financial reporting judgments is unclear.

GAAP standards

Putting aside the potential financial reporting misunderstanding from the phrase “legal entitlement,” the facts presented in the L3 release raise interesting discussion points regarding the application of Generally Accepted Accounting Principles, or GAAP, and how L3 may have viewed its ability to recognize revenue.

For foundation, L3’s revenue recognition policy is consistent with GAAP and sets forth four major requirements that must generally be met before revenue can 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.

Of significance, per the release, L3 failed to deliver the invoices to the Army. Thus, there is little basis to debate that collectability could be reasonably assured as of year-end if the Army didn't have them.

In addition, collectability could not be reasonably assured for the claims that L3 was asserting against the Army, because no agreement to pay had been reached.

As of year-end, the claims appear to be gain contingencies under GAAP. Guidance on accounting for contingencies can be found in ASC 450, which addresses both loss and gain contingencies.

Many aspects of financial reporting are founded in the principle of conservatism. Perhaps the greatest example relates to contingencies, which are defined as events that cannot be predicted with certainty.

Notably, loss contingencies should be accrued when the loss is probable and may be reasonably estimated. If the loss is only possible, then while not accrued in the financial statements, disclosure in the footnotes may be appropriate and even required.

However, gain contingencies, such as recoveries from lawsuits, are not allowed to be accrued. In fact, the L3 claims for recovery from the C-12 contract have all the characteristics of a classic gain contingency. As such, under GAAP and as gain contingencies, the claims amounts should never be recorded before a commitment to pay arises or, if in the dispute process, a final judgment.

That said, if L3 didn't envision the need for a formal dispute process with the Army based on the history of their dealings, one could understand how L3 may have been analogizing the recording of revenue to the GAAP guidance for sales with a right of return. That's not the proper treatment, but the facts in the release are sufficient to ponder if L3 envisioned that recording a revenue estimate was reasonable based on that approach.

For context, under GAAP, companies may recognize sales with a right of return if and only if a reasonable estimate may be established for sales returns based on historical experience with the sales of similar products. Following this approach, the company estimates the percentage that will be returned and reports the net amount that will not be returned as revenue.

If one analogized to those rules, the estimate for the claims for L3 would represent the sales volume amount, and the probability of success would represent the net reportable and assumed collectable amount, after estimating the historical rate of returns.

While seemingly analogous, there is an important distinction between L3's claims that are properly reported as gain contingencies and the guidance for sales with a right of return. The sale of product with a right of return is in fact a sale, whereas the claims amount is subject to negotiation and possible dispute resolution.

Identifying that distinction is vital to appreciate the lack of proper applicability for these rules to the L3 facts as presented in the release. And yet, from reading the release, one can see where L3, while aggressive, may have been trying to report a reasonable amount for revenue recognition taking this analogous posture.

Again, legal counsel is not responsible for the GAAP decisions that clients make. But sensitivity to how clients may use the advice, words and actions of counsel when forming financial statement assertions can significantly mitigate risks for improper applications of GAAP.

Joseph J. Floyd, a CPA and attorney, is president of Floyd Advisory, a consulting firm in Boston that provides financial and accounting expertise in the areas of business strategy, valuation, SEC reporting and transaction analysis.