

## L-3 Fires Four in Reported Revenue Recognition Violation

Written by Nick Sanders

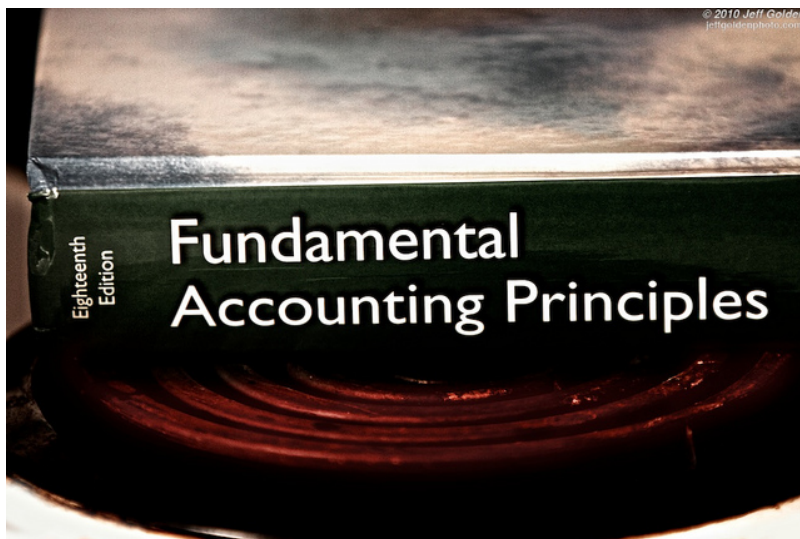
Tuesday, 12 August 2014 00:00

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From a recent [Reuters article](#) :

An employee complaint exposed accounting misconduct at [L-3 Communications], according to people familiar with the matter, prompting the aerospace and defense supplier to fire four people, revise two years of earnings statements and cut its earnings forecast.

L-3's shares plunged as much as 17 percent - their biggest intraday percentage drop ever - after the company said on Thursday it would take a pretax charge of \$84 million for misconduct and accounting errors, including cost overruns and overstated sales figures from 2013 and 2014. The surprise announcement prompted some analysts to cut ratings on the company, and raised concern about a broader problem at L-3, which also suffered an ethics scandal in 2010.



According to the article, a single fixed-price maintenance and logistics support contract in the L-3 aerospace segment was responsible for the accounting irregularity. The resulting charge and accounting adjustments were not considered to be material in amount and did not trigger restatements of the corporation's financial statements. However, the article cited an analyst's comment that "accounting irregularities tend to unnerve investors and bring further scrutiny of company's operations."

But that's not all that happens. In addition, attorneys start talking about lawsuits on behalf of

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investors who were allegedly harmed by management's alleged negligence and the resulting drop in the price of the company's stock. See, for example, [this notice](#).

That notice stated—

According to the Company, the adjustments primarily relate to 'contract cost overruns that were inappropriately deferred and overstatements of net sales, in each case with respect to a fixed-price maintenance and logistics support contract,' and are the result of 'misconduct and accounting errors' at the Aerospace Systems segment, which 'included concealment from L-3's Corporate staff and external auditors.'

Obviously we have none of the details unearthed by the company's internal investigators, or by the external law firm it hired, or by the external forensic accounting firm it hired. But based on the foregoing, we can surmise that the issue stemmed from a botched Estimate-at-Completion (EAC) on that contract. And by "botched" we mean that we tend to believe that a rigorous EAC would have disclosed an overrun at completion. Under applicable GAAP requirements, any such overrun should have been recognized on the financial statements immediately upon recognition, which would have affected the revenue (sales) being recognized for the current period.

Remember when [we wrote](#) about the difficulties in accurate revenue recognition? We said—

For example, if you have a firm, fixed-price contract to deliver 20 widgets over a 36-month period of performance, do you recognize revenue as each widget is delivered (say, at 1/20<sup>th</sup> of the contract price for each delivery) or do you recognize revenue based on the percentage of completion of the entire contract? What about if you believe your planned profit won't materialize because of unplanned cost growth? How does that knowledge factor in to the picture?

Hey, pretty good example, huh?

We have also repeatedly ranted about the importance of internal controls. We have asserted

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that good internal controls are not expenses; instead, they should be viewed as investments with an ROI that can be calculated based on prevention of just the type of problem that L-3 Communications recently ran into.

L-3 Communications has already recorded a charge of \$84 million associated with the RevRec violation. Undoubtedly there will be more charges to follow, if only to record the costs of defending against shareholder suits.

*Hmm.* We wonder how much L-3 Communications might be willing to invest in its internal controls today. What does \$84 million buy you in terms of salary and travel expense? We think you can buy quite a nice set of rigorous internal controls for that kind of money.