Written by Nick Sanders
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Revenue recognition can be a difficult task for the accounting departments of government contractors. Measuring revenue for a single period requires the exercise of a considerable amount of management judgment. That management judgment is spread out across the organization, such that accurate revenue recognition relies on input from any number of functions—ranging from program managers to engineers to financial analysts to procurement practitioners. Often those functions operate in remote geographic regions where English is not the native language, making it difficult to assure that the judgments are well-founded. The bigger and more complex the organization, the more challenging accurate revenue recognition can be.

Measuring revenue is a challenge, but it’s an important task, especially for a publicly traded company. The share price of a company can rise or fall based on its reported revenue numbers. The tension between accuracy and hitting the targets can be intense. Investment analysts and shareholders demand “good” quarterly numbers, and thus corporate executives demand “good” quarterly numbers from their subordinates. Companies that miss their quarterly numbers see their stock price fall. Thus, there is considerable pressure throughout the organization to make the projections and hit the targets, and there may be unpleasant consequences for a consistent failure to do so.

But the consequences associated with an intentional manipulation of the numbers—an intentional manipulation of measured revenue and/or profit in order to make the quarterly projections—are even more dire. A little less than a year ago, we **reported** on the consequences for one company – L-3 Corporation – that was alleged to have violated revenue recognition requirements. And now we have another company facing similar consequences, Computer Science Corporation or CSC.

According to **this story** , CSC agreed to pay the SEC $190 million in order to settle charges that it manipulated its financial results and concealed "significant problems about the company's largest and most high-profile contract, as well as ignoring basic accounting standards to increase reported profits." In addition to the complaint filed against the company, the SEC also filed charges against eight former executives, including the former CEO and the former CFO. Five of the eight executives have agreed to their own individual settlements, while three of the eight are currently contesting the charges.

CSC, of course, is a U.S. government contractor. It sells technology services to the Federal government via a number of different contract vehicles, from the GSA Schedules to NETCENTS 2 to a NAVSEA MAC. According to its annual report, in 2014 CSC generated 32 percent of its nearly $13 billion in annual sales (or $4.1 billion) from its North American Public Sector sales. The Department of Defense (DoD) was CSC's largest single Federal customer, accounting for $2.4 billion in sales, or more than half of its total public sector revenue. As a large Federal (and defense) contractor, CSC's revenue recognition methodology had to take into account some difficult government contracting issues—such has how to deal with change orders, disputes, and claims. That situation made an already challenging revenue recognition environment even more challenging. When you take into account that CSC had huge operations spread throughout the world, it becomes clear that accurate revenue recognition was an incredibly difficult task.

It was a task at which CSC failed.

In its 2014 annual report, CSC disclosed "certain accounting errors" and "certain aspects of [CSC's] accounting practices that involve the percentage-of-completion accounting method." The annual report told readers that "In the course of In the course of the … investigation [which was completed in 2012], accounting errors and irregularities were identified. As a result, certain personnel have been reprimanded, suspended, terminated and/or have resigned." The investigation resulted in approximately $88 million worth of adjustments, the vast majority of which related to FY 2012. The accounting errors and irregularities generally fell into three categories: (1) Nordic region operations, (2) Australian operations, and (3) contract adjustments for the contract awarded by the United Kingdom's National Health Service (NHS).

What did CSC do wrong? According to the story (link above)—

The SEC alleges that CSC's accounting and disclosure fraud began after the company learned it would lose money on the NHS contract because it was unable to meet certain deadlines. To avoid the large hit to its earnings that CSC was required to record, [CSC Finance executive] Sutcliffe allegedly added items to CSC's accounting models that artificially increased its profits but had no basis in reality. CSC, with [CSC CEO] Laphen's approval, then continued to avoid the financial impact of its delays by basing its models on contract amendments it was proposing to the NHS rather than the actual contract. In reality, NHS officials repeatedly rejected CSC's requests that the NHS pay the company higher prices for less work. By basing its models on the [rejected change order] proposals, CSC artificially avoided recording significant reductions in its earnings in 2010 and 2011.

The SEC's investigation found that Laphen and [CSC CFO] Mancuso repeatedly failed to comply with multiple rules requiring them to disclose these issues to investors, and they made public statements about the NHS contract that misled investors about CSC's performance. Mancuso also concealed from investors a prepayment arrangement that allowed CSC to meet its cash flow targets by effectively borrowing large sums of money from the NHS at a high interest rate. Mancuso merely told investors that CSC was hitting its targets 'the old fashioned hard way.'

The "old fashioned hard way," hmm?

But that's not all that was rotten in the state of Denmark, according to the SEC. The story also reported that –

… the SEC's investigation found that CSC and finance executives in Australia and Denmark fraudulently manipulated the financial results of the company's businesses in those regions.

The SEC alleges that Parker, who served as controller in Australia, along with regional CFO Wayne Banks overstated the company's earnings by using 'cookie jar' reserves and failing to record expenses as required. …

In CSC's Nordic region, the SEC alleges a variety of accounting manipulations to fraudulently inflate operating results as finance executives there struggled to achieve budgets set by CSC management in the U.S. Among the misconduct was improperly accounting for client disputes, overstating assets, and capitalizing expenses. For example, Edwards, who was a finance manager, allegedly recorded and maintained large amounts of ‘prepaid assets’ that CSC was required to actually record as expenses. This tactic guaranteed these expenses would not reduce CSC’s earnings.

So, *yeah*. The global technology company had accounting problems around the world. To some extent, those problems stemmed from local management “struggles to achieve budgets set by CSC management in the U.S.” Those folks did what they had to do to meet the projections and budgets given to them by Corporate – even if “what they had to do” involved violating accounting rules and breaching ethical guidelines.

We want to focus on the NHS contract problems. According to the story, those problems included “basing” financial analyses models of the contract’s at-completion costs on rejected change orders. By including rejected/disputed change orders in its models, the analysts also included the funding from those change orders into at-completion funding. Had those change orders not been included, the at-completion costs would have been the same, but the at-completion revenue would have been lower. And thus the at-completion negative variance between contract costs and contract revenue was reduced or even eliminated.

Now, a UK NHS contract is not a contract with the U.S. Federal government. But we bet the GAAP accounting requirements are pretty much the same. So we’ll take a few minutes of your time and discuss them in some detail.

To help understand the requirements we need to go back to the ancient GAAP guidance, SOP 81-1. Of course, that guidance has been superseded a couple of times and nobody is supposed to use it anymore; but we’re not professional accountants and we can use what we want. To our knowledge, nothing that we are going to use in SOP 81-1 has been contradicted in the several superseding guidance documents.

SOP 81-1 discusses change orders at paragraphs .61 through .63. Some snippets of the guidance include—

Change orders are modifications of an original contract that effectively change the provisions of the contract without adding new provisions. … Many change orders are unpriced; that is, the work to be performed is defined, but the adjustment to the contract price is to be negotiated later. For some change orders, both scope and price may be unapproved or in dispute. Accounting for change orders depends on the underlying circumstances, which may differ for each change order depending on the customer, the contract, and the nature of the change. Change orders should therefore be evaluated according to their characteristics and the circumstances in which they occur. In some circumstances, change orders as a normal element of a contract may be numerous, and separate identification may be impractical. …

For all unpriced change orders, recovery should be deemed probable if the future event or events necessary for recovery are likely to occur. Some of the factors to consider in evaluating whether recovery is probable are the customer's written approval of the scope of the change order, separate documentation for change order costs that are identifiable and reasonable, and the entity's favorable experience in negotiating change orders, especially as it relates to the specific type of contract and change order being evaluated. …

If it is probable that the contract price will be adjusted by an amount that exceeds the costs attributable to the change order and the amount of the excess can be reliably estimated, the original contract price should also be adjusted for that amount when the costs are recognized as costs of contract performance if its realization is probable. However, since the substantiation of the amount of future revenue is difficult, revenue in excess of the costs attributable to unpriced change orders should only be recorded in circumstances in which realization is assured beyond a reasonable doubt, such as circumstances in which an entity's historical experience provides such assurance or in which an entity has received a bona fide pricing offer from a customer and records only the amount of the offer as revenue.

If change orders are in dispute or are unapproved in regard to both scope and price, they should be evaluated as claims (see paragraphs .65–.67).

Over in paragraphs .65 to .67, accounting for disputed change orders – or claims – is discussed. Those paragraphs state (in part) –

Claims are amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs. Recognition of amounts of additional contract revenue relating to claims is appropriate only if it is probable that the claim will result in additional contract revenue and if the amount can be reliably estimated. …

If the requirements in paragraph .65 are not met or if those requirements are met but the claim exceeds the recorded contract costs, a contingent asset should be disclosed in accordance with FASB Statement No. 5, paragraph 17.

As can be clearly seen from the foregoing, CSC could recognize the at-completion revenue from its pending change orders only if it were probable that they would be agreed-upon and would result in additional funds. If that was not the case—and apparently it was not the case—then CSC was not permitted to recognize that at-completion revenue and, instead, was required to follow the requirements of FASB Statement No. 5. (We will not delve into those requirements here.)

The foregoing accounting problems cost CSC $190 million. They cost the former CEO $3.7 million worth of bonuses that were "clawed back," as well as a $750,000 penalty. The problems cost the former CFO $369,100 in claw back bonuses and a penalty of $175,000. They cost the Australian regional CFO $11,000 worth of claw back bonuses and interest on that amount of $2,400, plus a four year ban as acting as an accountant, officer, or director for SEC-regulated entities. The problems cost CSC's former Nordic finance director a similar ban of three years' duration.

Importantly, none of the accounting errors and irregularities involved CSC's contracts with the U.S. Federal government. They all stemmed from geographic areas on the other side of the world. But we believe the disclosed errors and irregularities are instructive for all companies, including those that sell to the Federal government. They point to a truism that the ability of a corporate HQ to ensure the integrity of its books and records is limited by its ability to monitor the activities of far-flung operations, and its willingness to get into the field and "kick the tires" from time to time.

In related news, on May 19, 2015, CSC **announced** that it was splitting into two publicly traded companies. According to the announcement, one company will focus on global services to commercial and government clients, while the other company will focus solely on public sector clients in the United States.