Valuation & Litigation Briefing

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Effective royalty audits start with the license agreement

Licensing can be a significant source of revenue for some of your clients who own patents, trade secrets, copyrights and other forms of intellectual property (IP), and an effective royalty audit program is critical to protecting that revenue stream. Regular audits can uncover royalties left unpaid due to mistakes, conflicting interpretations of the licensing agreement — or even fraud.

To avoid disputes or litigation that could disrupt the parties' working relationship, it's important to include a detailed audit provision in the license agreement that spells out the parties' rights and responsibilities. Getting a financial expert with forensic experience involved in drafting the agreement can help ensure the audit provision is consistent with auditing best practices and allows an auditor access to necessary information.

Fraud or simple mistake?

Licensees may underreport royalties for many reasons. While fraud does happen, simple mistakes are far more frequent — especially when royalty calculation methods are complex. Common examples include:

- Math, clerical or accounting system errors,
- Misinterpretations of contractual language,
- Communication errors (for example, the licensee's sales department fails to inform the accounting department of a new product that uses the licensed IP),
- Omission of royalty-bearing product sales because they're bundled with non-royalty-bearing products,
- Deduction of inappropriate or excessive expenses or allowances when calculating the royalty base (particularly when an element of judgment is involved), and
- Incorrect or outdated use of currency conversion rates for foreign sales.

Often, license agreements permit licensees to sublicense IP to third parties in exchange for a percentage of the royalties, but they treat sales by the licensee's wholly owned subsidiary as part of the royalty base. A common mistake licensees make is to underreport royalties by treating a subsidiary's sales as sublicensing revenue.

Effective provisions

To protect a licensor's rights under a license agreement, including a well-thought-out audit provision is key. Vague or overly simplistic audit provisions often lead to disputes or litigation when a licensor attempts to monitor the licensee's compliance with the agreement. To avoid conflict and help preserve the parties' working relationship, the audit provision should provide details on: 1) audit timing, 2) the type of information the licensee is required to maintain and provide, 3) the format in which that information should be delivered, and 4) the auditor's rights to access the licensee's accounting systems and facilities.

While it's important for the auditor to review the licensee's sales records and royalty statements, these documents are insufficient for a comprehensive audit.

Working with an expert during the agreement-drafting phase can help ensure that auditors will have the information and access they need to properly evaluate the licensee's compliance with the agreement. For example, while it's important for the auditor to review the licensee's sales records and royalty statements, these documents are insufficient for a comprehensive audit. To verify the number of royalty-bearing units the licensee has manufactured and sold, the auditor should have access to other types of documentation, including production records, inventory records, purchase journals and sublicenses.

The auditor should have some flexibility to define the types of records examined in the audit process, rather than relying on the licensee to decide what records will be produced. And to enhance the efficiency and effectiveness of the audit, these records should be made available in the format in which they're maintained. For example, if documents are maintained in electronic format, the auditor should have access to the electronic files. In addition, the agreement should allow the auditor to conduct on-site inspections and perform testing in the event his or her document review unearths any anomalies.

Be vigilant

There's a tendency among some licensors, once the license agreement has been executed, to sit back and count their royalty checks. But given the many ways royalties can fall through the cracks, it pays to monitor and enforce these agreements vigilantly. Well-designed audit programs often recover revenues that exceed audit costs. Indeed, many license agreements require the licensee to bear the cost of an audit if underreported royalties exceed a specified threshold — say, 5% of the reported amount.

A carefully drafted audit provision, designed with input from a forensic accountant, can help your licensors protect valuable IP assets, maximize their licensing revenues and avoid disputes. ■

Royalty audits aren't just about money

The primary purpose of royalty audits is to ensure that licensors collect all of the royalties to which they're entitled. But regular audits also serve several important nonmonetary purposes, including protecting the licensor's reputation and brand image.

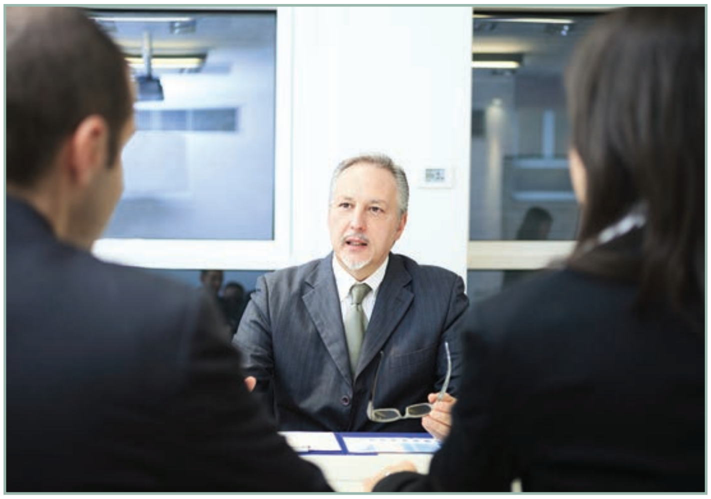
For example, audits can help ensure that the licensee is:

- Complying with fair labor standards,
- Maintaining quality control standards contained in the license agreement,
- Following advertising guidelines that are consistent with the licensor's brand identity, and
- Complying with any requirements that the licensed products be manufactured in specific countries.

Audits can also help the licensor enforce any territorial restrictions contained in the license agreement.

Achieving a fair settlement in divorce

Divorce is inherently acrimonious and difficult — and when a case ends up in court, both parties can be reluctant to cooperate, making a fair settlement difficult to reach. In such a situation, an experienced financial expert can be key in ensuring assets are fairly appraised and the split is equitable.



Improve discovery

Inadequate discovery can impede a fair asset split. When divorcing spouses own a business, it's usually their biggest, most illiquid asset. But the spouse who controls the business sometimes holds back on releasing certain information, such as financial statements, tax returns, business plans, contracts and marketing materials.

Some divorcing spouses may be unscrupulous and actually hide assets or income. Others may simply argue that giving an appraiser access to this information breaches the company's security and interrupts business operations.

Relevant issues include the appropriate standard of value, the appraisal date, and local courts' treatment of buy-sell agreements and goodwill.

When valuing a business, an appraiser needs access to information that's known only to insiders. Involve your financial expert early on to improve the scope of discovery. Ask him or her for a comprehensive list of documents and procedures needed to complete the job.

Uncover assets

Sometimes spouses hide assets in anticipation of an impending divorce. Or a business owner might delay reporting income or overstate expenses until his or her divorce is settled.

Suppose Mrs. Smith has opened a bank account under her adult daughter's name and has set aside $50,000 over the last year. She suspected Mr. Smith of being unfaithful, and wanted funds set aside in case he left her. But the $50,000 legitimately belongs in the Smiths' joint marital estate — regardless of which spouse might be in the wrong.

If you or a client suspects that the other spouse is concealing assets or income, the scope of an assignment may need to be expanded to investigate financial misstatement and asset misappropriation. Financial experts in divorce proceedings often have forensic accounting backgrounds, so be sure to tap into their fraud expertise.

Clarify tax and case law

It may be unclear whether discounts for lack of control and marketability, which are common in U.S. Tax Court cases, apply in divorces. Other relevant issues that might arise when an appraiser values a business include the appropriate standard of value, the appraisal date, and local courts' treatment of buy-sell agreements and goodwill.

While it's necessary to look at applicable case law in the appropriate state, an understanding of legal precedent in *other* jurisdictions can be helpful, too. Family courts sometimes consider cases in other states — or even U.S. Tax Court cases — especially if the state hasn't ruled on a similar case or if state case law is contradictory. The parties also might argue whether it's appropriate to subtract built-in capital gains tax liabilities when the marital estate includes C corporation stock. In a volatile economy, parties might argue over whether the filing date or the court date is the more appropriate "as of" date for valuing stock, retirement accounts and other marital assets.

Such points of contention can slow down divorce cases and add an element of uncertainty to court-imposed settlements, especially since judges may differ in their interpretations of these issues. Often the parties are better off negotiating their own out-of-court settlements.

Rely on professional expertise

It may be tempting to perform a do-it-yourself asset appraisal in a misguided attempt to save money — but it won't pay in the long run. Shortcuts, such as industry rules of thumb, net book value or buy-sell formulas, are likely to be found lacking.

And attempts to fraudulently hide or misrepresent assets could lead to additional legal trouble. In the end, such problems will make the original divorce action seem like a walk in the park.

Use the tried-and-true

Professional appraisers use sophisticated methods to value assets, particularly businesses. Such methods might include the adjusted book value, guideline public company, merger and acquisition, capitalization of earnings and discounted cash flow methods. These proven techniques are preferred by courts — and will lead to a better outcome for all involved. ■

Sweat the small stuff

How to detect and prevent expense reimbursement fraud

Companies often overlook expense reimbursement fraud because of the relatively small amounts involved. But these amounts can add up quickly, particularly if employees believe that management is "looking the other way." They can also be a way for dishonest employees to test the waters: If successful, they may graduate to bolder, costlier schemes. Expense reimbursement schemes are common, accounting for nearly 14% of all occupational frauds and resulting in a median loss of $30,000, according to the Association of Certified Fraud Examiners (ACFE).

Forensic accounting experts can help companies detect expense reimbursement fraud and implement measures to prevent it from recurring in the future.

Most common methods

According to the ACFE, expense reimbursement schemes generally fall into one of these four categories:

1. Mischaracterized expenses. This involves requesting reimbursement for a personal expense by claiming that it's business-related. For example, an employee takes a family vacation and requests reimbursement for meal and hotel expenses by submitting actual receipts and a false expense report.

2. Overstated expenses. Overstating expenses involves inflating the cost of actual business expenses — for example, by altering receipts or obtaining a refund for a portion of the expense. A common scheme is to buy a first- or business-class airline ticket with a personal credit card, submit the expense for reimbursement, and then return the ticket and replace it with a coach ticket.

3. Fictitious expenses. Obtaining reimbursement for nonexistent expenses by submitting false expense reports and fake receipts or other documentation would fall under the category of fictitious expenses. A common technique is to obtain a stockpile of blank receipts from taxicab companies or other vendors and submit them over time.

4. Multiple reimbursements. This scam involves requesting reimbursement for the same expense several times — typically by submitting photocopied receipts or different forms of supporting documentation (for example, receipts, email confirmations, canceled checks, tickets and invoices).

These schemes tend to continue for long periods of time before they're detected. The ACFE reports that the median duration of employee reimbursement frauds is 24 months.

Detection methods

Forensic accountants use a variety of techniques to detect employee reimbursement fraud. For example, they might review reimbursement documentation to look for photocopies, duplicates or fakes; compare employees' expense reports and supporting documentation to check for multiple claims for the same expenses; and compare the times and dates of claimed expenses to work schedules and calendars to look for inconsistencies, such as expenses claimed during vacations.

Forensic experts also search for red flags that may signal fraudulent activity or warrant further investigation. For example, they might look for employees who:

- Claim disproportionately larger reimbursements than other employees in comparable positions,
- Pay large expenses in cash despite access to a company credit card,
- Submit consecutively numbered receipts over long periods of time, and
- Consistently submit expenses at or just under the company's reimbursement limit for undocumented claims.

Another technique is to look for employees whose expense patterns violate Benford's Law — a statistical analysis tool that can reveal fabricated numbers.

An ounce of prevention

In addition to detecting expense reimbursement fraud, forensic accounting experts can help companies implement preventive measures. These include written expense reimbursement policies and procedures requiring detailed expense reports that set forth amounts, times, places, people in attendance and specific business purposes. Employees also should be asked to use company credit cards, submit original, detailed receipts (no photocopies), and provide boarding passes for air travel.

Periodic audits of travel and entertainment expense accounts also can have a powerful deterrent effect. Contact a forensic expert to schedule a surprise audit or to review your clients' current policies and procedures for reimbursing employees for out-of-pocket business expenses.

What's in a domain name?

Determining the value of an Internet address

A company's domain name may be more important than its street address. When customers are searching for a particular business, the Internet will likely be the first place they look. "Premium" domain names can fetch six or seven figures. So, how do appraisers value virtual real estate?

Several factors

Like other assets, domain names are valued based on what a willing buyer would pay a willing seller. But unlike most assets, each domain name is unique, making it more difficult to identify comparable sales. Also, many domain names contain the name of a specific person or business, and thus have little value to anyone else.

When valuing domain names, appraisers usually examine several factors that make them more or less valuable, including:

Brandability. Simple domain names that are brandable, catchy and easy to remember tend to have higher values. Examples include google.com and ebay.com.

Length. Short names and acronyms tend to have higher values because they're easy to remember and type. Two-letter acronyms — like American Airlines' aa.com — are particularly valuable because they're in short supply.

Intuitiveness. Generic terms that intuitively match a company's products or services tend to be more valuable. For example, hotels.com sold for $11 million in 2001, beer.com sold for $7 million in 2004, toys.com sold for $5.1 million in 2009, insurance.com sold for $35.6 million (including the website's content) in 2010 and medicare.com sold for $4.8 million in 2014.

Search volume. Words or phrases that are searched more often in Google and other search engines make for more valuable domain names. They also attract more advertising dollars through programs such as Google AdWords.

Existing traffic. Established domain names with histories of heavy visitor traffic tend to be more valuable.

Sales history. Previous sales of the same or similar domain names provide a good indicator of value.

Factors that tend to diminish a domain name's value include lengthiness (hard to remember and type), potential trademark infringement concerns, use of numbers or dashes, and use of uncommon words or "creative" spellings. Also, use of a top-level domain other than dot.com substantially reduces a domain name's value.

No substitute

These are just a few factors to consider in determining the value of a domain name. Do-it-yourself calculators are available online that can provide rough estimates of a domain name's value. But these tools are no substitute for an appraisal by a qualified valuator — and they're unlikely to pass muster with the IRS or SEC, or in court. ■