

The Witness Chair

Leading-edge Ideas for CPA Experts Providing Litigation and Dispute Resolution Services

SUMMER 2005

ISSUE 39

Finding Royalty

by Frances Franco-Valdez, CPA

Royalties are compensation paid to a producer, composer, writer, artist, or other talent for the use of their work. According to a study by the International Licensing Industry Merchandisers' Association (LIMA), manufacturers paid an estimated \$5.8 billion in licensing royalties in the United States in 2003.

The study also found that entertainment character licensing continues to be the largest category at about 43 percent of the market, or \$2.5 billion in royalties, which may, in part, explain why The Walt Disney Company spent 13 years fighting a lawsuit over royalties for Winnie the Pooh.

Manufacturers can increase sales significantly in the retail market by using popular characters, logos, brand names, and artwork on their products. The manufacturers of the products are able to use movie characters as a result of a license agreement with the licensor.

In turn, the licensor will require a royalty payment, which can range from 1 percent to as much as 20 percent of the revenue generated from sales. The percentage per the agreement is driven by the popularity of the characters licensed, with the most popular characters obtaining higher rates.

The amount of royalties paid on a license is dictated by the license agreement. It is standard for the license agreement to contain a clause that requires the licensee to

maintain accounting records supporting the revenue for the licensed item. Additionally, standard royalty agreements also contain a clause that provides the licensor with a right to audit the royalty reports that the licensee provides.

Royalties can be a significant source of revenue to the licensor, and, as a result, the licensor frequently will request royalty audits or forensic investigations by a CPA to ensure that the amounts reported are accurate.

Although misreporting royalties is often due to human and system errors or contract interpretation issues, a CPA's royalty audit or investigation should go beyond a simple checklist and may include the following:

1. Become familiar with the agreement and, if possible, meet with the attorneys who drafted the agreement to ensure that it is accurately interpreted by the licensee and auditor.
2. As most standard license agreements contain a minimum guarantee clause requiring that the licensee generate a minimum amount in royalties during a specified term, establish if the minimum guarantee has been met and how that impacts reported royalties. The minimum guarantees can range from \$10,000 to hundreds of thousands of dollars depending on the licensed product and the agreement terms.
3. Understand the product to ensure that the amounts reported are reasonable. For example, if the

licensed item is a classic, such as Snow White, Winnie the Pooh, or Mickey Mouse, there is a considerable amount of historical data on how these products perform in the market compared with products that are not as well known. A revenue analysis by type of product can reveal under-reporting of royalties.

4. Consider conducting research on historical royalty rates by using databases such as RoyaltyStat.com or RoyaltySource.com.

RoyaltyStat.com is a database of royalty rates and license agreements from the SEC's EDGAR archive and provides comparable royalty rates for valuing intangible assets. The database can be searched by Standard Industrial Classification (SIC) code or by full-text queries. There is an annual subscription fee of \$3,500, which includes an allowance of 100 license agreements.

RoyaltySource.com is a database of technology and trademark sale and licensing transactions. A subscription can be purchased for peri-

Continued on Page 5

In this Issue

- | | |
|--------------------------|--------|
| • Section Action | Page 2 |
| • Message from the Chair | Page 3 |
| • Keepin' It Legal | Page 4 |
| • AICPA Alert | Page 5 |
| • Happenings | Page 6 |

Section

ACTION

Business Valuation

by Ted D. Israel, CPA

As you know, we likely will have standards on valuation services from the AICPA very soon. The deadline for comments to the *Proposed Statement on Standards for Valuation Services* Exposure Draft has been extended to Sept. 30. The expectation is that after consideration of comments, and any modifications made, the standard may be issued as early as this fall and effective for valuation engagements accepted after Dec. 31.

If you have been following the process, you know that the initial *Exposure Draft* issued in 2002 needed a great deal of work; many versions and comments later have resulted in a much improved document. Your Litigation Sections Steering Committee has commented actively throughout the process.

One of the areas that caused concern among many practitioners was the intersection of the proposed valuation standards with the *Statements on Standards for Accounting and Review Services (SSARS)*.

What are the valuation professional's responsibilities for balance sheets and income statements appearing in valuation reports? Under what circumstances does the valuation professional have to perform compilation procedures? The answers to these questions reside in SSARS and exist whether or not the proposed valuation standards are adopted.

For firms that do not perform compilations, a re-familiarization with SSARS, including its definition of "financial statement" will be essential in coming up with a cost effective compliance strategy. When the new valuation standards are issued, we will address as many implementation questions as possi-

ble at our Business Valuation Section meetings.

Ted D. Israel, CPA, ABV, CVA is the Business Valuation Section chair and a partner at Eckhoff Accountancy Corporation in San Rafael.

Economic Damages

by Lynn Carl Jones, CPA

No specific time limit exists for the duration of depositions under the California Code of Civil Procedure (CCP), and many CPA experts can recall seemingly endless depositions. Since depositions pursuant to subpoena continue day-to-day, multi-day depositions can play havoc with an expert's calendar and commitments to other clients.

The court may limit the scope of discovery if it determines that the burden, expense, and intrusiveness of specific discovery outweighs the likely benefit. Further, the court may levy monetary sanctions upon findings that the discovery process has been misused. Refer to CCP Sec. 2023, which lists nine common misuses of the discovery process.

A determination on either the burden-benefit consideration or on allegations of misuse of the discovery process requires a hearing, which can escalate into a hotly contested mini-trial, as it is the behavior of attorneys, not their clients, that is being considered.

An efficient alternative is seeking the appointment of a discovery referee—often a retired judge—who the parties agree upon or the court appoints. Such a referee can manage personal antagonisms and limit behaviors that prolong proceedings or frustrate legitimate discovery efforts.

The referee can rule on objections, motions, and other requests immediately, facilitating legitimate discovery and slowing the onslaught of motions that otherwise would be brought to, and heard by, the court.

The appointment of a referee also benefits the expert, as more time is devoted to the expert's opinions and analyses and restrictions can be

placed on questions beyond the scope of allowable discovery, resulting in fewer objections and lawyers' colloquies.

The court's power to appoint a discovery referee resides in CCP Sec. 639. Parties having the economic ability to pay must bear a pro-rata share of the referee's costs. Because referees reduce the inefficient use of attorneys' and experts' time in excessively contentious litigation, the cost of a referee's services can result in a cost savings to the parties.

Lynn Carl Jones, CPA, CFE is the Economic Damages Section chair and managing principal of Jones & Co.

Family Law

by Leslie O. Dawson, CPA

The IRS recently released Private Letter Ruling (PLR) 200519011 (5/13/05) addressing the division of incentive stock options (ISO) in a divorce. This ruling, while technically not available for citing as authority, provides reporting guidance and rationale for the non-employee spouse's (NES) exercise and sale of ISOs pursuant to a divorce agreement.

The specific case involved an arrangement by which the employee spouse (ES) holds the NES's options and conducts transactions only at the NES direction.

Some important provisions of this ruling include:

1. The ES's designation of the NES as the beneficiary of a community property share of the ISOs will not disqualify them under IRC Sec. 422(b)(5).
2. The NES will recognize the alternative minimum taxable (AMT) income resulting from the exercise of his/her ISOs.
3. The NES receives the AMT credit resulting from the exercise of his/her ISOs.
4. Neither the designation of the NES as the beneficiary of his/her ISOs nor the transfer to him/her of stock received from an exercise will be considered a taxable event.

5. The transfer of the stock to the NES will not be considered a disposition of stock under IRC Sec. 424(c).
6. Gain or loss on the sale of the NES's stock will be reported by the NES, even if the stock is registered in the ES's name.
7. Reimbursements by the NES to the ES for any taxes withheld by the company will be tax-free.
8. The NES claims all income tax withholding resulting from the exercise of his/her options or the sale of his/her stock.

This ruling takes the next step after the IRS decided to allow the transfer of non-qualified options to the NES in Rev. Rul. 2002-22. Unfortunately, there is no discussion of how the company is to report the NES's ISOs, so, presumably, all transactions will be reported on the ES's W-2, which will require allocation between the parties. Stay tuned.

Leslie O. Dawson, CPA is Family Law Section chair and a partner in Glenn & Dawson LLP in Walnut Creek.

Fraud

by Amy H. Workman, CPA

The major financial reporting failures at Enron, WorldCom, and others led to the financial reporting reforms contained in the Sarbanes-Oxley Act of 2002. One of the most significant reforms for management and auditors is implementation of internal control reporting requirements contained in Sec. 404 of SOX and in the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*.

A consequence of implementing these internal control requirements is a decrease in the level and extent of communication between auditors and management regarding accounting and financial reporting issues.

Before SOX, auditors and management discussed how to account for transactions and auditors provided management with accounting advice.



Message from the Chair

by Andy Mintzer, CPA

Regular readers of this column will notice two recurrent themes.

First is the AICPA's *Statement on Standards for Valuations Services Exposure Draft*. The Exposure Draft was finally issued March 30 for comment. This Exposure Draft has been years in the making, and still has a long way to go before it becomes a standard. The formal comment period has been extended until Sept. 30 to accommodate AICPA members wanting to comment further.

The AICPA may issue the standards as proposed or with changes or to step back and reconsider issuing them altogether. I urge you to monitor the status at www.aicpa.org.

The Litigation Sections Steering Committee issued a six-page comment letter, which may be found at www.calcpa.org/LIT. I thank the steering committee members for working diligently and emotionally since December 2002 to provide thoughtful and candid comments to the AICPA throughout the development process.

Now, auditors are concerned that providing advice to management might impair their independence.

The SEC and PCAOB issued guidance May 16 to address issues raised at the SEC's April 13 Roundtable on Implementation of Internal Control Reporting Provisions. The SEC and PCAOB encouraged companies and auditors to engage in direct and timely communication with each other.

As long as management makes the final determination as to the accounting used for the company's circumstances, the auditor may, and is encouraged to, provide advice on accounting or internal control issues. For example, management may pro-

vide and discuss with the auditor preliminary drafts of its accounting treatment to get the auditor's views on assumptions and methods.

For discussions regarding the views of the SEC and PCAOB, refer to the SEC's *Staff Statement on Management's Report on Internal Control Over Financial Reporting* at www.sec.gov and the PCAOB's *Policy Statement Regarding Implementation of Auditing Standard No. 2*, PCAOB Release No. 2005-009, at www.pcaob.org.

Second is Litigation Sections membership and potential members. Section meetings are the focal point of value for your membership—with continuing education and networking opportunities with peers and attorneys all focused on your area of interest, whether it be in business valuation, economic damages, family law, or fraud.

Consider becoming a leader in your section. We will solicit nominations in the fall for section officers. Run or encourage one of your colleagues to run for a section leadership position. You will find your service personally and professionally rewarding.

Andy Mintzer, CPA, CFE is a sole practitioner based in Santa Monica.

vide and discuss with the auditor preliminary drafts of its accounting treatment to get the auditor's views on assumptions and methods.

For discussions regarding the views of the SEC and PCAOB, refer to the SEC's *Staff Statement on Management's Report on Internal Control Over Financial Reporting* at www.sec.gov and the PCAOB's *Policy Statement Regarding Implementation of Auditing Standard No. 2*, PCAOB Release No. 2005-009, at www.pcaob.org.

Amy H. Workman, CPA, ABV is an associate director in Navigant Consulting's Litigation and Investigations practice in Los Angeles.

Keepin' It Legal



A Rule of Thumb for Patent Damages?

by Jed K. Greene, CPA

A look into a 1999 ruling by Judge Marian Horn may help practitioners gain insight as to the application of "rule of thumb" methods in determining reasonable royalties in patent infringement cases.

In *Standard Manufacturing Co., Inc. and DBP, Ltd. v. United States* [42 Fed.Cl. 748 (1999)] (*Standard Manufacturing*), Judge Horn concluded that an appropriate royalty rate for damages should be calculated by applying a rule of thumb rate as a starting point for a reasonable royalty rate and increasing or decreasing that rate based on the *Georgia-Pacific* factors [derived from *Georgia-Pacific Corp., v. United States Plywood-Champion Papers*, 318 F.Supp. 1116 (1970), *aff'd*, 446 F.2d 295 (1971)] and other pertinent factors. In this case, damages were awarded to the plaintiff based on a 16.31 percent reasonable royalty rate on a compensation base of \$64,195,217 for the 136 infringing MHU-196/M trailers and \$32,798,004 for the 36 infringing MHU-204/M trailers.

These trailers load weapons into the B-52, B-1B and B-2 bombers used by the U.S. Air Force.

Case Background

On the first part of a bifurcated trial, the court determined that the U.S. infringed on the valid and enforceable patent. A second trial was held to determine damages.

Both parties agreed that a reasonable royalty would be the best method to calculate damages and

both parties mostly agreed on the appropriate royalty base. The parties, however, disagreed on what should be the appropriate royalty rate.

In calculating the royalty rate, the court determined that a reference, or "baseline," royalty rate would be the starting point, and that rate would be adjusted based on the *Georgia-Pacific* factors and additional pertinent factors. In the absence of any prior license agreements for the technology or typical royalty rates in the industry, the court sided with the defense's method of determining a baseline royalty.

Rule of Thumb Method

The defendant's expert, Dr. Robert Goldscheider, proposed a rule of thumb method known as the "25 Percent Rule." Goldscheider is considered one of the founders of this rule of thumb method.

Basically, the 25 Percent Rule suggests that the patent holder is entitled to 25 percent of the profits gained by the licensee from use of the patented technology. The remaining 75 percent of the profits are reserved by the licensee as its profits for manufacturing and market risks.

Among industry professionals, there are both advocates and critics of this rule of thumb calculation and similar calculations. Critics claim that the appropriate profit to use in a rule of thumb calculation can be subjective and that the calculation cannot replace the concrete facts used to determine royalty rates. Still, many courts have used this or some version of a rule of thumb calculation.

In *Rite-Hite Corp. v. Kelley Co., Inc.* [56 F.3d 1538, 35 U.S.P.Q.2d 1065 (Fed.Cir., 1995)], the court determined that 50 percent of the lost profits of the plaintiff should be an appropriate royalty to compensate the plaintiff.

The Royalty Calculation

Judge Horn decided that the 25 Percent Rule should be applied to the profit on the sale of the trailers, determined to be 17.26 percent. The baseline royalty was set at 4.31 percent. Then, the court decided to

adjust the baseline rate based on the *Georgia-Pacific* (G-P) factors and the other pertinent factors in the case, as shown in the following chart:

Factor	Result	Change in Royalty Rate
G-P #1	No adjustment	None
G-P #2	No adjustment	None
G-P #3	Favored a decrease	-1%
G-P #4	No adjustment	None
G-P #5	Strongly favored an increase	+2%
G-P #6	No adjustment	None
G-P #7	No adjustment	None
G-P #8	Strongly favored an increase	+2%
G-P #9	Strongly favored an increase	+2%
G-P #10	Strongly favored an increase	+2%
G-P #11	Significantly and strongly favored an increase	+4%
G-P #12	No adjustment	None
G-P #13	No adjustment	None
G-P #14	No adjustment	None
G-P #15	No adjustment	None
Other	One factor	
pertinent factors favored an increase		+1%
TOTAL ADJUSTMENT IN ROYALTY RATE		+12%
FINAL ADJUSTED ROYALTY RATE		16.31%

Conclusion

While it can be argued that assigning individual percentages to each *Georgia-Pacific* factor may be somewhat arbitrary, Judge Horn's ruling illustrates a method of using a rule of thumb calculation in connection with evidence considered through the *Georgia-Pacific* factors and other pertinent factors. Other courts have adopted similar methodologies.

In *Bose Corp. v. JBL, Inc., Infinity Systems* [112 F.Supp.2d 138 (2000)], the court referred to *Standard Manufacturing* and stated that it is prudent to establish a baseline royalty rate that can be adjusted depending on the *Georgia-Pacific* factors. The court found the "25 percent/75 percent" approach (the 25 Percent Rule) to be useful in arriving at a baseline royalty rate.

Jed K. Greene, CPA, CMA is a manager in the litigation services group of Hemming Morse, Inc. in San Francisco.



by Jeffrey H. Kinrich, CPA

Many of the AICPA's efforts in the Business Valuation/Forensic & Litigation Services (BV/FLS) area are focused on the business valuation practice. As you know, the AICPA grants the Accreditation in Business Valuation (ABV) to qualified practitioners in the BV field. To provide cost-effective support, the number of ABVs must grow.

Several years ago, the AICPA set out certain ambitious, but attainable, goals for the number of members holding the ABV by 2008. While the number of ABVs is growing, it is by no means clear that this growth will be sufficient to meet stated goals.

Members interested in business valuation are encouraged to apply for the ABV credential and to encourage their employees and peers to do the same.

The AICPA has many opportunities for members to publish relevant articles. Your materials can be published at the BV/FLS website, <http://bvfls.aicpa.org>, in the *CPA Expert*, or in other publications.

The AICPA is interested in both new and previously published material. If you are willing to share your

expertise, contact the AICPA or you may contact me and I'll put you in contact with the appropriate person.

There are many new items posted on the BV/FLS website every month. If you visit the Resources section, you will see that recent additions are highlighted so you easily can see what is new. The website also hosts a discussion forum where you can post questions and reply to questions raised by others. While most of the website is open to all AICPA members, the discussion forum is limited to ABV credential holders.

The FLS Committee is continuing its efforts in the fraud and economic damages areas. Both the AICPA and regulatory bodies have turned to FLS fraud prevention practitioners to integrate fraud prevention and detection into audit procedures. These efforts continue.

On the damages side, the FLS committee is finalizing a practice aid on Intellectual Property Damages. Although there are no guarantees, look for it to be published about the end of the year.

The AICPA Fraud and Litigation Conference will be held in Dallas Sept. 28–30. By the time you read this, the brochure should be available. You also can get information from the BV/FLS website. Consider attending or sending your associates.

Jeffrey H. Kinrich, CPA, ABV is a managing principal of Analysis Group in Los Angeles.

sonable. For example, when the product is associated with a theatrical release, the CPA may need to consider information such as the timing of the release, film performance, and the film's revenue cycle. If the license is for multiple territories, the individual may consider the timing for the various territories during the analysis. For example, if Shrek were the

Continued on Page 6

Letter to the Editor

Dear Editor:

I read with interest your article on appointments under Evidence Code Sec. 730 as it relates to appointments of a "common accountant." I recently had the unfortunate experience of having to deal with a court-appointed accountant retained to render a report on issues of cash flow available for support, separate vs. community assets, reimbursement claims and the like.

The parties spent substantial sums in dealing with the "common accountant," who performed these services in a less than timely manner, was not inexpensive, and was unwilling to resolve or attempt to resolve any disputed issues. By way of example, but not limitation, issues not resolved were: i) perquisites, ii) separate vs. community assets, iii) reimbursement claims.

The simple fact is that the accountant was not willing to resolve disputes or render an opinion, merely taking information from both sides and presenting same without any resolution. Since the issues were unresolved, the parties had no alternative but to retain their own independent accountants, all of which resulted in the parties incurring fees for three accountants rather than two.

Based on my experience, I do not believe that this process provides a cost saving to the participants nor time saving. In my case, it served little purpose except to spend significant fees outlining the respective positions of the parties without solution.

*John A. Ellis, Esq.
Trope and Trope*

Royalties

Continued from Page 1

ods from one month to a year, with fees ranging from \$100 to \$500.

Searches from both sources contain the names of the licensor and licensee, a description of the property, the royalty rate, duration of the license, and the territory covered by the selected license agreement.

5. Consider the industry to ensure that the amounts reported are rea-



H A P P E N I N G S

Litigation Sections Meetings

Business Valuation	Thursday, Oct. 6, Oakland
Economic Damages	Monday, Oct. 10, Oakland
Family Law	Friday, Oct. 7, Oakland
Fraud	Monday, Oct. 10, Oakland

Each section will send individual meeting notices.
Download a copy at www.calcpa.org/LIT
or contact Bobbie Nochenson at (818) 546-3502

**Education Foundation Courses—(800) 877-5897
or www.educationfoundation.org**

Business Valuation Overview	Oct. 18, SFV
(New) Business Valuation Fundamentals: Part II	Aug. 29–31, LA/BH
2005 ABV Examination Review Course	Sept. 26–27, LA/BH
Business Valuation Succession Planning:	Oct. 20, LA/BH
A Practical Approach	Oct. 21, SF
California Community Property	Sept. 22, BUR
	Nov. 8, SF
Family Law Conference	Nov. 3, LAX
	Nov. 4, SF
Litigation Consulting: Essential Skills for Staff and Others	Nov. 9, SF
(New) Tracing and Business Valuation	Nov. 10, SF
(New) Facing Fraud: An Internal Accounting Perspective	Sept. 20, San Jose
Accounting for Goodwill, Fair Value and Impairment	Sept. 8, SF
Key Ratio Analysis	Aug. 23, OC

Royalties

Continued from Page 5

licensed character, one would expect sales of the item to increase during the time that the movie is in theatres and start to decrease after the film exhibition. If sales of the licensed merchandise indicate an unusual trend, the CPA should

investigate the cause of this trend until it is explained.

- Consider seasonal impact on royalties when analyzing the reasonableness of the amounts reported. As an example, character licensing royalties may increase during the holiday season as a result of higher toy sales.
- Consider requesting reports that

are not part of the standard package provided by the licensee. Reports such as a listing of all product codes may identify sales of licensed merchandise not reported.

- Request that the client run computer queries of product codes with zero sales to ensure that the product is properly mapped to the royalty reports. The licensee will often add a new product, but sales are not reported, resulting in a material understatement in royalties. Royalties can be a material component of an entity's revenue and the results of the audit or forensic investigation can have a major impact on the financial statements. When conducting an audit or investigation of royalties, the CPA should consider steps beyond analytical and standard audit procedures.

Frances Franco-Valdez, CPA is a manager in the litigation services group of Hemming Morse, Inc. in Westlake Village.

The Witness Chair is published quarterly by the Litigation Sections of the California Society of Certified Public Accountants.

Editor

Susan Bleecker

Associate Editors

Leslie O. Dawson

Maria N. Nazario

Sections Chair

Andrew M. Mintzer

Individual Section Chairs

Business Valuation Ted D. Israel

Economic Damages Lynn Carl Jones

Family Law Leslie O. Dawson

Fraud Peter A. Salomon

CalCPA Staff Liaison

Maria N. Nazario

Nonmember subscription rate is \$75 for one year. To subscribe, call CalCPA at (818) 546-3502 or (800) 922-5272.

We welcome your letters, articles, comments and suggestions, which may be sent to the editors at bleeck@pacbell.net.



The Witness Chair does not provide legal advice. The material published, unless otherwise specified, represents the views of the authors and the individuals quoted and not those of CalCPA or the AICPA.

California Society Certified Public Accountants

www.calcpaexpert.org

© 2005 California Society of CPAs