



CRA Insights: Licensing

CRA Charles River
Associates

October 2014

Ten ways to make a contract compliance investigation more effective

While it is reasonable to assume contracts are based on an expectation of trust and mutual benefit, it is also fair to expect the rights holder to confirm that the other party is holding up their end of the deal—“trust but verify.”

Contract compliance investigations can vary, but the function is essentially the same: to test the compliance of a certain party against specific, agreed-upon contractual terms. In the entertainment industry, common contract compliance issues include:

- Royalty audits related to the licensing of trademarked characters on consumer products;
- Profit participation audits related to the rights of various talent to receive contingent compensation from the distribution of motion picture or television content;
- Investigations about the amount of contingent rent compensation stemming from a live entertainment venue; and
- Most Favored Nation audits related to certain terms between several motion picture studios and a specific DVD manufacturer.

Typically, contract compliance investigations are performed in the normal course of business and include planning, fieldwork, and reporting phases. After the investigation report is issued, the parties seek to resolve any resulting claims. Performing the compliance investigation right the first time is imperative for a number of reasons:

- If litigation is required to resolve the remaining claims, how the investigation was conducted and the resulting claims were determined will become a focus of the litigation.
- Past periods are typically not allowed to be re-audited, either by specific terms of the respective contract or industry best practices.
- If certain claims included in the issued report are significantly flawed, it may set an unrealistic expectation for the rights holder, which can make settlement more difficult, and may sully the credibility of separate claims that might otherwise be deemed reasonable.

Mistakes made during a contract compliance investigation can derail its intended effectiveness. This article highlights 10 issues that may seem obvious, but can help the investigator to make a more effective contract compliance investigation.

Understand relevant CPA professional standards

CPAs typically perform contract compliance investigations. When the investigation is engaged by the rights holder,¹ it is usually performed as a non-attest consulting service, which is governed by the professional standards included in the Statement on Consulting Standards No. 1, issued by the American Institute of Certified Public Accountants (AICPA).² Unfortunately, not all CPAs doing this type of work are aware that such professional standards exist and there may be occasions in which the CPA does not perform to them. While these standards may appear less restrictive than those related to attest functions, they still require the CPA to maintain a level of diligence related to the planning, fieldwork, and reporting aspects of a consulting engagement.

Identify and document audit risks and procedures

The fieldwork phase for a contract compliance investigation is scheduled in advance for a limited period of time, perhaps for one or two weeks, or longer in certain cases. In preparation, the investigator should review the respective contract including amendments, reporting statements from the licensee, and correspondence between the two parties for the relevant investigation period and discuss any concerns with the rights holder and/or their counsel. It is imperative to identify and document the issues that present significant risk, as well as the expected procedures to address those risks, before the fieldwork begins. Failure to do so increases the likelihood that key documents may not be requested and/or key audit procedures may be overlooked during fieldwork.

Assess reliability of documents

After the licensees produce the requested documents, it is worth taking time to assess whether they are reliable specifically for the purposes of the investigation. For instance, if a summary sales report has been produced, the investigator should consider requesting a reconciliation between the summary sales report and the relevant segment of that licensee's general ledger. Otherwise, the investigator might not be testing the entirety of the intended transactions. A damage claim based on a flawed sales report could result in the rights holder abandoning the claim calculation and the many hours wasted to transcribe data and/or calculate the claim based on the flawed sales report.

Alternatively, this does not absolve the licensee from providing reliable data for the investigation. If the investigator discovers flawed documents, they should request replacements and consider whether fieldwork needs to be delayed to give the licensee additional time to produce and vet the replacement documents.

Audit according to the contract, not GAAP

Each contract is different, and may have terms that are either not defined by Generally Accepted Accounting Principles (GAAP) (e.g., "Adjusted Gross Receipts"), or perhaps defined differently from GAAP. For example, some contracts may limit the term "revenue" to include only transactions in which the entity has received payment, as opposed to on an accrual basis under GAAP. The investigator should confirm their understanding of the material contract terms with the rights holder and/or their counsel.

¹ A contract compliance investigation may also be initiated by the licensee, for instance to demonstrate to the rights holder that the licensee is in compliance with certain contractual terms; this type of engagement is considered an attest engagement by the AICPA, and is governed by separate Compliance Attestation professional standards.

² These services may also be performed as an agreed upon procedures engagement, which has its own set of professional standards; however, since the scope of, and the reporting for, an agreed upon procedures engagement is generally limited to those procedures requested by the client, it is not often used to conduct a contract compliance investigation.

Defer legal interpretation of the contract

While most contracts are designed to address a host of unknown but possible situations or transactions, invariably new issues arise which may require interpretation. Since some of these new issues may require a legal interpretation, the investigator should refrain from reaching unilateral legal conclusions. However, there are certain types of accounting interpretations where it may be helpful if the CPA has a reasonable understanding of the industry involved and the relative investment/risk expectations between the rights holder and the licensee.

For example, before considering whether a certain sales rebate or discount represents an allowed deduction from the calculus of contingent compensation due, the investigator should have and/or gain a working knowledge of how the transactions occur and are recorded in the normal course of business, and whether such a sales rebate or discount is common practice in that industry.

Additionally, the investigator should not unilaterally assume monetary damages can be attached to alleged breaches of non-monetary contract terms. For instance, before considering whether excessive carriage of a cable television broadcast signal results in monetary damages, the investigator should first determine whether the broadcast license fees were contractually fixed (i.e., did not vary based on the number of subscribers receiving the signal), or the contract specifically provided for monetary damages relating to the excessive signal carriage.

Confirm bases and methodologies for claimed extrapolations

A contract compliance investigation typically includes testing a sample of detailed transactions back to source documentation to confirm whether the activity reported in the licensee's books and records was appropriate. In some cases, issues emerge from the sample testing that may result in potential claims. Sometimes those potential claims are extrapolated from the sample population to the overall population of transactions. These extrapolations may be flawed if the investigator uses either an improper methodology or an improper basis to extrapolate.

When an error occurs within the sample being tested, the person investigating must establish if the noted error is pervasive to either the entire population or just a subset. For instance, it is not enough to observe what may be an error related to a singular transaction and simply assume the remaining population has similar errors in the same proportion. Worse yet is when an investigation identifies more than one type of error in a sample, and then extrapolates the combined sample error to the entire population without investigating the nature and cause of the separate errors.

The investigator must apply a consistent methodology across the various population data being used to extrapolate, especially when certain systems or reporting formats may have changed during the investigation period. Consider the following example: a CPA extrapolated damages across a number of domestic and foreign territories. For one part of the investigation period, the CPA noted separate sales figures for more than 10 separate European territories, while for the second period the CPA noted sales figures for Europe in total. The CPA did not ask whether the later sales figures for Europe in total covered the same population of sales reported earlier by each separate territory, and extrapolated damages as if European sales were underreported throughout the investigation period, either in total or by separate territory. This extrapolation error resulted in unnecessarily overstated damages in excess of \$10 million.

Reflect the interplay between multiple claims

Multiple findings from an investigation need to be calculated with consideration of the potential interplay between certain claims. For example, assume two separate claims, one related to underreported sales of

a new product and another claim related to the overstatement of a return reserve. The combined amounts from these two claims would represent the net impact of underreported sales, less the appropriate return reserve.

Do not overstate the value of claims

When claim amounts are unnecessarily overstated, this can lead to unrealistic recovery expectations by the rights holder and call into question the credibility of the remaining claims. For instance, claims from underreported unit sales or software licenses might be incorrectly calculated using higher catalog list prices, instead of lower market-based unit prices.

The value of missing inventory can also be overstated. Sometimes, an analysis of inventory movement can indicate a significant amount of missing inventory that could possibly represent underreported sales. In some cases, these claims are valued as missing sales, assuming that the missing units were sold. However, unless there is evidence that these missing inventory units were sold, or at least could have been sold and not just sitting in the warehouse as additional excess inventory, the value of these claims may be better represented as the costs incurred to produce or purchase the missing inventory.

Communicate with licensee about potential findings

Unless the rights holder and/or their counsel specifically prohibit the investigator from discussing potential findings with the licensee, best practices dictate that such discussions should take place before issuing the investigation report. The benefits are two-fold: 1) the licensee may have additional information that may clarify the investigator's understanding of a potential finding, which may result in a more precise final report, and 2) the licensee may provide their initial response to a potential finding, which may be considered in the rights holder's recovery expectations. These discussions can also help identify any potential inadvertent errors made by the investigator, which if left unaddressed, could call into question the credibility of remaining claims.

Communicate with counsel

If the internal or external counsel to the rights holder is available, it is useful for the investigator to seek guidance throughout the investigation on the following matters:

- audit risks;
- document requests;
- fieldwork logistics and cooperation;
- scope limitations and extensions;
- contract interpretations;
- potential findings;
- discussions with licensee; and
- report presentation.

Consistent communication keeps the investigation on track and limits surprises. Failure to communicate may limit the effectiveness of the investigation, in terms of certain planned tasks not being performed, or the rights holder having the ability to request additional information during fieldwork, in response to certain potential findings.

Contract compliance investigations require focus and coordination, especially on the part of the investigator. While the potential pitfalls are many, to the extent that the investigator can work with the rights holder and counsel to confirm their understanding of what is being investigated, as well as the resulting claims, the investigation should produce more precise findings, and more efficient resolutions.

About Ben Sheppard

Mr. Ben W. Sheppard is a vice president in the Intellectual Property Practice of Charles River Associates. He has more than 20 years of authoritative experience providing litigation support, forensic investigation, and complex valuation analyses. With a special emphasis on entertainment and media industries, Mr. Sheppard has testified in numerous cases and sat on many discussion panels for his objectivity in all types of intellectual property issues. His vast professional experience is relied upon in crucial strategic and compliance business decisions regarding various types of intangible assets.

Contact

Ben Sheppard

Vice President

Los Angeles

+1-213-330-4017

bsheppard@crai.com

www.crai.com



The conclusions set forth herein are based on independent research and publicly available material. The views expressed herein are the views and opinions of the authors and do not reflect or represent the views of Charles River Associates or any of the organizations with which the authors are affiliated. Any opinion expressed herein shall not amount to any form of guarantee that the authors or Charles River Associates has determined or predicted future events or circumstances, and no such reliance may be inferred or implied. The authors and Charles River Associates accept no duty of care or liability of any kind whatsoever to any party, and no responsibility for damages, if any, suffered by any party as a result of decisions made, or not made, or actions taken, or not taken, based on this paper. If you have questions or require further information regarding this issue of *Insights: Licensing*, please contact the contributor or editor at Charles River Associates. Detailed information about Charles River Associates, a registered trade name of CRA International, Inc., is available at www.crai.com.

Copyright 2014 Charles River Associates