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Issues, cases, practice management tips and news for Forensic and Valuation Services Section members

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Audits, Forensic Accounting, and Fraud Examinations – Different Services

By Michael G. Ueltzen CPA/CFF, CFE and Annette M. Stalker, CPA/CFF, CFE

This article discusses some of the basic and fundamental differences in the approach, scope, procedures, costs, and reporting related to each of the preceding services. On one hand, the article is a relatively fundamental comparison of a GAAS audit and forensic accounting services, which may include a fraud examination, but the distinctions are important to the practitioner when such services are being provided. First, different standards apply to the two services. Second, the approach and procedures employed are frequently different. Third, the reporting related to the two services will be different. These differences are so fundamental that they should be communicated and understood by both the client and the practitioner from the outset of an engagement.

HISTORY & GUIDING PRINCIPLES

GAAS Audit. An audit is conducted in accordance with generally accepted auditing standards (GAAS) established by the AICPA's Auditing Standards Board (ASB) in the form of Statements on Auditing Standards (SASs).

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Chair's Corner

Unmatched networking opportunities, lively presentations and world-class entertainment. No, the conference isn't in Vegas again this year. Instead, we will be at the home of country music: Nashville, TN. If you want to expand your knowledge and professional contacts in an exciting setting, the 2016 AICPA Forensic & Valuation Services Conference is the place to do it. Perfect for anyone with an interest in our practice areas, the conference, which will be held Nov. 6–8 at the Gaylord Opryland Hotel, features hands-on, practical sessions on each discipline as well as forward-looking presentations on cutting-edge issues.

Act now! There's a $100 discount for FVS Section members and ABV or CFF credential holders and an added early-bird discount for those who register by Sept. 24. Hope to see you there!

Carol Carden, CPA/ABV, CFE, ASA

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Entities defined as *issuers*[1] are required to have audits conducted in accordance with auditing standards governed by the PCAOB.[2] For purposes of this article, an audit under both the AICPA and PCAOB standards will be referred to as a GAAS audit.

The AICPA auditing standards address auditor qualifications, the conduct of field work, and reporting the results of an audit. The first Auditing Procedure Standard was issued in October 1939, and the first SAS was issued in November 1972. Currently, there are approximately 131 statements issued by the ASB as of January 2016.

An audit performed in accordance with GAAS considers fraud risks throughout the process as it is designed to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error. The financial statements and related internal controls over financial reporting are a basic responsibility of company management.

Forensic Accounting. Forensic accounting can be traced to the 1800s, when James McClelland of Glasgow, Scotland began a business that, in part, advertised "the making up of statements, reports on disputed accounts and claims for the purpose of laying before arbiters, courts, or counsel."[3] A fraud examination is part of forensic accounting. The concept of an "auditor" can be traced to Grecian times, when the role of the auditor was to monitor shipping throughout the Grecian empire.

The first print example of the use of the term forensic accounting was in an article published in 1946 in the AICPA's *Journal of Accountancy*, authored by AICPA Gold Medal Award of Distinction winner[4] CPA Maurice Peloubet entitled "Forensic Accounting — It's Place in Today's Economy." Since the early references to forensic accounting, the specialty practice has evolved significantly and is now fairly common although the lines between forensic accounting and auditing seem to remain a bit blurred.

With the development of the AICPA credential, Certified in Financial Forensics (CFF), and an updated AICPA Code of Professional Conduct, the AICPA has defined forensic accounting as follows:

> *… Forensic accounting services are nonattest services that involve the application of (a) special skills in accounting, auditing, finance, quantitative methods and certain areas of the law, and research and (b) investigative skills to collect, analyze, and evaluate evidential matter to interpret and communicate findings. Forensic accounting services consist of investigative services and litigation services.*[5]

Forensic accounting services include several of the following core areas: (1) economic damages; (2) fraud prevention, detection, and fraud examinations; (3) bankruptcy, insolvency, and reorganizations; (4) financial statement fraud; (5) family law matters; (6) computer forensics and data analytics; and (7) valuation. A fraud examination is only one part of the broad umbrella of forensic accounting services.

Fraud Examination. Fraud examination can be considered a subset of forensic accounting. The Association of Certified Fraud Examiners (ACFE) defines a *fraud examination* as "a methodology for resolving fraud allegations from inception to disposition, and it is the primary function of the anti-fraud professional. The fraud examination process encompasses a variety of tasks that might include the following:

- Obtaining evidence
- Reporting
- Testifying to findings
- Assisting in fraud detection and prevention"[6]

Each fraud examination is unique because the approach and exam steps are determined first by the predication, and the approach is then modified as evidence is uncovered. Predication is the totality of circumstances that would lead a reasonable, professionally trained, and prudent individual to believe a fraud has occurred or may occur.[7] There are several elements to a fraud examination, that are not typically part of a GAAS audit. Some of these elements may include in-depth interviews of the client and others, the examination of email exchanges among parties, the knowledge of rules of evidence, in the conduct of public records searches, and the performance of extensive electronic data mining using sophisticated software and analytics.

DISTINCT DIFFERENCES BETWEEN A GAAS AUDIT AND A FRAUD EXAMINATION

Although general public opinion may be that a GAAS audit is closely related to

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1. An *issuer* is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.
2. Initially, the PCAOB adopted the AICPA's auditing standards (SAS Nos. 1–101) on an interim basis as of December 2008; there are currently 18 PCAOB Auditing Standards.
3. Alex Moore, "The Accountant as an Expert Witness," The Accountant, June 29, 1907, 879–886.
4. AICPA Gold Medal Awards, aicpa.org/volunteer/memberawards/pages/aicpa-gold-medal-distinction.aspx.
5. The "Nonattest Services" interpretation (AICPA, Professional Standards, ET section 1.295.140).
6. ACFE 2015 Fraud Examiners Manual §3.102.
7. Id. §3.104.

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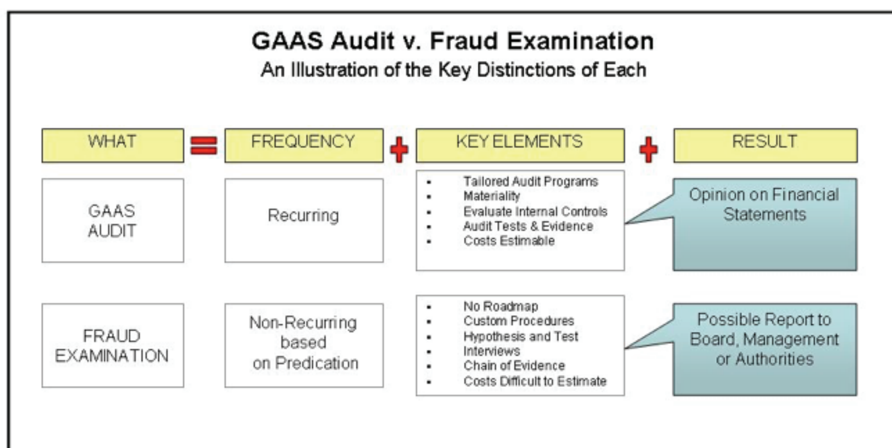
a fraud examination, that perception is incorrect.

Aside from the gathering and analysis of financial information, there are only a few similarities between a GAAS audit and a fraud examination. The illustration that follows provides a basic contrast of some fundamental distinctions:[8]



Evident in the preceding illustration, the objective (depicted within the Result column) of a GAAS audit is distinctly different than that of a fraud examination.

APPLICABLE PROFESSIONAL STANDARDS

Members of the AICPA are required to follow the AICPA Code of Professional Conduct. If a CPA is to conduct either a GAAS audit or a fraud examination, the General Standards apply to both services, and they consist of the following:

- Professional Competence
- Due Professional Care
- Planning and Supervision
- Sufficient Relevant Data[9]

If the CPA is to conduct a GAAS audit, the General Standards apply, as do the extensive Statements on Auditing Standards and the Independence Rule.[10]

If the CPA is to conduct a fraud examination, the General Standards also apply, as does the Statement on Standards for Consulting Services. The additional requirements for a consulting service, unlike the comprehensive SASs, are more general in nature and include the following:

- ***Client Interest.*** Serve the client interest by seeking to accomplish the objectives established by the understanding with the client while maintaining integrity and objectivity.
- ***Understanding with the Client.*** Establish with the client a written or oral understanding about the responsibilities of the parties and nature, scope, and limitations or services to be performed and modify the understanding if circumstances require a significant change during the engagement.
- ***Communications with the Client.*** Inform the client of (a) conflicts of interest that may occur pursuant to the "Integrity and Objectivity Rule" of the code (ET secs. 1.100.001 and 2.100.001), (b) significant reservations concerning the scope or benefits of the engagement, and (c) significant engagements findings or events.[11]

Embedded in the Audit Standards are the concepts of *professional judgment* and *professional skepticism*. Although professional judgment is not specifically cited in the consulting standards applicable to a fraud examination, the professional should exercise professional judgment throughout any engagement. Professional judgment, after all, "requires the application of relevant training, knowledge, and experience within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the courses of actions that are appropriate in the circumstances of an audit engagement."[12] The same concept of professional judgment should apply to a fraud examination.

Like professional judgment, professional skepticism is embedded in the auditing standards, but the concept should also apply in a fraud examination. For auditing purposes, professional skepticism involves "an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence."[13] Clearly, the CPA being sought to perform a fraud examination should already be on alert that something is amiss, and a heightened sense of skepticism is appropriate. In a fraud examination, the professional should exercise professional skepticism as a safeguard from developing an inappropriate conclusion.

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8. For example, an audit includes an evaluation of internal controls, an understanding of the accounting systems within the entity, completion of risk assessments (including fraud risk, control risk, and detection risk), tailored audit programs, and audit tests designed to result in sufficient appropriate audit evidence.
9. Paragraph .01 of the "General Standards Rule" (AICPA, Professional Standards, ET section 1.300.001).
10. The "Independence Rule" (AICPA, Professional Standards, ET section 1.200.001).
11. Paragraph .07 of CS section 100, Consulting Services: Definitions and Standards (AICPA, Professional Standards).
12. Paragraph .14 of AU-C section 200. (AICPA, Professional Standards).
13. Id.

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DETAILS OF GAAS AUDIT AND FRAUD EXAMINATION

GAAS Audit

"The overall objectives of the auditor, in conducting an audit of financial statements are to:

- Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud of error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and
- Report on the financial statements and communicate as required by GAAS, in accordance with the auditor's findings."[14]

In addition to the concept that a GAAS audit enables an independent accountant to express an opinion regarding the fairness of the financial statements, several additional concepts are embedded in the general approach of a GAAS audit.

1. Approach

Concept of Reasonable Assurance

The GAAS standards recognize that a GAAS audit should be planned and performed to obtain reasonable assurance about whether the financial statements are free from material misstatement whether caused by error or fraud. Reasonable assurance is a high, but not absolute, level of assurance.[15]

2. Scope

Responsibility of Management

Management of the company is responsible for the financial statements. Management has the responsibility to adopt sound accounting policies and establish and maintain internal control that will, among other things, initiate, authorize, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements. At the outset of the engagement, the auditor establishes an understanding with the client regarding the services to be performed. This understanding is documented in the engagement letter. As part of the audit, the auditor obtains a management representation letter. Management's responsibility is specifically referenced in the independent accountants report.[16]

Use of Professional Skepticism and Professional Judgment

Professional skepticism is an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence.[17] Professional skepticism should be exercised throughout the audit process. In the exercise of professional skepticism, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty.[18]

Professional judgment is "the application of relevant training, knowledge, and experience, within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement."[19]

3. Procedures

Sufficiency and Appropriateness of Audit Evidence

The auditor relies on evidence that is persuasive, rather than convincing. The types of audit procedures the auditor performs are as follows:

- Inspection
- Observation
- Inquiry
- Confirmation
- Recalculation
- Re-performance
- Analytical procedure

"Sufficiency is the measure of the quantity of audit evidence. ... Appropriateness is the measure of the quality of audit evidence; that is relevance and it reliability in providing support for the conclusions on which the auditor's opinion is based."[20]

Consideration of Fraud Characteristics

The audit standards recognize that due to the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement. Practical and legal limitations on the auditor's ability to obtain sufficient audit evidence may include the following:

- **a.** Failure to provide the complete information that is relevant to the preparation and fair presentation of the financial statements
- **b.** Sophisticated and carefully organized schemes to conceal it, including an intentional misstatement that may involve collusion
- **c.** A recognition that an audit is not an official recognition into alleged

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14. Paragraph .12 of AU-C section 200.
15. Paragraph .06 of AU-C section 200.
16. AU-C section 700, Audit Conclusions and Reporting
17. AU-C Glossary.
18. Paragraph .A26 of AU-C section 200.
19. Paragraph .14 of AU-C section 200.
20. Paragraphs .A33–.A34 of AU-C section 200.

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wrongdoing as the auditor is not given specific legal powers, such as the power of search[21]

d. Management's ability to directly or indirectly manipulate accounting records, present fraudulent financial information, or override control procedures designed to prevent similar frauds by other employees[22]

Assessment of the Fraud Risk

The auditor should do the following during the conduct of a GAAS audit:

- Discuss among engagement personnel regarding the risks of material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated
- Evaluate known external and internal factors affecting the entity that create and incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enable management or others to rationalize committing fraud
- Discuss the risk of management override of internal controls
- Consider circumstances that might be indicative or earnings management or manipulation of other financial measures
- Address the importance of maintaining professional skepticism throughout the audit regarding the potential for materials misstatement due to fraud
- Discuss how the auditor might respond to the susceptibility of the entity's financial statement to material misstatement due to fraud
- Evaluate unusual or unexpected relationships that may indicate risks of material misstatements due to fraud[24]
- Evaluate, identify and assess the risks of material misstatements due to fraud[25]
- Develop audit procedures that respond to the assessed risks of material misstatement due to fraud[26]

In addition to the discussion among the engagement team of the fraud risk factors, the auditor also has discussions with management and others within the entity as to (1) management's assessment of fraud risks, (2) management's processes for identifying, responding to, and monitoring the risks of fraud, (3) management's communication, if any, to those charged with governance regarding the processes for identifying and responding to the risks for fraud, and (4) management's communication, if any, to employees regarding the views on its views on business practices and ethical behavior.[27]

Embedded in a GAAS audit are the concepts of dual responsibilities (management and the auditor), reasonable assurance, professional skepticism, sampling, assessing the risk of fraud, and the use of professional judgment in evaluating the results of the audit work undertaken. As acknowledged in the professional literature, an audit conducted in conformity with GAAS may not detect a fraud due to the concealment through collusion, withheld, misrepresented or falsified documentation, and the ability to override what otherwise appear to be effective internal controls.

4. Time and Costs

The auditor is typically able to estimate the time and costs that would be necessary to complete an audit for an entity based on several of the following factors: history and experience with the client, review of audit requirements and industry guides, company organization and regulation, company control environment, and associated risks. In addition, the auditor and the client are often subject to regulatory or contractual deadlines to deliver the audited financial statements.

5. Reporting

Once an audit is complete, the auditor prepares a report that generally follows somewhat of a proscribed format consisting of the following:

- An introductory paragraph that identifies the entity, the financial statements audited, and the period under audit
- A section that describes management's responsibility for the preparation and fair presentation of the financial statements
- A section that describes the auditor's responsibility with respect to the audit of the financial statements
- A conclusion that expresses the auditor's opinion on the audited financial statements[28]

The auditing standards provide extensive examples of the various reports that should be rendered depending upon the facts and circumstances and the nature of the audit results. The auditor's report is the one component of a typical set of "audited financial statements" that is solely from the auditor. The financial

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21. Paragraph .51 of AU–C section 200.
22. *Paragraph .07 of AU-C section 240, Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*).
23. Paragraph .15 of AU-C section 240
24. Paragraph .22 of AU-C section 240
25. Paragraph .25 of AU-C section 240
26. Paragraph .28 of AU-C section 240
27. Paragraph .17 of AU-C section 240
28. Paragraphs .25–.36 of AU-C section 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*).

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statements and note disclosures are from management, although they have been subjected to audit procedures.

Fraud Examination

The conceptual approach, scope, procedures, and time and costs associated with a fraud examination are fundamentally different from the approach undertaken in a GAAS audit. From the initial predication, to the planning and execution of the examination, the fraud examiner evaluates the hypothesis about a hidden fraud.

1. Approach

The traditional audit methodology is fundamentally redefined in the conduct of the fraud examination, as discussed by Ron Durkin in a 1999 AICPA CPA Expert article, to include such concepts as the following:

- Not limiting the scope of the engagement based upon materiality
- Not accepting sampling as evidence
- Not assuming management has integrity[29]
- Seeking the best legal evidence
- Melding the requirements of the evidential matter standard with the rules of evidence

The forensic accountant performing a fraud examination is normally involved after-the-fact. The process begins in response to a complaint or suspicion of fraud related to financial and accounting issues. In addition, the fraud examiner may work directly with counsel and those who will assist in the development of the scope and conduct of a fraud examination.

2. Scope

The Association of Certified Fraud Examiners has also identified the principal differences between auditing and fraud examination[30] outlined in the following table:

Issue	Auditing	Fraud Examination
TIMING	Recurring Audits are conducted on a regular, recurring basis.	Nonrecurring Fraud examinations are nonrecurring. They are conducted only with sufficient predication.
SCOPE	General The scope of the audit is a general examination of the financial data.	Specific The fraud examination is conducted to resolve specific allegations.
OBJECTIVE	Opinion An audit is generally conducted for the purpose of expressing an opinion on the financial statements or related information.	Affix Blame The fraud examination's goal is to determine whether fraud has/is occurring and to determine who is responsible.
RELATIONSHIP	Non-adversarial The audit process is non-adversarial in nature.	Adversarial Fraud examinations, because they involve efforts to affix blame, are adversarial in nature.
METHODOLOGY	Audit Techniques Audits are conducted primarily by examining financial data.	Fraud Examination Techniques Fraud examinations are conducted by (1) document examination; (2) review of outside data, such as public records; and (3) interviews.
PRESUMPTION	Professional Skepticism Auditors are required to approach audits with professional skepticism.	Proof Fraud examiners approach the resolution of a fraud by attempting to establish sufficient proof to support or refute an allegation of fraud.

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29. In a GAAS audit (paragraph .A26 of AU-C section 200), the auditor neither assumes that management is dishonest nor assumes unquestioned honesty; the mindset of a person conducting a fraud examination does not assume management has integrity.
30. ACFE Fraud Examiners Manual, 2012.

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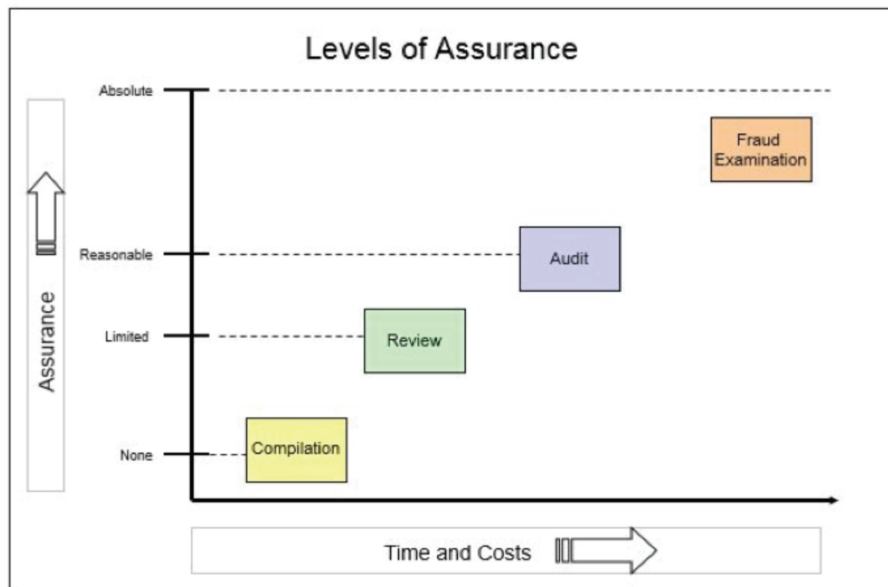
3. Procedures

The use of forensic procedures will often reveal evidence that is different than that obtained through audit procedures outlined in the AICPA *Professional Standards*. As noted in the preceding table, several non-GAAS procedures are used in the course of a fraud investigation. They include the following:

a. Extensive use of **interviews** leveraging techniques designed to elicit sufficient information to prove or disprove hypothesis
b. Document **inspection**, which may extend to authentication procedures and handwriting analysis
c. Significant **public records** search to uncover unexpected title or ownership, other known addresses, prior record of individuals, and so on
d. Legal knowledge regarding **rules of evidence**, including chain of custody and preservation of evidence integrity

In discussing the procedures employed by the Fraud Examiner, it is important to understand the contrast in the level of assurance provided and the time and costs associated with both the GAAS audit and a typical fraud examination.

In 2014, a new segregation in level of service was introduced with Statement on Standards for Accounting and Review Services (SSARS) No. 21, *Statements on Standards for Accounting and Review Services: Clarification and Recodification*. There are several distinctions in a financial statement preparation engagement, but for purposes of contrasting the costs and levels of service, it is similar to a compilation in that there is no assurance provided.



4. Time and Costs

Due to the hidden nature and unpredictable extent of possible fraud, fraud examinations are difficult to estimate at the outset. Because fraud examinations are not recurring, nor does any, one investigation mirror another, there is not a reliable historical record to estimate costs to complete a project. Frequently, the time and cost of a fraud examination are significantly greater than an audit; in many cases, it is not unusual if the costs were 10 times greater or more for a fraud examination than a GAAS audit.

5. Reporting

Unlike the auditing standards, there is no particular proscribed report for a fraud examination — it could be oral or written. If it is written, it may take the form of a PowerPoint presentation, an outline, or a formal written report with exhibits, and other supporting documentation.

Although no proscribed report format exists, several elements that should be considered to be included in the report include the following:

- Summary of findings
- The reason for the fraud examination
- The basis for the findings
- The scope of the fraud examination
- Whether the report is final or an interim report
- Restrictions on the use and distribution of the report[31]

A fraud examination should not conclude whether a fraud has been committed; rather, that conclusion is reserved to a trier of fact. The CPA can frequently report that the fraud examination revealed transactions that are indicators of fraud because they are

- unauthorized,
- undocumented,
- unknown,
- unusual,
- undisclosed,
- unapproved,

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[31] Ueltzen and Durkin, Fraud Reporting, *FVS Consulting Digest*, March, 2011.

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- unsigned, or
- unexplained.[32, 33]

Significantly, none of the above assessments reflect a direct conclusion that a fraud was committed or exists.[34]

CONCLUSION

The purpose, approach, scope, procedures, and reporting for a GAAS audit and a fraud examination differ dramatically from one another. The distinctions in scope, procedures, approach, and time and costs are fundamentally different between a GAAS audit and a fraud examination. Accordingly, and as should be expected, the level of assurance provided by the accountant is designed to be different. Finally, the end result of the activity is completely different in that the GAAS audit is subject to an extensive set of auditing standards, and the fraud examination is varied from an oral report to a free-form written document. The bottom line is that a GAAS audit and a fraud examination are different services designed for distinctly different purposes.

ABOUT THE AUTHORS:

Michael Ueltzen *is a partner in the Forensic, Litigation and Valuation Services Group at EisnerAmper and has participated and testified in excess of 100 forensic accounting engagements involving both criminal and civil complaints. Mike is the current Chair of the National Accreditation Commission (NAC) of the American Institute of CPAs (AICPA). Previously, he served the AICPA as the first chair of the Forensic and Valuation Services Executive Committee and as the first chair of the Credential Committee for the Certified in Financial Forensics credential.*

Annette Stalker *is the owner of Stalker Forensics and specializes in conducting forensic accounting investigations and special accountings over a broad range of company structures and industries. She has provided expert testimony in cases involving a variety of partnership disputes, commercial and individual damages, alter ego claims and has issued several forensic accounting investigation reports in both civil and criminal matters. Annette is the chair of the AICPA Forensic and Litigation Services (FLS) Committee and will serve as the 2016 Forensic Chair of the AICPA Forensic and Valuation Services Conference Planning Committee.*

32. Id.
33. See also AICPA Forensic and Valuation Services Paper, *Forensic Accounting: Investigation Report Writing*, 2014.
34. Paragraph .03 of AU-C section 240. Like an audit, the auditor does not make a legal determination of whether fraud has actually occurred.

Royalty Audits — Compliance With AICPA Standards

By Sidney P. Blum, CPA/CFF, CFE, CPEA

ABOUT ROYALTY AUDITING

Royalty auditing is a niche service that has exploded in popularity over the last 20 years. The primary purpose of a royalty audit is to test whether a licensee has complied with a license agreement or statutory requirement. The royalty auditor is hired by an intellectual property owner (aka, licensor) or minerals owner to inspect the books and records of a licensee primarily to determine if usage-based monetary amounts have been paid as contractually required. In addition to monetary damage calculations, most royalty audits examine for breach of contract in a wide variety of areas, such as intellectual property protection, record keeping, distribution channels, and permitted usage.

Over the last two decades, I have witnessed a large quantity of CPAs perform royalty audits with a lack of consideration to professional standards primarily because there is limited guidance and training other than internal private firm memorandum and the very broad AICPA professional standards. The lack of professional royalty audit training is leading to client and courtroom problems for the CPA royalty auditor who is unable to adequately support damage calculations, thereby leading to increased accusations of professional incompetency. The purpose of this article is to provide guidance to CPAs on the AICPA professional standards applicable to royalty audits and how to help avoid some of the most common standard violations. This article does not cover how to conduct a royalty audit.

A royalty audit is not a financial statement audit. On a monetary level, the royalty auditor is attempting to discover the unknown, eventually leading to the preparation of economic damage calculations for underreporting or other monetary contract violations. With a financial statement audit, the auditor often is concerned with the over-reporting of revenues, whereas the royalty auditor is concerned about the under-reporting of revenues. Royalties

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are paid for a variety of resource or property usages, such as minerals, patents, copyrights, and trademarks. Royalties are paid in every industry and can be a lump sum, variable royalty, or combination of both. A royalty audit focuses on variable royalties. Estimates of annual royalty payments are in excess of $1 trillion dollars. Depending on the industry, Big 4 firms have reported that royalty audits commonly disclose under-reporting in excess of 10%, with the highest percentage monetary under-reporting from trademark royalty audits and the lowest from regulated pharmaceuticals.

USING THE TERM ROYALTY AUDIT

License agreements commonly use the term royalty audit or right to audit. To a CPA, an audit is an independent examination of financial statements in which a financial fairness opinion is expressed. A royalty audit is not an independent examination of financial statements as defined by the AICPA and does not deal with many aspects of a financial statement audit, such as materiality or an expression of an opinion. The CPA royalty auditor needs to work within an agreement's "audit" terms and, therefore, must be conscientious of this difference in communications to ensure that the use of the word audit does not lead the reader to believe that a royalty audit is the same as a financial statement audit.

So as to not give the perception that a royalty audit is a financial statement audit, the CPA should note to the client in an engagement letter or other communication that the royalty audit is not an independent audit. Further, the third party being audited, often a licensee, should also be informed by the CPA that the royalty audit is not a financial statement audit as defined by AICPA professional standards.

USING THE TERM *ROYALTY AUDITOR*

Many states have regulations regarding the use of the word auditor. Generally, state regulations indicate that only a CPA may present themselves to the public as an auditor. Further, there is a perception that an auditor's work is, by definition, independent.

To help avoid confusion, when conducting a royalty audit, the CPA should refer to himself or herself as a *royalty auditor* and not just an *auditor*. The language of being a royalty auditor should be presented with language identifying the standard or standards under which the work is being performed, namely either under AICPA Statements on Standards for Attestation Engagements (SSAEs) or the much more common AICPA Statement on Standards for Consulting Services (SSCS) No. 1, Consulting Services: Definitions and Standards (AICPA, Professional Standards, CS sec. 100), which do not require independence.

INDEPENDENT AUDITOR REQUIREMENTS IN A CONTRACT

Most royalty audits are conducted under a "right-to-audit" clause in a license agreement. This clause often states that the royalty audit is to be conducted by an "independent auditor." Under AICPA guidelines, an *independent auditor* is a royalty auditor performing work under the SSAEs. When a royalty agreement requires an independent audit, the CPA almost always performs the work under SSCS No. 1, resulting in a royalty audit that is not independent under AICPA professional standards. Further, generally, the royalty auditor has not informed the licensor and licensee of the discrepancy between the independence license agreement language and the procedures actually performed. The reason for this is sometimes due to the niche or full-time royalty auditor not having training in performing work under the SSAEs.

Many licensors or their legal counsel will interpret "independent auditor" to mean the royalty auditor cannot be a licensor employee. However, I have seen more than one litigation in which royalty audit findings have been disallowed because the licensee has successfully argued that the royalty audit was not conducted by an independent CPA as required by the terms of the license agreement. The royalty auditor should consider and possibly consult with his or her counsel about the license agreement words "independent auditor" in the view of AICPA professional standards and not simply take his or her client's interpretation.

If an independent auditor is required by the license agreement and the royalty auditor intends to perform the work under SSCS No. 1, then the royalty auditor should inform both the licensor and licensee that the royalty audit will be conducted under SSCS No. 1 prior to the start of substantial work.

PERFORMING A ROYALTY AUDIT UNDER ATTESTATION STANDARDS AS AN INDEPENDENT AUDITOR

The requirements for performing a royalty audit under the SSAEs are very strict, and there are very few royalty auditors qualified to perform royalty audits under these independence standards. Generally, AICPA attestation standard royalty audits are only conducted when a royalty audit is performed for a financial statement client. Less than about 2% of all royalty audits are performed under the SSAEs. This 2% is important to recognize because more than about 25% of license agreements require the audit to be performed by an independent auditor. As such, the risk for noncompliance with contract terms of independence is high amongst royalty audit professionals.

SSAEs procedures for royalty audits will not be discussed in this article due to their complexity.

PERFORMING A ROYALTY AUDIT UNDER CONSULTING STANDARDS

Royalty audits are almost always conducted under SSCS No. 1, which defines the services as

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follows: "Advisory services, in which the practitioner's function is to develop findings, conclusions, and recommendations for client consideration and decision making."

There are seven applicable AICPA standards for a royalty audit conducted under SSCS No. 1. The first four standards are contained in the "General Standards Rule" of the AICPA Code of Professional Conduct and are applicable to both attestation and consulting standards. The remaining three are contained in the "Compliance With Standards Rule" of the AICPA Code of Professional Conduct and are specific for consulting services.

The AICPA general standards of the accounting profession are contained in the "General Standards Rule" (AICPA, Professional Standards, ET secs. 1.300.001 and 2.300.001), as follows:

- ***Sufficient relevant data*** — Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.
- ***Planning and supervision*** — Adequately plan and supervise the performance of professional services.
- ***Due professional care*** — Exercise due professional care in the performance of professional services.
- ***Professional competence*** — Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.

The AICPA general consulting standards promulgated to address the distinctive nature of consulting services established under the "Compliance With Standards Rule" (AICPA, Professional Standards, ET secs. 1.310.001 and 2.310.001) are as follows:

- ***Client interest*** — Serve the client interest by seeking to accomplish the objectives established by the understanding with the client while maintaining integrity and objectivity.
- ***Understanding with client*** — Establish with the client a written or oral understanding about the responsibilities of the parties and the nature, scope, and limitations of services to be performed and modify the understanding if circumstances require a significant change during the engagement.
- ***Communication with client*** — Inform the client of (a) conflicts of interest that may occur pursuant to interpretations of the "Integrity and Objectivity Rule "of the AICPA Code of Professional Conduct, (b) significant reservations concerning the scope or benefits of the engagement and (c) significant engagement findings or events.

SUFFICIENT RELEVANT DATA

The "Sufficient Relevant Data" standard states the following: "Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed."

The royalty auditor must gain sufficient relevant data to make a competent damages computation. Too often, the royalty auditor incorrectly considers only data beneficial for his or her client and ignores data beneficial to the third-party licensee being audited. It is the royalty auditor's obligation to ensure all relevant data is considered and to try not to increase damages in a biased manner. Bias can be observed when the CPA is working to satisfy the needs of the client while sacrificing professional requirements.

One area of high risk where a royalty auditor may not gain sufficient relevant data relates to obtaining an adequate understanding of the license agreement. It is a mistake for a royalty auditor to interpret a contract's terms and conditions. Rather, the royalty auditor should read the contract to gain an understanding of the terms and conditions and then should seek verification or guidance of his or her understanding from the licensor and licensee, especially when the terms are ambiguous.

Under SSCS No. 1, the royalty auditor should not blindly accept the client's definition of an agreement because to do so could be a lack of professional skepticism. If there is a difference about a contract's interpretation, it would be appropriate to present findings or damages using opposing sides' interpretations of the royalty agreement; however, this is not a requirement. In this process, the royalty auditor should avoid making what appears to be a legal conclusion.

PLANNING AND SUPERVISION

The "Planning and Supervision" standard requires adequate planning. Adequate planning would necessitate gaining an understanding from the licensor on the interpretation of the contract. Further, although not required, planning often is documented in a work plan and, at a minimum, there should be planning documented in the working papers.

A work plan helps demonstrate advance planning by creating procedures to be performed. It is not necessary that the planned procedures be performed, and often, the planned procedures are completely changed during the course of a royalty audit performed under SSCS No. 1.

Although an engagement letter is not required, an engagement letter with procedures that may be performed helps to ensure there is documentation of planning.

DUE PROFESSIONAL CARE

The AICPA, under AU-C230, describes due professional care. This description is geared primarily towards auditors performing independent audit

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work; however, the definitions also are applicable to understand due professional care for work performed under consulting standards. The AICPA states the following:

> An auditor should possess "the degree of skill commonly possessed" by other auditors and should exercise it with "reasonable care and diligence."
>
> Due professional care requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor uses the knowledge, skill and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence.

Exercising due professional care includes professional responsibilities such as adequate planning, and gaining an understanding of the contract that is the subject of the royalty audit during the planning phase and throughout the course of the engagement.

CLIENT INTEREST

The "Client Interest" standard requires the royalty auditor to serve the objectives of the client while maintaining integrity and objectivity. Royalty auditors risk not maintaining integrity and objectivity if they engage in contract interpretations or compute damage calculations not supported by the license agreement or associated data. It is possible for the royalty auditor to serve the licensor client's interests and disagree with the licensee when there is a licensee disagreement. Such a disagreement should be reported to the client licensor, often in the report or an email, so there is an appearance of objectivity. Objectivity does not require the royalty auditor to calculate damages under opposing viewpoints. The royalty auditor can present the damage calculation in an objective manner by using only the licensor client's interpretation of the agreement, provided the data used support the calculation. However, this does not relieve the royalty auditor of his or her responsibility to notify his or her licensor or client that the licensee disagrees with the calculation.

As mentioned previously, the royalty auditor should not interpret the license agreement. A royalty auditor who interprets a license agreement risks losing both integrity and objectivity. There is a difference between reading the actual language of a royalty agreement and applying that language, and inventing or speculating on the language of a royalty agreement. Speculation can lead to interpretation.

UNDERSTANDING WITH CLIENT

This standard requires the royalty auditor to establish with the client a written or oral understanding of the nature, scope, and limitations of the services to be performed.

Although not required, this is best accomplished with a written engagement letter. Other forms of communication, such as emails, also are acceptable. The auditor should not wait for the report to be issued before communicating the nature, scope, and limitations of the engagement.

COMMUNICATION WITH CLIENT

The "Communication With the Client" standard is best followed by issuing a report; however, there are instances when a royalty agreement states that no report shall be issued and further limits communications to only a damages amount. In such an instance, the royalty auditor should document in his or her working papers that both the licensor client and licensee require that a report not be issued, only a damages amount.

If a client requests that a report is not issued because, for example, there are no findings from the royalty audit so the client does not want to pay for a report, then the auditor should document in the working papers that the client does not require a report. The royalty auditor should also communicate with the client and confirm that no report is to be issued.

CONCLUSION

A CPA must be certain to follow the applicable AICPA attestation or consulting standards when conducting a royalty audit. Royalty audits require a high degree of expertise and professional competence and should only be performed under the supervision of a qualified and experienced royalty auditor. Performing a royalty audit under SSCS No. 1 instead of the attestation standards reduces professional competency risks to CPAs. However, even under SSCS No. 1, certain professional responsibilities must be maintained to avoid disciplinary actions and legal liability from both parties to a royalty agreement.

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Case Law Corner

This section focuses on important cases and how they relate to issues that practitioners are likely to encounter.

Chancery Rejects Deal Price Based on Unquantifiable 'Sales Process Mispricing'

By Sylvia Golden, J.D., Legal Editor, Business Valuation Update

***In re Appraisal of Dell Inc.*, 2016 Del. Ch. LEXIS 81 (May 31, 2016)**

The Delaware Court of Chancery's favored the value derived from a post-merger discounted cash flow analysis over the deal price in the latest Dell transaction, concluding the market price "functioned imperfectly as a price discovery tool."

Part of the attention this case is receiving derives from the brand-name firms that originally offered DCF opinions prior to the transaction itself. Some of the more noteworthy efforts:

- In January 2011, management prepared a "sum-of-the-parts" analysis that valued the company at $22.49 per share (based on line of business) and $27.05 per share (based on business unit). At the time, the company stock traded at $14 per share. Dell seemed undaunted: "We're transforming our business, not for a quarter or a fiscal year, but to deliver differentiated customer value for the long term." In contrast, analysts described the company as a "sinking ship" and its turnaround strategy as "fundamentally flawed."
- In fall 2012, JPMorgan made a presentation to the committee about the feasibility of an MBO, concluding that it was not very likely that financial sponsors other than the two with whom Michael Dell had talked or any strategic bidders would be interested in buying the company. JPMorgan and Goldman Sachs then prepared a series of valuations for financial buyers, ranging from between $11.75 to about $16.
- In late 2012, the market's outlook for the PC industry and Dell became even more pessimistic and the committee hired Boston Consulting Group (BCG) to prepare an independent set of forecasts. As a result of the negative outlook, one of the financial sponsors dropped out and the other — the eventual buyer — proposed to buy the company for $12.70 per share. BCG said the low valuation did "not match apparent company strengths" and suggested radical cost cutting. Under one scenario, the "BCG 25% Case," BCG assumed the company would be able to realize 25% of the savings. The "BCG 75% Case" assumed the company would realize 75% of the savings. The committee was doubtful about this scenario, which implied margins for FY 2015 that were higher than the company or its competition had ever achieved. Another set of projections, the "Bank Case," related to a presentation the buyout group and Michael Dell made in fall 2013 to banks that would finance the merger.
- Also, in early 2013, the committee hired a second financial adviser, Evercore, to conduct a potential go-shop period. In pitching itself for the job, Evercore prepared a DCF analysis that valued the company at between $14.27 per share and $18.40 per share. Its LBO analysis suggested a range of between $12.36 per share and $16.08 per share. The buyout group had offered $13.65 per share, but the merger agreement provided for a 45-day go-shop period. During that period, Blackstone Management Partners LLC and Carl Icahn submitted bids. Ultimately, neither bid went anywhere, but both had the effect of bumping up the original merger price to $13.75 plus a special cash dividend of $0.13 per share. A majority of the holders of outstanding shares approved the deal.

Fair value determination a different animal. However, a number of shareholders filed a petition asking the Chancery for a fair value determination. The court, performing a discounted cash flow analysis that drew on analysis from both sides' experts, achieved a value of $17.62 per share.

The crux of the Chancery's decision is that a statutory appraisal determination is not an inquiry into a breach of fiduciary duty claim. "An appraisal action asks a substantially more modest question: did the stockholders get fair value for their shares in the merger?" Regardless, there were factors related to the process that "undercut the relationship between the Final Merger

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Consideration and fair value," the court found.

Presigning phase problems. The problems started with the presigning phase, which produced an original merger price ($13.65 per share) that was below fair value, the Chancery said.

The paramount problem was that the players all were financial sponsors using LBO models — there was no outreach to strategic bidders. This is not "fair value." As evidence, the court cited JPMorgan's work: The firm performed a going-concern analysis using the DCF method and showed a value of between $20 and $27 per share. But, said the court with emphasis, "using the same projected cash flows in an LBO model," JPMorgan found a financial buyer would pay a maximum of $14.13 per share.

"As a practical matter, the Committee negotiated without determining the value of its best alternative to a negotiated acquisition," the court said.

The court also noted a "valuation disconnect" between the market's perception and the company's operative reality. The market focused on short-term results and on the company's $14 billion investment to transform itself, but this narrow view might cause it to "excessively discount the value of long-term investments," the court said. It also noted that proposing an MBO when the stock market is low meant using the low stock price to anchor price negotiations. Empirical evidence shows that the ensuing sales process is more likely to generate an undervalued bid, the court said — a fact all the participants in the merger understood, the Chancery pointed out.

Post-signing issues. The post-signing go-shop period did not cure the initial undervaluation, the court found. The fact that the two bids exceeded the final merger price "undercut the notion that the Final Merger Consideration provided fair value," the court observed.

DCF analysis tops merger price. So, in an unusual step, the court turned back to DCF analyses. The petitioners' expert said the company had a fair value of $28.61 per share on the merger closing date; the respondents' expert said the value was $12.68 per share. "Two highly distinguished scholars of valuation science, applying similar valuation principles, thus generated opinions that differed by 126%, or about $28 billion," the Chancery observed.

Neither expert analysis was entirely credible, the court found, focusing on the following disparities between the experts.

Forecasts — The projected cash flows underlying the experts' analysis accounted for much of the difference in value, the court said. The petitioners' expert used the BCG 25% case and BCG 75% case and weighted them equally. He also considered the Bank Case. The respondents' expert used the BCG 25% Case but adjusted for weaknesses and created a five-year transition period in the projections to better capture the company's operative reality and the likely schedule for the transformation plan to show results. (The Chancery normally prefers valuations "based on contemporaneously prepared management projections" but found the respondents' expert "persuasively justified his changes.")

Tax considerations — Several tax issues were critical to the different valuation results. One example: The petitioners' expert used a 21% tax rate throughout his forecast period based on rates in the valuations models the company's financial advisers prepared. The respondents' expert used a 17.8% rate during the projection and transition periods but a 35.8% marginal tax rate for the terminal period. The court adopted the petitioner expert's 21% rate. It pointed out the company had not paid taxes at the marginal rate since at least 2000.

Equity risk premium — The experts disagreed over every input, except the risk-free rate, in computing the company's weighted average cost of capital. Notably, the petitioners' expert used a forward-looking equity risk premium of 5.50%, whereas the respondents' expert used a blended historical and supply-side ERP of 6.41%. The court adopted neither approach but opted for a supply-side ERP of 6.11%.

Beta — The petitioners' expert arrived at a beta of 1.35 by analyzing peer companies. The respondents' expert generated a beta of 1.31 by analyzing weekly observations over a two-year period. The court favored the respondent expert's approach, noting a "beta specific to the Company is more targeted than a blended beta calculated from peer companies, particularly when both experts opined that the Company had few peers."

In the final analysis, the court arrived at a WACC of 9.46%, relying exclusively on the result of its DCF analysis as the indicator of fair value.

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