Forefront

ISSUE 2 | 2017

Inside:

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This issue of Forefront addresses some concerns with the retail industry. The beginning of 2017 saw numerous bankruptcies and big box store closings. Macy's and JCPenney are selling their company-owned real estate to provide the financial runway for rebranding and website strategies. Others like Sears are selling off brands like Kenmore and Craftsman, which arguably were a reason to shop there, to pursue a database strategy of consumer behavior. All retail seeks to rebrand and reposition. Some will survive, many won't.

Finding the Fraudster

By Carolyn Riegler

FRAUD COMES IN MANY FORMS – THEFT OF COMPANY ASSETS, BRIBERY, AND CORRUPTION ARE JUST A FEW. PEOPLE AT ALL LEVELS OF A BUSINESS ARE POTENTIAL FRAUDSTERS.

First, let's consider two real-life examples.

Two friends go into business together, one owns 75% of the company, the other a 25% share. After several years, the minority shareholder becomes angry that his partner is receiving more of the profits than he is, even though they both work equally as hard to establish the business. The disgruntled shareholder begins padding his company credit card with personal travel, gifts for friends and family, etc. Years go by with no questions asked. Suddenly the business is in distress and a new CFO comes on board to help. The charges are found and questioned. The two friends suddenly become enemies during the litigation that ensues.

An accounting clerk has been systematically writing checks to herself, using vendor invoices to back up the check disbursements. Over a two-year period, she embezzles over $89,000 without detection so that she can fund her gambling addiction. When the company hires a new controller, the theft is discovered. The employee is charged and convicted of the crime.

How could these frauds be detected earlier or prevented from happening in the first place?

1. Understand the elements of fraud and fraud deterrents to protect yourself, your business and every individual involved. There are three common elements of fraud: opportunity, pressure and rationalization.

2. Opportunity to commit fraud is present when employees have access to assets and the related information that allows them to commit and conceal fraud. Most companies are doing more with less resources which has resulted in managers with more access to systems and information, as well as more control over the operational areas of a company. Have you evaluated your checks and balances over asset access and reporting? Is there an open communication environment so employees feel comfortable discussing potential control problems or suspicions of fraud?

3. Pressure is the motivation or "need" felt by the person that commits fraud. Most people have felt the pressure of escalating medical costs, credit card debt, job loss or divorce. To the fraudster, combine this pressure with opportunity and you may have a situation too tempting to resist.

4. Rationalization is the final leg of the triangle. It is the glue that holds opportunity and motivation together. Common ways to rationalize fraud include making up for a lost raise or bonus, taking a temporary loan which never gets repaid, or believing that the "Company" doesn't need the money.

Business owners have the most control over opportunity – focus on this area should be first. Enlist your business advisors, forensic accountants, and/or attorneys for help in setting up strong fraud prevention plans. Be proactive, hire a professional forensic accountant to help you find the truth, deal with it, and move forward to a successful future.

Carolyn Riegler
CPA/CFE, Director, specializes in litigation support, dispute resolution, forensic accounting, real estate, and business valuations.

In lean or recessionary times, all businesses try to maintain profit through cost control which often means improving asset productivity. In other words, doing the same with less.

MANAGING THE TALENT GAP

A hot topic for businesses these days is the inability to find good talent to fill existing positions or to add positions to enable growth.

With this issue in mind, I would challenge you to think about the talent gap from another perspective. In lean or recessionary times, all businesses try to maintain profit through cost control which often means improving asset productivity. In other words, doing the same with less. Is that not exactly the same concept as trying to manage a growing business with open and unfilled positions? Doing the same (or more) work with marginally fewer employees? The concerns with finding and retaining talent are real and there comes a time when hiring is unavoidable but I've laid out a few questions to ponder if you or one of your clients is currently experiencing a "talent gap" issue:

Have you taken a detailed look at improving your current processes to squeeze the last bits of productivity out of your operation?

In growth times, firms tend to let optimization and cost control fall by the wayside. This is understandable as revenue and profits are typically growing, capacity is strained and everyone is busy. However, this is typically the time when non-value added activities increase, control variances increase, and efficiency suffers because, in the end, it doesn't matter. But, it does matter! The benefits of improving productivity, optimizing processes, and managing cost in growth times has numerous advantages. One, you can afford to experiment with new designs. Two, you can profit even more. Or, three, you could better manage the working capital required for growth and mitigate your hiring crisis.

Is your organization configured for your current and expected volume of business?

This question addresses two issues, are the people you have in the right positions and are you seeking the right skill sets. Very often, organization can drift out of alignment. Being "top heavy" is a typical concern but other issues may include a misalignment of resources within operating groups with respect to volume or workload, span of control issues where you may gain efficiencies through combining complementary or adjacent groups, or utilization effectiveness where one set of individuals is underutilized just due to their ill-designed role in the organization. A review of the organization structure and its roles and responsibilities may result in reduced need for talent or a need for different skill sets altogether.

Are technology solutions being employed properly and effectively that result in a productivity enhancement of your current workforce?

If your business is growing it is very likely you may be outgrowing some of your current systems which is putting a burden on your current workforce. The investment in technology can be daunting but one of the benefits is an increase in productivity. This applies to both new technology and upgrades of legacy systems. The less time your employees spend toiling in systems – whether it be entering data, searching for information, fixing issues or producing reports – is time that could be spent on value added activities. And, the more time available for value added activities means less time to be filled by additional headcount.

Uncertainty

in higher education...

The rising cost of college and related student debt is a huge problem facing the country. According to the Federal Reserve Bank of New York, student debt currently sits at a massive $1.31 trillion. In just 4 years, national student debt has grown approximately 36%. This trend has been caused by ever-increasing tuition costs over the last 20 years.

By Susan Koss

According to the College Board, during the last five years alone, the average cost of tuition rose by 9% in the public four-year sector, by 11% at public two-year colleges, and by 13% at private nonprofit four-year institutions, after adjusting for inflation.

The affordability of an education is an even bigger issue when you consider the increasing reliance on debt by colleges and universities. But why is this happening when tuition costs continue to escalate so rapidly? According to Moody's, a credit rating agency that monitors credit of certain universities, there are a variety of reasons including changes to state and federal funding. Most public universities rely on tax dollars to survive. Changes in state funding can vary greatly depending on each state's economic conditions and policy priorities. Consequently, state funding continues to be an area of greater uncertainty for public universities.

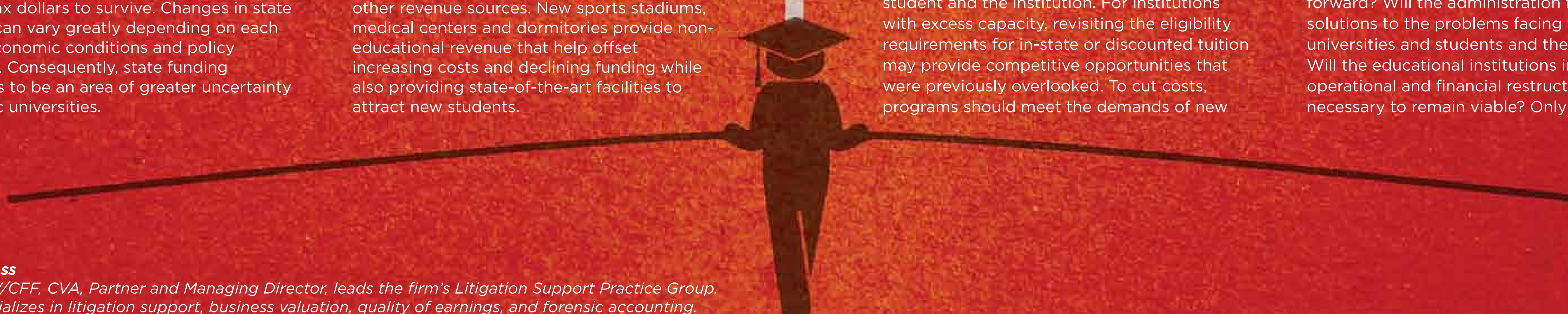
Uncertainty in federal funding continues to present risk as the Trump administration plans certain cuts in 2018. Where most state funds are used towards specific public institutions, federal funding is generally awarded through student aid and research grants. State funding goes primarily to public institutions, while federal funding goes to students at public, private and for-profit colleges, and to researchers at public and private universities.

Colleges and universities face many of the same financial pressures our public K-12 schools are experiencing such as rising labor costs and pension liabilities. Such pressures have forced colleges and universities to find other revenue sources. New sports stadiums, medical centers and dormitories provide non-educational revenue that help offset increasing costs and declining funding while also providing state-of-the-art facilities to attract new students.

However, many of these facilities are being constructed with debt financing, thereby creating greater financial risk and uncertainty, since the ability to pay back the debt may be hindered if the new revenue falls short of projections. Given the rapid growth in online learning at colleges and universities, adding real estate to increase revenues can be a very risky endeavor.

These institutions must focus on restructuring their operational costs and tuition. Since new students will be primarily concerned with minimizing their student debt, the challenge becomes reconciling the financial goals of the student and the institution. For institutions with excess capacity, revisiting the eligibility requirements for in-state or discounted tuition may provide competitive opportunities that were previously overlooked. To cut costs, programs should meet the demands of new students, thereby avoiding overstaffed and underutilized departments. In addition, an embrace of modern technology will provide opportunities to eliminate outdated administrative or educational processes while furthering the development of online education, which will provide both cost cutting opportunities and a competitive position in a growing segment of the market.

The only certainty in today's higher education system is that it is flawed in many ways. There seems to be no end in sight to the rising costs and rising debt. How will the Trump administration deal with these issues going forward? Will the administration find real solutions to the problems facing colleges and universities and students and their families? Will the educational institutions implement the operational and financial restructuring necessary to remain viable? Only time will tell.



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RETAIL

THE NEXT WAVE OF DISTRESSED INDUSTRIES.

With the plethora of store closings and bankruptcies filed after the holiday season, retailers in general are fighting to survive.

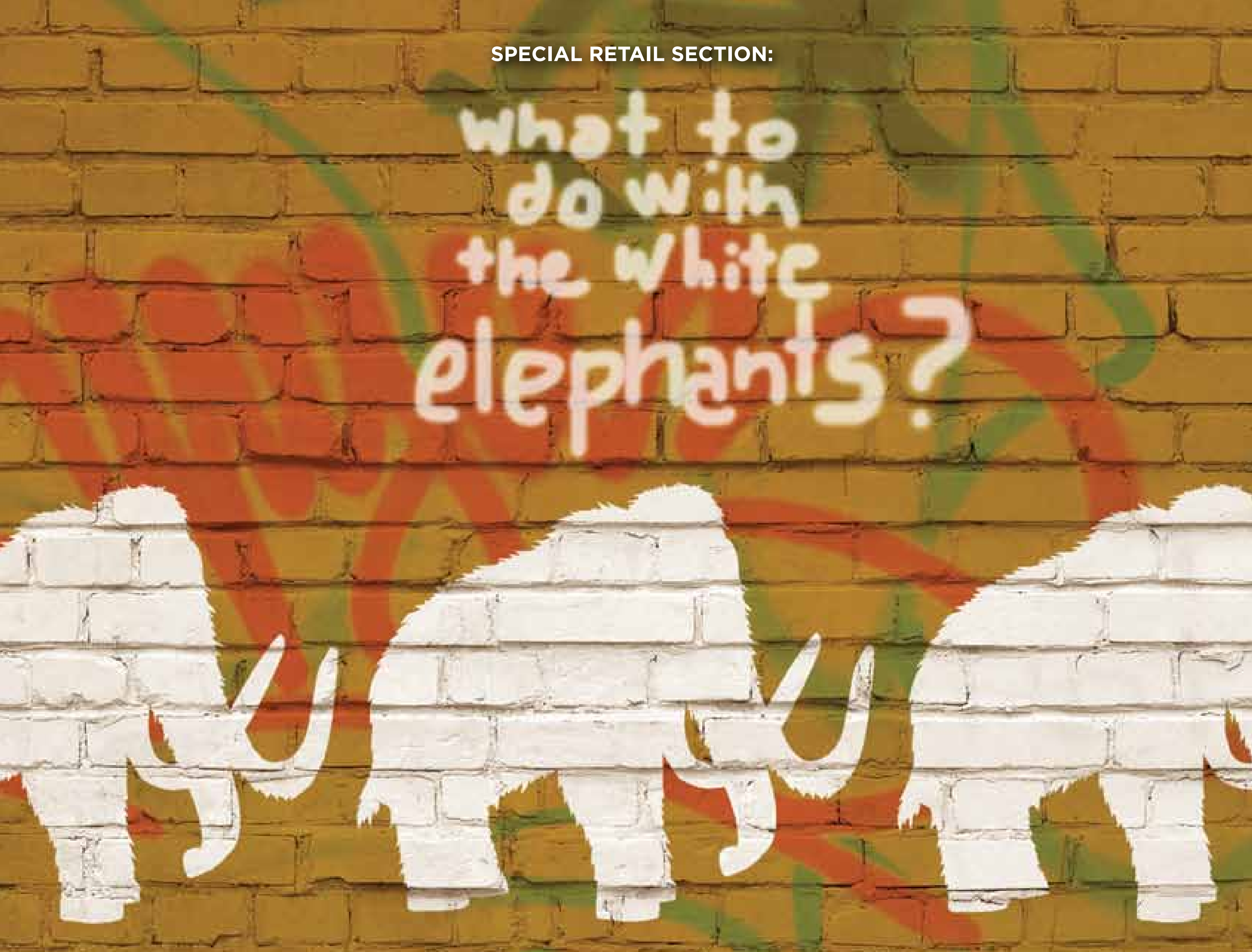
SPECIAL RETAIL SECTION:

While more than 80% of holiday purchases were done in brick & mortar stores, the impact of internet shopping is growing.

By Patrick O'Keefe

The retail stores most affected are clothing, department and small electronic stores. Many of the big box stores that are trying to restructure out of court have owned real estate that they can sell to create dry powder to rebrand and establish a website presence. Good examples are Sears, Macy's, and JCPenney. The ripple effect of big box stores going dark will be in those centers where other tenants have co-tenancy clauses requiring the big box to drive consumer traffic to the center. The impact of losing a big box tenant may cause the mall to have sudden financial distress as other tenants stop paying contractual rent because of a dark anchor store. The Aeropostale bankruptcy saw merchandise supplying creditors and landlords become part of the restructured capital stack. This is not unusual in that a restructured retailer is still a customer for a merchandise supplier and to a landlord, a source of rent. The prospects of losing a customer are more dire than prolonging the agony of a distressed retailer who may be in a position to be a paying customer at least for a while. It has been estimated that approximately 15% of all shopping space has been closed in the first quarter of 2017.

It is my opinion that retailers filing bankruptcy will have great difficulty establishing a sustainable game plan required for the future. The BAPCPA requirement of having debtors accept or reject leases within 210 days is not sufficient time to determine if the retailer can establish brands or a significant web presence to draw customers to their offering. Companies like Macy's and JCPenney, both of which have owned locations and have announced a wide list of store closings, are seeking to provide working capital from the sale of real estate assets to secure a future. This is a more efficient way to achieve a restructuring since the only thing that moves quickly thru a bankruptcy is a prepackaged 363 sale. Such sales are not inviting to the retail industry unless somebody is trying to pick up the real estate assets (aka Sears). Rebranding strategies take time and often at least a season to gauge traction and validation of the strategy. Many retail bankruptcies file in the first quarter after the holiday season when cash is high. However, making decisions on leased property before you understand the repositioning strategy is difficult. Rejecting leases before the next holiday shopping season, in many cases, will cause the baby to be thrown out with the bath water as stores that have historically been marginal could be profitable with a new strategy. Unfortunately, not enough time will have passed to validate such a repositioning.



what to do with the white elephants?

By Carolyn Riegler

As the retail industry continues to face the demise of the traditional brick and mortar business model, the country is dealing with hundreds of extinct malls. The "white elephants" are not just the business owner's problem, they are the community's problem. Hundreds of thousands of square feet of neglected buildings which stand out like ghosts from another time. They are a threat to public safety and a waste of financial resources. But, what can be done with them? In Michigan, we have several examples including the Summit Place Mall in Waterford Township, Eastland Center in Harper Woods, Wonderland Mall in Livonia as well as others gasping their last breath.

Recently, I have read several articles about new uses for these relics. Developers are turning many of these malls into creative alternative use facilities including LEED-certified apartments, senior housing, medical centers, walk in clinics, and community centers including police, fire, and EMS all under one roof. Other concepts have included child daycare centers, auto show rooms, art galleries, indoor farms, public libraries or classrooms. Not all facilities are suitable for these types of conversions, in some instances the buildings will need to be demolished to facilitate the redevelopment. However, proper planning and out of the box thinking could lead to new "downtowns" inside malls and a reinventing of suburban retail, while adding value to the community and its resident's lifestyle.

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SPECIAL RETAIL SECTION:

PREPARING FOR THE NEW LEASE RULES IN THE RETAIL INDUSTRY

In early 2016, the Financial Accounting Standards Board ("FASB") released Accounting Standard Update No. 2016-02, which focuses upon changes to lease accounting to produce more transparent and comparable financial statements. More specifically, it is planned to eliminate off-balance sheet accounting for operating leases, which in the past has allowed companies to avoid disclosing certain leased assets and corresponding liabilities on their balance sheets.

The new rule takes effect in 2019 and will vastly impact the retail industry, especially large public retailers with operating lease obligations in the tens of billions of dollars.

Here are some steps to prepare for the new rules.
1. Assess what types of leases are currently in place and how they will be affected by the new rules. Consider consulting with your CPA to gain a full understanding of the possible implications.

2. Companies should consider their current leasing strategy and what changes should be made in the future to make the new rules work in their favor, specifically considering whether to adjust to longer or shorter lease terms, or whether buying is financially beneficial.

3. Educate the necessary employees, especially those in accounting and those negotiating leases. Knowledge of the rules will be particularly important when considering new leases and renewals.

4. Create a timeline to begin collecting data and implementing lease tracking systems and controls compatible with the new rules. This is of particular importance for companies with numerous equipment leases, which are likely to make adherence to the new rules complex and time consuming.

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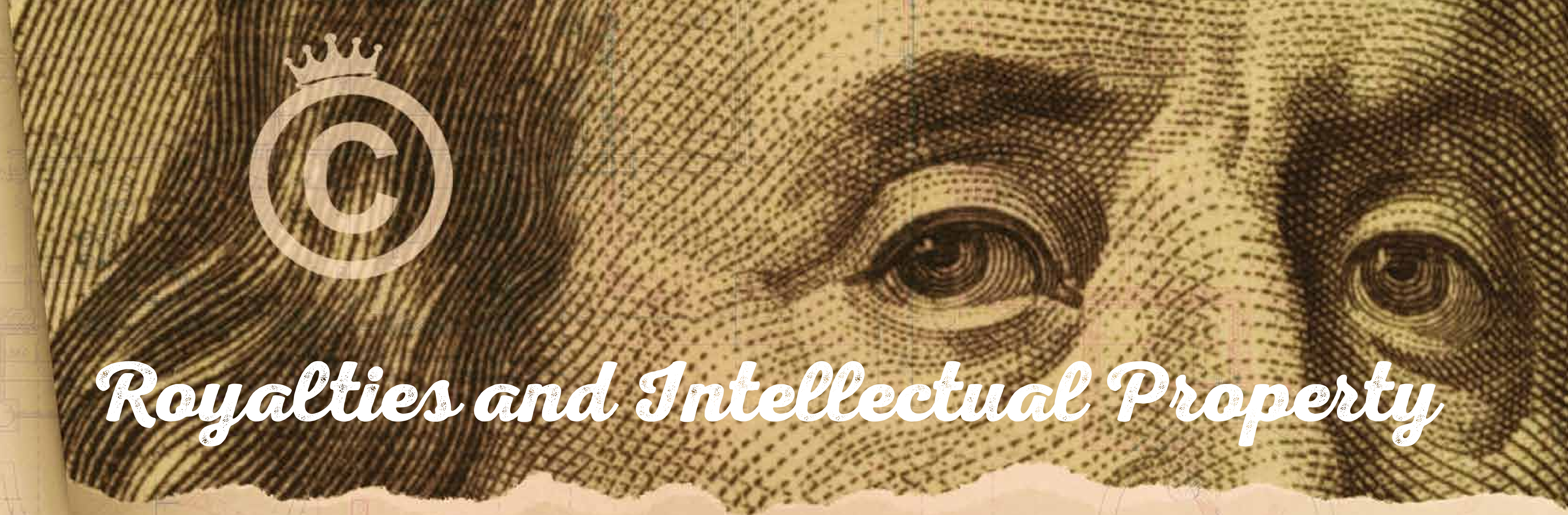

Royalties and Intellectual Property

By Andrew Malec, Ph.D.

Intellectual property is one of the most valuable assets that a company possesses.

Oftentimes, a company can monetize its intellectual property (e.g., technology, patents, trademarks, etc.) by licensing its use to another company for the manufacturing and/or sale of a product. As a result, economics suggests that the licensor should be compensated for licensing the asset to the licensee. However, the royalty payments (lump sum and/or running royalties) in licensing deals are not always at a fair market value ("FMV") rate.

One reason that a licensor may not receive a FMV royalty rate in a licensing deal is because the licensor knowingly entered into a "sweetheart" deal with the licensee. For example, if the licensor wants to secure or maintain a large contract with an existing customer who needs the licensor's technology to manufacture the product, then the licensor may feel compelled to execute a favorable licensing deal to the licensee to be awarded that needed business. Secondly, a FMV rate may not have been executed simply due to unsophistication of the licensor and licensee regarding the economics of the licensing agreement. A simple "what did we do on the last licensing deal" may have been adopted. From an economic perspective, comparable licensing agreements can be reviewed, and an industry analysis can be conducted to assist in determining the FMV royalty rate.

One way to determine a FMV royalty rate is to review comparable licensing agreements from publicly-available sources. Reviewing comparable licensing agreements for characteristics similar to the license being executed will assist in deriving a royalty rate (e.g., purpose/scope for licensing the asset, non-exclusivity/exclusivity of the license, term of the agreement, sub-licensing rights, and royalty rate compensation arrangement). This method assumes that the set of chosen guideline agreements are sufficiently comparable to the Subject License to provide a basis for determining the royalty rate. A careful read of the licensing agreements is necessary to ensure proper comparability to the license being analyzed.

In addition to the guideline agreement analysis, an industry analysis can also be conducted to analyze reported royalty rates as a percentage of operating profit for the industry in which the licensee operates. This percentage can then be multiplied against the expected operating profit margin of the licensee, or industry in which the licensee operates, to derive the royalty rate. This approach takes into consideration both the cost structure and profitability of the industry in which the licensee operates, and hence the industry's licensing profit split between the licensor/licensee.

Neither of the above methods should be used in isolation. Nor should a licensor/licensee simply settle on a royalty rate based on prior deals. The consequence of not performing any economic analysis in determining the royalty rate may provide a windfall of dollars to the licensor, or a bargain licensing deal to the licensee, if not analyzed with the proper due diligence.

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Partner and Managing Director, is the head of the firm's Intellectual Property ("IP") Practice Group. He is a recognized expert in providing economic advisory services, litigation support, and valuation opinions.

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- Business Valuator
- Forensic Accountant
- Financial Expert

Friday, July 28, 2017 | 8:00 a.m. **As part of the 23rd Annual Federal Bar Association’s Bankruptcy Section’s Seminar, Pat O’Keefe will be speaking on a panel titled, *Advanced Chapter 11/Asset Sale* with Paul Hage of Jaffe, David Hall of Miller Johnson, and Chief Judge Phillip J. Shefferly.**

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