Royalty Audit Checklist

By Ray I. Throckmorton

Is recapture of unpaid royalties worth the effort and expense involved in an audit? Is there a certain percentage of revenue at which the licensee pays for the cost of the audit? What are the areas of greatest payoff in an audit?

These and other questions are answered in this AmiCOUR advisory brief, which was previously presented at the Licensing Executives Society Annual Meeting held October 15, 2007 in Vancouver, B.C. under the title *Freedom to Operate 2007—Royalty Audits and China.* For purposes of reader economy, several of the important points are presented in the form of useful checklists. If any reader wishes clarification, we would be very happy to discuss specific items in detail.

Industry Statistics

Intellectual assets grew from 15 percent to 85 percent of the corporate market cap between 1978 and 2006.[1] By 2006 Licensing revenues had grown to over $500 billion[2] with 80 percent to 90 percent of Licensees reporting royalties incorrectly and underpayments ranging from 10 percent to 25 percent.[3] Companies and consultants have learned that good license management drives increasing profits, results in greater protection, and forms stronger relationships with licensees. The relative additions to shareholder value are often overwhelming.

Terms of Licensing Agreement

In performing the audit, the auditor must review the licensing agreement. As part of the review, the auditor should verify that there are clear and detailed definitions. Specifics of the licensing agreement include gross, not net, sales dollars, royalty reporting examples, payment in U.S. dollars, an Audit Clause and an Arbitration Venue. Special terms should also be considered for both the license agreement and the auditors review of the agreement including quality control requirements, first article production samples, periodic sample product evaluations, a secondary branding requirement, a statement which highlights the technology and adds value for both parties, calendar obligations, shipment deadlines (example: consumer product holiday shopping season), on time new model introductions, and special terms to accommodate tax situations. Also, take careful note of any of the financial elements that may be tied to these terms.

Why Do an Audit?

To ensure the Licensee is compliant with all financial and economic terms, one should ensure the Licensee is calculating, reporting, and paying royalties completely and accurately. The Licensee is less likely to under-report royalties if a risk of audit exists. Also, the Licensee may want to offer a "comfort" position to licensor by having an audit. Other reasons for a compliance audit include sending a "message" to other licensees, determination if there are unlicensed infringers, and to learn more about the possibility of terminating the license agreement. The licensor may want to modify or terminate the licensing agreement; therefore, non-compliance may be material to this interest.

Royalty Auditing Is a Special Accounting Practice

It is important to note the differences between royalty auditing and financial statement auditing. Financial statement auditors typically focus on materiality thresholds deemed relevant to acceptable accuracy of overall financial statements. Such statements are commonly used for comparative purposes with the financial statements of other companies. For instance, they may be used for stock trading purposes. Royalty audits are distinctly different because the royalty auditor identifies real (earned) money the company should be receiving or paying so a materiality difference or "threshold" simply does not exist.

Possible Causes of Royalty Under-Reporting

Reasons for under-reporting include inefficiencies, mismanagement, or common accounting errors that might include:

1) The Licensing, engineering, or sales department may not timely communicate newly licensed products or product SKU's to the accounting department responsible for tabulating and reporting royalty sales.

2) A new product number may be assigned and the old product number may be erroneously deleted from the sales database; yet, the licensee may continue to

1. PWC Report, 2006.
2. Greenberg Traurig, 2006.
3. IPLS 2006 Conference-Tokyo.

sell inventory under the old product number.

3) Some agreements may allow licensees to make judgments about deductible expenses allowed under agreement.

4) Accounting system weaknesses.

5) Mathematical errors or misinterpretation of license agreements, including but not limited to, use of "convenience" or "average" unit prices to "streamline" the accounting effort.

6) Poor inventory control.

7) Employee theft and/or grey market sales.

8) Inadequate loss prevention programs.

9) Intentional understatement of sales.

10) Inappropriate or miscalculated exchange rates.

Minimum Royalty Reporting Provisions

Reporting and related cash payments should be provided at least quarterly. If there is under-reporting above a specified amount, usually 2 percent to 5 percent, the Licensee should pay the full cost of the audit.[4] In calculating royalties due, interest should be charged on late or underpaid royalties. The licensor should also have the right per the licensing agreement to review at least three years of reporting and the right to terminate the license under certain conditions.

Actual Audit Procedures

As previously stated, Audit Procedures should include provisions in the licensing agreement that facilitate the audit, for example:

1) Review classifications: category, product line and retail price.

2) Secure and review accounting records including sales data, royalties, inventory, production, prior audit reports, and licensing agreements.

3) Review royalty report for inclusion of proper data-obtain support for payments made by the licensee, agree to reported royalty on royalty statement.

4) Review minimum guarantees and verify accuracy.

5) Review Licensee's system for recording sales, develop testing procedure to verify all units have been recorded, prepare a roll-forward of inventory units, review inventory adjustments, review cut-off procedures.

6) Review exchange rates.

7) Determine sales trends: volume/product line mix.

8) Test for variance of Licensee's suggested retail list prices by calculating actual base (average) price reflected in royalty reporting (actual dollars divided by actual units).

9) Test prices to sales invoices.

10) Recalculate royalty base price.

11) Review negative sales.

12) Recompute taxes, if deducted, and verify they are held in escrow to ensure the amount is proper and payments to the taxing entity are actually made.

Fact Finding Request to Licensee

The auditor should send out an initial letter to the Licensee requiring documents in a specified format to include the following:

1) Product numbers;

2) Units and sales dollars;

3) Country and currency translation used;

4) Details on internal product usage, promotional (and sample) units, returns/allowances, and amounts manufactured but not yet sold, that did not receive royalties;

5) If costs are deductible, specific details of all items;

6) Royalty rate calculations based on above.

Areas of Greatest Payoff:

1) Under-reported sales: related product lines that use licensed technology, trademark etc. or revenue generated in foreign territories.

2) Not adhering to contractual requirements, i.e. maximum amount for deductions or minimum guarantee for sales.

3) Transactions with related parties not conducted on an 'arms-length' basis.

4) Cost allocation that unfairly burdens licensed product (for example, a combination sale).

5) Beware of "Free After Rebate" traps and other clever product bundling approaches.

6) Be crystal clear on definitions of "returns" and "allowances."

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4. Responsibility for auditing costs is typically specified in license agreements and the ranges shown are common; however, in order to determine actual conditions under which either party may be liable for the cost of an audit, the terms of the license agreement should be reviewed. The same applies to interest on overdue payments.

7) Under-reporting that is not apparent by reviewing what has been reported, i.e. to find unreported revenues, the auditor should inspect records that show relevant cost information that might be inconsistent with reported revenues.

Auditing in the Far East Including China

1) Know local government contacts.

2) Auditor must know language and have some knowledge of local laws.

3) Contract may have a common loophole if the company states it did not understand terms and conditions originally drafted in English (e.g. "Chinese Only" law).

4) Auditor should be aware of local tax and export laws.

5) Determine correct accounting records to audit: Tax or Custom.

6) Need Chinese licensing liaison representative and have relationship with China Council for the promotion of International Trade (CCPIT).

Auditor Qualifications

The specialist for this type of work should have a solid record of accomplishment. At the appropriate time the auditor should be a savvy negotiator. Further, the auditor should also have solid litigation knowledge and skills, for use when necessary, and the auditor must be patiently persistent. Technical acumen and the ability to answer questions distinctly are often necessary. For some audits, the auditor should also know how to obtain engineering or technical help when needed.

Working With Your Royalty Auditor

One of common misconceptions is that audits are an expensive all or nothing situation. Ask your auditor about simple statistical checks which may assist you in deciding what to do. Or, there are various economic solutions that may assist in balancing the need and cost of a royalty audit. Common misconceptions about royalty auditing include the notions that audits are always adversarial and cost a lot of dollars, which are often not be the case. A simple investigation of the facts can usually help determine if an audit is even necessary. Consult with your auditor to determine which approach makes the most sense. ■

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.