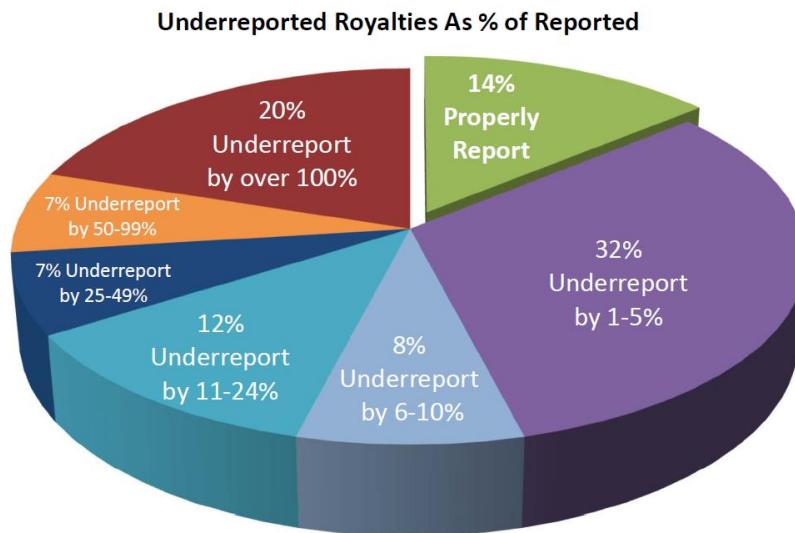


The Magnitude and Meaning of Royalty Misreporting

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SUMMARY

Approximately **86%** of licensees both underreport and underpay royalties to their licensors. In this chapter, the authors provide results of their study in which they examine the magnitude of royalty misreporting and its underlying causes and present problem-solving strategies to put into practice.



Source: InvoTexIP Audit Statistics 1997-2016

INTRODUCTION

Licensors are not reaping the full benefits of their license agreements and have cause to be concerned. Enormous resources are expended in drafting and negotiating license agreements, not to mention the time, effort and money spent generating or acquiring the intellectual property (IP). While some organizations are primarily interested in promoting society's common good, they are also concerned with recouping investments through royalty payments to the organization. As such, management is tasked with the responsibility of ensuring that assets are protected and used to their fullest earning potential.

Many fiscal problems arise when no one takes responsibility for protecting assets. We read about it in the news daily. Cash is embezzled. Fraud is perpetrated. Machinery and other consumables mysteriously "walk" out the door. These asset misappropriations are quite clear to everyone. However, what may not be so clear are other losses hidden within an organization's inattention to efficiencies, time value of money and operations below full potential. IP is frequently victim to this category of inattention, often overlooked due to its intangible nature.

In today's business environment, management is charged with the design and implementation of systems and procedures to protect and maximize their organization's assets, both tangible and intangible.

They are being asked to profess in writing that their organization's financial statements are their responsibility and that the statements are fairly stated. Historically, many have overlooked IP revenues as being incidental and immaterial to their organization. But not anymore. By today's standards, IP is an asset worthy of both protection and revenue stream monitoring.

Still, if you are a licensor in a royalty-bearing license agreement, chances are high that you are not receiving full compensation from your licensee. Since we began aggregating royalty audit data almost 20 years ago, we have found that approximately **86%** of licensees both underreport and underpay royalties to their licensors, frequently by staggering amounts.

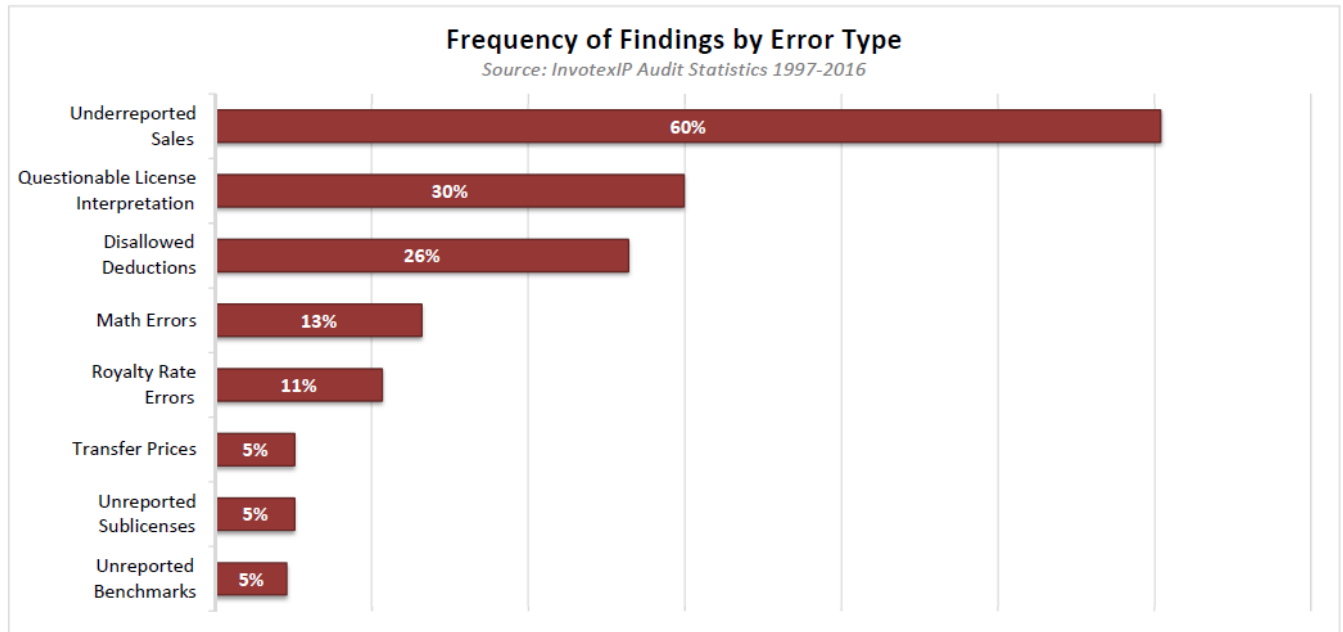
“WHY” VS. “HOW”

It is important to explore the reasons why underreporting happens. The answers can be predictable but noteworthy. Cynics will tell you that people are dishonest and try to push the envelope on minimizing their payments. Yes, willful misreporting happens but, in our experience, it happens in a minority of the cases. Typically, we find misreporting happens because of inattention, oversight or a disconnect. Often the people who negotiated and wrote the license agreement are not the people put into the position to interpret it. Worse yet, sometimes the people reporting royalties under the terms of a license agreement have never even seen the agreement. It is not unusual for a whisper-down-the-lane scenario to occur as new accounting clerks cycle through the royalty reporting role at an organization. Each clerk tells the next how to report royalties with the explanation changing slightly with each pass off.

Rather than focusing on the “why,” it is more important to understand “how” the misreporting happens. Understanding how errors occur and being able to spot the indications early can mean the difference between a healthy licensor-licensee business relationship and an adversarial one. The goal of the first is to initiate regular communication that produces mutual satisfaction with benefits rightfully enjoyed by both parties, which is the way it was negotiated. Adversarial relationships arise when there is silence, allowing a build-up of resentment for money and time wasted and distrust for current and future collaborations.

Which relationship would you prefer? Despite the clarity of this question, we find that many licensors want what they perceive as the best of both worlds. They mistakenly use “silence” as a way to promote a feeling of trust, fearing that any question raised is perceived by the licensee as an accusation of deceit. Are selling organizations offended when the buying company's accounts payable department verifies the receipt of all products listed on an invoice before paying? Don't you confirm that your credit card statement includes only items that you charged before you pay it? These actions are positive, fiscally responsible actions. Verifying royalty reports is no different.

The remainder of this chapter will focus on the causes of errors and will propose actions to take to limit future misreporting.



Underreported Sales – 60% Error Rate

Underreported sales are among the most common findings. Our 2016 study results show that approximately **60%** of all examined license agreements contained this type of error. In a rare case, we found the licensee was reporting the completely wrong product, one that did not include the licensed technology. However, in the vast majority of the cases the licensee missed a second generation or updated product. Oftentimes a relatively immaterial product update, such as a color change, will lead to a new product number being assigned. Without alerting the person preparing the royalty reports, these products are inadvertently left off the royalty report.

Often, at the heart of this issue is a flaw in the royalty reporting system itself, which is not set up to consider new product launches of royalty-bearing products. The accounting personnel preparing the royalty reports typically use a static template listing all licensed products and it is “rolled over” each reporting period. The template is updated for the current period sales amount, automatically performing the calculations resulting in a royalty report to submit with payment. There is often no mechanism for considering new products that should be added to the template.

Not all underreported sales relate to new products, there can be issues related to subsidiaries and affiliates that sell royalty-bearing products that are missed when calculating royalties. Geographical expansion, mergers and acquisitions, to name a few, can also lead to underreporting.

The Lesson: Know your licensee’s products and monitor what is happening in their research and development efforts. To achieve this, examine publicly reported information and compare it to what is on the royalty reports. Look to industry trends and see if your licensee is in line with them. Use your internal resources for tips and, of course, communicate with your licensee.

Questionable License Interpretation – 30% Error Rate

We found that in **30%** of examinations, uncovered errors were due to an inconsistency in license agreement interpretation. It is human nature to interpret things in the most advantageous way for ourselves and our organization. As previously mentioned, many times neither the licensor nor the licensee staff are the ones who initially negotiated and drafted the agreement. So, unless the language is crystal clear (and even based on everyone's best efforts – that is very rarely the case), interpretation is required. Further, the language is often drafted by lawyers and technology or product experts and interpretation is left to accounting personnel. It is no surprise to anyone who has drafted or managed an agreement that the clauses are interpreted in varying ways. This can lead to a significant difference in the royalty calculation. Findings in this category run the gamut from questionable definitions of covered products and sales to assuming apportionment is required when the agreement is silent.

The Lesson: The only way to uncover these errors is to gain a thorough knowledge of the accounting and reporting systems relative to royalty reporting and to ask questions.

Disallowed Deductions – 26% Error Rate

Deductions from gross sales are very frequently outlined in the “Net Sales” definition of the license agreement but are not as often separately stated on the face of the royalty reports. If the royalty reports are detailed and show the licensee's detailed calculation of gross to net sales, you may be able to spot the suspicious deductions in that data. If not, you might need to ask for it.

Most of the errors uncovered are from vague language in the license agreement such as “handling.” A handful of licensees we audited stretched this term to include corporate administrative expenses such as *accounts receivable management*, *storage facility rent expenditures* and *customer service*. Some licensees try to push back on these findings but most hang their head and admit to the issue when it is brought to light.

The Lesson: Ask the licensee to provide details of the gross to net sales deductions to ensure they fall under the allowable expenses defined in the license agreement. Specifically, in the healthcare field, beware of deductions that are recorded as the name of a service provider as these oftentimes include fees for services provided as part of group purchasing organizations (GPOs). Finally, many times the amounts reported as deductions are actually estimates or accruals. If the license agreement states that only amounts paid may be deducted, these may be disallowed and/or overstated.

Math Errors – 13% Error Rate

The fact of the matter is that although we use electronic spreadsheets for calculations and try our best to be accurate, we are human. At one time or another each of us makes mistakes.

Licensees have become more sophisticated in their reporting. They are also checking their math and finding errors prior to audits being performed. While this is good news, it doesn't mean math errors are no longer being made. It is important to note that the only math errors that the licensor can check are the ones on the face of the royalty reports, not the ones made in the underlying supporting data. We still find material math errors in individual audits.

The Lesson: Break out the calculator and make sure the arithmetic works. Better yet, ask for electronic copies of the spreadsheets so you can examine the formulas and methodologies behind the

calculations. An added benefit of electronic reports is that you can combine and compare them for trends, consistency and, potentially, internal forecasting and budgeting. If you cannot get them electronically it may be worth creating your own spreadsheets.

Royalty Rate Errors – 11% Error Rate

Misapplied royalty rates occur **11%** of the time. Royalty rate errors generally occur in scenarios with many royalty-bearing products along with several different royalty rates. Unless the reporting systems are fully automated and have been accurately programmed to apply the proper rates to each product, errors are bound to happen.

These errors are the hardest to find. Due to the high sales volumes, normally present under these scenarios, nickel and dime variances can add up to substantial dollar amounts. To further complicate matters, some agreements are written to include complex rate calculations based on an index.

If you have an existing agreement that contains unclear language, clarifying the correct method to calculate royalties could take some time and effort. After you understand how the rates are being applied, thoroughly discuss the matter internally to determine your legal and political positions. Then discuss it with your licensee to get a common understanding going forward. Together you can then both consider and discuss amending the agreement.

The Lesson: Try to simplify the application of royalty rates in the license agreement. When a large number of products exist, or is expected, group them and apply the rates by type or price range rather than by individual product. If volume is a concern to the licensee, use tiers and apply graduated rates. Whichever method is used, the license agreement should contain clear and precise language. It should provide detail on how the calculations are to be performed and include a sample calculation as an example. If a published index or other rate is to be used in the calculations, specify the publisher of the rate and precisely which rate is to be used. Also, include a copy of the last published index to ensure that all parties are considering the same piece of data.

Transfer Prices – 5% Error Rate

A transfer price is the price of goods and services sold between related subsidiaries within the same organization. Sometimes organizations also charge transfer prices to partners under a marketing and distribution agreement, providing a price break in exchange for other financial returns, such as royalties.

In contrast, arm's length pricing or third party pricing is the price at which two unrelated parties not in duress would agree to in a transaction.

Prices are higher in third party pricing and, typically, these are the prices contemplated in license agreements when net sales are used as the royalty base. However, even if the license agreement language specifies third party pricing, sometimes the licensee only has access to the transfer pricing sales generated at their subsidiary level and does not have access to the sales data recorded at the organization level depicting third party pricing to the ultimate consumer.

As a licensor, how do you spot this type of error? Often, to discover such a problem an on-site audit is the only means of reviewing the licensee's internal financial documents. Most likely your licensee will not provide you the same access to this confidential information. You should, however, be aware of the market price of the licensed products and perform analytics and trend comparisons on the royalty reports to ensure that the numbers make sense.

The Lesson: This type of error is not easy to identify. Even in trend analyses, changes in volume and pricing as well as multi-country sales can muddy the data. Verify reasonableness with online or catalog pricing. Review publicly reported information such as annual reports and press releases for sales alliances that relate to your licensed product(s). Lastly, try to be specific in wording the license agreement, particularly in the definition of the royalty base if related to sales.

Unreported Sublicenses – 5% Error Rate

If your license agreement grants rights to sublicense, it should also include language giving you rights to copies of the sublicense agreements, copies of the resulting sublicensee royalty reports and access to the sublicensee's supporting books and records. At times, licensees place scope limitations on auditors when the license agreement is silent to these matters.

Regardless of scope limitations, you can still utilize publicly available information of the industry, the sublicensee and their publicly reported statements. Also, as with unreported sales, look towards internal sources for guidance. We find our best tips come from inventors, faculty and others who have a financial or other stake in the amount of royalties collected.

The Lesson: You will not know what is or is not being reported unless you can get the sublicense agreements and can ask the right questions.

Unreported Benchmarks and Milestones – 5% Error Rate

Not surprisingly, we find that our university and government clients are the hardest hit by this reporting deficiency, due to the development stage of their licensed technology. Because benchmarks and milestones generally must be tracked outside of accounting for sales, licensees must have additional systems and checks in place to ensure that these license agreement requirements are fulfilled. Persons compiling the reports must have access to the license agreement and be mindful to consider if and when these payments need to be made. Frequently, benchmarks and milestones get lost in the shuffle.

Benchmark and milestone payments may be based on research and development, product trials or sales volumes and geographies. This information can be ascertained from press releases, annual reports and other promotional material. Ensure that the royalty report and payments correlate with public information.

Additional complications can arise when benchmark and milestone payments based upon your licensee's sublicense activity are due. The sublicensee payments are collected by the licensee and recorded in their other income categories. They are frequently forgotten by the time the royalty reports are due to the licensor. In some cases, the licensor did not have a copy of the sublicense agreement and was not aware of the milestones. In other cases, the licensor read about the payments in a public release and then neglected to inquire about the flow-through payment back to them.

The Lesson: It takes time and effort to investigate properly and follow up. Alternatively, as the licensor, you should request a regular status report on the progress toward the various milestones. Let the licensee know that you are mindful of the requirement and are monitoring the activity.

Milestones can be significant and, considering the time value of money and the opportunity

costs, the losses can be dramatic. In addition, it is helpful to word the license agreement such that the licensee is required to supply the licensor with copies of any sublicense or other type of agreements contracted concerning the subject licensed technology.

TIPS ABOUT THE ROYALTY AUDIT

Almost every license agreement gives the licensor the right to audit. However, licensors tend to be hesitant in initiating this right. This is due to an outdated perception that an audit is an accusation as opposed to an effective tool to open lines of communication and assure that all parties are on the same page. An audit should include a site visit with investigative interviews in accounting, royalty reporting, and technical, marketing, and business development.

Royalty audits are not financial statement audits. The audit firm should specialize in technology-based IP agreement audits. Of course, you want to verify that support exists for the amounts reported but you also want to ensure that the firm you hire will also identify what has not been fully reported in a thorough and professional manner.

The Lesson: When engaging a firm to perform your royalty audits, know who you are hiring - their experience, methods, and philosophy. Your goal is to get what is rightfully yours, no more and no less. Be sure the firm you hire will represent you well and respect the relationship between you and your licensee.

CONCLUSION

Intellectual property is valuable - probably more valuable than most organizations realize. Therefore, it is vital that systems are in place to inventory, monitor and perform audits for intellectual property license agreements. This includes regularly scheduled on-site royalty audits. As we have detailed in this chapter, it takes a lot of time, effort and experience to properly investigate license agreements, the subject companies and their business activities. Not every organization has these resources and not all organizations need or want in-house expertise in this area. At the same time, there is always someone, either investors, directors or board of trustees, who expect and demand that the organizations be run well. Their money and reputations are at stake. Make sure your entity has the proper controls in place to withstand this scrutiny.

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ABOUT INVOTEXIP

For more than 20 years, InvotexIP has been auditing royalties for corporations, universities and other institutions to ensure that intellectual property licensees are properly reporting royalties owed to licensors. The firm travels the globe auditing hundreds of agreements and has uncovered more than \$400 million in underpaid royalties for clients. For more information about InvotexIP, visit www.InvotexIP.com.