

Who Is Keeping An Eye On Your Royalty Income?

By Debora R. Stewart, David J. Lambdin and Megan E. Farrell

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You slept through your alarm and now you're late for work. Cruising down the highway at 64 mph, you notice the prominently displayed 55 mph speed limit sign. You rationalize that you aren't significantly over the speed limit so you keep your foot heavy on the gas. Then, out of the corner of your eye, you spot a police car and your foot immediately taps the brake. You were only going nine miles over the speed limit (16%). How would you feel if your licensees were paying you 16% less than they should?

It's human nature. If we know we're being watched and the potential is there for getting caught, we become less likely to bend the rules. Even a subtle sign of surveillance is an effective deterrent. A recent study found that people contributed three times more money to a coffee-payment honesty box when it was under a poster of watchful eyes, versus a poster of flowers. Yet another study shows that test takers in a dimly-lit room are more apt to cheat than those in a well-lit room.

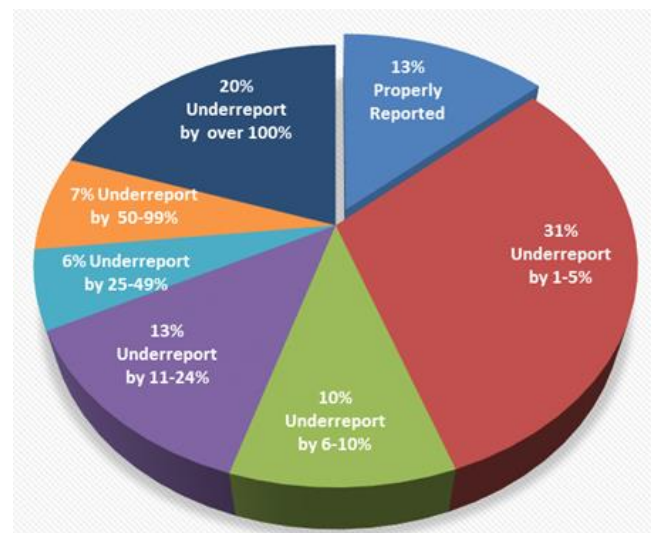


In the business world, independent auditors serve as your eyes and ears, providing an increased level of oversight that doesn't exist otherwise. The role of an independent auditor becomes even more important when the calculations and payments are self-reported, such as with license agreement royalty payments. Without the potential of a discovery, it is simply human nature to be more casual with royalty reporting and calculation. It should come as no surprise that one study showed both actual prior audits and a real prospect of future audits caused a significant increase in self-reported income.

87% of licensees audited underreported and underpaid royalties.

Underreported Royalties As A Percent Of Reported

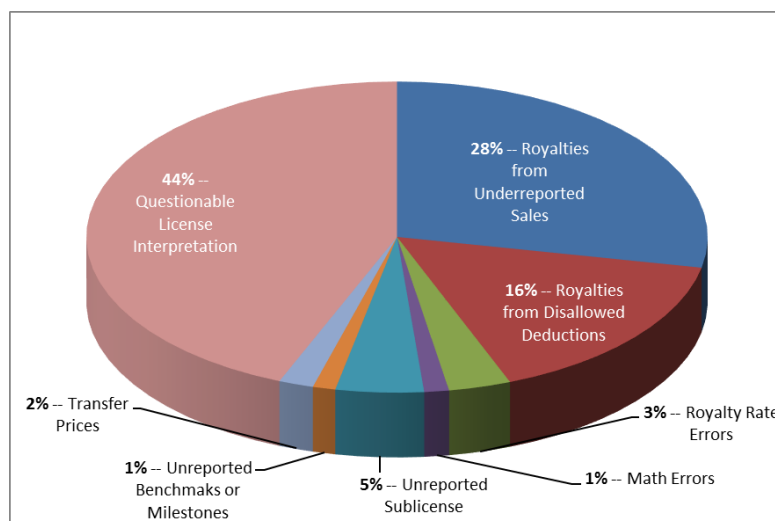
Source: InvotexIP Audit Statistics 1997-2014



InvotexIP has been performing royalty audits for 18 years and our data shows a staggering 87% of audited licensees underreport and underpay royalties. In our experience, the action is not one of malice. The majority of underreporting stems from honest oversights and misinterpretations. It is human nature to interpret things in one's best interest and not be quite so diligent when diligence only leads to higher payments.

Error Type % Of Dollars Uncovered

Source: InvoTexIP Audit Statistics 1997-2014



Having established that most errors are unintentional, there is surprising new research that shows many people actually develop positive feelings by getting away with things. There is also evidence regarding our ability to rationalize our behavior that makes it possible to be untruthful with ourselves. While much of this psychology exists at a subconscious level, a key factor in all of this is anonymity. Being anonymous creates a situation where the likelihood to be untruthful is even more probable. Conducting a royalty audit eliminates that anonymity factor.

Interestingly, it doesn't seem to matter whether these actions are human nature, intentional, or subconscious, increasing the level of monitoring and/or oversight always leads to fewer incidents of the incorrect behavior.

This year's royalty compliance report continues to demonstrate that there is a significant gap between expectations and reality. Parties to a license agreement spend significant time and money negotiating the terms of the agreement, expecting them to be clear and unambiguous.

Best practices are implemented, legal and executive reviews are performed, and tech transfer professionals are engaged. However, because of issues often outside the control of these experts, there is an extremely large amount of misreporting and misinterpretation.

The most common reasons for underreporting are questionable license interpretation and royalties from underreported sales. If royalty audits are not performed, such interpretation issues and missed sales will never be discovered. Depending upon the royalty stream of the license agreement, this could amount to millions of dollars in missed royalty income.

Questionable license interpretation is at 44% of the total dollar amount that is misreported and is a ripe area for issues. Legal and licensing professionals draft the terms of the agreement but it is often the licensee's accounting clerks who are left to interpret them. Many factors are involved in how the terms of the agreement are interpreted including complexity, institutional knowledge, turnover and the level of involvement in the negotiation process.

Events occurring in the normal course of business also impact royalty reporting such as changes in technology, products, accounting systems, personnel, etc.

Empirical data supports the necessity to audit royalty streams.

Compounding all of these factors is the tendency of employees at all levels to interpret issues in their company's best interest. It could be as innocuous as the subliminal (or not so subliminal) messages that they really need to control costs and increase profitability. Perhaps bonuses are tied to performance. When these factors are combined with the psychology of deceit, the momentum is in favor of the licensee's interpretation over that of the licensor's.

Frequency Of Findings By Error Type

Source: InvotexIP Audit Statistics 1997-2014

For Every 100 Audits Performed:

- **57** underreported sales;
- **31** underreported due to questionable license interpretation;
- **27** underreported due to disallowed deductions;
- **14** underreported due to math errors;
- **8** underreported due to royalty rate errors;
- **6** underreported due to transfer prices;
- **6** underreported due to unreported sublicenses; and
- **3** underreported due to unreported benchmarks or milestones.

Audits are the perfect platform to rekindle communications between licensor and licensee.

When negotiations have concluded and the license agreement is in effect, there is often very little communication between licensor and licensee aside from the quarterly royalty reports. The audit process brings to light possible differences in interpretations

and allows for prompt discussion and feedback on those issues thus highlighting and strengthening the mutual benefits of the business relationship.

IP licensing is one of the most significant and fastest growing sources of an organization's earnings, yet it continues to be one of the most poorly managed and under-utilized assets. Royalty audits are an imperative step to manage this asset effectively. ■

About

InvotexIP

For 18 years, InvotexIP has audited hundreds of agreements and uncovered more than \$250 million in underpaid royalties for our clients. Royalty audits are an imperative step to manage IP effectively. We believe that it is important to sustain positive sentiments and communications before, during, and after a royalty audit. With more IP related investigation experience than any of our competitors, InvotexIP maximizes the return and efficiency of its audits while minimizing the sense of disruption. We make every effort to accommodate your licensees' schedules, make use of data readily available to them, and most importantly not waste their time. With a Director level professional leading every site visit, we know exactly what questions to ask. We are able to identify areas of concern effectively and efficiently to get the results you need while respecting your partners' business and resource demands. For more information about **InvotexIP**, visit our website, www.InvotexIP.com.

The Authors

Debora R. Stewart, CPA/CFF
Managing Director, InvotexIP
443.821.0191 or dstewart@InvotexIP.com

David J. Lambdin, CPA, CFE
Managing Director, InvotexIP
443.821.0193 or dlambdin@InvotexIP.com

Megan E. Farrell, CPA
Manager, InvotexIP
443.821.0194 or mfarrell@InvotexIP.com