Trust, but verify: are you collecting your fair share of royalties?

A recent report reveals that 89% of audited licensees underreport and underpay royalties. Its authors detail how to become one of the 11% of licensors whose royalty fee is accurately reported

By **Debora R Stewart** and **Judy A Byrd**

Trust, but verify. Ronald Reagan's Cold War mantra offers excellent advice for intellectual asset managers. While licensors can generally audit licensee records to ensure accurate royalty reporting, they frequently forgo the option. However, according to a recent statistic, 89% of audited licensees underreport and underpay royalties.

Licensors invest substantial time and money in negotiating licences. Transactions can take months and involve executives, technology transfer teams, legal teams and others – easily adding up to a considerable investment. Typically, the resulting agreement will include an audit clause. Once the deal is signed, everyone walks away. However, if the licensor does not pursue that audit clause and instead relies solely on the licensee's royalty reporting, it will likely be leaving significant money on the table.

Outright fraud is rare. Licensees may be inattentive, make mistakes or interpret the agreement to their own benefit. However, intent is irrelevant and mistakes can mean millions in missed revenue for licensors.

In the findings of the recently published 13th Annual Invotex Royalty Compliance Report, an evaluation of worldwide licence compliance statistics, the amount of underreported royalties as a percentage of reported royalties was alarming:

- In 25% of all audits, licensees underreported the royalties owed by more than 100% of the total amount reported.
- Seven percent underreported royalties owed by between 50% and 99%.
- Eight percent underreported royalties owed by between 25% and 49%.
- Eleven percent underreported royalties owed by between 11% and 24%.
- Eleven percent underreported royalties owed by between 6% and 10%.
- Twenty-seven percent underreported royalties owed by between 1% and 5%.

Only 11% of the total licensees audited accurately reported and paid the royalties owed.

Given the increasing prevalence of non-compliance, together with the fact that IP licensing is one of the most significant and fastest-growing sources of organisational earnings, companies with regular royalty revenues are advised to institute a systematic licence compliance programme.

Once royalty revenues reach a threshold amount, companies will want to consider adding royalty audits to their compliance programme. As a rule of thumb, licensors should perform an audit for licences generating more than US$100,000 in royalties per year. In the life of a financially lucrative licence, licensors will want to perform a royalty audit about every three years.

Most common reporting errors

Analysis of the most common types of reporting error provides a roadmap for all involved in the development, compliance and enforcement of licence agreements.

Just three types of error account for more than 85% of all unreported or underreported royalties. Questionable licence interpretation accounts for 44% of

Chart 1. **Degree of misreporting uncovered in audits, 1998-2012**
– percentage by which audited licensees underpaid

Source: Invotex
NB: Figures are based on data collected during audits carried out by Invotex

the total dollar amount that is misreported; royalties from underreported sales account for 23% of the total; and royalties from disallowed deductions account for 20%.

No one who has negotiated or managed a licence will be surprised that the words written in the agreement are often interpreted in a variety of ways, sometimes causing a significant disparity in royalties as calculated by the licensee and licensor. Interpretation can take many forms – from the definition of the product itself to how to calculate the sale.

For example, although many licences lack apportionment or combination product clauses, licensees often take it upon themselves to apportion the sales price based on their own methodology. In one such case, the licensee slashed the reported sales price by 20%; in another it was reduced by almost 90% of the sales price paid by the customer. Without examining the documents underlying the sales in the royalty reports, the licensor has no way of knowing this is happening.

Royalties from underreported sales account for 23% of the total misreported dollar amount. One reason for this disparity is that sales that should be reported are often missed due to the fluid nature of product marketing – new products are introduced, new territories are created and new distribution channels open up.

To compound the issue, many products have product line extensions, updates and new versions, which may or may not get reported. Where there are overseas sales, the reported products may be sold under different names or item numbers that are often overlooked in the royalty calculation.

When the technology resides in products with many variations, relatively short lifecycles and frequent updates, the likelihood of missed sales skyrockets. In these scenarios, licensors frequently do not know what they are missing in the royalty reports because it is difficult to ascertain completeness in even the most detailed reporting without understanding the licensor's sales universe. Some 56% of audits reveal underreported sales.

Finally, royalties from disallowed deductions account for 20% of the total misreported dollar amount. Frequently, sales reported to the licensor are net of deductions even though the royalty report line is labelled 'gross sales'. Without investigation, it may be difficult or impossible to know what deductions were taken and whether they are allowed under the licence agreement.

In 28% of examinations licensees have taken disallowed deductions, at times even deducting prohibited general and administrative overhead expenses from a sale. Disallowed deductions mean missed income. This revenue loss can be substantial.

Most licence agreements have a definition of 'net sales' which provides that only specific deductions offered and taken by customers on the sale of licensed products – sometimes only those specifically stated on the customer's invoice – may be applied to the royalty calculation. Sometimes the licensor deducts expenses of the full product family or an allocation to a given product line, stretching the definition and taking more than the allowed deductions. Often inventory management fees, including charges for invoice collections and transportation between warehouses, are captured in these so-called 'discounts'. Licensors may take issue with the interpretation of these amounts once the magnitude of the deduction is fully understood.

Less frequent errors

Unreported sub-licences account for 6% of the total dollar amount that is misreported. The existence of and payments received from sub-licence activities may be uncovered and captured only through a royalty audit. It is only through an audit that receipts from a sub-licence appearing in the licensor's 'other income' categories will become obvious. The unaudited royalty report typically provides only sales information. Missed signing fees and royalties received are examples of income that may go unreported.

Some 7% of the licences audited underreport sub-licences. To protect their interest, licensors should include language in their agreement requiring licensees to provide them with copies of sub-licence agreements as well as copies of the related royalty reports. Whenever possible, the terms should also give licensors the authority to audit each sub-licensee's records and the flow-through payments to the licensee and, ultimately, to licensors.

Royalty rate errors account for 3% of the total dollar amount that is misreported. Royalty reporting and associated payments are often an afterthought for the licensee. Preparing a royalty report is not generally a core business function. It typically falls to an accounts payable group that may lack familiarity with the licensing terms. Often these individuals have never seen the licence agreement to know how the royalties are meant to be calculated.

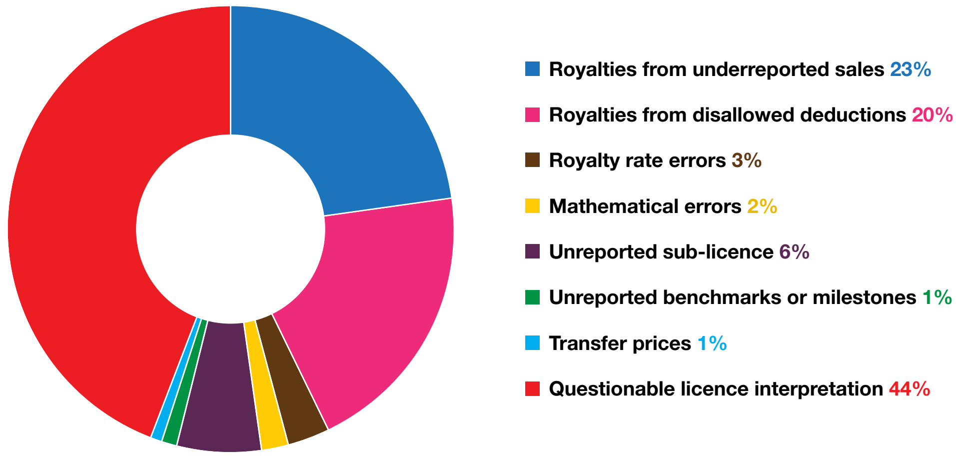
Some 8% of all licences examined reflect misapplied royalty rates. Without fully automated reports that accurately apply rates to products, errors will continue to occur. However, even the most robust royalty system can render reporting errors if the rate structure is complicated or requires frequent modification. Errors may have occurred when the automated calculations were initially programmed and perpetuate in the black box. We are all human and we all make the occasional slip.

Errors in arithmatic account for 2% of the total dollar amount that is misreported. Mistakes happen all the time. Spreadsheets contain mathematical formulae that go unchecked and errors perpetuate from report to report. Even in sophisticated multinational corporations, royalty calculations are often based on sales and deduction data accumulated on a working spreadsheet. The information is often collected via email. Input errors and omissions abound in these manual processes. Whatever the reason, whatever the process, misreporting happens and verifying accuracy is prudent. A total of 15% of the licences examined reflect calculation errors.

While the licensee may never fully automate its royalty reporting into its financial reporting system, licensors should learn what the reporting process is and request supporting documentation for the calculation methodology. Licensors should also request regular updates and status reports regarding the progress of identified milestones. Unreported benchmarks or milestones account for 1% of the total dollar amount that is misreported and 3% of what is owed. Because sales benchmarks and milestones are generally tracked outside of accounting systems, licensors need to ensure that licensees have mechanisms in place to measure progress. If goals are not met, learn why. Make sure that licensees know that their activity is of interest and is being monitored.

Finally, transfer prices account for 1% of the total dollar amount that is misreported. Transfer pricing is the practice of different divisions within the same company selling products to each other at below market rates. Five percent of the licences examined applied improper pricing. The existence of territorial affiliates and distribution or marketing partners often provide clues to the existence – or at least the possibility – of transfer and below-market pricing.

Chart 2. **Financial magnitude of errors identified in audits, 1998-2012** – proportion of the dollars underreported by error category out of the total underreported royalties in audits



Source: Invotex
NB: Figures are based on data collected during audits carried out by Invotex

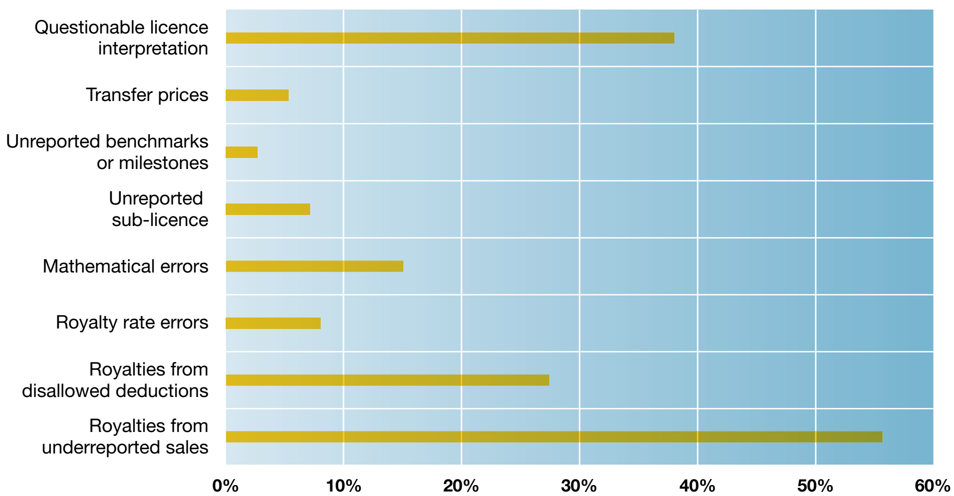
Where to begin: establishing a structure

A well-conceived management structure to regulate the licence is paramount. When licensors have a well-defined set of policies regarding records maintenance – when, how and how frequently to contact the licensees; when and how forceful to be in the relationship; how far to take any breaches in compliance – they are much better positioned to manage their agreements actively. In addition, those responsible for actively implementing the procedures have more responsibility, authority and autonomy to follow through with these policies. Further, having a structure for reporting and communications is vital for the licensee so that it knows what to expect and can develop and maintain its own set of policies and procedures to follow. Use of royalty reporting templates and consistent policies will benefit the reporting and overall relationship and avoid many of the common problems encountered when attempting to capture more complete and more accurate reporting and payments.

Not all licensors need to enlist royalty auditors. If an organisation has just one licence agreement with a small revenue stream, and has no reason to suspect that the licensee is exploiting the licence, in-house analysis and regular phone calls to the licensee may be sufficient to manage it. However, it is prudent to implement a compliance function to identify how your organisation will manage and monitor the licensing relationships and when a more stringent examination process needs to be implemented.

Where there is a larger portfolio of licences or larger anticipated revenue streams, a multifaceted compliance programme is appropriate. Overall, the goal of any compliance programme is to ensure the completeness and accuracy of a licensee's reporting.

Chart 3. **Error incidence in audits, 1998-2012** – how often particular errors were identified in audit results



Source: Invotex

NB: Figures are based on data collected during audits carried out by Invotex

If your licence agreement is still in development, be sure to insert language regarding structure and expectations. Define terms as clearly as possible. Engage the licensee's accounting team to ensure that the reports and calculations you request are within the scope of its reporting capability. Use ordinary business practices for currency conversion and reporting periods rather than asking for additional manual conversions and calculations. We also suggest including a royalty report template as an exhibit to the licence agreement detailing the information desired in a format both useable for the licensee and functional for the licensor to review and analyse.

A structure with solid reporting expectations is critical to reducing ambiguity between licensor and licensee. Share with the licensee when, how and what to report, to reduce confusion. Be responsive and consistent. If expected details are omitted from a royalty report, ask for them and refer the licensee to the reporting guidelines. Keep your relationship congenial and professional.

Early in the relationship, develop a routine of regular communication with the licensee to discuss developments, products, manufacturing and sales. If yours is a long but stale relationship, give it new life with open-ended questions that encourage dialogue. If conversation tends to veer off track, prepare an agenda in advance of your meeting or provide a list of items for the licensee to respond to if deeper research is required. Suggest a reasonable deadline.

Having a structure in place illustrates to licensees that you have a comprehensive compliance programme with an audit component as part of your overall licence management. Make it clear to the licensee that it has not been singled out, but is simply a part of your organisation's compliance policy of auditing valuable agreements and licence revenues at a particular threshold. Your licensees will understand it is business as usual when you inform them that it is their turn for an examination.

When that time does come, the right auditor can provide a buffer between licensor and licensee, so that the relationship remains on a good footing.

Some licensees may offer to do a self-audit. This is fine, but never accept the payment offered after a self-audit as complete without verification. Impress upon the licensee the benefits of a third-party audit, which can inhibit the potentially adversarial nature of the process by keeping it objective, professional and non-threatening.

Building a licence database

Logistically, an important first step in establishing a structure is to ensure that all licences that contribute to the portfolio are contained in a database filled with the necessary information to allow the portfolio to be monitored. At the very least, the database should contain:

- Complete licensee contact information.
- Intellectual property coverage by territory with expiration dates.
- Royalty base definition.
- Reporting requirements with royalty calculation and payment timing.
- Minimum annual royalty and milestone requirements and payments.

Once the licence population is known, the agreements should be stratified into various categories, including by size of the revenue stream; perceived quality of the partner and the relationship; known errors in previous reporting and methods for uncovering and resolving those errors; and complexity of the royalty calculation – that is, the number of products using the licensed technology, combination product issues, confusing or vague definitions for the royalty base and existence of sub-licensing arrangements.

The most basic stratification system places agreements governing intellectual property with high dollar royalty streams and intricate calculations at the top. This top stratum demands and deserves specialised attention, just like any other higher-value asset. These licence agreements should always be scheduled for both regular analysis of each royalty report and regular, in-depth, on-site royalty audits.

Regular analysis may include preparing a schedule of sales reported by product and territory to ensure that trends make sense, that expected products and territories are being reported, and that the deductions taken are allowed under the agreement. Other metrics, such as price per unit, may be useful as well.

Depending on industry and company information available, a review of public reports such as quarterly or annual financial reports, Securities and Exchange Commission (SEC) filings and industry statistics may also provide information on manufacturing, distribution, sub-licences, specific product sales data and more that could corroborate or refute the information included on the royalty reports. This type of research is time consuming, but extremely valuable. Although it may not yield hard evidence of misreporting, it does provide a framework for understanding and a basis for informed and meaningful discussion with partners.

Licence management should also involve inventors and others who have knowledge of the technology and industry to gain insight into potential reporting deficiencies. Inventors take great interest in their creations and frequently have close relationships with others who keep abreast of what is happening in their field, both in general and with specific research and products in development and launch.

Finally, the licensor needs to watch out for signs of reporting problems. Red flags such as the following are common in royalty reports:

- Changes in the reporting format (eg, level of detail provided) or the person preparing the report.
- Changes in the licensee's accounting system or entity structure as a result of a merger, spin-off or acquisition.
- Signs of stress, including organisational financial distress, strained communications or late or missed reports.
- Additional product lines, expanded sales

Action plan

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Take the following steps to establish a compliance programme for monitoring royalty revenues:

- If your licence agreement is still in development, insert language about structure and expectations.
- Develop a routine of regular communication with the licensee to discuss developments, products, manufacturing and sales.
- Share with the licensee when, how and what to report, to reduce confusion. Be responsive and consistent. If expected details are omitted from a royalty report, ask for them and refer the licensee to the reporting guidelines.

Build a licence database that includes:

- Complete licensee contact information.
- IP coverage by territory with expiration dates.
- A definition of the royalty base.
- Reporting requirements with royalty calculations and payment timing.
- Minimum annual royalty and milestone requirements and payment.
- Any other financial forms.

Actively manage the agreements and relationships by:

- Stratifying the licence agreements.
- Conducting regular analysis of licensee royalties appropriate to the expected present revenue stream.
- Watching for red flags that there may be reporting problems, such as changes in reporting formats, the licensee's accounting system, organisational financial distress or additional product lines.
- For higher-value streams:
  - Prepare a schedule of sales reported by product and territory to ensure that trends make sense, that expected products and territories are being reported, and that deductions taken are allowed under the agreement terms and conditions.
  - Review public reports such as quarterly or annual financial reports, SEC filings and industry statistics that could corroborate or refute the information included on royalty reports.
  - Above all, schedule regular, in-depth, on-site royalty audits for licences with high dollar royalty streams and intricate calculations.

territory, new manufacturing facilities or distribution methods.

If red flags are observed in the second or lower stratum of licence agreements, it may be time to take a deeper look into the reporting: perform more detailed analyses, and make some phone calls to the licensee and perhaps to your royalty auditor to get some concrete answers.

Royalty audit: the key to compliance

A royalty audit is the other key component of an effective licence portfolio compliance programme. Licence agreements generating significant royalty income streams benefit from a targeted investigation through royalty audits. Having a reputation for proactive management of intellectual property typically elicits better overall reporting from licensees.

Nearly every licence agreement includes a provision for the licensor to audit the books and records of the licensee to confirm compliance. These terms are negotiated and agreed upon before the agreement is signed. Licensors are well within their rights to pursue them.

Verifying royalty reporting practices and payment amounts usually takes place at the licensee's offices with accounting personnel. Auditors are professionals and the process need not be adversarial or burdensome. Audits allow the parties both the opportunity and structure to discuss what is happening with the intellectual property and interpretations of the contract, which leads to a better working relationship and more reliable reporting.

A royalty auditor is specially trained to discern the nuances of licence agreements and intellectual property, and possesses a deeper skill set than a financial statement auditor. Since most licence agreements restrict the frequency and periods open to investigation, this distinction is important. The royalty auditor will focus on licensee personnel interviews to reveal key facets of the reporting structure and possible royalty-bearing products, as well as the flow of revenue associated with sales of the products. The auditor will also analyse the licensee's financial support – including everything from worldwide sales data for the products to invoices and contracts with group purchasing organisations – to determine areas of underreporting to the licensor. The ultimate goal is not just to uncover underpayment, but also to maintain a good working relationship between the parties.

Technology and business practices develop and change over time, and it is essential to monitor and manage them. If audit resources do not exist within the licensor's organisation, or if richer expertise and outside independent assistance are preferred, seek out recommendations for a royalty auditor. Bear in mind that many licences contain language indicating that if audit findings exceed a given threshold, the audit fees will be paid by the licensee. In any event, recoveries from audit findings most often cover the cost of the audit. Take a periodic look at your licence portfolio to determine which licences may be due for a review.

Compliance reviews are standard business practice. Some business development, sales and marketing professionals are uncomfortable with the checks and balances associated with compliance; they fear that questioning their business partners will raise issues of mistrust. In truth, audits are performed every day in the business world and are expected.

More accurate reporting going forward is one of the benefits of a royalty audit. Following an audit, the licensee develops an enhanced understanding of the licensed products, deductions and agreement terms. Better and more open communication reduces misinterpretation. It is time well spent. For the licensor, it means that future reports will reflect a more proper accounting of the royalties due. *iam*

Debora R Stewart is a managing director and head of the licence management and royalty compliance practice at Invotex
dstewart@invotex.com

Judy A Byrd is a director with the IP services practice and co-manages the licence management and royalty compliance practice at Invotex
jbyrd@invotex.com