

Licence check

Invotex's **Debora R Stewart** and **Judy A Byrd** highlight how 56% of audited licensees under report sales



Every year billions of dollars are paid in royalties. While licensors can generally audit licensee records to ensure an accurate royalty reporting, they frequently forego the option and trust that the licensee will provide a proper accounting of the royalties due.

But according to a new report released by US-based Invotex, a financial analysis and economic consulting firm, licensors who fail to audit may be losing significant revenue. In the *13th Annual Royalty Compliance* report, a surprising percentage of audited licensees underpay royalties. The errors are substantial:

- 89% of audited licensees under pay royalties;
- 56% of licensees under report sales;
- 38% misinterpret the licensing agreement; and
- 28% take unallowed deductions under agreement terms

Chart 1 summarises our findings by magnitude of the total under reporting found. For example, 25% of the time, we found under reporting in our audits that was 100% or more of the total royalties that were reported to the licensee.

“Licensors who fail to audit may be losing significant revenue.”

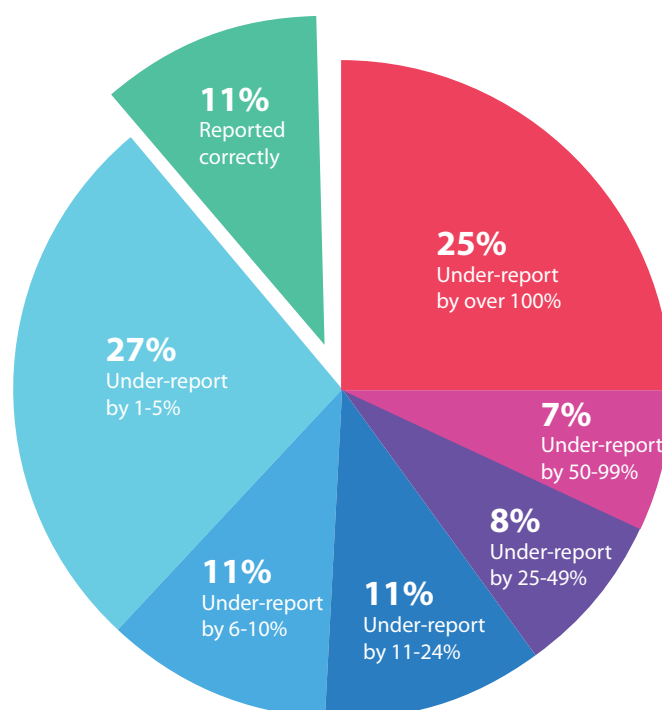
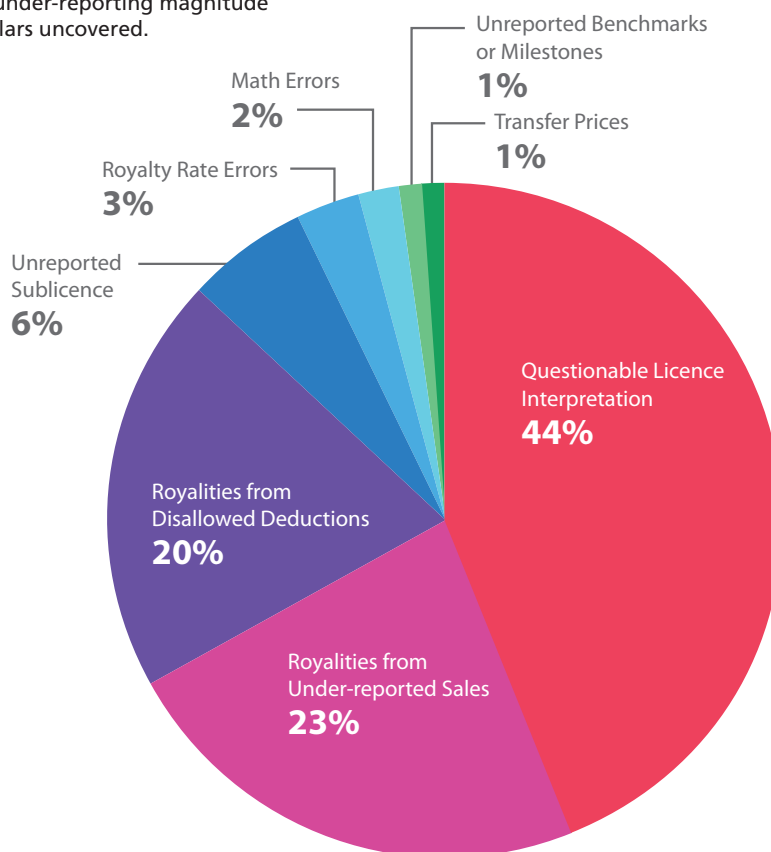


Chart 1: Under-reported royalties as a percent of reported royalties – 89% Under-reported – 11% reported accurately.

Chart 2: Dollar of findings by error type
This chart represents the under-reporting magnitude based on total royalty dollars uncovered.



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The study compiles worldwide licence compliance statistics gathered over the last 13 years. Significantly, the report finds that in 25% of the audits, the under payment exceeded the total royalties reported by more than 100%. This statistic has remained relatively consistent over the past decade.

Types of errors

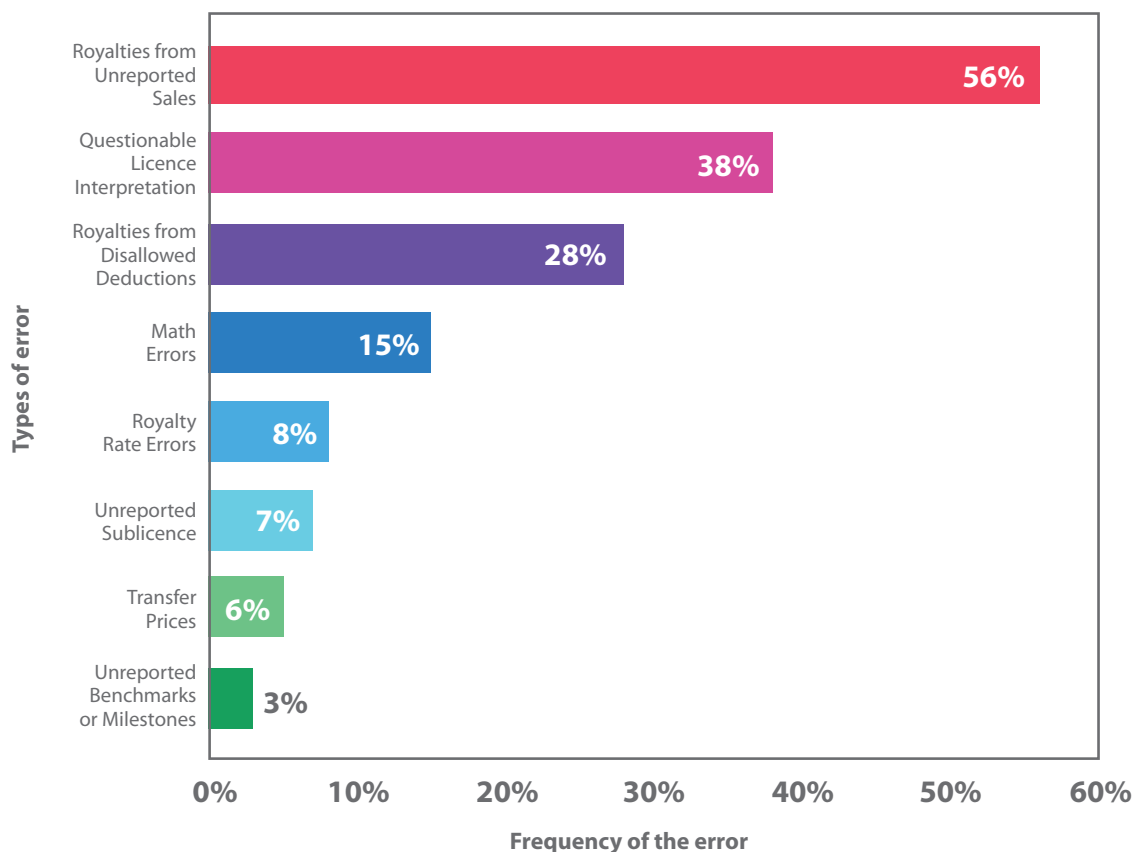
While several types of reporting errors regularly appear in audit results, three types of errors account for more than 85% of unreported or under reported royalties. Expectedly, under reported sales – missed product sales or territories – are the most common, occurring in more than half of the audits performed. Disallowed deductions and calculation errors also occur at a high rate but generally do not result in as high a level of under paid royalties. Questionable licence interpretation accounts for the most significant under payments in terms of dollars, occurring in 38% of the audits and accounting for more than 44% of the dollar findings.

When we analysed our audit results, we categorised the royalty dollars uncovered into various error categories, as you see in Chart 2. Chart 2 summarises our cumulative audit findings by these error types and provides the magnitude of those findings. For example, for the sales category, 23% of the cumulative dollars we have uncovered in our audits as under reported royalties originated from us finding under reported sales (ie, licensed products that have not been reported to the licensor in their royalty calculations).

Anyone who negotiates and manages licences will not be surprised that the words written in the agreements can and will be interpreted in a variety of ways, sometimes causing a significant disparity in royalties as calculated by the licensee and licensor.

Chart 3: Frequency of errors by type

This chart breaks down the frequency of royalty reporting error by type of error. When compared with Chart 2, the significance of reporting errors becomes quite apparent.



Because royalty report preparation is generally not a licensee's core business function, it is another area vulnerable to misreporting. It is typically done by an accounts payable group that is often unfamiliar with the terms of the licence agreement.

And then there are mistakes. We all make them. Spreadsheets contain math formulas that go unchecked and errors are perpetuated from report to report. Manual input or data manipulation errors are made, repeated, and compounded. Database queries lack checks and balances to ensure completeness for proper products and new sales territories. Accounting system changes cause unforeseen complications. Whatever the reasons, misreporting happens, and verifying accuracy is wise.

Chart 3 shows our findings by error type as well but instead of showing dollars found, we represent the frequency that we see the errors happen. So for example, we discovered under reported sales in 56% of the audits Invotex performed.

"It is incumbent upon licensors to actively manage their patent and technology licences as part of an established audit programme," comments Jane Schultz, vice president, intellectual property at InterDigital, Inc, a licensor of wireless patents and technologies worldwide. "For example, licensees may have changing businesses as a function of product mix or distribution channels which might impact reportable products under an existing royalty bearing licence. A regular audit programme is a best practice that all licensors should employ."

Whether omissions of product sales, human error, ambiguity within the licence agreement, or something else, the frequency of misreporting suggests that licensors consider proactive measures to prevent misreporting.

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Authors



Debora R Stewart, CPA/CFF is a managing director of Invotex's IP services practice. With more than 25 years of financial and consulting experience working with corporations, universities and government entities and their counsel, she provides strategic assistance and tactical expertise to help clients optimise the value of their IP, primarily in the areas of licence management and royalty compliance.

Judy A Byrd, CPA/CFF is a director with Invotex's IP services practice and co-manages the licence management and royalty compliance practices. Judy uses her 20 plus years of broad financial consulting and audit experience to help IP owners manage and maximise the value of their license portfolio and maintain active healthy relationships with licensees.