

Effective licensee monitoring

Businesses that include proper contract language instructing a licensee how to calculate a royalty, and that have a proactive licensee monitoring programme, are best positioned to achieve higher royalty revenues at reduced monitoring costs, without damaging business relationships

By **Sidney Blum**

Both novice and seasoned licensors make the same critical mistake by not adequately instructing the licensee on how to calculate the royalty and preserve supporting records. The emphasis to close the deal and rely on the honesty of the self-reporting licensee to report royalties properly and to maintain documents usually costs the licensor significant income. Experience shows that the typical licensee under-reports revenues sufficient to trigger the cost recovery provision of the licensee agreement. Licensees with better record keeping and royalty accounting practices make more accurate and higher royalty payments, reducing the need for royalty audits and the inevitable negotiations to recover underpaid royalties and audit costs.

Prior to executing a licence agreement, the following questions should be considered:

- How will I make certain the licensee understands its responsibility to self-report the royalty income properly?
- How will I be comfortable that the licensee has complied with the licence agreement?

There are four important royalty reporting items to be communicated to the licensee prior to executing a licence agreement:

- Method of calculating royalties on the disposition of all licensed product(s).
- The licensee's responsibility to maintain internal records that support the creation and disposition of licensed product(s) (ie, inventory and sales records).
- Information to be provided in royalty statements.
- Information to be provided in periodic reports regarding the status of the licensee's operations.

Calculating royalties on the disposition of all licensed product(s)

Authors of licence agreements generally do not have financial experience and are therefore unable to identify properly the very specific financial records that should be considered for retention. They are also unable to contemplate how a licensee might interpret seemingly simple royalty calculations in various ways that inevitably lead to under-reported royalties. For example, many licensees consider gross revenues to be calculated after discounts, returns and taxes, while they should actually be an accounting consideration before any deductions. Therefore, many licensees under-report revenues when these deductions are limited. Seasoned intellectual property attorneys may also miss the detail required in the licence agreement that instructs both the licensee's entry-level accounting clerk as well as management on how exactly to calculate the royalty for all licensed product dispositions.

Most licence agreements tend only to address the payment of royalties from net sales, generally defined as the gross of invoiced sales minus certain deductions and any product returns. Also, these agreements do not often cover other non-sale dispositions of licensed property such as free goods, missing goods and intellectual property used internally by the licensee for things such as research and development or personal consumption.

A well-written agreement must cover all potential uses of licensed products and define restrictions on each prospective disposition and its associated royalty, if any, to be paid to the licensor. Consider the seemingly simple area of free goods. Many agreements are silent on the topic, or when limits are placed on them, the term free good is not defined. The lack of both

Licensee record keeping

Specific records a licensor should suggest the licensee consider as required for retention might include:

Inventory-related records:

- Annual year-end inventory records
- Annual inventory roll forwards for each licensed product
- Inventory count records
- Purchasing records
- Free goods shipped from inventory, including recipients
- Catalogues

Sales ledger records:

- Gross sales
- Deductions
- Original invoices

Financial records:

- Annual audited financial statements
- General ledger
- Calculation of royalties

Royalty statements

In a royalty statement, the licensee should provide the following information as a minimum requirement:

- Signed certification by a company executive that the statement is in compliance with the licence agreement.
- Gross sales by licensed product and territory, if international sales are involved.
- Deductions by licensed product (each deduction should be separately listed).
- Returns by licensed product.
- Net sales by licensed product.
- Royalties to be paid based on net sales and exchange rates (including their country source).

In addition, royalty statements should consider covering the movement of the licensed property including: gross number of units sold; gross number of units returned; gross number of free units; and gross number of other unit dispositions.

these limits and a definition of free goods commonly results in licensees providing the free goods to a customer in exchange for promised higher purchases of non-licensed goods or other favours that result in reduced royalty payments.

The following are commonly missed instructions to licensees for calculating royalties:

- Unaccounted for, free, internally used and other property dispositions not included in sales shall bear a royalty based on the highest net selling price for the licensed property.
- Consideration should be given to not allowing free goods (unless there are strong restrictions).
- Licensed products are not to be sold bundled with non-licensed product. If they are, the total bundled selling price shall be fully allocated to the licensed product.
- The gross sales price shall be the invoiced price before any deductions.
- Product returns shall not be subtracted from gross revenues or shall be limited to a small percentage of gross revenues.
- A licensed subcomponent shall have the royalty paid based on the sales price of the total working end product.
- All deductions must be specifically defined by the agreement. For example, taxes must be specifically listed on the invoice and identified by category (eg, value added or sales).

A leading practice is to have the licensor's royalty auditor review the licence agreement prior to signing to identify loopholes that may allow the licensee to miscalculate the royalty.

Maintenance procedures for licensee's internal records

Licensees rarely maintain the proper records to support their royalty calculations. Usually, the licensee's internal record retention requirements do not consider the needs of the licensor or auditor. Even when records are required to be maintained by the licence agreement, there is rarely a penalty should the licensee not retain the records. In the initial licence agreement, and annually thereafter, consideration should be given to reminding the licensee in writing of its obligation to maintain financial records to support the royalty statements.

If records are not retained, the licensor should give consideration to requiring that the licensee pay liquidated damages, generally defined with a minimum and maximum range (eg, between 20% and 100% of the royalties owed). And such liquidated damages should

be considered to be further defined as not less than a specific dollar amount or at the minimum guarantee. In the end, the lowest amount is usually claimed.

Information to be provided in royalty statements

Licensees tend to provide minimal information in royalty statements. From their perspective, the more information provided to the licensor, the more opportunity the licensor has to identify potential under-reporting. The initial licence agreement should also consider inclusion of an appendix with the royalty statement the licensee must complete.

Information to be provided in periodic reports

The licensor should consider constantly monitoring the licensee's operations to identify red flags of concern that could diminish the value of the licensed property. A customised, signed checklist should be submitted with each royalty statement that provides the licensor with an update of the licensee's operations. Certain responses provided by the licensee may trigger a detailed assessment of the licensee's contract compliance.

Establishing a licensee monitoring programme

A licensor must establish a licensee-monitoring programme to assess on a continual basis whether the licensee is properly self-reporting royalties and complying with other key contract terms and conditions. With many organisations in the US, for example, now following Sarbanes-Oxley 404, the need to have a licensee-monitoring programme is more critical than ever.

Licensees have relied far too heavily on their licensees' own ability to provide accurate self-reporting or to adhere to various other contract provisions. In relinquishing contract oversight to the licensee, licensors fail to see that licensees have been reducing the number of staff responsible for overseeing licence compliance or have been giving this responsibility to less experienced workers. More troubling, as awareness of staff cutbacks spreads, so does the risk rise that licensees will purposely under-report royalties knowing the chances of getting caught are low. Licensors generally are not monitoring licensee operational changes. Cutting internal monitoring capabilities may prove especially risky in situations where licensees have international operations and the licensor lacks the resources to monitor worldwide sales.

It is important to understand that under-reporting royalties appears to be more of the norm than the exception. Over the past two

years, an overwhelming majority of royalty compliance projects completed by KPMG, for example, have resulted in tangible recoveries. This often results in a no-cost project to the licensor if the licence agreement has a cost recovery provision (eg, passing on the cost to the licensee should the under-reporting in any one period exceed the lesser of 3% of reported royalties or \$5,000).

Due to the complex nature of licensing contracts and the prevailing reliance on licensees to report and pay royalties accurately without substantiating back-up documentation, the only way licensors can assess that royalties are correct and can ensure contract compliance is to establish a proactive licensee compliance programme. Because the potential additional revenue from uncovering under-reported royalties and licence fees is greater than programme costs, leading companies implement a systematic program with three major goals: (1) increase licensee awareness of their obligations; (2) assess licensee compliance with their obligations; and (3) inform the licensee of leading practices.

These three goals are accomplished by two methods: internal monitoring and external monitoring through royalty audits.

Internal monitoring is generally very limited in scope and relies on an analytical review of the royalty statements that search for pre-determined risk warning red flags that indicate licensee under-reporting of royalties. Generally, a red flag warning will dictate the need for a royalty audit.

Royalty audits

Royalty audits can be an effective deterrent to licensee abuses and those conducting the audits can perform several important roles: they can help to preserve, and even enhance, the licensor/licensee relationship; they know how to secure the greatest recoveries at the lowest cost; they provide valuable insights and advise on how to reduce future contract violations; and they often discover under-reported royalties that are many times greater than that of auditors lacking this particular expertise.

Take the case of a leading company that initially assigned its internal audit team to perform three biannual audits of its licensees. The work findings from the internal auditors yielded about US\$20,000. After hiring external advisers to conduct the next biannual royalty compliance project, the findings ranged from approximately US\$200,000 to US\$500,000 per licensee. In addition to recouping these funds, the process helped the licensee and licensor strengthen their internal controls and

clarify their reporting requirements through rewritten licence agreements. In another case, a university received US\$15,000 in royalties from its licensee, but an external royalty compliance project completed in 2004 found US\$23 million more was due.

The importance of the royalty auditor's background and approach cannot be overemphasised. Ambiguous contracts are subject to varying degrees of interpretation, and under-reported royalties are often so well hidden that only a very experienced royalty auditor can find the funds and successfully present the claim. Even the most sophisticated companies may under-report royalty income as a result of contract ambiguities or the efforts of inexperienced or overzealous personnel to meet pre-determined operating goals. While the auditor does not interpret the agreement, they can point out weakness in language for licensor/licensee discussion.

A dedicated royalty auditor will be alert to these and other problems and will look beyond collections and revenue recovery issues to identify reporting problems. The auditor also can help put controls in place at both the licensor and the licensee that address the root causes of the reporting issues without damaging or undermining valuable business relationships.

Unfortunately, too many licensors fear upsetting the relationship and therefore do not execute their rights to audit. This is a real risk if using a non-dedicated auditor to perform the royalty audit. Financial statement and internal auditors may not understand the business relationships that go beyond and often exceed the importance of monetary findings.

There are several important steps to consider when developing strategies to monitor intellectual property. The first step is to identify which licensees present the highest risk based on their internal monitoring capabilities and then, if necessary, conduct a royalty audit. But it is equally important for the royalty auditor to review:

- Processes and controls to offer improvement ideas to both licensees and licensor.
- Existing agreements to ensure compliance and reporting requirements.
- Agreement structures to reduce underpayments by licensees.
- Contract-administration processes to benchmark against best-in-class standards.

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Periodic reports

Issues that a licensee should cover in periodic reports include:

- Have there been any changes to the following since the last royalty statement: personnel completing the royalty statement calculation; accounting systems; and/or new or discontinued licensed products?
- Have you begun selling in any new territories?
- Has the company declared bankruptcy or is it in financial difficulty?
- Have there been any reorganisations related to personnel who calculate the royalty?
- Have there been any layoffs?
- Have you changed the way you calculate the royalty?
- Are you in the process of or will you be merging with another company in the near future?
- Have you identified any areas of potential non-compliance with the agreement?