Performing a License Agreement Royalty Audit: A CPA's Perspective

Brett Brandenberg, CPA, CFA, ASA, and Daniel Wetzel, CPA

Brett Brandenberg, CPA, CFA, ASA, is a director and Daniel Wetzel, CPA, is a managing director in the Washington, DC, office of AlixPartners LLP. AlixPartners LLP is not a CPA firm.

Introduction

The limited lives of legal and regulatory protections act to diminish the value of your intellectual property (IP) over time. Every year a valuable technology sits idle, a portion of that value goes unrealized, never to be recovered. Conceptually, licenses offer the IP owner the ability to stop the bleeding and earn a return on properties that may represent the culmination of years of expense and effort. It is, however, the truly unique nature of the financial relationship created by the typical license agreement that creates an environment ripe to become a distraction or management nightmare. In almost no other financial transaction do obligees (i.e., licensees) have such unbridled control over defining both the magnitude of their obligations and their counterparties' ability to verify those assertions. The royalty audit serves as an essential tool available to licensors in balancing the relationship; and ultimately, making the license much more effective in capturing value for the IP owner.

Defining the Royalty Audit

A royalty audit is an analysis or investigation of a licensee's compliance with the various obligations, financial and otherwise, laid out in a binding contract, namely the license agreement. Financial compliance is generally determined through an examination of the accounting books and records of the licensee and its sublicensees. As such, experienced accountants, including certified public accountants (CPAs), typically possess the skills appropriate to the basic royalty audit functions.

However, because of the legal disputes or litigation that potentially could arise from the royalty audit findings, forensic accountants,[1] who have skills tailored to detecting fraud or

©2010 Association of University Technology Managers and chapter authors named above. All rights reserved. Reproduction in whole or in part without written consent of the copyright owners is prohibited. Contact AUTM regarding reuse of any part of this work. Opinions expressed in this publication by authors are their own and do not necessarily reflect the opinions of AUTM or the organizations with whom the authors are affiliated.

misrepresentation, often are best-suited to conducting royalty audits and communicating findings in a potentially contentious environment.

Many issues associated with a royalty audit may require supplemental expertise or experience, in addition to the core accounting or financial skills. For example, a technical expert's understanding of a licensed technology may assist in determining whether a licensee's new product embodies the licensed IP or not. Legal training and a knowledge of case law may assist in interpreting ambiguous language in the license agreement.

Finally, someone experienced in the industry of the IP's application may know whether sales of covered products were made to parties that are related to the licensee, and thus, may not reflect arms-length pricing of the covered products. Because these areas of expertise are not as broadly utilized as accounting or financial expertise, it is generally easier to supplement, as necessary, the core royalty audit team of experienced accountants with members of the technology transfer team (e.g., licensing manager, inventor, IP counsel), who probably represent the best and most cost-effective resource for these other skills.

One important disclaimer concerning what a royalty audit is *not*: Within the accounting world, an *audit* is a technical term used to describe an engagement implementing generally accepted auditing standards to express an opinion as to whether financial statements are prepared in conformity with generally accepted accounting principles. This differs from the use of the word *audit* in the licensing industry, where it is a term of art that does not necessarily imply the use of very specific procedures and standards promulgated by a governing body.

If you engage third-party accountants to perform a royalty audit, it should not be surprising to experience the accountants' reluctance to characterize their work as a royalty audit. Instead, such accounting practitioners might refer to their work as a *contract compliance investigation.*

©2010 Association of University Technology Managers

Justifying the Royalty Audit

The benefit of performing a royalty audit is often reduced to the potential near-term recovery of underreported royalties. However, other advantages can be just as important to a licensor that manages multiple, active license agreements. The range of benefits offered by a royalty audit can include the following.

- *Royalty underpayment recoveries:* The near-term financial benefit of potentially recovering royalties from underreported royalty sales is often a prime motivating factor for initiating a royalty audit. Anecdotal and small-study evidence indicates that it isn't uncommon for recoveries to be on the order of five to twenty times the cost of conducting the audit itself. For an organization reluctant to authorize the resources necessary for an audit, this argument can be persuasive. In addition to the very obvious benefit of receiving a check for underreported historic sales, another more latent benefit is that audited licensees may change their royalty reporting behavior in future periods.

- *Signaling value to licensees:* The signal provided by carrying out audits is a powerful incentive for all of an organization's licensees to engage in desired behavior. First, as auditing increases the probability of catching an intentionally misreporting licensee, there is a greater probability licensees will choose to honestly report their sales of licensed product when a licensor is known to actively engage in auditing its licensees. Second, an audit will typically entail examining multiple years of documentation. Faced with the prospect of having to produce this amount of documentation in support of their royalty payments, licensees will be more likely to put policies and procedures in place that will allow them to generate, organize, and retain documentation necessary to support their claimed royalty sales.

- *Grounds for license amendment or termination:* Given the typical long-term nature of license agreements, economic and other conditions can change dramatically from when agreements were negotiated. Termination provisions in the license agreement can be useful in allowing the licensor to adjust to and take advantage of these new conditions. A royalty audit can develop the evidentiary basis necessary for the appropriate exercise of termination rights. Alternatively, substantial examples of a licensee's noncompliance will improve the licensor's ability to negotiate favorable amendments to the original agreement.

©2010 Association of University Technology Managers

- *Identifying unauthorized or damaging use of property:* Use of the licensed property in unauthorized applications, countries, or products, or by unauthorized sublicensees, could come at a significant risk or cost to the licensor. In addition to royalties payable for the likely unreported sales, the context of those sales may be made at great legal or reputational risk. The sales made by a licensee in a territory for which it is not licensed may impinge on another licensee with rights to sell in that territory. An unapproved sublicensee may incorporate licensed trademarks in marketing products with which the licensor, for reputational or political reasons, does not want to become associated (i.e., a university name and mascot in the marketing of liquor). While all licensing will entail risks, the unregulated use of the licensed property is risk that cannot be planned for or weighed.

- *Reputational benefits to the technology transfer office (TTO):* Parties that rely on or coordinate with the TTO may perceive a greater benefit to working with the office. University administrators may be more likely to recognize the commercial diligence and professionalism the TTO exercises in ensuring compliance by licensees and attempting to maximize the university's financial return. Inventors, who could have a direct financial interest in the outcome of the royalty audit, feel like they have an ally in protecting their discoveries and future royalty share.

Targeted Auditing

As part of a larger license audit program, decisions concerning which licensees to audit should reflect the consideration of many criteria. Some of the more common considerations follow, listed in order of the precision and immediacy offered by the rationale.

1. Whistleblower from the licensee's organization claims underreported royalties.
2. Analysis by licensor of licensee's product line suggests unreported licensed products.
3. Indications from other participants in the industry that the licensee has new, unreported products incorporating the licensed technology.
4. Past discord or a lack of communication in the relationship with the licensee.
5. Lax or deficient reporting practices by licensee in the past.
6. Licensee reported product volumes trending lower than the overall trend in a growing industry.
7. Evidence that an event or milestone triggering a payment has occurred.
8. Licensee's royalties comprise a significant portion of entire licensing program.

©2010 Association of University Technology Managers

9. A major accounting system change at the licensee's organization (often reflected in new or differently formatted royalty report support).
10. New licensees who may be developing their information collection and reporting processes.
11. Significant financial deterioration or distress experienced at the licensee organization.
12. Licensee was acquired by another organization.
13. Licensees with limited or no history of entering royalty-bearing license agreements.
14. Random selection.

The types of licensees designated for audit should be evaluated over time for any unnoticed or unintended trends. For example, if as part of a licensing program, a licensor has only selected licensees in its top quartile of royalty generators, the licensor may not be realizing the value of systemic messaging from the audit program because an entire pool of smaller licensees may believe they are not truly subject to potential audit; thus, their incentive to properly report is muted.

Theory Meets Practice: Considerations in Getting to Go

Practical considerations at the outset of the audit program are several and can act to not only limit the ultimate success of the program, but also prevent the program from starting at all. While not a major part of the work, these nuanced, more politically oriented challenges are nevertheless important.

The anticipated cost will likely always be cited as one of the most common repudiations for conducting an audit. Especially in situations where the historic realization of royalties from an intended target is not that large relative to the cost of the audit, not following through on an audit program can be more easily rationalized. For those in an administrative or leadership capacity at a university, who are not typically faced day to day with the commercial nuances of running a technology licensing program, a greater understanding of the economic incentives in licensing and the strategic benefits of the audit will be helpful.

Further, the very reason a target's royalty payments may be relatively (or unexpectedly) small is that there is underreporting of royalties. A valuable perspective to offer is that, unlike financial statement auditing, which even when performed well is purely a cost of complying with regulatory authority, royalty auditing performed well is responsible for generating additional revenue and is not a cost center activity.

©2010 Association of University Technology Managers

University administrative procedures and politics should be closely managed through the process of receiving approval and funding for the audit. It is quite common that the cost of a royalty audit engagement will exceed typical purchase approval limits of a technology transfer office and force the audit into a formalized purchasing and/or competitive bidding process. Given this, the involvement of the university contracting/purchasing department will likely be necessary.

In addition, approvals from administrators that may be further removed from the business and day-to-day operation of the TTO might be required. Given this remoteness, additional efforts to educate the appropriate personnel to the benefits of the royalty audit may be necessary. Also, if competitive bidding is necessary, timing expectations for the start of the audit should obviously be dialed back.

Finally, once the royalty audit has received the go ahead, a simple notification to the targeted licensee that a royalty auditing process will soon be initiated would likely be a welcomed consideration. Aside from laying the groundwork for a more cooperative audit process, it furthers the good will between the parties for after the conclusion of the audit when the parties will most likely still be involved in a continuing financial relationship. Only in situations where you have reason to believe forewarning would affect the audit, such as where a whistleblower has informed you of a pattern of document destruction or falsification at the licensee, would you likely withhold this consideration. In most cases, isolated instances of missing or corrupted documents will not prevent the true financial details from being identified by a meticulous and skilled auditor.

Audit Process

The audit process can be characterized with a two-word mnemonic, LOST TRACK. This memory device captures the steps for both the planning and execution phases of the audit.

©2010 Association of University Technology Managers

The components of the LOST TRACK audit process are:

PLANNING PHASE	**L**icense	Develop thorough knowledge of agreement and licensor's interpretations.
	Opposing side	Understand counterparty's positions, disagreements, and historic performance under the license.
	Systems and accounting	Familiarize with licensee's accounting methods, processes, and documentation.
	Timing and documents	Develop and communicate intended timing and documentation requirements of the licensee.
EXECUTION PHASE	**T**est	Test licensee's books and records for agreement with royalty reports.
	Recalculate	Recalculate royalties due based on licensor's understanding of license and auditors testing.
	Analyze	Analyze and attribute source of differences between royalties paid and royalties due.
	Communicate	Communicate to licensor, and possibly licensee, findings.
	Keep pursuing	Keep pursuing recoveries and needed changes to reporting process.

Because the license agreement provides the framework around which all reporting, documentation, and even the parties' relationship is formed, it is necessary to understand the license thoroughly. For defined terms in the agreement or specialized terminology, the auditor should seek out the input of appropriate parties, including the inventor, licensor, drafting attorney, or outside counsel. Also, it is important to understand the licensor's specific interpretations of ambiguous portions of the agreement.

Similarly, the opposing party's viewpoint is informative for designing the audit. Different interpretations, areas of historic dispute, and the licensee's general approach to the license commitment will highlight areas that may require additional procedures or study. Although direct discussion of these considerations with the licensee is potentially most informative, analysis of the royalty reporting documents that have been submitted historically will also provide clues to the licensee's position on the license.

The financial accounting systems, processes, and procedures that the licensee has in place to fulfill its royalty reporting obligations will also determine what will be available for the auditor's review and testing. Understanding these factors will provide shape and real-world meaning to the phrase books and records, as often used in license agreements to describe what must be made available to an auditor.

©2010 Association of University Technology Managers

There is a definite benefit to specifying, as part of license negotiations, what types of documentation will be available for audit purposes. Following is a list of commonly used, but by no means exhaustive, documents:

- invoices
- general ledgers
- sales registers and sales analysis reports
- audited financial statements and/or income tax returns
- inventory roll-forwards
- sales tax returns
- shipping documents
- price lists, catalogs, and brochures
- purchase records

Based on the completion of the previous steps, the auditor should be able to flush out a preliminary work plan. With this plan, the auditor will be able to provide thorough document requests to the licensee and an indication of how much time may be required on site at the licensee's location. Providing these to the licensee ahead of arrival should smooth the process of executing the work plan and create more ease in the mind of the licensee, who likely will be more cooperative if there is definition as to his or her commitment during the audit.

With planning complete, the execution of the audit begins with testing of the accounting records. Depending on the volume of transactions and the risk associated with the particular item being examined, the testing could be performed on a sample or complete review basis. There are many procedures that could be performed in validating the assertions the licensee has made in its royalty reporting; however, some common procedures include:

- reconciling units in royalty reports to inventory roll-forward
- agreeing unit sales in inventory roll-forward to sales recorded in general ledger/ sales register
- tracing selection of units by order/customer/period (depending on reporting detail) to customer invoices and/or shipping documents
- testing for variance between suggested price lists to average prices derived from royalty reports and a selection of customer invoices
- verifying accuracy of exchange rates used in converting any foreign currency denominated sales

©2010 Association of University Technology Managers

- identifying and developing support for allocations and estimates used for adjustments made to gross sales to arrive at net sales royalty base

Ultimately, the royalties due for the investigational periods should be recalculated. The recalculation is premised on the findings of the testing performed and the appropriate interpretation of the obligations outlined in the license agreement (e.g., unit minimums, royalty floors, tiering of royalty rates, success/milestone payments, etc.). This calculation essentially establishes the bar for financial noncompliance.

Variances between actual royalties paid and those calculated as appropriate should be analyzed and attributed to specific causes, where possible. By aggregating the variances for each cause across all of the investigational periods, the most significant themes can be identified and best addressed with the licensee.

Generally, the findings of a royalty audit are communicated in a written report. As part of this, one common procedure is to allow the licensee to review a draft of the report and include as an exhibit any written rebuttal or explanatory information the licensee desires to provide as part of a final report. This will assist in further defining the nature and extent of the differences between the parties to the license agreement. Additionally, it provides the licensee the opportunity to research the issues in a reasoned and diligent manner, as opposed to a reactionary and defensive manner. In situations where deficient royalty reporting is not intentional, this provides an opportunity to avoid a prolonged dispute in recoupment of deficient payments.

Finally, the pursuit of all deficiencies, financial, reporting, interpretive, and otherwise, is the vital final step in the royalty audit. To preserve and ingrain the benefits of the royalty audit, identified issues need to be brought to a conclusion. An identified problem, known to both parties to the license, which remains unaddressed, will provide a strong signal to the licensee that the licensor is unwilling to disturb the relationship. This simply invites further aggressive interpretations of the license by the licensee. Deficient royalty payments are most comfortably pursued, as they represent tangible value, but they are also most likely to lead to a courtroom setting.

©2010 Association of University Technology Managers

Audit Design

As part of periodic royalty reporting called for in the typical license agreement, some level of documentation will almost always be required in support of the royalty paid. This may be only an exhibit depicting the final computation of the royalty due or it could be a schedule detailing every invoice issued by product line along with the source documents. Whichever end of the reporting requirements spectrum, the royalty audit will go substantially beyond the reporting requirements in providing comfort to the licensor regarding the level of licensee compliance with the terms of the license agreement. Following are some of the considerations in designing an audit to achieve that comfort.

Guiding Objectives

The audit is designed to achieve two primary objectives: completeness and accuracy. Completeness describes the extent to which the licensee has designated all licensed product sales appropriately for royalty payment, identified those sales to the licensor, and made payment on those obligations. To characterize the completeness of reported licensed sales the auditor will need to gain an understanding of the sales of the licensee more broadly. This would likely entail collecting detailed information on sales that ultimately do not reflect the use of the licensed property.

Because the licensee will often consider this information proprietary and will probably be reluctant to share information it does not consider directly relevant to the licensed property with the licensor, the benefit of using an independent third-party to perform the audit becomes more apparent. Without a direct stake in the outcome of the royalty audit, the third-party auditor may be able to elicit more timely and cooperative assistance from the auditee.

Further, looking beyond the audit, the auditor's involvement potentially provides lasting benefits to the auditee. The auditor's role as a buffer between the involved parties may serve to limit any collateral damage to the ongoing relationship between the licensor and licensee. Finally, the auditor's collection and maintenance of the auditee's documents outside of the licensor's control should serve to limit confidentiality or privacy concerns arising out of the applicability of open records laws to governmental entities and programs.

©2010 Association of University Technology Managers

Accuracy refers to the computational integrity of how the royalty payments were calculated. More than simply checking the math, this concept reflects considerations such as the use of the correct royalty rate, especially in tiered royalty structures; assessment of required late fees/interest where appropriate; inclusion of success/milestone payments; and consideration of minimum periodic royalties. While achieving certainty on completeness relies very heavily on specialized accounting/auditing skills and experience, many aspects of achieving confidence in accuracy are more accessible to the layman. However, there are likely aspects of legal interpretation that may come into play, as royalty tiers, due dates, and trigger events are given their meaning by contractual language or definitions.

Context Important to Planning

Rather than approaching an audit as a routinized endeavor, a consideration of the specific facts surrounding the targeted licensee will help create a plan that is more efficient in its approach and more exhaustive in its examination of possible areas of dispute. A plan that reflects historic and anticipated areas of disagreement should limit the need to make significant follow-on requests for documents or a return visit to the licensee, both of which can cause further disruption to the licensee's business and diminish the level of cooperation as the perceived intrusiveness of the audit increases. Following are examples of contextual concerns that can have significant influence on the design of the audit plan.

- *License agreement drafting:* The success the legal team had in drafting a license agreement that limited ambiguous terms and addressed with specificity real-world situations goes a long way in defining the scope of the audit. Where differing interpretations of the license's meaning arise, a royalty audit will often require additional documents and procedures to address both interpretations.

  For example, the adjustments to gross sales to arrive at the more common net sales royalty base could be interpreted differently. While returns expense may only be tracked at the corporate level, and thus, this expense may be appropriately allocated to individual product lines according to accounting convention, the license agreement may seem to require that adjustments to gross sales must only be expenses specifically identifiable to the licensed products. This situation may necessitate the need to not only test the allocation calculations of the licensee but also assess whether documentation may be required to make an alternative calculation that attempts to specifically identify returns of the relevant products.

©2010 Association of University Technology Managers

While many license terms are defined relatively easily and in an unambiguous manner (e.g., license period, unitary royalty rate, periodicity of royalty reporting), other terms lend themselves to different interpretations depending on the party. Some examples include:

- books and records (commonly used to describe the documents that must be made available by the licensee to the auditors)
- retention standards for licensee documents
- basis or criteria for tiered royalties
- identification and reporting of subsequent products that incorporate the licensed property
- procedures for reporting royalty audit results

- *Industry trends:* The nature of the industry in which the licensed property is used will affect the manner in which the royalty audit is conducted. An industry characterized by a high level of product innovation, the regular introduction of new models, and the use of consumer rebates would require an audit more extensive in its testing of product pricing, the treatment of obsolete/excess inventories, and identification of product models containing licensed property.

  Another aspect of the industry important to the audit would be the general trend of industry volumes and the competition in the product space. Expectations for licensed product volumes should be informed by the growth or decline of the area of application of the licensed property. New competitors or new products in a space may be expected to have an effect on the licensee's sales. As such, significant negative average sales price or volume trends may be understandable and not necessarily warrant additional procedures.

- *History of the licensing relationship:* The relationship between the licensor and licensee should provide some of the most salient insight into areas that may need special consideration in the audit design. Areas of disagreement, sensitivity, or reluctance to provide additional detail in the past all provide clues to the auditor for possible additional procedures. In instances where the licensee's sensitivity may be attributable to

©2010 Association of University Technology Managers

concerns about confidentiality, the independent orientation of an auditor may mitigate some of the concerns expressed in the past. Finally, it may also be the case that the parties have already come to an accommodation concerning the interpretation of aspects of the license agreement; in which case, the auditor should take care to reflect those as directed by the licensor.

The Aftermath

There are a number of small-sample or anecdote-based assessments that provide estimates of licensee noncompliance based on royalty audit experiences. Not surprisingly, because they tend to be drawn from such small and personalized populations, you can see a wide range of probabilities. What is generally agreed, it appears, is that a significant majority of audits find noncompliance by licensees. Perhaps more importantly, however, is the nature of the noncompliance. Upon a finding that a licensee has been willfully and intentionally understating its royalty liability, a licensor will need to reevaluate the licensing relationship and determine whether termination, agreement amendment, or more active enforcement is required. If the noncompliance rationale appears to be something less malicious, less dire options could be sufficient.

An entire continuum of noncompliance rationales exist, running from pure instances of fraud to simple administrative errors in aggregating data or performing calculations. Between these extremes are other examples that could be differently interpreted as lying closer to one extreme or the other. As stressed at the outset of this chapter, the overriding principle driving so many of the deficiencies or problems in the licensing arena is that the financial obligee has such a substantial amount of control over defining what happens. As a result, there is often a nefarious interpretation that could be made for many fact patterns.

For example, while a sales department may simply have overlooked communicating to royalties payable personnel the need to add a newly introduced product stock-keeping unit (SKU) to their sales report accounting system queries, a more willful interpretation is that the licensee believed the licensor was not monitoring SKU-level product offerings of their licensees. Often a specific interpretation cannot be confirmed from the documentary evidence and only a range of possibilities, based on the totality of the evidence and the licensor's experience with the licensee, can be gained.

©2010 Association of University Technology Managers

While an exhaustive list of findings is not possible, following are some of the more common identified reasons for noncompliance:

- fraud or reckless misinterpretations of contractual language
- sales or transfers to related parties that do not reflect full price to consumer or arms-length pricing
- unintentional misinterpretation of license agreement
- omission of new, updated, or changed products
- improper or nonrigorous application of foreign exchange currency conversions
- inappropriate or noncontractual deductions for calculation of net sales (e.g., marketing, commissions, research and development)
- application of rebates, discounts, or other sales incentives to licensed products in advantageous manner
- sale of products outside of geographic, industry, customer, or other constrained authorization areas per the license
- unauthorized and/or deficiently reported sublicensing
- inappropriate attribution of value on bundled product sales
- missing or complete noncapture of required documentation to support royalty reports
- minimums or milestone/success fees not being reflected
- inappropriate withholding of taxes, especially for foreign tax liabilities

Whatever the particular findings from the royalty audit, pursuing the results to a conclusion is vital. Auditing is a backward-looking process, and without action, deficiencies will only continue, if not multiply, in the future.

Addressing deficiencies with the licensee could very well be a more difficult discussion than the original negotiations surrounding the formation of the license. Involving legal counsel, whether internal or external, is important as the context of disputed findings could eventually make it to a courtroom setting. Further, recognizing the financial implications of addressing the findings will help the licensor negotiate more effectively and strategically.

For example, the licensor proving flexible on the payment of a one-time success fee that the licensee argues may only be triggered a year from now, instead of a royalty audit determination that it is currently due, may be beneficial in getting a concession on the

©2010 Association of University Technology Managers

royalty rate applicable to a particular product. The net effect would be gaining an entirely new revenue stream (the incremental royalty on the particular product) for the concession of a simple timing difference—the cost of having to wait for the payment of the success fee—likely a beneficial trade.

Conclusion

Royalty audits are a valuable tool to the licensor in ensuring that what was bargained for is what is received. Fundamentally an exercise in specialized auditing techniques, the successful royalty audit also typically draws on very differentiated skill sets, including legal, technological, negotiation, and interpersonal. Executed in a professionally disciplined, skeptical, and planned manner, this tool affords the licensor the opportunity to level a playing field over which the licensee has an inordinate amount of control.

Notes

1. Whereas a common credential for an *accountant* or *auditor*, as those terms are commonly used, may be a certified public accountant, forensic accountants will often additionally maintain specialized credentials, such as the certified fraud examiner or certified in financial forensics designations.

©2010 Association of University Technology Managers