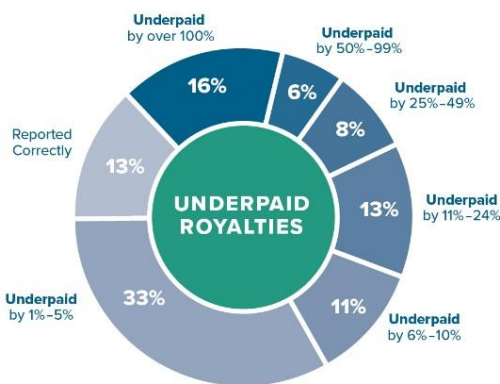


Top Tips for Finding Out

Parties to a license agreement spend significant time and money negotiating the terms of the agreement. Best practices are implemented, legal and executive reviews are performed, intellectual property professionals are engaged. However, what happens once the ink is dry and its business as usual? Is anyone checking to ensure compliance with the meticulously negotiated contract?

Licensors often tend to be hesitant in initiating a proactive compliance program. This is due to an outdated perception that engaging with the licensee is an accusation as opposed to an effective tool to open lines of communication and assure that all parties are on the same page. A strong compliance program is conducted with respect for the licensor-licensee relationship.

Since we began aggregating royalty audit data 25 years ago, we have found that approximately **87% of licensees underpay royalties** to their licensors, frequently by staggering amounts. Why does this underpayment occur? While there are rare cases of intentional misreporting, our experience shows that it is most often due to human error.



FREQUENCY OF FINDINGS



(Source: Invotex Audit Statistics 1997-2022)

Here are some simple ways to keep an eye on what's going on to give yourself a better probability of compliance.

At License Inception

It is surprisingly not uncommon for the people responsible for tracking, calculating, and paying royalties to be completely different from the people who negotiated the license. In fact, we often find that the people calculating the royalties due have never even read the agreement. A good way to mitigate this is to establish a relationship with

the person at the licensee who will be responsible for the administration of the license and send them a **Licensee Welcome Package**.

Include the following:

- ☞ A copy of the agreement
- ☞ Contact information for someone in your organization who can answer questions
- ☞ A royalty report template in excel if you don't have a company reporting portal and instructions for transmission
- ☞ Payment instructions
- ☞ Interest calculation for late payments
- ☞ A letter explaining compliance practices that include routine royalty audits

Providing this Licensee Welcome Package is an excellent first step in establishing a licensor-licensee relationship built on trust and transparency. It encourages direct communication and establishes the expectation that you are paying attention to all of your licensees. It sets up future inquiries or notification of a royalty audit as a routine best practice and not an accusation of wrongdoing.

Annually

Each year, we recommend sending a letter to every licensee explaining any changes that occurred in the past year and providing a status update on your compliance practices. Include a reminder that you may reach out with questions and that you routinely initiate third party royalty audits. Request each licensee perform the following tasks and fill out a standard survey to summarize:

- Results from the performance of a self-audit.
- Any royalty true-up due after recalculating royalties to include any end of year adjustments.
- Outcome from the recalculation of guaranteed minimums and milestone payments.
- Any difficulties in the royalty calculation process.

Ask your licensee to list any additions or significant changes in the SKUs of licensed products, product categories, sales channels, or territories. Ask for an updated list of all sublicensees, affiliates and distributors. This is also a great time to ensure that you have copies of all sublicenses and other agreements to which you are entitled. Inquire about any potential new licensed products in the pipeline.

You may be pleasantly surprised to receive a check from a licensor for a spontaneous correction of a royalty underpayment as a result of this annual inquiry.

Ongoing

At the very least, have someone perform a cursory review of every royalty report and payment received. Perform a high-level check that the royalty report data appears correct and that no math errors are apparent. Confirm that guaranteed minimum royalties are being met. Match the cash received to the royalty report received. Reach out to your contact at the licensee with any questions on a routine basis.

It is a great idea to also perform a general analysis of the data provided. Some simple items to check:

- Confirm the correct royalty rate is applied.
- Review deduction categories and confirm allowance under the license agreement.
- Compare royalty reports from quarter to quarter and identify inconsistencies.
- Confirm cash payments were received by the due dates. If they were not, calculate applicable interest and bill the licensee.
- Check that all required information on the royalty template is being provided by the licensee.

Tools to Decide if I Should Initiate Third Party Royalty Audits

Almost every license agreement gives the licensor the right to audit. A good royalty audit is a collaborative not confrontational process where the goal is to strengthen the relationship by clarifying the understanding of the royalty calculation on both sides. In reality, royalty audits yield many benefits in addition to the recovery of underpaid royalties. It may seem daunting to evaluate your license portfolio for royalty audit candidates, but here are some potential **audit triggers** to help jumpstart your analysis.

Basic Metrics

- License generates \$100,000 or more in annual royalties.
- Trend analysis of royalty reports is not consistent with expectations.
- Licensee reported a correction of a prior over or underreporting.
- Licensee is slow to answer questions and does not provide consistent royalty calculations.
- Royalty reporting process seems overly manual and therefore subject to human error.
- Royalty reports are not transparent in presenting information regarding the licensed products sold and the royalty calculation.
- Licensee sells a lot of customized products.
- New SKUs are added often.

Unique Scenarios

- Agreement expired or will expire soon (sell off issues may need to be resolved).
- New licensed products/brands have been added (by an amendment or verbal/email agreement).
- Licensee had a change in business structure such as an acquisition or merger.
- There has been turnover at licensee, those who originally negotiated the license and prepare the royalty report are no longer there.
- Licensee is consistently reporting sales very close to the guaranteed minimum.

Net Sales Definition

- Has limited deductions or does not allow for general deductions like “customary trade discounts.”
- Disallows deductions that are commonly allowed under GAAP (for example co-marketing spend to customers/distributors).
- Allows for allocation of Net Sales for combination products or bundling.

Complicated Royalty Due Calculation

- Royalty rates are different by product / distribution channel / territory.
- There is a deduction % limit.
- Deductions are defined as the lower of an allowed % or actual.
- More than one guaranteed minimum royalty calculation.
- Deduction allowed for royalty stacking (\$ or royalty rate reduction).

Agreement Includes Pricing Terms Between Licensor and Licensee

- Licensee sales of licensed products to licensor at specified discount.
- Licensor sells components/ingredients to licensee at discount to only be used in licensed products.
- Licensor is entitled to free goods or samples in specified quantities.
- Licensee sales to licensor are not royalty bearing as long as discount extended to licensor is at least what the royalties would have been on the sale.

Beyond these considerations, always pay attention to your gut feeling. Do you feel there is a reason to audit based on your communications and relationship with the licensee?

There is Only an Upside in Monitoring Your License Portfolio

To circle back, 87% of licensees underpay royalties. It is your corporate responsibility to make sure yours are reported and paid correctly. A well-designed compliance program only strengthens the licensor-licensee relationship and sets the stage for mutual success.

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Debora (Stewart) Rose is a CPA and the Managing Director of Invotex. Arguably, Debbie has personally managed more royalty audits than anyone else in the industry. The firm's practice philosophy is one of polite persistence. Her firm is known for their ability to uncover large underpayments while relationships are preserved.

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