

# Monitoring License Agreement Financial Compliance and Auditing

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Licensors and licensees alike spend enormous amounts of time negotiating license agreements for intellectual property. This investment of time will hopefully result in a license agreement that is clear and palatable to both parties. After the agreement is signed, however, the license is often put in a file drawer, never to be looked at again except when problems arise. Why don't licensors spend the same amount of time and effort in license monitoring as they do in securing the license agreement? After all, in a typical business transaction, parties do not rely on trust alone to document the exchange of goods and services. For example, payment amounts often are compared against invoices, shipping logs, or other documents from an accounting system.

However, sometimes in licensing, due to a lack of resources or based on a concern that a monitoring program will send the wrong message, there is a lack of financial monitoring. License agreements can be complex, with the actual royalty calculation based on variable data from many sources. In addition, the licensee staff members who are responsible for royalty calculations and monitoring compliance with the license agreement usually are not the same people who negotiated the license agreement. Further, the university office staff members who are responsible for monitoring compliance may be unfamiliar with the license terms.

These facts alone signal the need for a monitoring program. The development of a systematic license-monitoring and compliance program sends a clear message to the marketplace that such a program has become a normal and routine part of your licensing practice. (It also sends a message that the university is treating this as a business.) Just as sales customers are not angered by payment-to-invoice verification, licensees will not be angered by similar examination of royalty streams (and other payment obligations and actions required by the license agreement).

Consider this: did the give and take of the negotiating process force you to sign your most recent deal for a little less than you originally wanted? If your license-monitoring procedures are lax, then the gap between what you wanted and what you are getting is going to widen. Several ways to minimize the likelihood that your licensees will be offended by an audit are to give them early notice, make audits routine rather than in response to a suspected problem, and make it clear that you audit all licenses of a certain size or type.

Many people think financial license monitoring is limited to royalty audits. However, there is a great deal more to a compliance program. This chapter will discuss these topics, including language of your agreement, desk audits, royalty audits, and, most importantly, communicating with your licensees.

## The Language of the Agreement

A specific and well-written license agreement is the true underpinning of accurate and timely royalty payments. In any given license, the definition of *net sales* is perhaps the most important definition along with *field of use*. However, many licenses lack specificity about the essential components of the royalty calculation. It is this ambiguity that causes the most trouble for the parties when a dispute arises regarding the amounts owed under the terms of the license. The factors that go into a royalty calculation must be carefully and clearly defined.

For example, if there are different royalty rates for different products, is it absolutely clear what those rates are? It should be clear if the definition for *licensed products* is based strictly on issued (or pending) patent claims or a broader, more inclusive *use of the technology*. The agreement should state exactly how to calculate the royalty if the product being sold is a combination of licensed products and other components that fall outside the scope of the license agreement. Antistacking clauses, calculations, and any credits should be clearly defined.

The determination of net sales should be specifically defined. Many large companies often simply apply a standardized percentage, determined by company-wide experience, against gross sales. The license agreement should specify what specific deductions from

gross sales are allowable and that these deductions must actually be given to be appropriately deducted. These specific ambiguities are to be considered examples with the specifics of the individual licensed product to be considered when drafting an unambiguous license agreement.

Another example of potential ambiguity in the license agreement involves the use of transfer prices to related entities. This often occurs in large corporations when one entity must purchase components from another entity or product is sold from one division to another and an artificial price is set. This price, called a *transfer price*, is for internal use only and has no bearing on the cost of the product in the marketplace. Transfer prices should not be used by your licensee in determining net sales of the licensed product.

Example language to avoid this could be: “If LICENSEE makes any SALES to any party affiliated with LICENSEE, or in any way directly or indirectly related to or under the common control with LICENSEE, the Royalties payable to University shall be computed on the basis of the regular price charged to third parties.”

Therefore, the best way to avoid ambiguity is to draft a license agreement with precise, well-defined terms. In addition to these precise definitions, you must require your licensee to include certain specific information in its royalty report. At the very minimum, the royalty report should contain:

- product description (product number or SKU)
- number of units sold by licensee and sublicensees
- gross sales amount
- deductions from gross to net sales for the licensed products (if applicable)
- country in which the product was sold (if applicable)
- foreign currency (if applicable)
- conversion rate to U.S. dollars (if applicable)
- net sales amount
- applicable royalty rates
- royalty amount due
- advances or credits paid to date that are being deducted

The more detailed and complete the reporting, the easier the verification process for the licensor. If the product has been sublicensed, then all required information from the licensee should also be required from the sublicensee.

It is also important that the language of your license agreement allow you to monitor the reporting of the licensee. You should utilize as much of the information and standardized reports from the licensee's accounting systems as possible. This lightens the reporting burden on the licensee, and it also minimizes errors because a new report is not being created solely for royalty reporting.

For example, suppose your licensee's normal business practice is to convert its foreign sales to dollars at the end of each month using the average exchange rate for that month as reported in the *Wall Street Journal*. Structure the foreign-currency conversion section of the license to require the same process for conversion. This saves the licensee time, will eliminate potential clerical errors, and will also be easier during the royalty-audit procedure for the auditors to determine whether the foreign-currency conversion was calculated correctly. Therefore, as you are negotiating your agreement, spend some time familiarizing yourself with the systems and reporting processes utilized by your licensee; it will be time well-spent.

One creative way to avoid reporting errors that has been proposed is to add a clause in the license agreement that allows an independent party to set up a royalty-reporting system for the licensee. This system would coordinate the terms of the license agreement with the internal data systems and processes in place at the licensee, thereby immediately clarifying how sales of each licensed product are to be accounted for in the royalty report. The licensor would also receive information detailing, for example, any subsidiaries of the licensee that may be involved in selling the licensed products, as well as how these subsidiaries report sales and revenue to the parent company. The relatively small upfront investment in a royalty-reporting system pays off in the long run for both licensor and licensee. The fee associated with this can be shared by both parties or treated as a minimal upfront fee by the licensee.

The license agreement must also provide that the licensor be permitted to monitor the accuracy of the information being furnished by the licensee. This provision is typically referred to as the *audit clause*. The audit clause should provide, at a minimum, language providing for the right to audit the licensee and provisions that the licensor receive immediate payment of understated royalties or fees and interest on such royalties or fees. It should also include an obligation that the licensee pay the cost of the audit if an understatement exceeding some threshold (often 5 to 10 percent of total royalties paid) is found.

This clause should also detail record-retention requirements by the licensee. Sample language could be: “LICENSEE shall keep, and shall require SUBLICENSEES to keep, true and accurate records containing data reasonably required for the computation and verification of payments due under this Agreement. LICENSEE shall, and it shall require all SUBLICENSEES to: (a) open such records for inspection upon reasonable notice during business hours by either UNIVERSITY auditor(s) or an independent certified accountant selected by UNIVERSITY, for the purpose of verifying the amount of payments due; and (b) retain such records for six (6) years from date of origination.

“The terms of this Article shall survive any termination of this Agreement. UNIVERSITY is responsible for all expenses of such inspection, except that if any inspection reveals an underpayment greater than five percent (5%) of royalties or other consideration due UNIVERSITY, then LICENSEE shall pay all expenses of that inspection and the amount of the underpayment and interest to UNIVERSITY within twenty-one (21) days of written notice thereof. LICENSEE shall also reimburse UNIVERSITY for reasonable expenses required to collect the amount underpaid. The specific interest and compounding rate should be specified.”

## Desk Audits

In general, an efficiently monitored license agreement is less likely to have significant royalty-reporting errors. Desk audits are the first step in a well-planned monitoring program. These audits are performed by the licensor's staff, at the office of the licensor, without traveling to the licensee's place of business. Each royalty report that is received should be compared to the prior period's report to determine how sales and royalties have increased or decreased. This analysis should then be compared to publicly available information on the licensee to ensure the royalty reports are consistent with the licensee's sales trends on a product segment or a company-wide basis. Comparison of the reported numbers should also include comparison to industry trends.

For example, if the licensed patent is used by the licensee in components for cellular phones, look at sales of phones on a marketwide basis to see if they are increasing or decreasing along with your licensee's sales. Your inventors can be invaluable sources of information because they often continue to interact with the licensee or colleagues in academia or industry who may know about your licensee's activities.

As part of the desk audit, specific licensee reports should be included with the royalty payment for review. These reports will be identified by the royalty-reporting system and will allow for the licensor to continue the checks and balances required to assure more accurate royalty reporting.

Another desk-audit procedure is the comparison of the licensee's published price lists against the royalty statements. The published lists should roughly equate to the sale prices that are included on the royalty statements. The licensor's staff should also take time during the desk audit to understand how the licensed product is bundled with other products. This helps the licensor understand whether the allocation of the selling price among the bundled items is a fair allocation. It is much easier to investigate this type of issue the first time it appears on the royalty report rather than years later.

Finally, the desk audit should ensure that licensees are contacted after every payment. This initiative assures that the licensor-licensee relationship remains strong with a high level of accurate royalty reporting.

A consistently performed desk-audit program has numerous benefits. Such a program allows the licensor to discover problems in the early stages, thus saving all parties time and money. It also gives your licensee notice that you enforce the terms of your licenses as a normal course of business. Therefore, when and if problems do arise, you will have already established open lines of communication with your licensee, and resolution of the problems may occur more easily.

This component of the license-monitoring system can be done internally by the licensor or outsourced to a reputable firm that specializes in this area.

It is understood that many university offices do not have the necessary resources for routine desk audits. If this is the case, a cost-benefit analysis should be considered to justify obtaining these resources. In the meantime, a priority system should be put into place to assure that those licenses with the highest risk of noncompliance be subjected to these procedures more often than those with lower risks.

## **When Desk Audits Lead to Royalty Audits**

Your compliance program should be a normal part of your licensing business, and you should notify your licensee that you will audit its royalty payments at least every three years. This correspondence alone may increase the likelihood of compliance without having to actually perform the audit. In addition to these regularly scheduled audits, you may need to audit some of your licensee more often if you discover that a licensee is not complying with the terms of an agreement or if there are questions concerning the royalty report. It is to be expected that this will happen at some point, because the individuals in charge of preparing royalty reports and making royalty payments were probably not on the negotiating team. Also, as time goes by, it is inevitable that circumstances change. You need to be aware of the red flags that may indicate your need to move beyond the desk audit and regularly scheduled royalty-audit programs for certain licensees.

Any royalty report that contains insufficient required details should immediately pique the licensor's interest, particularly if the license requires that certain information be included in the report. Unfortunately, it is often the case that a licensor will accept a

report that consists of one number: the royalty amount. This is ridiculously incomplete, but because there is also a check included with that report, many licensors are happy to accept it. In addition, if the licensee is unable to answer questions about how the royalty is calculated, the licensor should be on alert.

Another red flag that is seemingly obvious, but that can go undetected in the day-to-day frenzy of the workplace, is a royalty report that comes later and later during each reporting period. If it is arriving at the licensor's office two weeks late, the licensee is likely procrastinating on putting the report together. Ask yourself why, and you are beginning the effective monitoring of your license.

What if the ownership changes at your licensee? Maybe your original license agreement has been acquired by a larger company with more manufacturing resources and distribution networks? It stands to reason that a larger company would be able to sell more of the licensed products, but if the reporting systems of the two companies are slow to be combined, you may not be receiving royalties on all of the sales of the relevant products.

Other red flags that may be raised by the licensee are: opening of a new manufacturing facility, financial difficulty, launching new products, selling old products in new territories, changes in accounting systems, and significant changes in product sales that aren't revealed in the public reports.

When these red flags pop up, you should consider an audit. If, as previously discussed, you have an established program of auditing every three years with desk audits on each royalty report, simply move the problem licensee up in the schedule so that the licensee will be audited sooner. Because you have established open lines of communication with all your licensees, everyone will understand that royalty audits are not designed to single out "bad" licensees and punish them. Rather, your licensees know that you, as a fiscally prudent licensor, perform these audits as part of your regular course of business.

## Performance of the Royalty Audit

The word *audit* is a defined term in the accounting profession whereby the books and records of an entity are examined to determine whether its financial statements are

prepared in accordance with generally accepted accounting principles. A royalty audit has a much more narrow focus. Simply put, a royalty audit confirms that the terms of a license are being complied with by testing payments, research milestones, or any other obligations that can be tested by an independent party. The royalty audit is a fiscally sound business practice. If the audit uncovers noncompliance, the auditors then quantify the amount of past royalties due to the licensor.

A consistently performed audit program allows the licensor to be proactive rather than reactive. Your audit program will be part of a strategic effort to ensure compliance with the terms of your agreement and demonstrate that you are willing to protect your rights. Audits can actually help your licensees as well by uncovering and fixing problems in their financial accounting systems.

When you are auditing your licensees, selection of an auditor is important. The auditor should be someone who has experience with royalty auditing, as opposed to financial statement auditing. In addition, the licensor should feel that the auditor will perform his or her work in a professional manner and represent the licensor in a positive way. It is very important for the auditor to understand that the licensor's relationship with the licensee is an important business relationship. Therefore, choose an auditor whose conduct will enhance, rather than hurt, the alliance between the parties to the license.

The audit itself is generally performed in three phases:

- preparatory work completed off site
- site visit
- wrap-up work and delivery of the audit report

## **Royalty Audit Phase One: Preparatory Work**

The licensor should first write and call the licensee to provide notice that the audit clause is going to be invoked. Again, if there has been good communication with the licensee since the inception of the license, the audit notification is easier because the licensee knows that auditing is a regular function of the licensor's program.

Prior to visiting the licensee's facility, the auditor should review all royalty reports and other information that has been received by the licensor. The auditor should also review the license and discuss the licensed technology with the licensor (and the inventor, if possible) to better understand the technology. The auditor must understand which of the licensee's current products utilize the licensed technology and are subject to royalty payments. This review allows the auditor to prepare questions for the licensee and have them answered prior to visiting the licensee's site so that time on site can be utilized as effectively as possible.

The auditor should also prepare an information request for additional materials from the licensee so that the auditors can familiarize themselves with the licensee's accounting system, financial reports, organizational chart, product line, and other relevant materials. The licensor should be sure to provide the auditor with contact information for a representative of the licensee that can assist during the site visit. Your auditor should not have to spend time during the visit looking around for someone to answer questions.

## **Royalty Audit Phase Two: Site Visit**

The site visit will necessarily be limited in time so the auditor should plan his or her visit so that he or she can be as efficient as possible. The importance of a site visit should not be underappreciated. A site visit is critical as it allows the auditor to uncover many things that may have gone undetected. There is little substitution for face-to-face communication. The auditor should spend time on site working to reconcile the documents received from the licensee to the royalty reports that the licensor has received since the inception of the license.

The auditor should also gain an understanding of the licensee's accounting and reporting system so that the licensor can understand what types of reports can be generated from the system. This will help with the desk-audit process in the future. Along with this understanding should be an understanding of the financial reporting, production, and sales-recognition processes.

The auditor should keep good records of all the people he or she talks to and be as persuasive as possible in getting staff members to talk to them. Finally, your auditor should

represent you in a professional manner and be able to do his or her job at the licensee's site with minimal disruption to the licensee's business.

## Royalty Audit Phase Three: Wrap-Up Work

In this final phase, the auditors take the information gathered during the site visit and apply it to the calculations so that the correct royalty payments can be determined. It is often discovered during this phase that there are new products sold by the licensee that may not be included in the royalty calculation. Due to the complex nature of many licensed technologies, the auditor is not the best person to determine whether a product being sold by the licensee falls within the scope of a license agreement.

However, the auditor can include such products in his or her calculations, and a technical expert can review the products at a later date to see if they should be included. This type of situation is more common in patent and copyrighted licenses as opposed to other intellectual property licenses, due to the fact that it is more difficult to determine whether a patent is included in a product or if a product is a derivative of a copyrighted program than it is to see whether a trademarked action hero is printed on a tee shirt.

During the wrap-up work, the licensor should take steps to prevent future reporting problems. One way to help eliminate unintended reporting problems is to implement a royalty-reporting system as discussed earlier in this chapter. Again, outside consultants can be called on to prepare these types of overview packages. During this phase, you will also begin negotiations to collect any underpayment uncovered by the auditors. Licensors should develop a systematic process for immediate follow up and settlement of the auditor's findings so that any negotiations with licensees over disputed payments do not continue for extended periods of time.

## Auditor Selection and Costs

The costs of an individual audit can vary dramatically based on the complexity of the license as well as the number of physical locations that need to be visited. Universities are often tempted to use internal auditors to perform this function. While this may seem to be an economic alternative, if the university auditors do not have the appropriate experience, the university may lose its chance to recover the royalties it is due. Most

license agreements only allow for one audit of a specific period, therefore, if you choose the wrong auditor, you may forfeit your audit rights.

The auditor selection should be heavily weighted to an auditor who has performed similar services. Also, make sure that the auditor you interview is the specific person who will be performing the work and not a figurehead. There are numerous audit and consulting firms with royalty-auditing capabilities with varying price structures such as fixed costs, hourly fees, contingency relationships, or a hybrid approach. A reputable auditor will review the license with you prior to being engaged to assist you in the cost-benefit analysis.

## Communicating with Your Licensee

The common thread woven into all components of a license-monitoring program is communication with your licensee. This communication should take place throughout the life of the license whether or not problems arise. Upon initiation of the monitoring program, send a letter of introduction to all of your licensees so that each one is aware of the program and no one feels singled out for scrutiny. Call your licensee after a desk-audit procedure uncovers a problem with the way the calculation is being performed. You should call your licensee contact after you receive a royalty report to let he or she know you received it and to thank him or her for sending it in a timely fashion as well as discussing any new developments of the licensee. This communication can only improve your licensing relationship.

## Conclusion: Benefits of a Sound Monitoring Program

The establishment of a monitoring program is a necessary part of licensing. Audits should be performed early in the licensing relationship so that both parties can eliminate potential ambiguities of the contract without having a financial dispute present to cloud judgment. When there appears to be a problem with the way the contract is being interpreted, contact your licensee or call in your auditors and take care of it immediately.

The irony is that delaying, while often intended to save money or the licensee's feelings, will almost always cost a considerable amount more than if the audit was performed earlier.