

Tangled Webs of Royalty Misreporting Spotlight on License Interpretation

By Debora R. Stewart, CPA and Judy Ann Byrd, CPA

About InvoTex Group

InvoTex Group provides advisory services for intellectual property owners, including licensing, technology evaluation, license compliance and royalty audits, asset management and enforcement of IP rights. The firm offers a comprehensive suite of services to provide the strategic and tactical expertise necessary to optimize IP value throughout its lifecycle. Specifically, InvoTex monitors licenses for compliance to help clients maximize the value and revenue generated by their IP. For more information about InvoTex Group, please visit www.invoTex.com.

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INTRODUCTION

in-ter-pre-ta-tion – noun: opinion regarding a set of facts. A degree of subjectivity is involved on the part of the individual, based on his or her experience, personality, and biases.¹

At last, everyone has signed the agreement! With great enthusiasm you receive the official copy of your latest license agreement. Let's reflect on its history. You spent countless hours romancing potential licensees, wooing the top few who looked promising, and then you built trust and a relationship with that special someone: the business development manager of your choice. You grew close with the hopes that, together, you may solve a critical need in the community, achieve the notoriety you so deserve, maybe break-even or dare to make a small fortune from all of the efforts expended. Ah, the ideals of young love. The sparks were almost extinguished when each of you brought in the legal counsel needed to consummate the deal, but you stuck it out through the negotiation process, and your relationship was sealed. Congratulations!

Licensors, what happens next? Likely, you deliver a copy to the license manager, who if you're lucky is... you. Who is better equipped to understand the technology, language, and nuances fleshed out in that document?

But what if you are not the license manager? What if you must hand over this precious relationship to another person? Will they provide the required attention and nurturing? Look at it from the other side: we have all inherited some thing or situation and are

¹ Siegel, Joel G., Ph.D., CPA, and Jae K. Shim, Ph.D., *Dictionary of Accounting Terms*, 4th Edition, Barron's Educational Series, Inc.

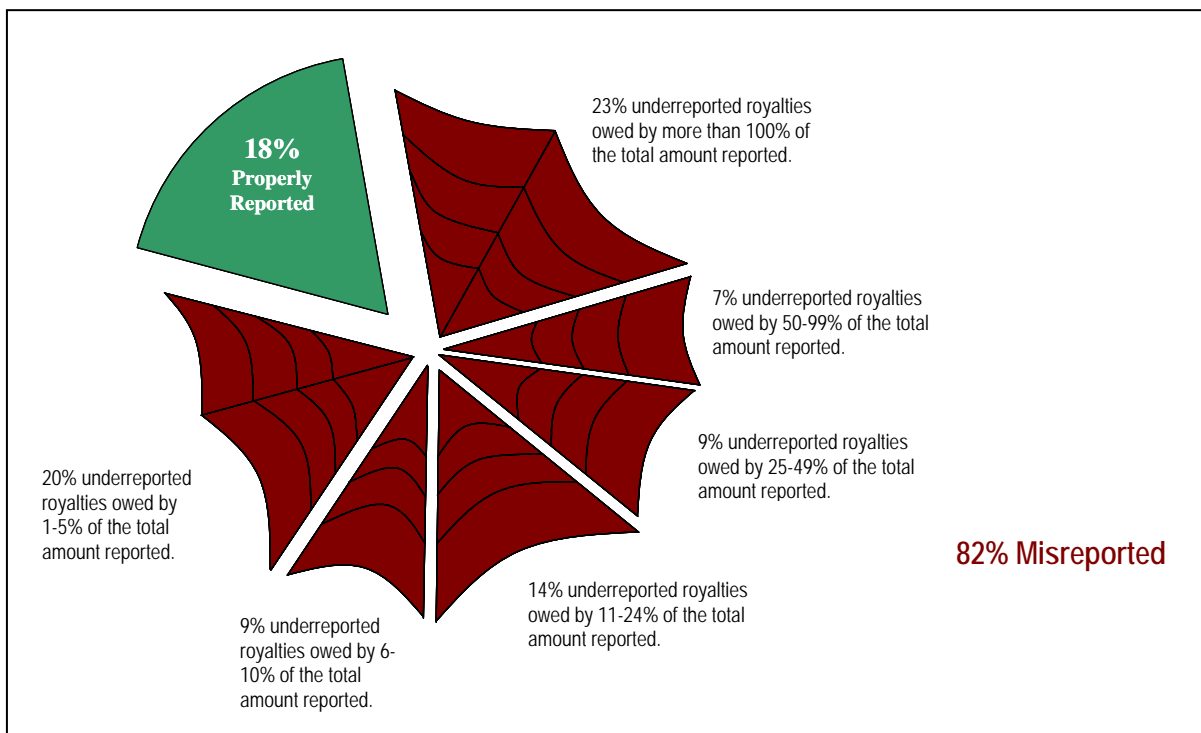
asked to handle it, or worse, just deal with it. It isn't the way you would have written the agreement. Maybe you don't even understand it, but, oh well, it is not your place to say so. You just deal with it.

Now let's look at the licensee. After the deal is done, it is on to the next deal. Are they involved in the maintenance of the agreement? For the most part, no. The agreement is handed off to be managed and reported through another group - the royalty reporting department, right? That would be rare indeed. Sometimes the relationship is managed through the legal department, but, more likely, it is handled through the finance department.

So, the people who inherit your license are left to deal with it. They read the agreement and, if they are conscientious, do the best they can. They interpret the agreement through their own eyes, experiences, and biases. We cannot expect more. We think we write our agreements using crystal clear language, but maybe we do not. We must start with what is written. The best we can do is to ask questions, investigate, and communicate our interpretations.

If you are the licensor in this royalty-bearing license agreement, chances are good that you are not receiving full compensation from your licensee, even after your careful, lengthy courtship. In fact, since we began aggregating royalty audit data, we have found that approximately 82% of licensees both underreport and underpay royalties, frequently in staggering amounts. **Chart 1** illustrates the magnitude of this underreporting epidemic.

Chart 1: Only 18% Properly Report Royalties



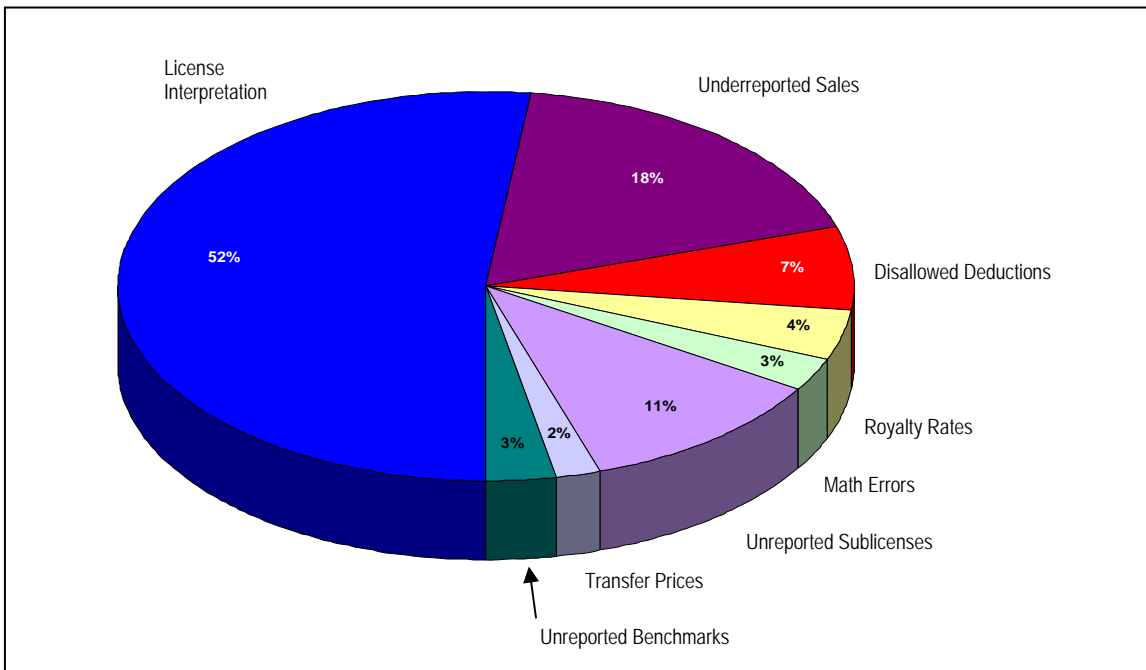
WHAT HAS CHANGED?

Last year, using our audit experiences as our population, we explored various misreporting errors together with their magnitude and frequency. We concluded that, generally, misreporting happens because of inattention, oversight, or disconnect between those who negotiated and wrote the license agreement and those who are put in a position to interpret it, or, worse yet, those who have never seen the agreement but are asked to report under its terms. Another year has not changed this conclusion. What has changed is our understanding of new ways to interpret the language of licenses. The stories that follow illustrate the tangled webs of misinterpretation and subsequent misreporting. It may start out as a clearly worded license agreement, but when it comes to interpretation and reporting, oh, what tangled webs we weave.

Historically Consistent Offenders

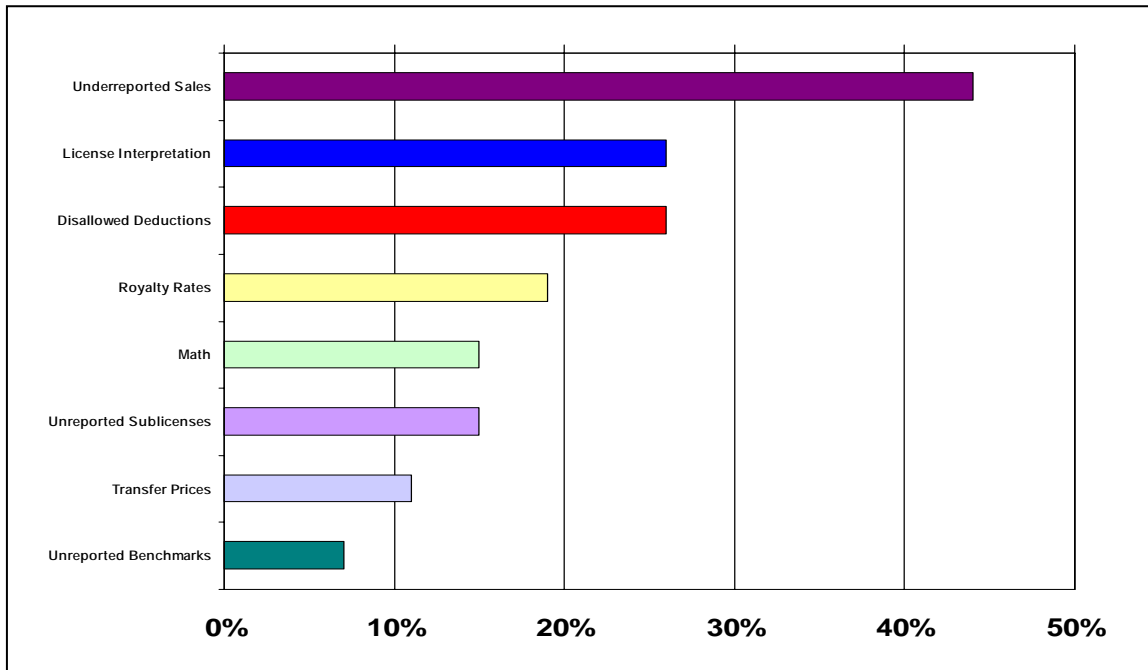
Several types of reporting errors appear regularly in our audit results. The majority each account for only a small amount of money, but three types of errors account for more than 80% of unreported or underreported royalties. **Chart 2** illustrates variances between royalties originally reported and our examination results. This chart represents the underreporting magnitude based on total royalty dollars uncovered through audits.

Chart 2: Findings by Total \$ Misreported



In addition to the dollar value of the misreporting, it is helpful to understand how frequently these errors occur. **Chart 3** breaks down royalty reporting errors by how often they appear in our audits. Taken together with **Chart 2**, the significance of certain reporting errors becomes quite apparent.

Chart 3: Frequency of Misreporting by Error Type



Unreported benchmarks and milestones, which represented 3% of our monetary findings, occurred in more than 5% of our audits. Unlike sales, such milestones are not generally programmable into the financial reporting systems and, instead, have to be monitored outside the systems through some kind of checklist or “tickler” file. Further, these terms are seen more frequently in government and university licenses than corporate licenses typically because of the stage of the technology being licensed. If your license does not specify that the licensee provide a progress report toward milestones, don’t be afraid to ask your licensee about his progress.

Bad spreadsheet formulas were found in 15% of the audits and accounted for 3% of total dollar findings. It does not take a CPA to use a calculator, unless you have one of those fancy wiz bang Hewlett Packard financial ones. Check the math!!

Transfer price is the price that is assumed to have been charged by one part of a company for products and services it provides to another part of the same company to calculate each division’s profit and loss separately. Sometimes organizations charge transfer prices to partners under a marketing and distribution agreement, providing a price break in exchange for other financial returns, including royalties. Transfer price errors were found in more than 10% of our audits.

Unreported sublicenses represent a significant number of misreporting errors, occurring in approximately 15% of our audits and accounting for 11% of the money we found for our clients. As such, it is more than worthwhile to retain the right to be informed of new sublicenses, receive copies of royalty reports from sublicensee to licensee, understand how the royalties flow through to you, as well as maintain audit rights to the sublicense records.

Incorrect royalty rates appear in almost 20% of the agreements we audit. At times this is because rates change over the term of the agreement through indexing or product life cycle. Other times it is due to incorrect product categorization by the licensee. These errors can be very difficult to spot unless you have access to the details.

Disallowed deductions, which were taken 25% of the time, are easily identified. Ask licensees to report detailed categories of these deductions on their royalty reports. Then, watch for spikes that highlight changes in methodologies such as accruals or division of cross-product deductions such as rebates, promotions, and handling.

When we audit, as expected, we find unreported sales, and we find such sales misreporting errors in nearly 45% of our audits. These errors range from reporting the wrong product to missing legacy products to missing new sales territories. Since we are not scientists, we have to rely on documentation supporting the products. We examine bills of material, product specifications and marketing materials. We ask questions until we are satisfied that we understand the proper classifications and whether specific products are royalty bearing or not. Finally, we look at product numbering and naming conventions to identify products we should consider unreported.

Last but certainly not least is our favorite category, questionable license interpretation. As illustrated in **Chart 2**, 52% of the royalty dollars we find are due to a variance between how we interpret the license agreement, the way the licensor interprets it and the way the licensee interprets it. We see license interpretation errors in one out of every four audits we do, and some of the excuses are classic – much better than “the dog ate my homework.”

LET'S DISH

Now for a few anecdotes. The following are true stories of circumstances we encountered during audits. All company and product names have been changed to protect our insurance policy.

Example 1: Defined vs. “In the Spirit”

A licensee makes and sells wildly successful product called Sparkly-goo. The licensee and licensor agree that Sparkly-goo is a royalty bearing licensed product under the terms of their exclusive agreement. Royalties are calculated at 5% of net sales, a defined term. Net sales is defined as “invoiced amount for product less returns and regular trade discounts.” Sounds simple, right?

The licensee determines independently that in the goo industry, royalties are paid on the fair market value (FMV) of the active ingredient in goo which makes it gooey. The licensee interprets “invoiced amount of product” to mean FMV of the active ingredient. The licensee does not sell the active ingredient as a stand alone product; licensee manufactures it for use in

Sparkly-goo. So to approximate the FMV of the active ingredient, the licensee uses the weight of the active ingredient compared to the weight of Sparkly-goo as finished product. This effectively discounts the net sales amount by 80%. Licensee is adamant this is “in the spirit” of the agreement and fair under industry norms.

Licensor defined royalty = 5% * Net Sales

Licensee defined royalty = 5% * Net Sales * 20% (or effectively 1% * Net Sales)

Is this what you negotiated?

In another instance, the licensee decided that the royalty rate for a multi-pack product should be prorated if the components of the multi-pack were sold separately, even though the definition of a product was “up to a five-component package.” In this case, over \$5 million in underreported royalties was found.

Example 2: Shell Game

The license agreement grants rights to make and sell therapeutics and related delivery apparatus devices with royalties calculated at 4% of net sales. If there are sublicenses, the royalties are calculated at 2% of the sublicensee’s net sales.

Original licensee A was purchased by B. B formed two divisions:

- BP - pharmaceutical division that manufactures and sells therapeutics, and
- BD - device / apparatus division.

BD was sold and sold again and is now known as D. BP was renamed current licensee.

Current licensee BP pays 4% on its net sales of therapeutics (which includes a D delivery apparatus) and 2% on its purchases of D’s apparatus, indicating D as a sublicensee. D sells its apparatus worldwide and pays no royalties whatsoever to the licensor. Hmmm, what do you think of that?

In a similar situation, the licensee was manipulating the price charged between a medical device (royalty bearing and not yet qualified by insurance) and related disposables (questionably and arguably royalty bearing but insurance qualified). The licensee was giving away the royalty-bearing medical device but charging substantially high prices (nearly enough to cover the price of the device!) for the disposables. No royalties were being paid at this time. When the device became insurance qualified, the licensee began to pay royalties, and the price of the disposables dramatically declined. Disposables are integral to the operation of the device. Should royalties be paid on the disposables?

Example 3: If we are in a forest, then where are all of the trees?

In a situation where there are 1,000 products categorized into one of six technologies to which you apply a series of tests in a specific order to determine which royalty rate should be applied - when literally each product may have a different royalty calculation - you need a little detail. Actually, not just a little, you need a lot of details. What did the licensor receive? Each quarter, it received a one-page summary of royalties by technology category and a big fat check, sufficient to make just about any one of us independently wealthy for years. When we got the details, we found another \$12 million that had been underreported for the prior two years.

After the products were classified, which was surprisingly accurate, we examined the order of the tests performed to apply the royalty rate. We found random order to the tests. Some errors inflated the royalty due and some deflated the royalty due. However, the biggest problem we encountered was a phrase in the License Agreement mandating that the average sales price for a certain technology category, and in certain circumstances many categories, be used as a minimum sales price for each of the component products in a given category. We raised the question: does this mean the arithmetic average (total sales dollars divided by total units sold) or the weighted average (giving more weight to the products that had more unit sales)? It mattered, to the tune of \$7 million.

CONCLUSION

As you can see, interpretations of license agreements run the gamut. The only way we discover the resultant errors is by gaining a thorough knowledge of the accounting and reporting systems relative to royalty reporting and asking many questions. Some clients are surprised at the amount of time we spend performing investigative interviews during our site visit. We talk with anyone we can access in the accounting, finance, royalty reporting, technical, marketing, and business development areas. We tour facilities when appropriate. We show a true interest in the process in a professional, nonthreatening manner. We are fortunate in that our objective is not to prove who is right and who is wrong; rather, our objective is to gather information. It takes a special person with an inquisitive mind, who will ask questions, without being annoying or becoming too invasive, until the subject matter is understood, to perform these types of audits. Not everyone can do a thorough job.

Royalty audits are not financial statement audits. A royalty auditor's job is to investigate and test available information to determine the completeness and accuracy of the reporting and payments under the terms of the agreement. Your goal is to get (or pay, if you are the licensor) what is rightfully due, no more and no less. Be sure that the firm that you hire to conduct a royalty audit will represent you well and respect the relationship you have with your license partner.

In 18% of the audits we have performed, the licensor and licensee have interpreted the agreement in the same fashion. Perhaps it was the clarity of the language. Maybe it was open and frequent communications. Both will help. However, 82% of the time Invotex has found misreporting. Intentional or not, it happens. The dollar magnitude of findings varies with the license examined but typically audit findings cover the cost of the royalty audit. Why not verify?