Technology Transfer Tactics™

The monthly advisor on best practices in technology transfer

Underpayment, underreporting widespread

Active management of licenses keeps big dollars from slipping away

Institutions need to actively manage their technology licenses or they risk losing significant revenue from incorrectly reported royalties and sales, say auditors from the Invotex Group who have studied the mistakes universities make in managing licensing agreements.

Underpayments normally are not due to fraud, says **Judy Byrd**, a director at the Baltimore-based financial consulting and intellectual property management firm. Instead, inattention and poor systems are the major causes of underreporting.

Regardless of the reason, underreporting is widespread, Byrd told attendees at the AUTM Eastern Region meeting in

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Washington, DC. In a survey of Invotex Group's 2006 audits, the consultants found that 80% of licensees misreported license revenue, Byrd says. "What surprises us is the magnitude of the underreporting," she notes. "Fifty percent of the time, we find underreporting in excess of 10%," which is important because there's often a clause in licensing agreements stating that, if an audit finds underreporting of 10% or more, then the licensee pays for the audit.

About 29% of licensees underreport by 1% to

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10%, 11% underreport by 11% to 24%, 9% underreport by 25% to 49%, 6% underreport by 50% to 99%, and 25% underreport by more than 100%, according to the survey.

Establish proper management controls

Problems can be averted or uncovered by proper management of license agreements, she says. "These types of agreements and contracts need to be managed -- they require extreme attention to detail," says Byrd. "If you don't ask the questions, then you're giving the power away. The knowledge of what's being reported is the power."

What do most university tech transfer offices do when they get a royalty report and a check? "If you're like most people, you take that check and you run all the way to the bank," she says. "What you should do is look at that royalty report. Make sure the math checks. And, call your licensee. Talk to these people in good times, and they're more likely to talk to you in bad times. We don't want to be perceived as not trusting our licensees, but if people know you're watching, they're more likely to report accurately."

Focusing on the details of the relationship strengthens that relationship, protects the university's rights and sends a proactive message of enforcement, Byrd says.

For example, most companies use Excel spreadsheets to track results and generate revenue reports, but if the person inputting the data has failed to tell the program to include or exclude a column from those results, they'll be skewed, she says. "It just takes five minutes to add it up and check it."

In addition, companies can underreport benchmarks or milestones, which often trigger payments. "If you think a milestone happened by looking at their 10K or press release, then ask them about it: 'Didn't we have a milestone payment due?'"

In other cases, sales are underreported -- for example, a specific geographic area or legacy product is missed and doesn't get reported, Byrd says. "This is something easy but time-consuming to check -- look into the 10K and find out what these numbers are."

Survey reveals common errors

In the Invotex Group's survey:

• 17% of licensees with audits that turned up underreporting had unreported sublicenses, Byrd says, adding that licenses frequently do not mention the right to receive and/or audit sub-licensee information. "That's a real [red flag] for us when we go in to audit," she says. Universities can avoid problems in this area by monitoring publicly reported information, including language allowing the transfer and audit of information, and making sure their sub-licensee definition clarifies what relationships might be included.

• Another 4% of license agreement audits showed problems with transfer prices, which generally are below-market prices charged by one company affiliate to another. The license language may omit any reference to arms-length transactions, Byrd says.

The way to deal with this mistake is to be aware of market prices of the licensed product and to perform analyses on royalty reports, she says: "Calculate price per unit and know the trends." In addition, the license agreement sales definition should reference third-party pricing, she says.

• Royalty rate errors affected another 4% of license agreements. The problems in this area generally involve overly complicated calculations and the use of different rates for different products, Byrd says. To combat these types of errors, Byrd advises grouping products into categories, using tiers, and including in the license agreement example calculations with sources for the indexes.

• Disallowed deductions plagued 9% of audited license agreements. Here, the problems involve vague language and companies that push the definitions included in the license agreement to their own benefit, Byrd says. In license agreements, the definition of net sales must be clear, she says. For example, universities should mandate that royalty reports itemize deductions and then analyze what's been reported.

• Questionable contract interpretations were responsible for 40% of problems in license agreement audits, Byrd says. The major causes of these problems were that the parties who originally negotiated the agreements had left the organizations, and the language didn't clearly state the spirit of understanding between the parties, she says.

For example, a company selling disposable products for a licensed machine might not count the disposables as a royalty-generating sale, or a company might decide to prorate up-front revenue for a multi-year contract involving a software- and maintenance-based product, Byrd says. The institution

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that granted the license may not agree with that interpretation, she adds.

Key language for license agreements

When drafting agreements, says **Debbie Stewart**, managing director at Invotex, institutions should consider including some key language, including the following:

- including an appendix with definitions at the end of the agreement, which allows for the reader to focus on the agreement and not get bogged down with terms prior to their use;
- capitalizing words consistently;
- ensuring that if a term is capitalized in the body of the agreement a definition for it exists;
- understanding what the licensee is capable of reporting. "We can ask for the world, but that does you no good if they have no ability to report that way," says Stewart. "It's not hard to find out what they can do."
- when defining the term "net sales," avoid the use of "in accordance with generally accepted accounting principles" because it can mandate deferrals of revenue.
- consider the overall economic value of the product package, including disposables, as part of the agreement;
- consider and address the impact of transfer pricing through marketing partners and affiliates; and
- be mindful of how the "Territory" is defined and pinpoint manufacturing locations, if possible. Require the licensee to tell you where the product is being manufactured, if a third-party contractor is manufacturing the product, if there are any sublicense or distribution agreements, and about any other types of agreements that include the technology, Stewart says. "I have clients who hire me just to ask these questions," she says. "If you're nice to people and you ask, they're going to tell you."

The right to audit

The audit paragraph in an agreement should include the right to audit at least annually, the right to audit for completeness, and the right to audit sublicensees. Require that the books and records of the licensees, affiliates and sublicensees be maintained and open for inspection for a set time from the date each royalty report is submitted, and require that those reports include the original data files used to prepare them, Stewart says.

Those books and records should include (but not be limited to): invoice registers and original invoices, product sales reports, accounting general ledgers, sub-licensee and distributor agreements and royalty reports, price lists, audited financial statements, inventory and manufacturing records, and shipping documents, she says. "The whole idea of an audit is not to check what they told you -- it's to check what they didn't tell you," she adds.

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