As corporate business structures and license agreements become more complex, organizations are discovering more issues with their licensees' underreported royalties. Many organizations license their intellectual property, such as a patent or trademark, for use by a third party and should be compensated fairly based on the license agreement's terms. Once you execute a license agreement and start to receive royalties, you must understand potential red flags that signal reporting inconsistencies and could result in lost revenue.

Red flags that your licensee may be underreporting royalties

Protecting your intellectual property and royalty revenue stream

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Intellectual property is vital to an organization's success, and, if this intellectual property is licensed, a process must be in place to determine whether all financial obligations are being paid accurately. To effectively monitor compliance, organizations must have an understanding as to why royalty underreporting can occur, so that these issues can be identified and remediated with licensees. Identifying irregularities quickly and efficiently will lead to future compliance and maximized revenues moving forward.
In the majority of cases, royalty underreporting is an oversight of the licensee. For example, when working with large multinational companies, the royalties they pay usually do not hit the materiality level for external auditors. In other cases, royalty reporting processes can be overlooked or inconsistent because it is not a significant part of the licensee’s business. Problems can arise from issues as simple as deficiencies with maintaining the necessary record keeping, as larger companies are often more siloed with their processes.

A thorough program to identify potential issues with licensees can help organizations ask the right questions to determine whether underreporting may be occurring. If a business does not have a program in place, or believes that the royalty payments they receive are inaccurate, it may be time to conduct a royalty audit on licensees and their practices.

**Red flags identified based on historical results**

Based on our experience conducting royalty audits, we have identified certain characteristics of licensees, which contribute to their underreporting of royalties. The following licensee profiles should be assessed, as they indicate that these organizations are more at risk for underreporting royalties. For each of these areas, we have provided examples of how underreporting may exist.

**Multiple countries involved:** Typically, a license agreement indicates the specific countries covered under the agreement. A complexity arises when several countries are involved, and the royalty reporting personnel in those countries might not have access to the license agreement, or if they have it, they might interpret it in a different way than intended.

For patent-covered countries, is the licensee including both products made and sold from that location? Frequently, licensees may be deficient in reporting sales related to each scenario. Also, certain deductions are taken from gross sales to determine net sales subject to royalties, and some countries might include additional deductions that are not allowed, which would result in underreported royalties.

**Multiple entities involved (affiliates, subsidiaries, sublicensees, etc.):** Similarly, if multiple entities are involved, such as affiliates or subsidiaries, are they interpreting the terms of the agreement correctly? Is the data from an affiliate calculated correctly and is it flowing up to the right person to compile reports? Is the licensee including the transfer price for intercompany sales or are they using the sale to third-party end users?

The right information is not always included, or not included consistently. Further confusing the issue are sublicensing scenarios, where adherence to contract terms can become murkier. The licensee may elect to sublicense the intellectual property to another company. Within agreements that allow sublicensing, language should exist regarding sublicensees and how those sublicensee royalties should be reported and flow through to the licensor. We frequently see that terms are not always consistently applied, oftentimes leading to significant underreported royalties.

**Changes in licensees’ accounting systems:** When a licensee moves from one enterprise resource planning (ERP) system to another, several issues can arise. The data the licensee is pulling may change, as well as reports and the way data is compiled. The system can pick up new deductions that include additional costs that are not allowable based on the license agreement. In addition, sales and how they are compiled may be in a different format and may not be complete.

**The licensee was acquired by another company or acquired another company:** In the current economy, businesses are changing hands rapidly, and a licensee may be acquired or merge with another entity, causing process changes. With potential changes in systems and personnel, how does key information get carried over and has reporting changed? Alternatively, if the licensee acquires another company and that new subsidiary starts to use the licensed intellectual property, how does the licensee ensure that those sales get included in the royalty reports? Organizations must pay close attention to these complexities that could lead to underreported royalties.

**Changes in royalty accounting personnel:** Unfortunately, accounting staff turnover occurs often, and practices may change with new personnel. As royalty audits typically cover a multiyear period, the person compiling the royalty reports during the review time period frequently has left the organization. Someone else comes in to pick up the pieces, and without standard operating procedures for compiling royalties and documenting what information to pull, there is a learning curve and increased potential for errors. The new people must interpret past work, and they may not pull all the necessary information. This scenario is always challenging and can lead to errors in royalty payments.

**New products or expanded product line:** While a licensee may pull a report for specific product numbers subject to royalty, sales and marketing may come up with new products or product lines, which are covered under the license agreement. These new products can be as simple as different sizes or shapes that include the patent or trademark, but packaged a different way.

Sales, marketing or engineering may not communicate with accounting to notify them of these new products that utilize the licensed patent or trademark and, therefore, should be subject to royalties. Thus, those products are not included for royalty reporting purposes. In other cases, new products are communicated months after their first sales have occurred, and those past royalties could be omitted.
Be proactive to identify issues

Licensors can implement several monitoring activities to help prevent underreported royalties or identify them quickly when they arise. These processes include:

- **Evaluating royalty report templates**: Often, royalty report templates are included as an attachment to the license agreement. Ensuring they are as descriptive as possible gives the licensor as much information as possible to manage any issues that arise.

- **Maintaining contact with licensees**: Promoting good interaction and dialogue with licensees helps to build awareness of any potential events and concerns.

- **Developing a royalty payments trend analysis**: One scenario we see that has a direct impact on licensor’s royalty income is when royalty payments are inconsistent, progressively get smaller or are not paid at all. This should raise a red flag that royalties are not being accurately compiled or the licensee may be struggling financially. Regardless, this scenario begs further questions and must be immediately addressed.

- **Benchmarking sales of licensed products with market and industry trends**: Do reported sales of licensed products align with the marketplace? Is the same technology licensed to another entity and those sales are significantly higher? A licensor’s inventors, engineers and other personnel likely have certain expectations for how products should be performing. Product sales not correlating with projections is another indicator of potential underreported royalties.

- **Developing a questionnaire**: Sending a periodic questionnaire to licensees around these potential red flags provides increased transparency into potential issues. It yields key information about whether any red flags are prevalent within the organization and provide a better sense of the risk of underreporting royalties.

The next step

If any of the previously mentioned red flags are identified, it increases the risk that the licensee is underreporting royalties. A royalty audit may be an effective course of action to validate or determine if the licensee is in compliance with the terms and conditions of the license agreement.

These reviews are typically performed at the licensor’s location, and the review period can be dictated by the license agreement and how long books and records must be kept. If issues are discovered, the reviews do not just recover current underpayments; for systemic issues, they can go back to quantify past royalties due as well. Given the frequency of issues and irregularities in royalty reports, royalty audits are becoming more common and a best business practice to protect revenue streams.

Conclusion

When you enter an agreement to license your intellectual property to an organization, you cannot assume that royalties will be accurately paid. It is a complex process, and underpayments can happen with inefficient controls, misinterpretation of contract language or clerical errors within licensees. Royalties can also be purposely underpaid.

To ensure you receive the royalties you are contractually obligated to, consider implementing a proactive framework to identify issues before they become significant. If you discover any red flags within your licensees’ reporting, or your royalty revenue is not meeting expectations, a royalty audit can be used to identify and recover underpayments.