

Royalty Audits Can Help Companies Realize Additional Revenue

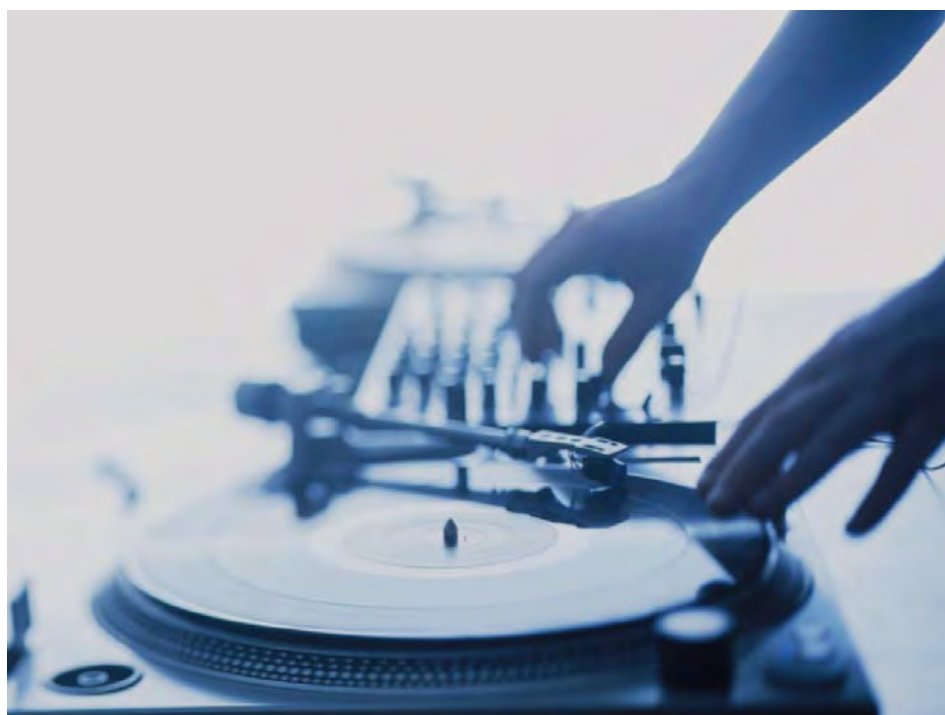
by George Gallinger, Principal, and Chandrasekar Venkataraman, Director

Many companies, especially those in the apparel, entertainment, and technology industries, but companies across a range of other industries as well, may be missing an opportunity to recognize the additional revenue due to them through royalty payments. For businesses with intellectual property such as patents, copyrights, and trademarks, revenue can be realized by executing the "right to audit" clauses contained within the licensing agreements with licensees.

The primary objectives of a royalty audit are to ensure that (1) all royalty payments due to a licensor related to the contracted use of the licensor's intellectual property by a licensee are completely and accurately reported and remitted to the licensor in a timely manner, and (2) the licensee is in overall compliance with the licensing contract.

When a company decides not to perform a royalty audit, it is forced to rely upon the controls and periodic reporting of the licensee, which could ultimately result in a misrepresentation of net sales. Many factors could result in a licensee underreporting sales to a licensor. Some examples include:

- Lack of proper and timely communication among the sales/service departments and the accounting groups charged with royalty calculations
- An overall poor control environment relating to royalty calculations and reporting
- Misinterpretation of specific terms such as gross sales, net sales, product, or territory as defined in the agreement on the part of the licensee
- Non-reporting of sub-license revenues or sales by affiliates
- Inaccurate reporting of product launches and sales in new markets, geographies, or countries
- Unwarranted deductions from the gross sales in the areas of quantity discounts, returns, allowances, charge backs, and/or price reductions
- Improper accounting and reporting of samples or donations
- Calculation of royalty amounts not in accordance with the schedule in the agreement
- Improper foreign currency conversions



An independent firm can assist in completing the royalty audit for the licensor. At J.H. Cohn, professionals in our consulting division assist licensors in securing and enforcing their rights under their licensing agreements with licensees. This includes helping licensors develop appropriate royalty compliance and oversight programs. Where such compliance programs already exist, we can review and suggest recommendations for their improvement.

Typically, a royalty audit includes:

- Reviewing the licensing agreements to gain an understanding of how royalty payments due to the licensor should be calculated;
- Understanding and reviewing the licensee's process for recording sales of the "in scope" products with proper cut-off procedures;
- Verifying exchange rates and foreign currency conversion calculations;
- Determining trends and identifying outliers relating to volumes, product mix, and price;
- Validating the accuracy and completeness of royalty calculations, reporting, and payments; and
- Verifying appropriate evidence that withholding taxes, if any, are properly deducted and held for and on account of the licensor and paid timely to the taxing authority.

In many instances, cost benefits will be immediately realized through identification and recovery of underreported royalties, especially for first-time audits.

While there are costs associated with performing royalty audits, it is likely that the short- and/or long-term benefits of regularly performing royalty audits will far outweigh the costs.

In many instances, cost benefits will be immediately realized through identification and recovery of underreported royalties, especially for first-time audits. Additional cost benefits will be realized when the licensee implements process improvements that ensure that future payments to the licensor are accurate. Further, a heightened awareness on the part of the licensee that future reviews will be performed may strengthen their overall control and reporting environment.

At J.H. Cohn, our approach to royalty audits also includes reviewing the terms of the licensing agreement and preparing related checklists so we can conduct a thorough, focused examination of the licensee's royalty process with the goal of ensuring complete and accurate reporting of royalties and their timely payment. Where there is no conflict of interest, we also have the ability to create dashboards to help licensees report gross sales, deductions and allowances, net sales, and royalty

income streams, and for licensors to monitor compliance of the licensing agreement.

The results of our review can be used as a springboard to facilitate better understanding among the parties about the efficacy of the existing licensing arrangement and/or to make improvements. Our vast process knowledge across a broad spectrum of industries enhances the value of the recommendations we make to licensors that, when implemented by licensees, strengthens their underlying business relationships. ■



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