Is it Time for a Royalty Audit?

By ILAN HAIMOFF

Licensing agreements exist in almost every industry and can provide tremendous income opportunities, but license holders often do not take advantage of their audit rights and miss out on income they are entitled to.

Under licensing agreements, individuals, companies and other entities with intellectual property rights (licensors) receive royalty statements from various production, manufacturing, distribution and other companies (licensees). Licensing agreements determine when, where and how the licensee can use the property and provide methods for determining payments due to licensors. But how can licensors ensure they are being compensated correctly?

A systematic plan for review of royalty statements is the only way for licensors to protect their rights and maximize income. Companies who license property to numerous parties should develop a risk-assessment framework to help monitor licensees. Well-designed risk assessment programs can identify potential problems and reveal when detailed audits of royalty and profit statements are needed.

In addition to risk-assessment programs, licensors should consider working with royalty audit experts to prevent revenue slippage and ensure the integrity of intellectual property. Properly identifying risk factors can help licensors focus on auditing licenses that pose the greatest risk.

As part of the process to assess the need for an audit, a licensor should consider the following:

STATEMENT RISKS

• **Statements in the Black Pose Greater Risk:** Licensees are more likely to focus on statements once actual cash changes hands. Once being paid in excess of the initial advance or minimum guarantee, licensees are more likely to delay reporting of revenues or over-report deductions. New entries added soon before or immediately after the recoupment of the initial advance may represent a red flag.

• **Identify Inconsistencies with License Agreements:** There is significant risk involved in the development of statement templates by licensees. Statements are often handled by individuals not directly involved with drafting license agreements so misinterpretation can be common. Licensees may also subjectively interpret terms in their favor, resulting in under-statement of royalties. Statements should be reviewed for improper application of the license terms.

• **Look for Unusual Entries on the Statements:** When licensees issue a high volume of statements with limited staff, quality control can suffer. Entries that are out of the norm, such as negative revenues and unfamiliar deduction accounts, may indicate risk that the integrity of the statement has been compromised.

LICENSING AGREEMENTS RISK

• **Complex License Agreements Pose Greater Risk:** More complex agreements generally have a higher risk of errors. Complex agreements should be considered for periodic royalty audit by professionals.

• **Beware of Multiple Versions of Licensing Agreements:** If an agreement remains unsigned due to unresolved differences, there is risk that the licensee may be applying their preferred terms. A licensor needs to be aware of differences between agreement versions and scan statements to identify where the licensee has reported things different from expectations.

• **Watch Out for Expiring Audit and Tolling Rights:** The licensee is unlikely to warn the licensor before audit or tolling rights expire. While a licensor may have concerns about the statements, once audit rights expire, it may be too late. Licensors must evaluate the need for an audit prior to the expiration.

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CHANGING MARKETS GIVE RISE TO NEW RISKS

• **Globalization:** With the continued globalization of companies, the books and records may be maintained across the world by different teams with different levels of controls. As licensees may have inconsistency in the quality of their reporting from different territories, a licensor should monitor activities from different territories for unusual trends.

• **New Forms of Revenue Underreporting:** In recent years in the entertainment industry, there has been a growing risk of underreported new media revenues (such as streaming video, mobile downloads, electronic sell through, among others). Licensee systems and processes have yet to be upgraded to account for new media revenues. In many cases, licensing agreements do not address new media, which can result in revenue underreporting. Agreements and statements should be reviewed to ensure the accuracy of new media revenues.

• **Licensee Changes Give Rise to Risk:** If a licensee is going through a significant internal change (such as a merger, lawsuit, change in leadership or system change), its quality controls in statement issuance could be compromised. Significant change within a licensee organization may lead to increased risk and the need for an audit.

Implementing a risk assessment program will help licensors systematically identify these and many other risks. If any risks are present, a licensor may want to consult with a royalty auditor to evaluate the possibility of performing an audit.

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