Considerations in Forensic Royalty Audit Engagements

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Licenses are becoming an increasingly common means for intellectual property owners to reap some benefit from their inventions without having to manufacture a product or employ a process themselves. Therefore, the royalty audit is an important tool for licensors who want to successfully manage their intellectual property. This procedure serves to ensure that the licensor receives the agreed upon level of benefits (in the form of royalty payments) as outlined in the licensing agreement. Licensing agreements can be inherently complex contracts. Further, evidence from royalty audits shows that licensees perform very poorly in self-reporting royalties. When the potential for litigation or disputes over royalty amounts is possible, the royalty audit should be conducted by a forensic analyst who is experienced in reviewing and analyzing complex financial information.

Introduction

Owners of intellectual property (IP) will often license IP to a third party in exchange for payments based on usage (usually referred to as royalties).

Licenses serve to capture the full market value of IP by providing the IP owner with the means to benefit from the IP without having to singularly expend all efforts towards manufacturing and marketing the products associated with the IP. Using different forms of licenses, the owner of the IP can engage in distribution and marketing of the invention by imposing appropriate terms and conditions of sale, use, and further development of the technology.[1]

A licensee is beholden to the binding contractual obligations within a license agreement. However, a core issue with licensing agreements is that most of these agreements rely upon the licensee to self-report royalties.[2]

Issues in Underreported Royalties by Licensees

Licensee self-reporting presents a unique issue in that licensees appear prone to misinterpreting the contractual language in the license agreement, thereby leading to underreported royalties. Numerous reports on the findings of royalty audits reveal that the underreporting of royalties is a commonplace occurrence.

According to one royalty compliance report published in 2013, whether due to intentional or unintentional causes, up to 89 percent of audited licensees underreport and underpay royalties.[2]

Reasons for Contract Noncompliance

Many reasons exist for contract noncompliance, ranging from instances of fraud to simple administrative errors in aggregating data or errors in performing calculations.

Some of the more common reasons for noncompliance with licensing agreements include the following:

- Intentional fraud or reckless misinterpretations of the contractual agreement
- Sales or transfers by the licensee to related parties in transactions that do not reflect arm's-length pricing

- Unintentional mistakes in interpreting the license agreement
- Intentional or unintentional omission of new, updated, or changed products
- Inappropriate or noncontractual deductions in the calculation of net sales
- Application of rebates, discounts, or other sales incentives to licensed products in a manner that underreports license-related sales
- Inappropriate attribution of value to licensed products on bundled product sales

According to the Invotex study, the frequency rate of common underreporting errors are as follows:

- 55 percent of licensees underreport sales
- 38 percent misinterpreted the licensing agreement
- 28 percent overstated deductions
- 15 percent made calculation errors
- 8 percent misapplied royalty rates
- 7 percent underreported sublicenses
- 5 percent applied improper transfer pricing
- 3 percent underreported benchmarks.[3,4]

Benefits of the Forensic Royalty Audit

The most obvious benefit of the royalty audit is the recovery of royalty underpayments. Evidence from findings of royalty audits conducted by auditors and royalty compliance investigation professionals suggest that royalty recoveries are within the magnitude of 5 to 20 times the cost of conducting the royalty audit.[5]

In addition to the recovery of royalty amounts due to discoveries made during the actual conduct of the royalty audit, evidence from certain royalty audit case studies suggests that licensees will often report a self-corrected royalty amount from a self-conducted audit once they are informed that a royalty audit will take place.

Additionally, the royalty audit has the potential to reveal the unauthorized use of licensed property. The unauthorized use of licensed property could be a troublesome circumstance for the licensor, resulting in possible damage to the licensor's reputation or creating legal risks.[6]

Conducting regular royalty audits typically has the effect of deterring inappropriate reporting of royalty amounts by licensees. Regardless of whether the underreported royalty amounts result from intentional or unintentional means, the royalty audit serves as a powerful tool that the licensor should utilize on a regular basis.

If a royalty underpayment issue does exist, it is in the licensor's best interest to discover the problem before the expiration of any statutes of limitations. Otherwise, depending on the state in which the suit is brought forth, recovery of the underpayments may become impossible.

For example, in *Shell Oil Co. v. Ross*, Shell entered into a mineral lease with the Ross family in 1961. Under the terms of the lease, Shell was obligated to pay the Rosses a royalty equal to 1/8 of the amount realized from the sale of any gas produced from the land. Shell did not consistently calculate the 1/8 interest based on the third-party gas sale price.

The Ross family sued over these discrepancies in 2002, which was outside the Texas four-year statute of limitations for a contract claim. But, plaintiffs argued that the claims were not barred because of the fraudulent concealment doctrine, which tolls limitations when a person attempts to conceal his wrongdoing until the risk period is over.

Plaintiffs argued that Shell had concealed the fact that it was underpaying the royalties because Shell's royalty statements did not reflect the amount that Shell was actually receiving from the third-party gas sales.[7]

The trial court ruled that Shell breached the lease by paying royalties to the Ross family based on a weighted average between 1988 and 1994 instead of the actual prices for that time period. The jury agreed with the plaintiffs and awarded damages to the Ross family.

However, the Texas Supreme Court reversed. The court acknowledged that the royalty statements did not reveal that the Ross family was being underpaid. However, the court's position is that the Ross family had a duty to investigate the royalty statement, and "make themselves aware of relevant information available in the public record."[8]

In other words, the Ross family had the ability and duty to conduct a royalty audit.

Licensors should also take care to stay apprised of how the changing technological and business environment affects the amount of royalties that are due for their intellectual property. In the music industry, recent court cases and settlements point to an apparent consensus that digital music sales should be treated as licenses instead of as sales, with the former yielding a substantially higher royalty rate.

In 2014, Warner Music Group Corp. agreed to pay upwards of $11.5 million and increase the percentage paid for royalties going forward for digitally downloaded music, which will now be treated as a license, instead of the lower royalty yielding category of sales.[9] In 2015, Universal Music agreed to a similar settlement of a class action lawsuit.[10]

The issue of whether digitally downed music should be classified as a license or as a sale was first presented on a large scale in the landmark case *F.B.T. Productions v. Aftermath*. Plaintiffs for the case argued that digitally downloaded Eminem songs should be treated as licenses instead of sales since F.B.T Productions was not incurring expenses to package and sale any physical product.[11]

What Is a Forensic Royalty Audit and Who Should Conduct the Investigation?

A royalty audit is an analysis or investigation of a licensee's compliance with the contractual license agreement. Financial compliance is generally determined through an examination of the accounting books and records of the licensee and its sublicensees.

Evidence from royalty audit engagements suggests a significantly high level of royalty contract noncompliance on the part of the licensee. Licensees are inclined to underreport royalty amounts via a myriad of mechanisms.

Therefore, experienced forensic accountants and other forensic investigation professionals are typically better suited to successfully conduct royalty audit functions involving any schemes or mechanisms to obfuscate correct royalty amounts due.

Further, when legal disputes do arise, forensic professionals, who have skills tailored to detecting fraud or misrepresentation, often are best-suited to conducting royalty audits and communicating those findings to a court or in arbitration.

Auditors have historically been criticized for employing a "check-the-box" mentality when conducting auditing procedures. Audit regulators have been lobbying for increased use of professional judgment in the audit of complex financial statement accounts.

However, auditors seem to interpret audit standards as increasingly prescriptive.[12] Forensic professionals are arguably less inclined to employ a mechanical or check-the-box audit approach to decisions in those situations in which it is most important to make decisions based on professional judgment.

Engaging the services of an experienced forensic accountant with royalty audit experience is especially judicious when there is a possibility of contentious disagreement and litigation associated with the royalty audit.

Use of Data Analytics in Forensic Royalty Audits

The volume of data and electronic information has increased substantially over the last few years. This increase is changing the way companies manage and extract value from data.

Therefore, it is imperative that the royalty audit team has extensive experience in dealing with complex and massive data sets within the context of corporate disputes. Specifically, analysts should have experience in reviewing transactions and methodologies relevant to the licensing of IP in order to determine if royalty payments are compliant with the terms of the licensing contract.

Our data analytics methodologies provide complete and efficient results through the creation of data warehouses and the utilization of data mining. This is typically accomplished through the use of various software tools, databases, and programming languages.

Forensic Royalty Audit Planning

Royalty audits begin with a planning phase. Therefore, during the planning process, the audit team will work closely with the client (the licensor) to determine if there are red flags with regards to sales that should be highlighted during the audit.

Some events and circumstances that raise the level of concern include a history of issues in communication between the licensor and licensee, any analysis by the licensor that indicates the possibility of underreported licensed products, analysis that points to possible errors in interpretation of the licensing agreement by the licensee, and any questionable reporting practices by the licensee, to name a few.

During the planning phase the audit teams should also work to develop a thorough understanding of both the license agreement as well as the licensor's interpretations of the licensing agreement where interpretations may be applicable.

To the extent possible, prior to communication with the licensee, the audit team should become familiar with the licensee's accounting and royalty reporting methods, processes, and reporting. The royalty audit timeline and all required document requests should then be clearly communicated to the licensee.

Execution of the Forensic Royalty Audit

During a royalty audit, certain key procedures should be undertaken. As previously mentioned, the forensic royalty audit team should gain a thorough understanding of the licensing agreement as well as a solid understanding of the way the licensor interprets the licensing agreement.

Most royalty audits are based on testing some form of sales (unit, gross, or net) and careful consideration should be given to these calculations. Special attention should also be given to ambiguous contract language, especially when the possibility of litigation over royalty payments exists.

Examples of common contract provisions that require special consideration include the adjustments made to gross sales in arriving at net sales (net sales is a common royalty payment base), the methodology for the allocation of sales returns by the licensee in determining net sales for royalty payment calculations, the basis and methodology for the calculation of tiered royalty payments, and the treatment of subsequent products that utilize the licensed property, to name a few areas.[13,14]

The royalty audit team should recalculate the royalty amounts that should have been paid based on appropriate interpretations of the licensing agreement.

This calculation should then be compared to actual royalties paid. The licensee's royalty reporting and payment records are tested for thoroughness and accuracy.

Part of this process should include reconciliation between licensee-prepared royalty reports and the licensee's accounting records such as inventory reports, invoices, and purchase records.

Depending on the volume of transactions and the level of assessed risk, the testing could be performed on a sample or complete transaction review basis. Any differences between royalty amounts due and royalty amounts paid should be analyzed, and, to the extent possible, specific causes for the variances should be identified.[15]

Interpersonal skills are also important during the forensic royalty audit. In most royalty audits, the audit team must also take into consideration the ongoing nature of the licensor/licensee relationship and take care to solicit direct, meaningful, and accurate information from the licensee while maintaining a nonhostile approach that does not damage the licensor/licensee relationship.

Conclusion

A royalty audit is a contract compliance investigation that requires special forensic investigation and in-depth auditing skills. Licensors are well served by employing their right to conduct a royalty audit of licensees.

Royalty audit findings suggest benefits for licensors of recovered royalty amounts as well as signaling to licensees that any unscrupulous royalty reporting practices will be unacceptable.

"[T]he audit team must also . . . take care to solicit direct, meaningful, and accurate information from the licensee while maintaining a nonhostile approach that does not damage the licensor/licensee relationship."

Notes:

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12. Anthony Carl Bucaro, "Applying Systems-Thinking to Reduce Check-The-Box Decisions in the Audit of Complex Estimates," Dissertation (University of Illinois, 2015).
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