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Licence agreements: are you getting the royalties you bargained for?

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Almost all licence agreements provide the right for the licensor to review the accounting records of the licensee. Such a review (sometimes called an audit) is undertaken to ensure that all licensed products subject to royalty payments are included in the calculation of royalties due, and that the calculation process itself is correct. This article discusses the pros and cons of such an audit focusing on experience in the USA, criteria for selecting whom to audit, things to expect from such an audit, and what you should receive from the person or accounting firm you select to conduct the audit. The results from a survey of university auditing practices are included.

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While the audit of trademark licences is common, it is a fairly rare event for university technology licences. Holders of a trademark licence in the USA expect to be audited on a regular basis. As trademark licensees typically have licences with a large number of universities, as well as the professional sports leagues, there is an opportunity for cost-sharing of the audit. A university will typically have to pay only a few hundred dollars to participate in an audit of a trademark licence.

A technology licence audit generally related to a single licence transaction is much more complex. The procedure may cost in the thousands or tens of thousands of dollars. It will probably be a surprise to the licensee when such an audit is requested. There is the potential danger that the licensee may consider such a request as a challenge to the mutual trust between the parties.

Thus, university licensing professionals around the USA are debating the merits of auditing their licensees, and it is an interesting debate. While the licensing professional may harbour well-founded suspicions that licensees are underpaying, an audit may have adverse consequences for the relationship with the licensee.

Increasingly, US university–industry licensing occurs in a complicated web of relationships involving university administrators; inventors who are also licensee consultants or on licensee advisory boards; research funding that may involve industry/university consortia; and donations of equipment or money to the university by the licensee. The licensing professional may be quite unsure as to who is the spider and who is the fly. However, it is generally possible to protect the university's intellectual property, and even to conduct audits, without becoming ensnared in an adversarial process that damages the delicate relationship between the parties.

This article is based upon a workshop in which the authors participated at the 1997 Annual Meeting of the Association of University Technology Managers in San Francisco. The authors also conducted a survey of attendees concerning royalty examinations. The results are presented at the end of the paper.

Experiences at Stanford

At the time of the writing Stanford University has conducted two significant royalty examinations, and has launched a third. The first involved the 'Cohen/Boyer' licensing programme. The technology in question is the process for inserting genetic material into certain cell types that results in protein 'factories'. This is the foundation of the biotechnology industry, with over 300 licensees worldwide, and royalties to date of over $250 million. One of the 'Big 6' accounting firms was selected to perform the audit. Twelve companies have been audited to date; their selection was based upon the amount of royalties they had paid to Stanford. Although to date the total recovered royalty revenues of $56,000 (from three licensees) are exceeded by the audit costs of $211,000, all licensees may be a little more diligent in future in reviewing the calculation of royalties knowing that this audit programme is underway.

The second royalty examination involved a licensing programme for Phycobiliproteins, a tag used in medical diagnostic devices. The programme had 50 licensees and total royalties of over $10 million. Another 'Big 6' accounting firm was selected as the auditing firm, and questionnaires were sent to the licensees. Three companies were selected for audit. The results were that two of the three companies, when given notice of the impending audit, determined that they had underpaid royalties by $247,000. The payments were received prior to the audits. It was found, during the audit of the third company, that $75,000 in royalties had not been properly reported. Fees to develop the questionnaire, evaluate the responses, plan and conduct the audits, and report the findings to Stanford, amounted to $27,000.

Licences must be monitored

A licence permits one or more companies to use patent-protected technology to develop new products or processes. Once the licence is signed, however, the work is not over. Licence agreements must be monitored to ensure compliance with diligence and royalty requirements. Every licensor knows the feeling of uncertainty that accompanies the receipt of an unsupported royalty report that includes only the number of units sold and the amount of the royalty remitted. Has the royalty been calculated correctly? Has the licensee accounted for all of the products sold? Why is there a significant change, upward or downward, in the amount of royalties paid? Is the licensee taking proper deductions to determine net sales? These and many more questions are legitimate concerns.

That said, a licensee may not take kindly to being audited. How can the university audit a licensee without causing possible harm to the relationship, especially if the licensee has other relationships with the university, such as sponsoring research? Difficult as it may seem, the university licensing professional should not abdicate the responsibility of ensuring that the proper stream of royalties is received. If the university decides to audit certain licensees, how should the candidates be selected? How should the licensor identify and retain a suitable professional services firm to perform the work? How will the work be performed? Are there issues of confidentiality? How will the professional firm charge for its services? These questions and others are considered in this article.

Are royalty 'audits' misunderstood?

In exercising its right to 'audit' a licensee's books and records, the licensor seeks to determine the methods of calculation used and accuracy of royalties remitted by the licensee. To an accountant, this procedure is not an audit. When an accountant audits a company's financial statements, he or she is evaluating financial statements prepared by company management for issuing to shareholders and the public in accordance with generally accepted accounting principles (GAAP). The accountant's level of effort in a financial statement audit is often based upon testing the representations of management (the accountant's client). By contrast, a royalty examination is a detailed examination of a limited set of transactions and activities related to the manufacture, distribution, and sale of goods resulting in payment of a potentially incorrect royalty to the accountant's client. The circumstances of the engagement, and the approach of the accountant should differ significantly between a financial audit for purposes of reporting to shareholders, and a royalty examination.

Accounting for royalties under a licence agreement is not generally subject to GAAP. Indeed, for many public companies licensing-in, the royalties payable to a licensor may escape the scrutiny of the licensee's external auditors because the amount of royalties due may be immaterial in the context of the financial statements, and auditors express opinions on the fairness with which the company's financial statements materially present the company's financial condition. Thus, be cautious about accepting the licensee's contention that 'our auditors would have looked at it'. If the royalties paid under the licence appear insignificant when compared with total sales, there is a good chance the licensee's auditors did not test the accuracy of royalty payments made by their client.

Why universities should consider royalty examinations

Many university licensing professionals feel that a royalty examination may strain the relationship with the licensee. In our view, however, licensees generally accept the notion that licensors must monitor their licence agreements, and part of that oversight function should include royalty examinations. After all, these same businesses keep their cash in the bank, insure their hard assets, and attend to them when they need repair. They spend vast sums to protect their brands, trade secrets, and other intellectual property. Why wouldn't they understand the university's use of the same sound judgment in protecting its own assets, which include licence agreements?

Three main benefits of licence examinations

In addition to sound business practice, there are at least three good reasons why universities should conduct regular royalty examinations. First, underpayments regularly arise for a variety of reasons. Second, other licensees will get the message, and the quality of royalty reporting will improve. Third, the university will have greater confidence in the licensee's attention to, and adequacy of, its royalty reporting.

Uncovering underpayments

There are as many reasons why underpayments occur as there are licensees. In our experience, most are unintentional. Why do such errors occur? Generally, such underpayments may be traced to several causes, of which the three most significant may be poor internal controls, poor communications, and ambiguous language in the agreement.

Poor internal controls of the licensee reflect the inattention of a licensee to the agreement. Simply stated, the licensee may not have designated anyone to have primary oversight responsibility for the accuracy of royalty payments, or may not have communicated internally the importance of reporting accurate royalties on a timely basis. In addition, many companies use integrated accounting software programmes that are very effective at taking orders, creating invoices, causing product to be shipped and receivables to be collected, but have no mechanism for identifying royalty-bearing sales and calculating the proper royalty resulting from such sales. In other words, the calculation of a royalty often involves the collection of data from different information systems that may then be manually entered to determine the royalty to be paid, leaving considerable potential for error.

A second fundamental reason why royalties often are underpaid is indirectly related to the first. Licensees frequently develop derivative products from the licensed technology. However, the fact that they are royalty-bearing is not communicated to the analyst preparing the royalty report. This problem is particularly acute in the licensing of both biotechnology and software. To illustrate the point, a patented biotech property is licensed and the licensee immediately incorporates the element into four of its products. For three years, sales grow. In the fourth year, sales of one of the products fall to zero and sales of the remaining three have flattened or declined. Normally, a licensor might not be concerned. However, in this case, the property had been licensed non-exclusively, and other licensees were enjoying growing sales. A review and comparison of the royalty reports of the other licensees quickly showed that most of them were reporting additional product codes on their royalty reports, suggesting that new licensed products were replacing the sales of older licensed products. In the subsequent examination, it was observed that the first licensee's product development personnel had never communicated the new replacement licensed products to the company's internal accountants, leading to a substantial amount of unpaid royalties.

For significant licensees, we recommend that the licensor obtains current product catalogues and performs occasional reconciliations between the products listed on the royalty reports and the products sold by the licensee. Such a reconciliation can identify possible products being sold where no royalty is remitted.

Another frequent cause of underpayments is the unclear or ambiguous language in the royalty and audit sections of the licence agreement. Licensors will, quite understandably, interpret the language in ways favourable to them. The licence terms must be very clear on exactly what the royalty rate applies to (eg the entire product sold by the licensee, just a portion of it, or a derivation of it) and how the royalty will be calculated. The agreement should also set out if there will be any transactions that will not produce royalties, such as products provided for testing or evaluation purposes. Be alert to ensure that the licensee is not providing your licensed product for free or at a large discount, if coupled to other products or services; although with respect to the latter, unless your licence agreement is explicit, the licensee may argue that discounts are permissible. Also, if sublicensing is allowed under the agreement, be sure to cover explicitly whether or not the licensee may issue essentially royalty-free licences as part of a cross-licensing arrangement. In the audit section of the licence agreement, ensure that the language permits a complete and thorough review of records and allows

interviews of key licensee personnel. The audit section should include such provisions as satisfactory books and records, audit periods, recovery of expense and interest, notice, access to key people, right of access to the manufacturing facility, right to copy documents, and a required retention period for records.

Sending a message to other licensees

A second benefit which licensors typically enjoy as a result of conducting regular royalty examinations is that licensees should begin to pay closer attention to the timing and quality of disclosure in their royalty reporting. This seems especially true where a technology is licensed non-exclusively, but also occurs where a licensor has issued multiple exclusive licences in different fields of use. One explanation for this is that licensees talk to one another. Once licensees learn that the licensor has conducted one examination or more, they are more likely to examine internally their royalty-reporting practices. They also may have reason to anticipate that the audited licensees (especially under a non-exclusive licence) will divulge information to the licensor concerning the propensity for other licensees to follow accounting or business practices that have the effect of reducing their royalties payable. After all, those licensees have no desire to see their competitors 'get away with' paying less, because it would place them at a competitive disadvantage.

Peace of mind

The third principal benefit to licensors is peace of mind. Licensors often express frustration that their expectations are not met by outcomes. In other words, they do not receive the royalties they think they should. This dissatisfaction is not likely to improve unless the parties address it directly. Ideally, the outcome of the royalty examination is that the licensor and licensee share a common understanding regarding interpretation of the royalty and accounting provisions of the licence agreement. The examination will permit the licensor to understand what the licensee is doing, and to adjust expectations if the licensee is reporting properly, or to influence the licensee's reporting behaviour so that it becomes consistent with the requirements of the agreement.

Thus, the main benefits from royalty examinations include possible cash recoveries, the communication to your licensees of your intention to protect your intellectual property, and greater peace of mind. Collateral benefits that a qualified examiner will provide in the process include tips on drafting audit clauses, tips on royalty provisions, help in selecting licensees to examine, and even assistance in identifying companies that may be interested in taking a licence.

Licensors' 'hot points'

Once the decision has been made to conduct one or more royalty examinations, the licensor is faced with three decisions, each of which may have real consequences for the licensing professional and the university. First, which licensees should be audited? Second, how should they be notified? And third, who should conduct the examination? The importance, and inter-relatedness, of the answers to these questions should be understood before conducting any examinations.

Selecting licensees for examination

The selection criteria employed by a licensor may encompass a variety of considerations, such as the amount of the royalty stream under the licence, the adequacy of the licensee's royalty reporting (quality, clarity, and timeliness), the nature of the reporting (degree of fluctuation between reports, or the extent of adjustments taken), or information regarding the licensee's practices that the licensing professional may have gained through one or more sources. All else being equal, licensees reporting in a clear and timely manner, showing evidence that some measure of care was used in determining and reporting the royalty, are less likely to warrant an examination. However, thoughtful licensors will maintain a database of royalty reports that permit the licensor to evaluate a licensee's royalty reporting over time, or, in the case of non-exclusive licensees, to compare and contrast the reporting of licensees.

In some cases a questionnaire may be useful for alerting licensees to the licensor's intention to scrutinize royalty reporting. Indeed, some licensees, upon reviewing a questionnaire, will undertake an internal review. In one examination conducted by a major accounting firm for a university, a licensee's questionnaire-inspired internal review resulted in a cheque to the licensor for a six-figure sum, representing over 25% of average annual royalties.

Giving notice properly

A second 'hot point' is the manner in which the licensee is notified of the impending examination. Some licensors think it is perfectly acceptable for the firm that is going to perform the examination to notify the licensee. However, hearing that an accounting firm is coming in to pore over the books and records is not a message the licensee should hear from someone it does not know. The licensing professional should notify the licensee in writing, with sufficient warning to permit the licensee to gather the materials the examiner will need. It is important to advise the licensee that it is not

being singled out. Instead, the royalty examination should be seen as part of the licensor's ongoing efforts to monitor its intellectual property. The explanation as to why the examination is warranted need not venture beyond sound business practice. Indeed, for public universities, there is a good argument that the university owes a duty to the public to assess the accuracy of licensing revenues.

Who will perform the examination?

A lack of internal auditing resources usually causes universities to retain outside audit firms. Many large accounting firms have professionals who have performed royalty examinations. However, licensors are strongly recommended to seek out firms with groups that specialize in royalty examinations. (They are not 'audits', remember!) If possible, interview the leader of the royalty-examination team to gain an understanding of their qualifications and their sensitivity to the special circumstances and needs of university licensors.

In addition, the examination work papers are private documents belonging to the public accounting firm. This would not be the case if the internal auditors of a public university were to perform the examination. Thus, using a public accounting firm means there is a greater likelihood that the examination work papers will remain confidential (one less objection for the licensee to make) than if a public institution's internal auditors were to do the work.

Public accounting firms will bill for their services. You should therefore obtain a letter of engagement that discloses billing rates and provides an estimate of budgeted fees. The fee arrangements a firm may use to bill for its services can vary. Billing for royalty examinations can be on an hourly, fixed-fee, or contingent basis. Many firms generally will be reluctant to bill on a fixed-fee basis, because they will have only a limited sense of the scope of work to be performed. While contingency fees may appear attractive at first, the situation can become complicated if the licensee learns about the billing arrangement, especially if the examiner appears over-zealous. If the licensee disputes the examiner's findings, will a provision requiring the licensee to pay for the audit, if under-reporting is found, be honoured? If the matter then goes into dispute resolution, how credible is the testimony of an examiner whose fees are tied to the outcome of the arbitration or trial? For these, and other reasons, the licensor should, in most cases, retain the Certified Public Accountant (CPA) on an hourly rate basis. To keep control the fees, the licensor should insist on a detailed work plan and frequent progress updates during the fieldwork.

What should an examiner do?

As a prelude to visiting the licensee, the examiner should review the licence agreement and any amendments, the royalty reports, and any relevant correspondence. The examiner should then develop a work plan. The initial interviews with the product development and accounting personnel should provide information as to the assumptions and documents used in preparing the royalty reports. At this point, the examiner should consider whether the licensee's approach appears consistent with the licence agreement. The examiner may then perform the procedures detailed on the work plan and prepare a report of preliminary findings for discussion with the licensor and the licensee. In communicating the results to the licensee, it is best to do so in a manner that achieves the licensee's 'buy-in' to the approach taken by the examiner in order to obtain payment for back royalties owed, and to get the licensee's cooperation in implementing procedural changes to improve reporting.

What should the licensor expect?

The examiner's report to the licensor should include:

- the scope of the engagement;
- the examiner's understanding of the licence agreement;
- the examiner's understanding of the licensee's accounting system; and
- the approach the licensee used to determine and remit royalty payments.

The report should set out the examiner's findings and the licensee's reactions to the examiner's conclusions and recommendations.

Summary and survey

University licensing professionals face a difficult decision in whether to examine the royalty-reporting practices of their licensees. By selecting qualified professionals and giving notice properly, the licensing relationship is less likely to be compromised In our experience, the benefits of conducting examinations unquestionably outweigh the costs.

The results of our survey of attendees of the 1997 Annual Meeting of the Association of University Technology Managers are presented below. The purpose of the survey was to determine what universities were doing with respect to royalty examinations and how they were doing it. Our findings confirmed certain preconceptions and shed valuable light on other issues of concern. While virtually all

universities include a right to audit in their licences, only slightly more than half of the respondents have ever exercised that right; of those, only about 13% have conducted more than three separate royalty examinations.

The primary reason for conducting examinations appears to relate to the inadequacy (timing, quality, completeness, etc) of the licensee's royalty reporting. Of those who had not conducted examinations, most felt they had never been given a compelling enough reason to do so. Surprisingly few said the cost of the procedure was prohibitive. Indeed, the majority of responses understood that a thorough royalty examination could result in fees of $20,000 or more. Almost 90% of the respondents turned to 'Big 6' accounting firms, while 20% sought assistance from smaller firms or from their own internal audit staff (ie certain licensors used 'Big 6' firms in one matter and a smaller firm in another). A significant majority, 83%, engaged the firms on an hourly-rate basis, with the balance paying for the work on a fixed-fee or contingent basis.

The area of the survey about which we were most curious concerned the interest on the part of universities licensing the same or similar technologies to a common licensee to 'band together' to share audit costs. We were encouraged to find that 65% of the survey respondents saw merit in this concept. The potential for cost savings when auditing agreements which are unlikely to be audited on a stand-alone basis suggests that this approach could be attractive to many universities. We expect this question will receive further consideration as the volume of agreements and amount of royalty income increases over time.

Survey questions

1. *Do your licence agreements include an audit provision?*
   Yes: 100%. No: None
2. *If 'yes' to Question 1, have you ever exercised the audit provision of one of your licences?*
   Yes: 55%. No: 45%
3. *If 'no' to Question 2, what reasons can you give for not ever having done so?*
   78% said they never had a good enough reason to audit. 44% said the amount of royalties did not justify an audit. 30% said they were concerned about damage to the relationship with the licensee. 11% said the cost of the audit would not justify the effort.
4. *If 'yes' to Question 2, approximately how many separate examinations have been performed by your institution?*
   87% had conducted between one and three separate examinations. 13% had conducted more than three separate examinations.
5. *If your institution has performed royalty examinations, how were those licensees selected?*
   83% stated that inadequate royalty reporting had prompted an examination. 66% said the size of the royalty payments warranted an examination. 40% credited their own research or feedback from third parties. 11% stated that the length of time the licence agreement was in place had prompted the examination.
6. *Do you commonly include the following provisions in the audit provision in your licence?*

Right to audit	100%
Audit fees may be paid by licensee	80%
Use independent CPA firm	80%
Frequency of audit	75%
Identify documents available during exam	70%
Licensee may pay interest on balances	65%
Exam results will be confidential	60%
Examiner may make copies of documents	20%
Examiner may interview selected personnel	10%

7. *Who conducted the examinations for you?*

'Big 6' CPA firm	18%
Other accounting firm or internal auditors	20%

8. *Where you have retained outside firms to perform examinations, how have their fees been charged to the project?*

Hourly rates	83%
Fixed fee or contingent fee	16%

9. *Would you consider 'banding together' with other universities licensing the same/similar technologies to perform royalty examinations of a particular licensee in an effort to save costs if the accountants' costs could be split among the universities?*
   Yes: 65%. No: 35%
10. *Would you be willing to exchange information with licensing professionals at other institutions to identify potential licensees which could be the focus of a 'joint' royalty examination?*
    Yes: 75%. No: 25%
11. *What would you consider to be a reasonable fee for a royalty examination of a single company?*
    A variety of figures was provided; the most frequent responses were in the $10,000 – $20,000 range, with a maximum of $50,000

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