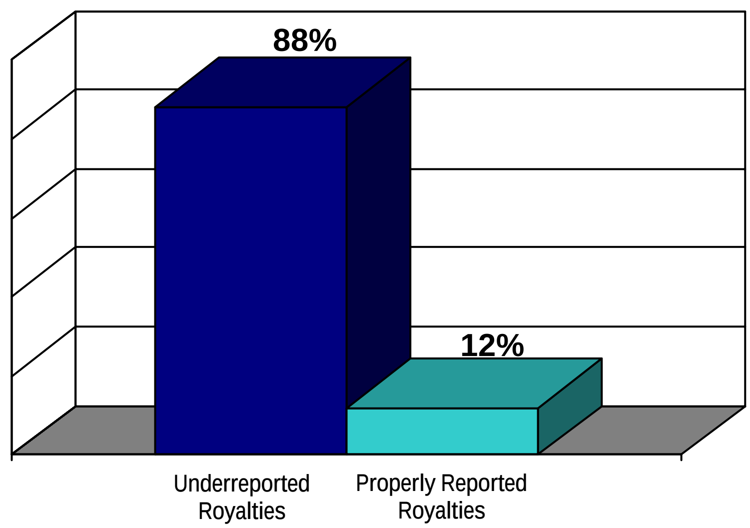
The Significance of Underreported Royalties:
Royalty Audits Produce Bottom Line Revenue

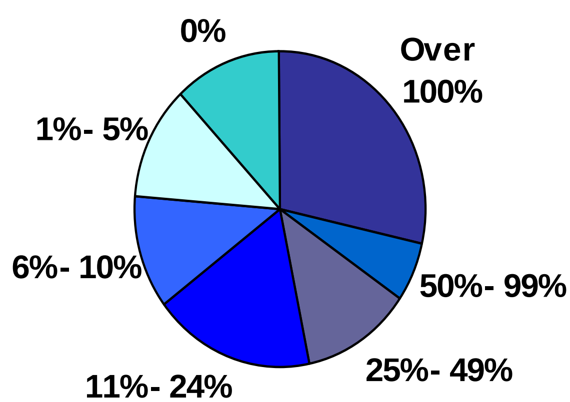
by Debora R. Stewart, CPA and Judy A. Byrd, CPA

With estimated annual IP licensing revenue in the United States at more than $120 billion, unrealized revenue from underreported royalties may be significant. Invotex Group studied licensing relationships to measure the frequency of underreported licensing revenue and the impact of such underreporting on a licensor's ultimate financial results. Ineffective management often results in licensors collecting much less than they are owed. The report discusses the results of a study and examines causes of underreporting.

88% of licenses have underreported royalties



Nearly 50% of licenses have underreported royalties in excess of 25%*



** For example, in almost half of the cases reviewed, a licensee with reported royalties of $100,000 should instead have reported royalties in excess of $125,000. In more than 25% of the cases reviewed, actual royalties were double the reported amounts.*

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Introduction

Intellectual Property (IP) license revenue is one of the most significant and fastest-growing sources of revenue in the U.S. today. Current estimates place annual IP revenue in the United States at more than $120 billion. Even though IP revenue continues to constitute ever higher portions of overall revenue, ineffective management of such revenue often causes licensors to collect much less than they are owed. Invotex Group, a national intellectual property management firm, has undertaken an analysis of numerous licensing relationships to measure the frequency of underreported licensing revenue and the impact that such underreporting has on a licensor's ultimate financial results.

An Underutilized Resource

In spite of its current materiality and growing significance, IP license revenue remains one of the most poorly managed and underutilized assets in America. This is problematic not only because of the obvious effect on the licensor's bottom line, but also because today's regulatory environment is one of increased scrutiny, characterized by substantial changes embodied in legislation such as the Sarbanes-Oxley Act.

Although not specifically directed to IP assets, Section 302 of the Sarbanes-Oxley Act requires CEOs and CFOs to certify the financial information presented in their annual and quarterly reports as fairly representing the financial condition of the entity. In addition, Section 404 requires companies to implement and maintain increased controls over their assets, as well as maintain documentation that certifies internal reporting procedures and controls. Companies also must comply

About Invotex Group

Invotex Group provides advisory services for intellectual property owners, including licensing, technology evaluation, license compliance and royalty audits, asset management and enforcement of IP rights. The firm offers a comprehensive suite of services to provide the strategic and tactical expertise necessary to optimize IP value throughout its lifecycle. Specifically, Invotex monitors licenses for compliance to help clients maximize the value and revenue generated by their IP. For more information about Invotex Group, please visit www.invotexgroup.com.

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with the requirements of recent Financial Accounting Standards Board pronouncements 141 and 142, which require companies to measure and report on acquired intangible assets.

If increased regulatory pressure alone does not motivate executives to pay more attention to their IP, consider the following facts:

- Intangible assets represent 87% of the Standard & Poor's market capitalization today, compared to 62% in 1992 and 38% in 1982.
- Although more than $100 billion is collected annually in intellectual property licensing income, more than $200 billion is written off from intellectual property impairments and more than $300 billion is registered in unpaid infringements.
- Companies with intellectual property are more than twice as likely to survive as those without intellectual property.[1]

Despite regulatory requirements and the increasing importance of IP in today's competitive business environment, most organizations lack clear delineations of responsibility with respect to the collection and monitoring of license payments. In addition, many organizations are not even aware of all the royalty-bearing licenses to which they are a party. Organizations that are not proactive in terms of managing royalty income may find themselves in a situation similar to that of the National Institutes of Health (NIH), which in the year 2000, was forced to respond to a report issued by the U.S. General Accounting Office (GAO) entitled, "Financial Management: Improvements Needed in NIH's Control Over Royalty Income."[2]

Proper management of an IP license portfolio necessitates the implementation of a comprehensive royalty compliance program. Some may argue that simply monitoring royalty reports and payments is sufficient in terms of evaluating a licensee's adherence to the payment terms under a license agreement. Many professionals disagree. Managing the licensee relationship requires persistent proactive communication, a healthy dose of professional skepticism, interview skills, the ability to read and comprehend complicated legal agreements as well as math acumen for complicated calculations. License compliance, when done properly, can be extremely time-consuming and may surpass the resources and expertise of an in-house licensing department.

Hiring an independent external compliance auditor to undertake a royalty audit will, in most cases, increase identification of underreported license revenue. While some may view the cost of outsourcing this function as prohibitive, our study proves the recovery of underreported royalty revenue from these efforts more than covers the cost of the

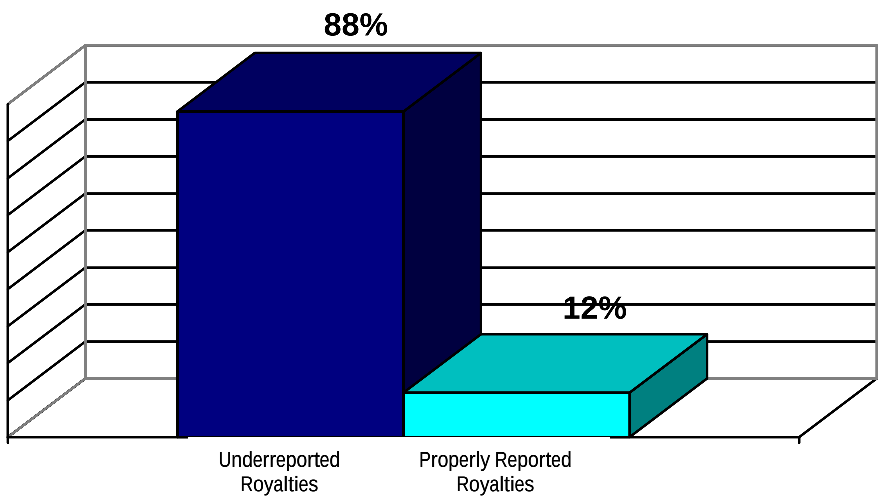
[1] www.usa-canada.les.org/chapters/fairfield/6.24_Newspaper_Article.pdf
[2] State Science & Technology Institute Weekly Digest, August 18, 2000

examination. In addition, auditors can provide guidance by prioritizing those licensees where the likelihood of underreporting is highest, and many are willing to work on a success fee basis.

<u>The Invotex Study</u>

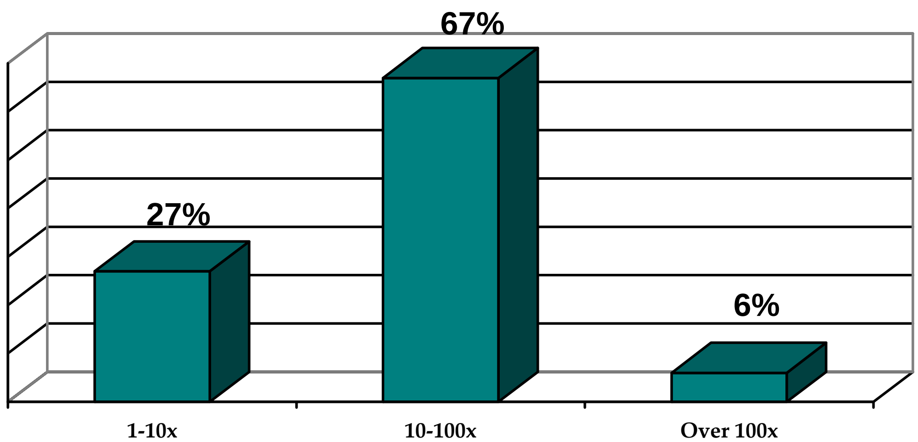
How does ineffective management of license revenue really affect an entity's bottom line? To answer this question, Invotex Group conducted royalty audits of certain licensing relationships to determine the pervasiveness and ultimate impact of revenue underreporting. Our analysis shows that 88% of the royalty audits conducted uncovered royalty underpayments. *See Figure 1*. In our study, reported royalties, during the period audited, ranged between approximately $5,000 to approximately $15.2 million, and the range of underreported royalties was $0 to approximately $6.2 million.

Figure 1: Percentage of Licenses with Underreported Royalties



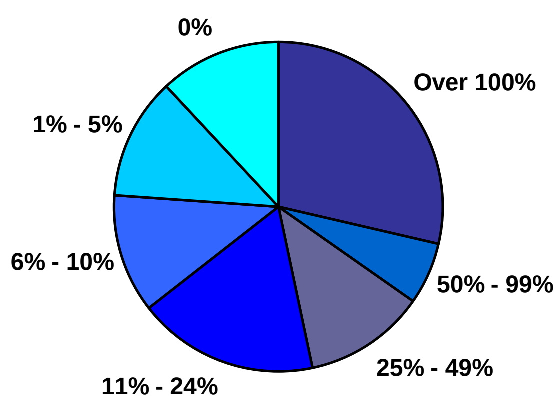
In each audit where underpayments were uncovered, the magnitude of the underpayments more than offset the cost of the audit. *Figure 2* provides data regarding the return on audit fees as demonstrated by our dataset.

Figure 2: Return on Audit Fees



The value of a royalty audit cannot be understated. For example, GAO found that "While NIH reported $45 million in royalty income in fiscal year 1999, the one audit conducted revealed previously uncollected royalty payments of $9.2 million and the expectation of an additional $1.2 million."[3] Based on our study, total underreported royalties far exceeded total reported royalties. *See Figure 3.*

Figure 3: Underreported Royalties as a Percent of Reported Royalties



We also analyzed the underlying terms of the license agreements in our study. The results showed that 73% of the license agreements contained clauses whereby the licensees were responsible for the audit fees if a certain threshold was met, with the approximate average threshold equaling nine percent. Therefore, if an audit uncovered underreported royalties equal to nine percent or more of total reported royalties, the

[3] State Science & Technology Institute Weekly Digest, August 18, 2000

licensee would be responsible for the cost of the royalty audit. In 87% of the royalty audits where the license contained this payment responsibility clause, the threshold was met, meaning responsibility for the payment of the audit fees transferred to the licensee.

Reasons for Underreported Royalties

Royalty underpayments can result from various causes including, but not limited to, human error, deliberate omission of royalty-bearing sales, or a lack of understanding of the terms of the license agreement. Our dataset shows that, generally, the underreporting uncovered by the royalty audits was not caused by one factor alone. The two most common reasons for underreporting were: (1) the licensee added new products and did not include these products in its royalty reporting and (2) the licensee incorrectly apportioned the licensed product value for reporting purposes. Other examples of the causes of underreporting are:

- Intentional unreported product sales
- Use of a royalty base comprising sales at prices other than third party prices
- Omitted sales to entire region/territory
- Omitted sublicense revenue
- Over-reported deductions from gross sales

Conclusion

Your intellectual property is unique and valuable to your organization. It is your responsibility to protect and maximize the value. In today's regulatory environment, mismanagement can carry greater penalties than loss of revenue.

Clearly, the benefits of a royalty compliance program greatly outweigh the costs of implementation. First, any recovery of underreported license revenue goes straight to a company's bottom line. Second, conducting a royalty audit sends a clear message to licensees that underreporting will not be tolerated.

As a part of this program, royalty audits not only increase compliance from licensees (both the audited licensee and others), they also promote the accuracy of future royalty remittances and engender a healthier relationship between licensor and licensee. Furthermore, audits may allow for the recovery of interest and audit costs if such provisions exist in the underlying license agreement.

Companies put forth a great deal of effort in negotiating licensing agreements, but ongoing monitoring has taken a back seat to continued efforts to enter into new license agreements. As our study shows, enforcing your license agreements is as important as negotiating them.