



Underreported Royalties Could Lead To SOX Problems

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Four years after the passage of the Sarbanes-Oxley Act, which requires executives to sign off on corporate financial data, many companies are still inadvertently underreporting the value of their intellectual property royalties, according to a survey of royalty streams conducted by a data research group.

The study showed a vast majority of patent licensing agreements lead to underreported royalties worth billions of dollars. According to the researchers, pinpointing the problem early could save a lot of time and money by avoiding litigation and keeping regulators at bay.

Conducted by Maryland-based IP management firm Invotex Group, the non-scientific study showed that a staggering 88% of licenses lead to underreported royalties. Annual IP licensing revenue in the United States is estimated at more than \$120 billion and unrealized revenue from the agreements could be an even larger figure.

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

Regular IP audits may be a way to meet those requirements and increase revenue from royalties at the same time, according to the study.

"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," said Invotex researchers Debbie Stuart, who conducted the study along with Judy Byrd.

Analysis of the data showed the underreporting was caused by a combination of human error

and the deliberate omission of royalty-bearing sales. In addition, the underreporting was often caused by a simple lack of understanding of the terms of a license agreement.

Specific reasons included the intentional underreporting of product sales, the omission of sales from an entire region or territory, the omission of sublicense revenue and the overreporting of deductions from gross sales.

The analysis covered a range of license agreement, ranging in value from \$5,000 to more than \$15 million. The range of underreported royalties was between \$0 and \$6.2 million.

The \$6.2 figure was the result of royalties for a certain product the licensee suspected was being underreported. While Invotex was investigating that product, it uncovered several other products that should have fallen under the agreement, which the licensee wasn't even aware of.

"That was a huge surprise to our client," Stuart said, adding that in cases where certain sums are recovered, the licensee is responsible for paying the cost of the audit.

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

While studying licensing relationships to measure the frequency of underreported licensing revenue and the impact of the underreporting on financial results Stuart and Byrd realized a lack of communication is often to blame.

"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," Stuart said.

Underreporting may also go unnoticed by licensees because the safeguards built into licensing agreements are often not taken advantage of, according to attorney Lee A. Goldberg, partner at Brown Raysman Millstein Felder & Steiner LLP in New York.

"Often times, the terms of a license agreement will say 'you have the right to audit our books' but for a lot of companies, that's not their priority – especially if IP royalties are not the company's main source of income," Goldberg said.

Stuart agreed with that prognosis, but suggested there is more at stake than the perceived value of an audit.

"That is accurate," Stuart said, "If a company has \$1 billion in revenue, a few million dollars of underreported revenue isn't material. But in this day and age, a company has a responsibility

to maximize its assets," Stuart said.

The study, conducted to prove the benefits of a royalty compliance program, suggests the benefits greatly outweigh the costs, according to InvoTex. Although the survey wasn't scientific, the researchers are confident the data is representative of the state of IP licensing agreements.

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 9%.

Therefore, if an audit uncovered underreported royalties equal to 9% or more of total reported royalties, the licensee would be responsible for the cost of the royalty audit. In 87% of the royalty audits where the license contained such a payment responsibility clause, the threshold was met.

"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," Stuart said.

--By Erik E. Larson, erik.larson@portfoliomedia.com