A Crash Course on Royalty Audits
the Road to Recovery

Presentation to the D.C. Chapter of the Licensing Executives Society
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Overview
• License agreements are the codification of a business relationship entered into for the benefit of both parties

• Many agreements are complex and highly negotiated while others are standard, such as those found in the publishing industry.

• In both cases, it is often left to others in the organization to calculate royalties, many of whom many have never seen the actual agreement.

• Licensors / IP Owners may not conduct a royalty audit unless fraud is suspected, however most of the underreporting is not intentional.
What is a Royalty Audit?

The right to review royalty calculations is not automatic – it may be contractually granted.

A royalty audit involves the review of the licensee’s underlying financial information used to calculate royalties and generate royalty statements.
Why Perform a Royalty Audit?

Maximize future revenue generation

Eliminate feelings of uncertainty

Royalty calculations can be very complex

Underreporting is can be in the range of 15-30%

Right the ship

Confirm integrity and competence of licensee
How Far Back?

Statute of Limitations for Breach of Contract Claims that govern agreement

6 Years
New York

4 Years
California

6 Years
Massachusetts

10 Years
The “I” States

Or We will maintain relevant records with respect to any royalty statement we provide to you under the Agreement for a two-year period from the date of the statement. Royalty statements will be final and binding upon you unless, within two years from the date of the statement, you object to such statement in a writing which states the specific objection and the basis for such objection.
9. Paragraph I(6) of the Agreement is hereby amended by deleting it in its entirety and substituting the following:

"Upon written request and at a mutually convenient time after the request, and during ordinary business hours, the Author or a professional representative may examine the Publisher’s books and records relating to the Work at Publisher’s offices. During said examination, the Publisher shall promptly provide Author or the representative all documentation requested that is customarily provided to an auditor in the textbook publishing industry necessary to a complete audit”.

2. Upon giving the Publisher reasonable written notice, the Author may, at the Author’s own expense, examine or cause to be examined through certified public accountants the books of account of the Publisher in so far as they relate exclusively to the sale or licensing of the Work, or otherwise relate to the computation of royalty payments or other payments under this Agreement; provided any such audit shall be conducted no more frequently than one time per calendar year, and shall be conducted where the Publisher maintains its books and records, at reasonable times so as not to disrupt the Publisher’s business operations. If, with respect to any royalty statement inspected, such audit discloses an error to the Author’s disadvantage, to the extent it is undisputed, then the Publisher shall promptly pay the Author the balance due. The Author and the Author’s accountants shall treat any and all information obtained as a result of any audit conducted pursuant to this Section confidentially, except as necessary to enforce the Author’s rights hereunder. Statements rendered by the Publisher will be final and binding upon the Author two (2) years after the date rendered unless before the end of such period the Author delivers to the Publisher specific written objections to the statement.
4.6 Audit. The independent auditor may examine Licensee's books and records to verify royalty calculations, Gross Revenues, and sales records regarding Licensed Products sales. This audit may only be done during Licensee's usual business hours and upon reasonable notice. The Licensee shall pay the cost of such examination unless underpayment exceeds 5%. In such case, Licensee shall pay the reasonable cost of such audit.

3. The Licensee agrees to keep full and accurate books of accounts, records, data, and memoranda based on the manufacture and sales of each individual ITEM in sufficient detail to enable the payments to be determined, and further gives the right, at expense, to examine said books and records, insofar as they concern each individual ITEM and not more often than once in any calendar year, for the purpose of verifying the reports provided for in this Agreement. In the event that the Company shall examine the records, documents and materials in the possession or under the control of with respect to the subject matter, such examination shall be conducted in such reasonable manner as to not unduly interfere with the business of and its representatives shall not disclose to any other person, firm or corporation any information acquired as a result of any such examination; provided, however, that nothing herein contained shall be construed to prevent and/or its duly authorized representatives from testifying, in any court of competent jurisdiction, with respect to the information obtained as a result of such examination in any action instituted to enforce the rights of under the terms of this Agreement.
G) Books and Records.

[Redacted] and its AFFILIATES shall keep books and reasonable supporting documentation, according to standard accounting practices and standards, to determine the accurateness of the items reported in the reports required under paragraph H) below. [Redacted] and its AFFILIATES shall keep such books and documentation at its principal place of business for five (5) years following the end of the calendar year to which they pertain (and access shall not be denied thereafter if reasonably available). [Redacted] AND [Redacted] LICENSOR, may retain an independent [Certified Public Accountant] to inspect such books and documentation to verify [Redacted] its AFFILIATE’S, (and in the case of a SUBLICENSSEE, a SUBLICENSSEE’s) earned royalty statements or [Redacted]’s, its AFFILIATE’S or its SUBLICENSSEE(s)’, if any, compliance in other respects with this Agreement. Such inspection shall take place during ordinary business hours and upon reasonable prior notice to [Redacted] on the frequency of no more than once per calendar year. If any such inspection discloses an underpayment of earned royalties of 5% or more of the amount of royalties actually due for any quarterly period, then [Redacted] shall promptly pay the reasonable cost of such inspection after [Redacted]’s receipt of the bill/invoice for such inspection. [Redacted] shall require its AFFILIATES to keep such books and documentation to enable [Redacted] to comply with this paragraph and shall impose similar requirements on SUBLICENSSEEES to keep such books and documentation to enable SUBLICENSSEEES to comply with this paragraph. It is understood and agreed that any inspector or auditor conducting such an audit shall not be allowed to make copies of any of the documentation without the written consent of [Redacted] its AFFILIATE or SUBLICENSSEE, as the case may be. If such disclosure of records takes place, it shall be bound by provisions of confidentiality with respect to any third party.
Red Flags

- Calculations in reports that are not supported
- Insufficient detail
- Licensee’s inability to answer questions
- Late payments
- Escalation payments not in accordance with contract clauses
- Payments not as high as expected based on discussions with marketing
- Repeated incorrect calculation
- Licensee’s poor internal controls
- Change in accounting software
- Change in royalty accountants / change in contact with knowledge of license
- Business mergers / acquisitions (change in ownership)
Getting to Work – The Audit
Audit Phases

1. Preparation Phase
2. Paperwork Phase
3. Communication with Licensee
4. Document Analysis
5. Licensee’s Response
6. Dispute Resolution
Preparation Phase

- Talk to Client
- Review Contracts
- Review Statements
## Document Analysis

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<tr>
<th>Rates</th>
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<td>Subsidiary Rights</td>
<td>Price per Unit Over Time</td>
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<td>Types of Sales Over Time (channels or product types)</td>
<td>Overall Revenue Trends</td>
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<tr>
<td>Overall Unit Sales Trends</td>
<td>Deductions</td>
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Results of the Audit
June 9, 2020

Publisher
Address 1
Address 2

Re: Professor X Royalty Audit Findings

Dear Ms. Doe,

We have completed our preliminary review of the royalties paid to Professor X for the following titles:

- July 1, 2011 through June 30, 2017
  - General Science 1st through 5th editions
- July 1, 2014 to June 30, 2017
  - General Science 6th and subsequent editions
- Any associated supplements and/or versions and editions, in all mediums, including, but not limited to textbooks, ebooks, or any other author content for all English and translated editions (both completed by Publisher affiliates and third parties), as well as custom publishing derivatives.

Based upon our preliminary review, we have determined that Publisher Education (“Publisher”) has underpaid the Author $1,392,081 in royalties, including interest. Below is a summary of our findings:

1. Custom Editions
   We have calculated the amount owed to Professor X from underpayment of the use of this content to be $107,879, before interest.

2. Derivative product royalties

   Therefore, under the, Professor X is owed royalties in the amount of $824,562, before interest.3

3. Works with no reported revenue
   Amount underdetermined.

4. Interest
   We calculated interest of $459,641 on the additional royalties owed to Professor X.

Our findings are based upon calculations performed from data provided by Publisher related to Professor X’s audit request. Ankura’s findings are preliminary and represent our analysis to date. We are continuing our analysis of the information provided and reserve the right to supplement our findings.

Thank you for your assistance with this audit. We look forward to your response.

Best Regards,

1 See enclosed Professor X Audit Findings spreadsheet, summary tab
2 See enclosed Professor X Audit Findings spreadsheet, Schedule 2.0 and Schedule 2.1
Common Errors:
- Incorrect Royalty Base
- Underreported Sales
- Excessive Price Discounts
- Inappropriate Deductions
- Unaccounted Production
- Misapplied Conversion Rates
- Inappropriate revenue attributions (bundles)
- Unreported Distribution Channels
- Transfer Pricing Miscalculations
- Misunderstanding of License Agreement
- Non-escalation of Royalty Rates

Due to:
- Lack of Understanding
- Human Error
- Poor Tracking Systems
- Deliberate Omissions
Results of the Audit

Two types of findings

1. Clear mistakes and/or miscalculations
2. Disagreement over contract interpretation

Report may be formally written or simply schedules

Findings may be actual or some estimate of underreporting
  - Depends on amount of data analyzed

Report of findings may facilitate production of documents
Road to Recovery
Resolution

- Negotiation
- Mediation
- Arbitration
- Litigation
Litigation Considerations

- NDA Restrictions
- Fee Structure
- Qualifications of Auditor
- Fact or Expert Witness
STATEMENT ON STANDARDS FOR FORENSIC SERVICES

Statements on Standards for Forensic Services (SSFSs) are issued by the Forensic and Valuation Services Executive Committee (FVS Executive Committee). The FVS Executive Committee provides guidance and establishes enforceable standards for members performing certain forensic and valuation services. The AICPA Council has designated the FVS Executive Committee as a body to establish professional standards under the “Compliance With Standards Rule,” found in ET sections 1.310.001 and 2.310.001 of the AICPA Code of Professional Conduct. Members should be prepared to justify departures from this statement (ET sec. 0.100.010).

9. A member engaged as an expert witness in a litigation engagement may not provide opinions pursuant to a contingent fee arrangement, unless explicitly allowed otherwise under the “Contingent Fees” (ET sec. 1.510).
Juli Saitz is a Senior Managing Director at Ankura and is based in New York. She has 20 years of experience in providing forensic accounting and financial and economic analysis to attorneys in litigation. Juli specializes in commercial disputes matters and has significant experience providing financial consulting services relating to financial analysis and damage analysis in a variety of industries including hospitality, consumer products, manufacturing, and entertainment. She has performed financial analyses relating to profit calculations, additional cost claims, incremental profit analysis, licensing and royalty determinations, manufacturing and marketing capacity, fixed and variable cost analysis, allocation of costs, evaluation of forecasts and projections, and product line profitability.

Prior to joining Ankura in 2015, Juli was a managing director at FTI Consulting. While at FTI, Juli developed and implemented a global royalty compliance program for a Fortune 100 company to monitor and protect its trademark and patent royalty streams. In post–merger scenarios, she assisted buyers, sellers, and neutral arbitrators in working through capital disputes.

Juli joined KPMG in 2001 and worked on a wide variety of projects prior to its acquisition by FTI Consulting in 2003. Juli provided economic analysis for one of the country’s largest police unions in an important contract negotiation. She led a large team in connection with a widespread document retrieval exercise as part of a broad discovery request. In addition, Juli worked on a number of patent infringement cases in a variety of industries in support of nationally recognized experts.

From 2000–2001, Juli worked in Silicon Valley as a senior general ledger accountant for the startup, GetThere.com. In addition to her regular general ledger responsibilities, Juli developed the company’s revenue recognition policies and procedures and implemented a program for managing and depreciating the company’s fixed assets. GetThere.com was acquired by The Sabre Group.

Juli began her career at PricewaterhouseCoopers in the financial advisory services practice in New York in 1997. As an associate and senior consultant at PwC, she assisted on a variety of matters, including working as part of a court-appointed neutral accounting team in a highly-publicized divorce case, class action settlement administrations, large scale accounting investigations, and full-scope financial statement audits.