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Accountants and
Business Advisors

Risk Assessment Approach to Evaluating the Need for a Royalty Audit

While royalty and profit participation agreements can provide tremendous income opportunities for many in the entertainment industry, ensuring they are administered fairly can be challenging. Those that license intellectual property must ensure that their property rights are protected and that royalty statements are accurate. Failure to effectively review or audit reports and payments can result in underpayment or even misuse of intellectual property.

Under licensing agreements, individuals, companies, and other entities with intellectual property rights ("licensors") receive royalty statements from production and distribution companies ("licensees"). The licensing agreements determine when, where and how the licensee can use the property and provide methods for determining payments due to licensors. But how can those who license property ensure they are being compensated correctly.

A systematic plan for review of royalty statements is the only way for licensors to protect their rights and maximize income. Companies who license property to numerous parties should develop a risk assessment framework to help them monitor licensees. Well-designed risk assessment programs can identify potential problems and reveal when detailed audits of royalty and profit reports are needed.

In addition to risk assessment programs, licensors should consider working with royalty audit experts to prevent revenue slippage and ensure the integrity of intellectual property. Properly identifying risk factors can help licensors focus on auditing licenses which pose the greatest risk.

As part of your process to assess the need for an audit, consider the following:

Statement Risks

Statements in the Black Pose Greater Risk
Licensees are more likely to focus on statements once actual cash changes hands. Once you are being paid in excess of the initial advance or minimum guarantee, licensees are more likely to delay reporting of revenues or over-report deductions. New entries added soon before or immediately after the recoupment of the initial advance may represent a red flag.

Identify Inconsistencies with License Agreements
There is significant risk involved in the development of statement templates by licensees. Statements are often handled by individuals who were not directly involved with drafting the license agreement, so misinterpretation of terms can be common. Licensees may also subjectively interpret terms in their favor, resulting in under-statement of royalties. Statements should be reviewed for improper application of the agreement terms.

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Look for Unusual Entries on the Statements

When licensees issue a high volume of statements with limited staff, quality control can suffer. Look for entries which are out of the norm such as negative revenues and unfamiliar deduction accounts. These may indicate risk that the integrity of the statement has been compromised.

Licensing Agreements Risk

Complex License Agreements Pose Greater Risk

More complex agreements generally have a higher risk of errors. Complex agreements should be considered for periodic royalty audit by experienced professionals.

Beware of Multiple Versions of Licensing Agreements

If an agreement remains unsigned due to unresolved differences, there is risk that the licensee may be applying their preferred terms. Be aware of the differences between agreement versions, and scan statements to identify instances where the licensee has reported in a manner different from your expectations.

Watch Out for Expiring Audit and Tolling Rights

Remember that the licensee is unlikely to warn you before your audit or tolling rights expire. While you may have concerns about the statements, once your audit rights expire, it may be too late. Consider evaluating the need for an audit prior to the expiration of your rights.

Changing Markets Give Rise to New Risks

New Media Reporting (if applicable):

In recent years there has been a growing risk of underreported new media revenues. Licensee systems and processes have yet to be upgraded to account for new media revenues. In many cases, licensing agreements do not even address new media, resulting in potential underreporting of revenues. Agreements and statements should be reviewed to ensure the accuracy of new media revenues.

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Licensee Changes Give Rise to Risk

If a licensee is going through a significant internal change (such as a merger, lawsuit, change in leadership, or system change), their quality controls in statement issuance could be compromised. Significant change within a licensee organization may lead to increased risk and the need for an audit.

Implementing a risk assessment program will help you systematically identify these and many other risks. If any risks are present, you may want to consult with a royalty auditor to evaluate the possibility of performing an audit on your behalf. &

For additional information or questions regarding the content in this newsletter, please contact:

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