

Chapter 23

Royalty Audits and Contract Compliance Investigations

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Droverai no proverai (Trust but verify)

—President Ronald Reagan to General Secretary Mikhail Gorbachev during Intermediate Nuclear Force Treaty negotiations

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23.1 Introduction

When one party (the *grantor*) enters a contract granting certain rights to another party (the *grantee*), both parties have an initial expectation of trust and mutual benefit.¹ Even so, most of these contracts allow the grantor to verify the grantee's performance. Contracts subject to licensing management programs should include contract compliance provisions (also known as *audit rights*) to ensure their effectiveness. Practitioners often use the term *royalty audit* to describe contract compliance investigations that relate to the enforcement of certain intellectual property rights.² Grantors also use contract compliance investigations to enforce non-intellectual property rights such as the use of certain real estate assets or back-end contingent compensation agreements. Contract compliance investigations are different in scope and purpose from other types of investigations, such as investigations that address potential or suspected fraudulent activity.

In most cases, grantors perform royalty audits and compliance investigations in the normal course of business, outside the scope of litigation. If litigation becomes necessary to resolve remaining issues, the standards and methods of the investigation can become a material factor that affects whether the trier-of-fact upholds or rejects the proffered claims. This chapter provides the expert, whether presenting claims or rebutting them, with an understanding of best practices in the conduct of contract compliance investigations.

The chapter first discusses the various types of rights that these investigations enforce and why the grantors decide to conduct the investigations. The chapter then distinguishes between contract compliance investigations and financial statement audits, as they relate to accounting and professional standards. Finally, the chapter reviews

certain testing procedures that practitioners often perform and other issues that financial experts consider, based on specific industry or other identified risks.

23.2 Rights Commonly Subjected to Contract Compliance Investigations

Some contracts contain clauses that require contingent compensation payments to the grantor, expense reimbursements to the grantee, or both. Other contract clauses set certain performance expectations for manufacturing, distributing, marketing, or other business functions that could have specific financial ramifications if the grantee does not meet those expectations. The agreement could subject each type of contract clause to a contract compliance investigation, depending on the relative priorities established by the grantor.

The examples below highlight various types of contractual relations for which grantors use contract compliance investigations.

(a) Intellectual Property Royalties and License Fees

Licenses for the use of some intellectual property—including patents, copyrights, and trademarks—typically involve the payment of royalties or license fees. Sometimes the grantee pays these royalties as up-front lump sums, but most often they pay royalties as contingent compensation (e.g., as a percentage of net sales or a set monetary amount per net unit sold). Examples of these intellectual property licenses include the following:

- Patents for pharmaceutical and high-tech products
- Copyrights and trademarks for entertainment content and related consumer products
- Trademarks and trade secrets for franchising operations

(b) Other Contingent Compensation Arrangements

Contracts for the use of some real estate or for some goods or services also involve the payment of contingent compensation. Most often the payments reflect a flat or sliding-scale per-unit fee, but occasionally the parties structure these payments as lump sums. The following lists examples of these rights:

- Oil and gas mineral rights
- Rights to use commercial real estate (e.g., a percentage of the revenue instead of a fixed-fee rent)
- The rights to rebroadcast television content by cable or satellite providers to their consumers
- Profit participation rights held by talent (e.g., actors, directors, and producers) in motion picture and television content

(c) Construction, Design, and Commercial Overhead Costs

Contracts for the construction or design of a real estate project often allow the reimbursement of out-of-pocket costs plus a fixed or variable fee for the project manager. In addition, some commercial real estate landlords allocate general and administrative overhead costs to the tenants. In each of these cases, the agreement often subjects the reported reimbursable costs and additional fees to a contract compliance investigation.

(d) Development, Distribution, and Marketing Agreements

Some companies collaborate on the development, distribution, or marketing of certain products. For example, suppose a joint venture produces a pharmaceutical product and splits the various worldwide territories between two joint venture partners, giving them reporting responsibilities for the contingent compensation payable between them. In such a case, the agreement could subject the activity of both partners to contract compliance investigations.

In other cases, the terms for providing development, distribution, or marketing services could allow for the reimbursement of out-of-pocket expenses plus some sort of fixed or variable fee, which is subject to investigation.

(e) Most Favored Nations Provisions

When a vendor or distributor has agreements with multiple customers or suppliers, these agreements can include most favored nations (MFN) provisions, which prohibit the vendor or distributor from providing favorable terms to one but not all of its customers, such as a preferred price that does not exceed that provided to other customers of that vendor. The agreement terms for the various customers, as well as how these terms apply to transactions between the vendor or distributor and its customers, may be subject to a contract compliance investigation. Such an investigation can occur before or after the relevant transaction period has commenced.

23.3 Reasons for Contract Compliance Investigations

Investigations offer several benefits, both short-term (e.g., an immediate increase in proceeds from the grantee) and long-term (e.g., the resolution of operational and reporting issues or an affirmation of the grantee's compliance). In each case, the following questions shape the grantor's business decision:

- Will the costs of performing the investigation exceed the value of the expected benefits?
- What costs could arise if I do not perform the investigation?

Of course, the answers to these questions depend on many factors, including the grantor's short-term and long-term business goals. A grantor could have many reasons to initiate a contract compliance investigation, such as:

- Increased proceeds from the grantee
- Maintenance of periodic oversight as a form of management
- Improved collaboration with and responsiveness from the grantee
- Investigation of payment expectation gaps
- Resolution of potentially adverse issues
- Expiration of investigation rights for certain periods
- Preparation for anticipated or ongoing litigation

23.4 Comparing Contract Compliance Investigations and Financial Statement Audits

Practitioners sometimes use the term *royalty audit* to describe a contract compliance investigation. License agreements often use the word *audit* to describe the rights holder's investigation rights. For a certified public accountant (CPA) who performs many of these contract compliance investigations, however, the term *audit* has a specific meaning related to financial statement audits, which involve different rigors and standards than a royalty audit or compliance assessment. In preparing for litigation, the expert should understand the differences between royalty audits, or contract compliance investigations, and financial statement audits. This section discusses some of those differences.

(a) Basis of Accounting

Most financial statements use an accrual basis of accounting: the company can record revenue before it receives payment (net of reserves for such items as product returns and bad debts) and can record expenses before it pays invoices. Conversely, companies typically report contingent compensation from license agreements and similar contracts on a cash basis, albeit modified in certain instances to allow for estimated returns and other accruals. The cash basis ties the licensing proceeds to the net cash flows from the licensed products and uses reserves to prevent potential claw-back situations (i.e., the licensee requests the return of cash flow for royalties related to product that a customer later returned).

The expert should note how the contract defines the “what” and “how” of transactions subject to contingent compensation. For instance, using the term *cash received* rather than *consideration received* could exclude barter transactions, wherein the parties do not exchange cash but transfer consideration between them. As such, the expert should consult with the grantor or its counsel because the question could require a legal conclusion.

(b) Professional Standards

CPAs who audit financial statements must adhere to a comprehensive set of professional standards known as the generally accepted auditing standards (GAAS).

GAAS addresses the responsibilities of the auditor in reaching an opinion on whether a set of financial statements is presented fairly, in all material respects, in accordance with generally accepted accounting principles (GAAP) or some other financial reporting framework. The auditor's opinion enhances the level of confidence for stakeholders and others who use the financial statements.³

In contrast, royalty audits and similar contract compliance investigations have a limited scope and usage and most often do not contain an opinion on compliance (or lack thereof).⁴ Contract compliance investigations requested by the grantor are typically performed as either agreed-upon procedures engagements or consulting engagements.

Agreed-upon procedures engagements require, among other things, an agreement between the CPA and the parties about the procedures that the CPA will perform, the sufficiency of those procedures, and the CPA's final opinion based on the findings from the procedures.⁵ Because the agreed-upon procedures standards may limit the scope and direction of an investigation, practitioners most often perform contract compliance investigations as consulting engagements, governed by the AICPA's Statement on Standards for Consulting Services No. 1 (SSCS 1).⁶

Although the standards included in SSCS 1 are general in nature and less restrictive than the attestation standards issued by the AICPA, the expert must be aware of the SSCS 1 standards (such as the following) and how they could apply to the contract compliance investigation:

- **Due professional care.** Exercise due professional care in the performance of professional services.⁷
- **Planning and supervision.** Adequately plan and supervise the performance of professional services.
- **Sufficient relevant data.** Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

Although CPAs most often perform contract compliance investigations and therefore must observe and comply with the AICPA professional standards, non-CPA experts can also perform such investigations if a contract allows it. These experts should keep the AICPA professional standards in mind when they plan, execute, and report on a contract compliance investigation.

(c) Materiality Concerns

In a financial statement audit, a CPA will define an amount representing the quantitative materiality of potential accounting errors or misstatements that could result in adjustments to that company's books and records. Contract compliance investigations will likely have a lower threshold for materiality that results in a reportable finding. The expert and the grantor (or counsel) should agree on the extent of quantitative materiality before commencing fieldwork.

(d) Scope of Activity Tested

Financial statement audits have comprehensive standards in terms of the following:

- The accounts to test,
- The procedures to test the transactions and account balances,
- The breadth of the financial statements, and
- The review of the written disclosures that accompany those financial statements.

The fieldwork for an annual financial statement audit can last several months.

In contrast, contract compliance investigations most often focus on testing certain revenue and expense-type transactions, related solely to the licensed products and contract terms at issue. The fieldwork often lasts one or two weeks.

Notes

¹ Although the terms *grantor* and *grantee* refer primarily to the parties in a licensing agreement, this chapter uses these terms to describe the parties involved in other contractual relationships as well.

² The term *audit* is often used in licensing contracts, but CPAs recognize it as relating to a financial statement audit, which is different in terms of purpose, scope, and professional standards, as discussed later in this chapter. Although this term will continue to be used in this chapter, it is important for the financial expert to understand these differences.

³ American Institute of Certified Public Accountants (AICPA), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards,” AU-C Section 200.

⁴ The AICPA provides professional standards on two types of compliance-related attestations: (a) compliance audits, which are required by certain governmental compliance standards and are generally performed in conjunction with a financial statement audit, and (b) compliance attestations, in which a grantee might engage a CPA to opine on its compliance with the grantor’s contract; see AICPA, “Compliance Audits,” AU-C Section 935; and AICPA, “Compliance Attestation,” AT Section 601.

⁵ AICPA, “Agreed-Upon Procedures Engagements,” AT Section 201.

⁶ Note that there is no Statement No. 2 or beyond as of this writing.

⁷ Though not defined within SSCS 1, the term *due care* is defined by AICPA’s AU-C Section 200.A.19 as requiring “the auditor to discharge professional responsibilities with competence and to have the appropriate capabilities to perform the audit and enable an appropriate auditor’s report to be issued.”