Top 5 Findings in a Royalty Audit

As a forensic accountant specializing in royalty audits for over two decades, I've encountered numerous instances where licensees or franchisees fall short of their contractual obligations. While each audit presents unique challenges, certain issues consistently emerge across industries and agreement types. Understanding these common findings can help both licensors/licensees and franchisors/franchisees better manage their relationships and ensure compliance with their agreements.

1. Miscalculated Payments

One of the most prevalent issues we encounter is the miscalculation of royalty payments. These errors can stem from various sources and may be either intentional or unintentional. In my experience, companies still utilizing manual processes for royalty calculations are particularly susceptible to data entry errors and problematic spreadsheet formulas that often go undetected. Even automated systems aren't immune to mistakes, which is why we emphasize the importance of reviewing both input sources and calculation outputs during our audits.

The complexity of royalty calculations increases significantly when agreements include tiered rate structures based on sales volumes or unit thresholds. These sliding-scale provisions, while beneficial for incentivizing higher sales, often lead to calculation errors. I've frequently observed situations where the responsibility for these complex calculations falls to clerical-level employees who lack proper training or access to the original license or franchise agreement. This disconnect between the agreement's nuances and the personnel handling the calculations creates a perfect storm for payment discrepancies.

2. Failure to Abide by Pricing & Distribution Restrictions

Another significant finding in royalty audits involves violations of distribution and pricing restrictions. Premium brands and franchisees, in particular, often incorporate specific guidelines to protect their market position and brand value. For instance, a luxury brand might explicitly prohibit the sale of licensed products through discount retailers. When licensees breach these restrictions, they not only violate the agreement but potentially damage the brand's market positioning and value proposition.

3. Territorial Disputes

Territorial violations represent another common finding in our audits. License agreements – and especially franchise agreements - typically specify permitted geographical markets for product distribution or business activity. For example, a licensee might have rights to sell products only within the United States, yet we often uncover sales occurring in unauthorized territories. Or a franchisee might try to serve customers from the protected territory of an adjacent franchise owner. These violations can create conflicts with other licensees and franchisees who have legitimate rights in those regions and potentially expose both parties to regulatory complications.

Top 5 Findings in a Royalty Audit

4. Advertising Shortcomings

The fourth significant finding relates to advertising requirements. Many license and franchise agreements mandate specific levels of advertising expenditure and impose guidelines for advertising content. During our audits, we frequently discover instances where licensees and franchisees fail to meet these obligations. This non-compliance can manifest as insufficient spending on promotional activities or unauthorized advertising content that doesn't align with brand standards. Such violations can significantly impact brand awareness and market penetration, ultimately affecting both parties' financial outcomes.

5. Quality Control Issues

Quality control requirements round out the top five findings in royalty audits. License and franchise agreements commonly include detailed provisions regarding product quality standards. These might require licensees or franchisees to submit product samples for approval, maintain approved manufacturing standards, or maintain certain customer service standards. In my practice, I've found that while these requirements are typically clearly outlined in agreements, they're often overlooked or treated as secondary considerations by licensees and franchisees. This oversight can lead to serious consequences, particularly when substandard products or poor customer service reach the market and potentially damage the licensor or franchisor brand reputation.

Accentuating the Need for Royalty Audits

These findings underscore the importance of regular royalty audits as an essential tool for maintaining healthy licensing and franchise relationships. Beyond merely ensuring correct payment, these audits help identify systemic issues that could potentially damage brand value or disrupt business relationships. For licensors and franchisors, regular audits serve as a protective measure for their intellectual property, brand image and revenue streams. For licensees and franchisees, they provide an opportunity to identify and correct internal control weaknesses before they become significant issues.

The key to avoiding these common pitfalls lies in maintaining robust internal controls, providing proper training to personnel handling royalty calculations, and ensuring clear communication channels between all parties involved in the licensing or franchise relationship. Regular internal reviews of compliance, combined with periodic third-party audits, can help both licensors/franchisors and licensees/franchisees maintain productive and profitable relationships while protecting valuable intellectual property and brand rights.

Kevin Howley, CPA
Partner
khowley@ggglip.com