

Checklist for determining whether to audit a license agreement

The following is a checklist to be utilized by technology transfer associates as a "diagnostic tool" for reviewing commercial license agreements, in order to determine whether the agreement should be audited.

Choose the answer which best describes your situation:

1. Does your licensee remit their royalty payments timely, in accordance with the terms and conditions of the license agreement?

Points

- 0 Yes, all the time.
3 Yes, most of the time.
5 No, payments are always late.
7 No, sometimes no payment is received and we have to remind them.
15 No, we cannot get them to remit payment.

Score _____

2. Does your licensee include a detailed supporting schedule with their royalty payments?

Points

- 0 Yes and it conforms to the reporting requirements in the license agreement.
3 The schedule shows sales dollars, units sold, country of sale and foreign currency translations.
5 Supporting schedules show sales dollars, units sold and country of sale.
7 Supporting schedules are not required by the license agreement.
15 Supporting schedules are required, but they are not provided.

Score _____

3. How is the royalty calculated?

Points

- 0 Based on a fixed amount per unit sold, or as a percentage of the selling price.
3 As a percentage of the selling price of a product and related accessories.
7 As a percentage of the selling price of a product bundled with other products.
10 The license agreement uses a more complicated formula than noted above.

Score _____

4. Quantitative analysis:

Points

- 0 Is the royalty this period within + or - 5% of the last reporting period or the same period a year ago? **Note:** If the royalty is exactly the same, there is a possibility that one of the royalty reporting periods has been estimated.
3 Has the royalty this period decreased by greater than 10% from the last reporting period or the same period a year ago?
5 Has the royalty this period decreased by greater than 15% from the last reporting period or the same period a year ago?
7 Has the royalty this period decreased by greater than 20% from the last reporting period or the same period a year ago?
10 Have the reported royalties been in steady decline for the last 4 reporting periods without a satisfactory explanation?
15 We have documentation that definitely shows that sales are greater than the licensee is reporting.

Score _____

5. What is your understanding of the market for your licensed technology?

Points

- 0 its small, as the technology is still relatively new.
3 Seems about what we expected it would be when we signed the agreement.
7 Seems greater than the licensee is reporting to us.
10 Is definitely more than the licensee is reporting to us.

Score _____

6. How does your licensee distribute the licensed products made from your technology?

Points

- 0 No commercial sales of the product have been made.
3 Licensee manufactures and sells to end users in the United States only.
5 Licensee manufactures and sells to end users worldwide.
7 Licensee utilizes outside manufacturer, but sells directly to customers.
10 Licensee utilizes affiliates, sub-licensees and/or distributors to sell products to US end users.

Score _____

- 15 Licensee utilizes affiliates, sub-licensees and/or distributors to sell products to worldwide end users.

Score _____

7. How is your licensed technology used commercially?

Points

- 0 It has not been turned into a commercial product as yet.
3 It has only been on the market one year and its use is limited to one product.
7 It has been marketed commercially more than 3 years.
10 It has been marketed commercially more than 3 years and has more than one use.

Score _____

8. What has been the comments/feedback/involvement from the inventor(s)?

Points

- 0 They have made little or no inquiries to our office regarding the status of the product or amounts of royalty payments.
5 They have a conflict of interest, such as active roles in the licensee company or their own consulting agreement with them.
7 They have a feeling that the licensee has sales in excess of the amounts reported.
10 They have told us that they know the licensee has sales in excess of the amounts reported.

Score _____

9. Which best describes the audit paragraph in the license agreement?

Points

- 3 Agreement is silent with respect to audit rights.
5 It provides right to audit, but places restrictions on information, time or other areas.
7 It provides us with full access to information and provides for licensee to pay for audit if underpayments in excess of 5% are discovered.

Score _____

10. Which best describes your relationship with your licensee?

Points

- 0 We act as partners.
3 We have a good relationship with them and think they are accurately reporting sales.
5 We have a good relationship with them, but don't know if they are accurately reporting sales.
7 We have numerous licenses with this licensee, but have never audited any of them.
10 Very contentious, such as they don't respond to our correspondence, they are late with milestone or minimum annual royalty payments or we have disputes on patent cost reimbursement, etc.

Score _____

11. Which best describes the current stage of the patent life?

Points

- 0 Our royalty does not start until the patent is issued and it has been less than 2 years since issuance.
3 Our royalty starts with sale of licensed product and it has been less than 2 years since the first sales were reported.
7 It has been 3 to 7 years since the reported sale of the first licensed product.
10 It will be expiring soon and we have never audited this agreement.

Score _____

12. What is your gut instinct about the accuracy of the royalty payments derived from this license agreement?

Points

- 0 We have done sufficient analysis of the reported royalties and believe no errors have been made in the reporting.
3 We think they are accurate.
5 We don't know.
7 We suspect there may be problems.
10 We know royalty payments have been under reported.

Score _____

TOTAL RISK FACTOR _____

If this agreement scored a risk factor of 0 – 15, this agreement probably does not need to be audited at this time.

If this agreement scored a risk factor of 16 - 45, there may be some risk factors to consider and you need to monitor this agreement closely and you will want to re-score this agreement in a year or if the market for the product changes.

If this agreement scored a risk factor of 46 - 60, there may be issues or concerns that you should discuss. You should consider a self-audit and/or the use of outside auditors.

If this agreement scored a risk factor of 61+, you should give strong consideration to auditing this agreement at some point in the near future; there are too many red flags to ignore. You should also increase your in-house monitoring and re-score every six months.

For additional information, contact Sidney Rattner, Partner at sid.rattner@mcgladrey.com or 847-413-6217.

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