Maximizing Licensing Revenue

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For many companies, licensing revenue is an important part of total income. Fashion and apparel businesses regularly enter into licensing agreements. These licensors allow others, for a fee, the rights to exploit the products, designs and trademarks they own. The rights given to licensees come in many forms. The licensee may, for example, purchase finished goods for sale to customers. The licensee may also be given the product design and then manufacture and market the product as they see fit. Another possibility may be a joint venture utilizing the developed asset of the licensor with the sales and distribution strengths of the licensee.

Audit The Licensee

Audit clauses are an important part of every licensing agreement. They grant to the licensors the rights to examine the accountings of the licensee to verify the correctness and completeness of the information contained in the rendered statements. In a business environment of rapid changes in technology, where there is a lack of visibility in the operations of the licensee, the licensor needs to effectively monitor and assess the accountings to determine whether the licensee is in compliance with the terms and conditions of the agreements.

Objectives And Methodology

The objectives of the audit are to determine compliance with the agreement and to verify complete and accurate reporting. Completeness means that all terms of income which should be reported, are reported. Various testing of manufacturing and distribution records are utilized. Accurate reporting means that all of the income is accounted and paid at correct rates, prices and terms. In addition, any charges or adjustments appearing on the statements are examined to verify correctness. Other areas, such as compliance with various marketing or promotional terms, are also examined.

Income

The verification of income includes an analysis of the accounting sales reports coupled with a reconciliation of unit activity. Based upon the testing of a sample of items, such as sales invoices, purchase orders, customer accounts and cash receipts ledgers, we verify that all income related to the licensors products are included in the royalty accountings.

Royalty Rates

Most licensing agreements are based on the payment by the licensee to the licensor of a royalty. The royalty is computed by applying a percentage rate to a base price. It is common that the royalty rate increases as various sales levels are achieved. The definition of the base price – which may for example be stated as the wholesale price minus a deduction for trade discounts and allowances – as well as definitions for other components in the royalty calculation, are set forth in the agreement. We verify that the calculation of the royalties reported by the licensee conform to the terms and conditions governed by the agreements.

Discounts And Allowances

Many agreements contain clauses detailing maximum percentages and types of allowable discounts from wholesale prices for the calculation of royalties. This prevents diluted royalties from being paid to licensors when sales are made at drastically reduced prices, or the licensee grants margin allowances or trade discounts to a customer for total sales which may include multiple licensor products.

Bad Debts

In most cases royalties are payable on goods shipped, regardless of whether the licensee has been paid by the customer, however, sometimes the licensee will pay royalties only after being paid. The licensor is entitled to be paid, regardless of receipt of payments due to the licensee. The licensor did not guarantee the credit worthiness of the licensee's customers. Charging the bad debt against royalties reduces the agreed upon royalty. Expenses such as bad debts are licensee costs of doing business.

Charges And Adjustments

In addition to royalty income, the accounting statements may include items which reduce the licensor's earnings, such as manufacturing expenses, allowances for returns and co-op advertising, or a portion of fixed costs allocated to the licensor. The appropriateness of these charges is governed by the terms contained in the agreements. If they are chargeable against royalties, they are then examined to determine accuracy and fairness.

Non-Financial Terms

The agreements may also contain non-financial terms negotiated in good faith by the parties which we examine during an audit. Examples include advertising commitments and marketing support. These terms are valuable rights to which the licensor is entitled. For instance, the agreement may state that the licensee must meet minimum advertising commitments. Under such circumstances we would calculate amounts due based upon reasonable assumptions.

Conclusion

Auditing the royalty statements you receive from your licensee offers the checks and balances needed to ensure fair and accurate accountings. Errors and omissions may occur, costing you monies rightfully due to you. Don't let them slip by unnoticed.

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