

Royalty Reporting On 'Net Sales' By Charles Schnaid, C.P.A.



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Introduction

The proper definition of 'Net Sales' in a licensing contract goes to the core of any contract between Licensor and Licensee. Ambiguity in drafting of the contract could have serious consequences for both the Licensor and Licensee resulting in financial issues and strained relationships.

Effective Language

Royalties are generally computed on a percentage of the dollar amount of 'Net Sales' although in some instances royalties are based on units sold or possibly on units manufactured.

Experienced Professionals

The use of an attorney experienced in licensing agreements as well as a Certified Public Accountant well versed in the financial impact of licensing and resultant royalties, is highly recommended. A combined effort of these professionals should provide the parties with a clear interpretation of the intentions of the Licensor and Licensee. Ambiguity and potentially contentious issues should be avoided at all costs.

Royalties

Royalties are defined as a share of the product received by the grantor (Licensor). The objective is to realize optimal revenue achievement to the bottom line while protecting and enhancing the value of the Brand. The ongoing positive relationship between Licensor and Licensee is obviously essential to the success of the joint venture.

Net Sales

'Net Sales' may have several meanings. Licensing Agreements may loosely define 'net sales' as gross sales minus returns, discounts and allowances. 'Net Sales' needs to be more specifically defined. Avoid ambiguity as much as possible, as this may result in costly conflicts between Licensor and Licensee. The result could have severe financial impact on royalty receipts due to the Licensor and payments by the Licensee as well as straining the interparty relationship.

Depending on whether the Licensee is a Manufacturer, Retailer or Distributor, the following factors need to be considered in determining contractual deductions of adjustments to gross sales:



1. Is 'gross sales' the list price? Are price lists and catalogues available? Are sales prices reflected on the internet? Sales direct to a customer by the Licensee or via a wholesaler, distributor or the internet may affect the selling price per unit. This could result in separately stated royalty rates.

2. What discounts are allowable. For example, do discounts include customary trade, quantity and cash discounts? Are there volume discounts for larger customers?

3. Are amounts not recovered by the Licensee from its customer deductible, e.g. bad debts and disputed amounts.

4. Basis for allowances, e.g. advertising and promotion. Does the contract provide for a standard percentage allowance?

5. Samples and 'give-aways.' In some industries, it may be business practice to provide customers, free of charge, with samples of products for display purposes. In other instances, for promotional purposes, the licensee may deliver 13 items and only charge for 12 ("Bakers Dozen"). The Agreement should clearly indicate the allowance and/or basis for computing royalties in such circumstances.

6. Bundling of products: In many instances, the Licensor's products may be bundled with other products (e.g. toys, die cast models). The contract should clearly state the basis for computing royalties e.g. on a proportion of units to total units or sales price to total sales price or some other acceptable and mutually agreed basis.

7. Specify which, if any, other items may be deducted. Examples include freight and insurance, if separately stated on the invoice.

8. Shipping practices: At what stage are royalties determinable, e.g. when items are manufactured, delivered or shipped (including FOB sales which may be drop shipped directly to the Licensee's U.S. customer by the overseas manufacturer).

9. Withholding taxes - the recoverability for income taxes withheld by a foreign licensee can significantly affect the cash flow to the Licensor. There are provisions for a U.S. Licensor to file a form with its annual federal income tax return in order to claim the foreign tax credit. However, this could delay receipt by the Licensor of this portion of the royalty payment. In certain countries, it may be

possible to obtain exemptions from withholding taxes.

10. Consignment sales - how are these provided for?

11. Related party and interdepartmental sales; spell out the effect on 'net sales' for royalty purposes. At what stage and on which basis or price are these sales subject to royalties. Similar provisions as explained herein should apply in determining net sales.

12. The agreement should clearly spell out at what stage royalties accrue. This may be on date of shipment, invoiced, or when invoice is paid. Generally, this latter method is not recommended, since it involves the Licensor in the collection process.

13. The right to audit provision and the accessibility to ALL records of the Licensee has a direct correlation to the definition of gross and net sales and the resultant computation of royalties payable.

14. Currency fluctuations - In these uncertain global economic times care should be taken between Licensor and Licensee to clearly define their understanding of the currency to be used in determining net sales particularly where global sales of product take place.

15. Communication between Licensee and Licensor is of paramount importance. The definition of 'net sales' may need to be changed as circumstances change, e.g. change in trade practices, products, customer base and manufacturing sources (US domestic vs overseas).

Returns

In determining 'net sales' one of the most important and potentially litigious terms of any License Agreement relates to returns of product.

- These returns could result from defective product. If so, the terms for royalty reductions, repair, resale and applicable royalty payment need to be spelled out as well as, if applicable, steps for destruction of these products.

- In other instances returns of product and the treatment for royalty purposes needs to be clearly written in the Agreement. The Agreement needs to explain what happens with actual returns of products versus credits for non-returned items retained by the Licensee's customer. At times, it may be more cost effective to allow the customer to retain these products for which a credit is passed and the royalty payment adjusted accordingly. Adequate controls should be established to ensure these

products are not sold subsequently as ‘seconds’ with no royalty paid thereon.

- Returns of products to the Licensee by its customer effectively void (cancel) the whole or part of the original sale. This means that since there is ostensibly no sale having taken place, royalties would not be payable on these returns by the Licensee’s customer to the Licensee. The wording of the License Agreement should clearly state how returns of the products are to be dealt with for purposes of royalty computations. If royalties were still to be paid, despite the goods having been returned, the effect could be multiple royalty payments being made on the sale and resale of the same item. Any payment of royalties in these circumstances would, in my view, be inequitable.

- In a recent international arbitration matter in which the author was an expert witness, the issue of deductibility of royalties for returns was a major and contentious issue. The original License Agreement had covered the royalty treatment for returns of product but on revision several years later the sentence covering this aspect was erroneously omitted.

Financial Commitment from Licensor’s Business Partners

It’s your money. Are you getting your fair share?

Five Simple Questions for You to Answer:

1. Do you appropriately manage your licensing revenue with the same financial standards and accountability as you do for other important aspects of your business?
2. Do you simply rely on your Licensees reporting? How effective are their internal controls? Particularly important for Sarbanes-Oxley Section 404 reporting, especially for publicly held companies.
3. Do you expect your Licensees’ staff to be professionally trained in royalty accounting?
4. Can your Licensees effectively self-govern in accurate and timely royalty accounting?
5. Have you reviewed your licensing agreements recently for any changes relating to royalty payments?

Bear in mind that things are not always what they seem to be. So more caution, back to basics and a certain amount of skepticism can go a long way toward achieving your objective.

Conclusion

From the above it should be abundantly clear to both Licensor and Licensee, as well as their professional advisors and agents, that there are many pitfalls, which could result from not devoting adequate time in negotiations, acceptance and drafting the Licensing Agreement in relation to ‘Net Sales’. As the basis for computing royalties, the initial time and effort will result in more financial certainty for both parties and ward off the prospect of strained relationships in the future.

Charles, a partner with Miller, Kaplan, Arase & Co., LLP has over 22 years experience in Licensing and Royalty Services. He specializes in licensing and royalty compliance services and consulting for licensors and their licensing agents in a variety of industries including entertainment, toys, video games, software, apparel, manufacturers, distributors, retailers and food service. He is a teaching professor of the Faculty for LIMA’s “Certificate of Licensing Studies” (CLS) and has been a featured speaker on royalty compliance audits on many occasions, including at Licensing International, the licensing industry’s annual trade show and conference. He was the court appointed neutral co-accounting referee in one of the largest royalty litigation matters in U.S. history (Stephen Slesinger, Inc. v. the Walt Disney Company, Case #BC022365, in the matter of Winnie-the-Pooh royalties) and has testified as an expert witness in a major international toy license dispute. He is an active member of the American Institute of Certified Public Accountants, the California Society of Certified Public Accountants, and a non-resident member of the South African Institute of Chartered Accountants, United Kingdom Institute of Chartered Accountants and the Israeli Institute of Certified Public Accountants.