A Crash Course on Royalty Audits

by Juli Saitz and Steve Gillen

In the typical transaction between a book author and a publisher, the author grants to the publisher certain exclusive rights in a manuscript and, in exchange, gets from the publisher a right to receive a portion of the publisher's proceeds from commercial exploitation of the rights granted. Though the specific terms vary from publisher to publisher and book to book, the author's share is commonly referred to as a royalty, and the manner of its calculation and payment are spelled out in a written book publishing agreement.

Most of the time, the publisher dutifully and accurately reports on sales and calculates and pays the royalty as provided in the written agreement, and the author accepts the accountings without question. However, every once in a while, the author is moved to look more closely at the publisher's accounting. The process by which this is accomplished is termed a royalty audit, though it is not actually an "audit" in the strictest sense of the term and is more properly characterized as a "review." The general parameters under which this review is accomplished may be spelled out in the written agreement or they may be left to voluntary resolution by the publisher, auditor, and author.

If you are involved in the publishing industry long enough, it's likely that you will at some point in your career either request, or be subjected to, one of these audits. In anticipation of that event, we answer some of the questions that are likely to arise.

What Is a Royalty Audit?

A royalty audit is the review of a publisher's underlying books, records, and systems used to calculate the royalties an author has been paid. Royalty audits are performed by specialized auditors—often accountants—who have experience in this type of examination. Auditors with experience in performing audits in book publishing are well suited to perform reviews on behalf of authors, as they are most familiar with the types of systems used and records maintained by publishers. This is especially true in higher-education publishing, where the reporting of royalties is more complex than trade publishing, given regular edition updates, books packaged with other materials (e.g., study guides), and the increase in online content and interactive learning platforms. The overall purpose of a royalty audit is to ensure that an author's royalties have been calculated and paid in accordance with the terms of the publishing agreement. At the conclusion of the examination, the auditor will write a report of his or her findings, including a calculation of amounts due to the author or, on occasion, amounts overpaid to author.

Getting Started

It is best practice to utilize an independent third party to perform a royalty audit. Potential referral sources include attorneys, literary agents, other authors, and trade organizations. If there is an audit provision in the

underlying contract, it may specify the characteristics or certifications required for an auditor.

Once an auditor is selected, the auditor will ask for copies of royalty statements for the period under review and copies of all contracts and amendments. The author and auditor will have a discussion about the author's history with the publisher, sales, and any unusual patterns the author may have noticed with respect to the royalty statements.

Often, royalty audit engagements are set up under an engagement letter with the author's attorney, meaning the attorney engages the auditor on behalf of the author. This provides the author with certain additional legal protections, among them that the auditor's work papers and communications are treated as attorney work product and thus are shielded by attorney-client privilege until such time as the author chooses to release them.

When ready, the author will either alert the publisher about his or her intention to carry out an audit, or the auditor will supply an author-signed notice and consent form along with the initial request for production of documents and information. A publisher may respond by asking the author and auditor to sign a nondisclosure agreement, since the publisher also has an interest in preserving the confidentiality of its business records. Once the process has started, the auditor handles communications directly with the publisher and consults with the author as needed.

What Are Auditors Looking For?

Audit findings are generally based on two factors: clear mistakes or miscalculations and/or disagreements over contract interpretation and the calculation of royalties. Intentional misstatements are very rare. Auditors look for underreported sales resulting from human error and flaws in the publisher's accounting systems. Underreported sales are often the result of oversights such as a failure to associate a particular product with the appropriate royalty rate and royalty payee (certain ISBNs are not marked as royalty-bearing in the publisher's systems); non-escalation of royalty rates (the publisher's systems are not equipped to handle escalation rates across multiple ISBNs related to the same work); misunderstanding of the publishing agreement by the person associating ISBNs with corresponding royalty rates in the publisher's system; applying charges incorrectly or to the wrong accounts; failing to account for specially negotiated provisions in a particular author's contract; misapplied conversion rates (with respect to foreign sales); unreported distribution channels; and in the case of bundled products (e.g., text books packaged with study guides or children's books packaged with toys), underpayments based on an improper allocation of value amongst individual components.

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What Do Auditors Ask For?

Royalty auditors generally ask for the following:

- Detailed information related to the publisher's royalty reporting systems
- Detailed sales information related to the author's work containing the customer, date of sale, invoice number, units, returns, and type of sale (e.g., foreign, domestic, e-book)
- Bill of materials: information regarding all items bundled and sold together in a package
- Sub-rights contracts and evidence of payment for sub-rights
- Inventory records showing the total number of books printed and how they were disposed
- Random sampling requests of invoices

The auditor will then take the information provided from the publisher and check to see that it supports what has been reported on the royalty statements. Auditors will also verify the accuracy of royalty statements in reverse—that is, by taking the information provided by the publisher and recalculating what should be reported on royalty statements using detailed records.

Publisher's Response

Publishers typically cooperate with audit requests. Sometimes this process has been expressly provided for ►

in the book contract, in which case, the publisher has a contractual obligation to cooperate. Even when this is not the case, it is generally in the publisher's interest to cooperate voluntarily. The alternative is to risk being sued and having to provide the same information in a more expensive, burdensome, and contentious process.

However, it is important to appreciate that royalty departments typically handle a large workload with a small staff of individuals. The royalty function in publishing is a cost center, not a profit center. Accordingly, it is usually last in line for allocation of scarce resources. Royalty departments are nonetheless responsible for the regular generation of royalty reports, answering questions from multiple parties, performing ad hoc analyses, and fielding audit requests. Thus, the response time to audit requests can take longer than is desired by authors and auditors alike. The time to complete an audit can range from as little as three months to more than a year, depending on the response time of the publisher and the volume of the information provided.

Audits provide value by correcting mistakes going forward, affirming the integrity and competence of the publisher, and improving author-publisher trust.

Because an audit can take some time to complete, author and publisher should consider entering what is called a "tolling" agreement. Each state has a statute of limitations for breach-of-contract claims, meaning you only have just so long to file a complaint for breach of contract before your legal right to pursue the claim expires. These periods can range from three to 10 years, depending on which state's laws govern the contract at issue. Many publishing contracts specify New York law, because the publisher is located there. The New York limitations period is six years. Other contracts specify Illinois law, which is one of the states with a 10-year limitations period. In any event, at any point in time, an author has the ability to look back for the applicable period of limitation. Assuming that a publisher provides royalty statements and payments twice per year, if an audit takes more than six months, one royalty period will fall outside the statute of limitations during the time it takes to complete the audit. An author can stop this from happening by filing a lawsuit at the commencement of the audit, but a less contentious way of addressing the same issue is for the author and publisher to sign an agreement to "toll" the statute of limitations during the pendency of the audit.

What Might the Auditor Find?

Because of the nature of royalty accounting systems and the nature of the mistakes most likely to be made, virtually every audit uncovers some amount of underreported sales and thus unpaid royalties. These amounts vary by industry segment, publisher, and author. Our experience is that underreporting is typically in the range of 15 to 25 percent. That said, every once in a while, an audit turns up errors that favored the author, in which case, the author must be prepared for the publisher to recover the overpayment. In addition to monetary findings, audits provide value by correcting mistakes going forward, affirming the integrity and competence of the publisher, and improving author-publisher trust.

Should I Have an Audit Clause in My Publishing Contract?

It may be a good idea to provide expressly for an audit in the book contract. However, there is no one-size-fits-all audit provision. The matters typically addressed include the following:

- An obligation on the publisher to keep accurate records for some minimum period of time
- A requirement that the parties enter into a nondisclosure agreement prior to audit
- A list of necessary qualifications of an auditor—independence, certified public accountant (CPA) designation, etc.
- A list of what the publisher is obliged to provide access to, such as all relevant records (physical and electronic) and all relevant employees (individuals

with pertinent information may reside outside of the royalty department)

- The right to perform a site visit during regular business hours at the location where relevant records are routinely kept. (Note: Most of the information the auditor needs can be provided electronically by email so the burden and expense of a site visit can generally be avoided. Also, royalty records may be kept at a location far removed from the editorial offices.)
- A specified look-back period that may well be shorter than the relevant statute of limitations. (Note: Publishers have an interest in reducing their exposure, especially in states that have a long statutory limitations period. The downside to a short look-back period is that it may drive the author to audit more frequently.)
- An obligation on the part of the publisher to reimburse the author for expenses of the audit if the amount determined to have been underpaid exceeds a specified percentage of the amount reported and paid (typically in the 2 to 10 percent range). Auditor and attorney fees are not recoverable in a successful breach-of-contract action unless they have been provided for in the contract.

A fairly balanced audit provision will add certainty to the process for both sides. That said, no audit provision is better than a bad audit provision.

What Should We Look For in an Auditor?

Authors should select an auditor whom they trust. An individual with a certified public accountant (CPA) designation is a good indication as to the auditor's level of skill and training. If the author suspects large amounts of unreported sales, a CPA with a focus in forensic accounting may be required to go beyond the scope of a typical audit review and perform an investigation. If an author believes that the relationship with the publisher may become contentious and/or lead to litigation, an accountant with a background in litigation support and expert testimony may be the best choice of auditor. Regardless of the choice of auditor and his or her background, the auditor should be objective and independent. Selecting such an auditor will ensure the results of the audit "hold up" and that the parties will not expend unwarranted amounts of time and money arguing over the auditor's findings.

How Much Does an Audit Cost?

Many auditors will provide their services on a contingent fee basis. This means that the auditor's fee will be based on a percentage of the audit findings and no payment is due until the payment is made by the publisher to the author. In situations where an audit is not expected to result in large findings, but the initiation of an audit is sought for strategic or other business reasons, auditors will work with clients by charging an hourly rate or a fixed fee. Many auditors will have a discussion with an author and review royalty statements and agreements free of charge in advance of an audit. If it is expected that the audit will or may likely lead to litigation, it will be necessary for the auditor to perform his or her work on a fee basis rather than a contingency basis. Otherwise, the auditor's findings will not be admissible as expert testimony in court.

Final Advice

At the end of the day, an audit is just another opportunity for publisher and author to improve their level of trust and cooperation. A publisher behaving ethically should welcome review and embrace corrections and improvements. Likewise, authors shouldn't view an audit as an unwelcomed confrontation and shouldn't shy away from asking for an independent examination. But he or she should endeavor to hire an auditor who is competent and who will conduct the examination in good faith, as well as reasonably, efficiently, accurately, and with minimal disruption to the publisher. ●

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