

Royalty Auditing Issues Arising Under Recording Artist Agreements

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In any business, it is standard practice to monitor sales to ensure that revenue from all transactions is realized. A businessman knows the sales his company makes, and realization involves making collection for all amounts billed. In a royalty situation, however, one's revenue is actually determined by another unrelated entity, and the royaltor's ability to determine completeness and correctness of the royalties reported are limited to information that is set forth in the royalty statements received. There are measures that can be taken to help ensure that one is being fairly compensated for the usage of one's property, including critically reading the royalty statements rendered by the licensee and making comparisons with information that is known personally or which is publicly available. However, in many instances, the royalty statements rendered set forth such a paucity of information that it is frequently difficult, if not impossible, to draw any meaningful conclusions from the information provided. In order to determine whether the royaltor is being appropriately compensated, it is generally necessary to conduct a royalty audit of the licensee.

Royalty audits are considered normal business practice and make good sense as a way to maximize revenues. Top selling artists, producers and other rights owners exercise audit rights on a regular basis. As such, rights owners must be cognizant of the audit provisions contained in their agreements and be sure to make proper notification of their intent to conduct an audit within the allotted time frames. Typically, audit periods are limited to three years, although it is not uncommon for licensees to frequently grant access to longer time periods.

There are a multitude of income streams in the recording industry on which rights owners may be entitled to receive royalties, including: the traditional outlets (such as the sale of physical records through normal retail channels); record club sales and sales made directly to consumers; recouped usages in compilations, including releases by unrelated third party labels; and masters licensed for synchronization usage in film, television, video games, and other productions. In addition, there are emerging outlets, such as sales made in conjunction with non-musical products; master tone licenses issued for telephonic use; licenses issued to third parties for digital downloads and subscription streaming services; and public performance fees.

It is my intention to provide the reader with a royalty auditor's perspective on certain royalty issues and share with you some of the insights gained through years of experience in conducting royalty audits. "In order to determine whether the royaltor is being appropriately compensated, it is generally necessary to conduct a royalty audit of the licensee."

As an initial comment, it is worth noting that audit issues generally arise for one of the following reasons:

- **Calculations Based on Company Policy.** Companies responsible for the payment of royalties sometimes determine royalties pursuant to Company policy rather than the provisions set forth in the subject agreement. Policy implementation seems to be a means to addressing limitations in the Company's royalty system, or perhaps as a way to streamline royalty processing.
- **Human Errors.** Although most royalty statements are generated by highly sophisticated computer systems, the royalty calculations are based on parameters as input by royalty department personnel who may be responsible for the royalty statements rendered to thousands of rights holders. Various elements of the royalty calculation are frequently entered incorrectly.
- **Interpretations of Agreements.** The royalty statements that a Company renders implicitly represent the Company's interpretation of the royalty terms contained in the subject agreement. Royalty agreements have become considerably more precise over the past several years. Nevertheless, gray areas continue to exist and it is the norm for entities paying royalties to interpret these issues in the way that is most beneficial to themselves.

Artist royalties are determined pursuant to terms contained in the artist's recording agreement and typically take the shape of a calculation that looks something like this:

Royalty = Price Basis x Royalty Percentage x Units.

This seemingly simple equation can quickly turn quite byzantine when each element is reduced and otherwise diminished by a variety of factors. The Price Basis (either retail or wholesale) is typically reduced for container deductions and can be further reduced by a contractually stated percentage for breakage (a holdover from the old days when fragile vinyl was the principal format and records would break during shipment).

The contractually stated Royalty Percentage can be reduced for almost any sale of analog records that does not occur in the United States at top price, including: (1) digital and new technology rate reductions that are taken against sales of compact discs; (2) distribution channel rate reductions such as sales from record clubs, television advertisements, libraries, and military post exchanges; (3) price rate reductions for sales made at mid-line and budget; (4) territorial rate reductions for sales made outside of the United States; (5) foreign withholding taxes; and (6) shares payable to producers and other participants.

Units refer to sales units and are typically reduced by quantities described as free goods (and sometimes still further for discounts that record companies convert into free goods). Units are also sometimes reduced by a contractually stated net sales percentage.

Many of these reductions are vestiges from other eras of recording industry history that live on today at inflated levels and which bear no resemblance to reality. For example, when the compact disc format was first introduced in the early 1980's, record companies approached the artists to request that they accept reduced rates on sales of the new configuration as a way to help shoulder the companies' initial capital expenditure. Needless to say, the capital outlay was an exceedingly good investment, as the CD proved to be the biggest boon to recorded music sales in the industry's history. The cost of the investment in the format was probably fully recouped by about the time the average music fan was just starting to convert his record collection from vinyl to CD. Another example is the container charge on a compact disc unit, which is typically equal to 25 percent of the price basis. In the case of a retail based contract, and an album released at a top-line price of \$17.98, the container deduction would be \$4.495. This is exceedingly high when one considers that top quality finished CDs, including all elements of packaging, shrink-wrap and stickers, can be readily purchased in small batches for well under \$1.00. Nevertheless, these reductions live on in agreements drafted years later and can only be negotiated out or down by prominent artists.

The point here is that typical royalty calculations are not based in any way on reality; but rather exist in some kind of a parallel universe that is rooted in the years of record industry accounting practices that have been melded into a standard royalty framework. The bottom line and the questions that need to be answered after considering all of the elements of the defined calculation and the various diminutions are: (a) "What is the dollar and cents royalty that my artist is entitled to be paid?" and (b) "Were the proper royalties paid?" The purpose of the royalty audit is to identify underpayments resulting from the record company's failure to comply with the terms of the agreement. Here are some of the issues that have frequently turned up in recording artist royalty audits:

- **Each element of the royalty calculation represents a moving part, in that it is the subject of a negotiated term and is therefore subject to being erroneously accounted for.** Those agreements that contain non-conforming language, such as rate escalations for when sales levels eclipse stated thresholds, are particularly subject to miscalculation. Other examples of non-conforming language include those agreements that contain minimum royalty provisions or most favored nations provisions, which basically require that if the record company is obliged to pay another royalty on a more favorable basis, then the contracting artist is entitled to be paid on the same basis.
- **Unreported and/or Underreported Sales.** Invoiced sales are recorded in the record company's billing system which interfaces with the company's royalty system, where sales are tabulated on a record number basis for processing. If a record number is not set up in the royalty system, or if there is a discrepancy in the record number between the two systems, then invoiced sales will be dumped into the company's unmatched account where it sits until such a time that the royalty department personnel analyze the account and identify the unmatched sales for processing in the royalty statement. Foreign sales, which may be reported by affiliated licensees under different record numbers, are also candidates to end up in the unmatched account. It should be noted that the best and perhaps only way to truly ascertain whether the record company has reported royalties on all sales is to gain access to the company's inventory reports and general ledger. With these source documents, it is possible to complete a reconciliation of derived movement (units manufactured as adjusted by opening and closing inventories) with sales as tabulated in the

company's royalty system. Unfortunately, most record companies resist requests for these documents, citing confidentiality reasons and/or contractual stipulations.

- **Unreported Licensee Income.** Record companies derive substantial revenues from licensing their master recordings to third parties for usage in compilation albums, films, television productions and various other forms. In addition, through the advent of Apple iTunes and other legitimate download and streaming services, the companies are beginning to recognize monies from the sale of digitally transmitted music. It is important to ascertain the completeness of licensee income, which often times is non-recurring and subject to omission. In these instances, information available to the public, and more importantly, specific knowledge from the artist's management and attorney, is very helpful in identifying unreported usages.
- **Excess Free Goods.** The sales plans of most major record companies include free good programs pursuant to which a customer is charged for a certain number of units (usually 80 or 85) and then receives another allotment of units at no charge (usually 15 or 20). Additional free goods are also routinely distributed under seasonal restockings and short term or special marketing plans. Recording agreements normally provide that artist royalties are only payable on sales units, and free goods are specifically deemed non-royalty bearing. Further still, record companies may grant dollar value discounts, which they convert into unit quantities, which are sometimes excluded from the royalty calculation. However, agreements normally provide limits on the number of free goods that can be distributed, and it becomes an audit issue when the maximum allowable number of units is exceeded. Excessive free good distribution through record clubs is also a recurring issue, as the clubs often give away more units than they sell.
- **Advances, Recording Costs and Other Recoupable Expenses.** Record companies take substantial risks in developing artists and bringing new products to the marketplace. However, those risks are tempered by the fact that the advances they pay an artist, as well as recording costs and some other expenses, are recoupable from royalties earned by the artist. The sums of these payments can amount to hundreds of thousands of dollars, and for many artists, the royalty earnings from the sales of their records do not exceed the recoupable amounts. The costs charged against royalties need to be substantiated on audit, as incorrect charges for unrelated costs do occur. Further, the date of the charges must conform to the period set forth in the royalty statement. The charging of an expense incurred subsequent to the royalty statement period, but prior to the date the statement is rendered, is an incorrect offset. This could result in a payable balance being diminished or wiped out, and instead being erroneously reported as part of an unrecouped balance.
- **Foreign Base Prices.** Most royalty calculations are based either directly or indirectly on retail list prices. That works fine in the United States and a few other foreign territories where such price lists are published; however, a problem exists in the European countries and other foreign territories where retail list prices have been outlawed since the early 1970s. Thus a vacuum is created in the royalty world where defined calculations have to be made on non-existent prices. It is a widely held opinion that the foreign base prices used by record companies are substantially lower than the actual selling prices.
- **Controlled Composition Royalties.** Songs written or controlled by either the artist performing on the recording or the producer who produced the recording are generally defined as controlled compositions. Mechanical royalties for controlled compositions are paid pursuant to the controlled composition clause that is contained in the artist's recording agreement. If the controlled mechanical royalties have not been the subject of a separate publisher's examination, then they are normally encompassed within the context of an artist royalty audit. Controlled composition clauses can dramatically reduce the mechanical royalties that would otherwise be payable under United States Copyright law, which requires that mechanicals be paid at the minimum statutory rate on all units manufactured and distributed. The terms of these clauses are negotiated and therefore vary greatly depending on the stature of the artist or producer; but generally result in:
 1. a reduction of the per song rate to some level below 100 percent of the minimum statutory rate, typically 75 percent. Based on the current statutory rate of \$.085 and a 75 percent rate reduction, the controlled per song rate would be \$.06375.
 2. The controlled per song rate is normally fixed in time based on the statutory rate in effect at either the date of delivery of the subject master or its release date and is not subject to increase for subsequent changes in the statutory rate. In 2006, when the statutory rate is increased to \$.091, the record company will still only be required to pay the above-noted per song rate of \$.06375.
 3. the introduction of a "cap" or maximum amount of mechanical royalties the record company will have to pay in respect of all songs (both controlled and non-controlled)

contained in the record. The cap is normally based on a stated number of songs multiplied by the previously noted per song rate (for example: 12 songs x \$.06375 = \$.765).

Mechanical royalties on non-controlled songs are normally payable at the full statutory rate and are first deducted from the cap to determine the pool of controlled royalties that is spread over the controlled songs. In this example, if the album contains 14 copyrightable songs and five are non-controlled, then the per song rate payable in 2005 on the nine controlled songs would be: \$.0378 [(\$.765 - (5 x \$.085)) / 9]. This rate is only 45 percent of the current statutory rate. It can be further reduced with the passage of time, because the controlled royalty rate must absorb the increase in the statutory rate that is enjoyed by the non-controlled songs.

4. Unit quantities are also reduced. While mechanical royalties are payable on units manufactured and distributed (sales units and free goods), controlled composition clauses typically limit the number of payable units to sales units, which may be further reduced by a contractually stated net sales percentage. Thus, if the record company has a free good policy pursuant to which 80 units are invoiced as sales and 20 units are described as free, and if the subject agreement contains an 85 percent net sales percentage, then payable units are reduced from 100 percent of units shipped to 68 percent of units shipped (100% x 80% x 85%).

All told, the effect of the controlled composition clause in this example reduces mechanical royalties to 30 percent of what would otherwise be payable under United States Copyright law. As illustrated, the calculation of controlled composition royalties is comprised of several elements that are subject to miscalculation and which require detailed analysis in the course of the royalty audit.

Each of the above-noted issues is orientated to a traditional royalty arrangement. Some of these issues carry over to other arrangements such as pressing and distribution ("P&D") deals or joint venture ("JV") deals. P&D and JV arrangements, however, are structured differently, in that they are orientated to a profit and loss statement in which the record company reports revenue from sales and licensing deals and from which it deducts a variety of specifically defined charges that may include distribution fees, manufacturing costs, recording costs, copyright royalties, union payments, royalties paid to other participants, and promotional costs. In auditing P&D and JV arrangements, it is important to verify completeness of reported revenues and to make a determination of whether all deductions are authorized by the agreement, and whether they are valid and appropriate. "Royalty audits are considered normal business practice and make good sense as a way to maximize revenues and help contain expenses."

Conclusion

Royalty audits are considered normal business practice and make good sense as a way to maximize revenues and help contain expenses. The best results are achieved when auditors work closely with attorneys and business managers as a team, because so many of the accounting issues are borne from agreements that require legal interpretation and directions.

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