

Audits: A Developer's Best New Year's Resolution

If you are an independent developer or licensor, this article is a *MUST READ!*

If I had a nickel for every time I heard a developer shy away from auditing their publishing partners **for fear of "upsetting the cow so it ceases to yield milk,"** I could have retired to the islands by now.

In the early days, audits only occurred when there was a breakdown in a relationship between publisher and developer, and the developer wanted to give the publisher a working over. So it was a bit of a vengeance play which also contributed to the negative connotation about auditing. While it is true that publishers don't like to undergo audits because it usually ties up one of their already busy people for at least a week, **upsetting the apple cart is less of a consideration than it used to be.**

These days auditing is seen by both sides more as just good corporate governance. Bigger developers have third-party shareholders to answer to, plus they have licensors they must report to at least quarterly, and this is part of what is expected for appropriate protections. Whether your studio has these external reporting requirements or not, you need to read on and learn when it makes sense to audit and why. Because, if you are seeing some of these flags and doing nothing about it, **you could be leaving serious money behind.**

FOG Studios exclusively uses our strategic partner Media Forensics for our auditing needs and, yes, although this article is designed to educate the community to a very serious issue, I am shamelessly plugging these guys as well -- and for good reason. Over the last five years, Media Forensics has done more than 50 audits on game publishers with a 100% success rate of finding errors in favor of the developer -- **and recovered over \$20 million for its independent developer clients in the process.**

Let me say that again: 50 audits, 50 wins! Not a shabby heavyweight record. **And their most recent fight netted the lucky development studio \$800,000 against a \$16,000 audit cost.**

"Hey, wait a minute! 100% errors?" you shout. "Does this mean all the publishers are just lining up to put the screws to us?"

"This does not mean that publishers are deliberately attempting to hide money," says Media Forensics CEO Tim Christian. "The main issues that cause errors are ...

... contractual interpretation and leaky accounting systems and processes."

Game development is a business where everything begins boilerplate and ends up a custom negotiated agreement between the parties. While the nuances of contractual interpretation on modifications to net sales definitions or other important recoupment language may be readily apparent to yourselves and the negotiators who cut the deal with you, consider the situation of the royalty accountant down in finance who is tracking hundreds of SKUs across multiple territories and retail channels in a publishing system where every agreement is different. His or her process is built from the ground up around the way the boilerplate works and they simply do not have the time or the inclination

to track the variations from that process. Add to that the fact that 18 months to two years elapses between the time the agreement was signed and the royalty accountant is involved in the first place, during which the original biz dev people and even the accounting personnel may have changed, or the boilerplate upon which the entire accounting system is based can change as well. You should be beginning to develop a good picture of the issue.

"The tendency of the accountant is to do the same for everyone and wait until he is audited," says Christian.

Christian offers a lot of good advice when it comes to determining when the time is right to audit.

"First, it is important that the title has either recouped or is close to recouping. If the title is massively underwater, it is unlikely we are going to bring cash into the developer. It is also probably best that a title is in the market 12 months before audit, the first one should occur between 12 and 18 months, and then, if you have a big title with legs, follow on audits should occur every 12 months thereafter. The reason for this is because even though you have had a recovery, the financial systems the publisher is using may not have changed based on the audit results, or royalty accountant personnel have changed and there may be a whole new way internally that they are doing it."

To determine if one of your titles is a good candidate for an audit, start with some common sense and some math. One of the telltale signs to look for is whether or not you are getting royalty reports on time. If the publisher is consistently late and you have to harass them to get a report, that is a flag. Another flag is -- and, believe me, this is not as uncommon as you might think -- if you are not getting reports at all, which sometimes happens after titles go out of the limelight of the first couple of quarters where most sales occur though the titles may remain on sale for much, much longer. If there is a lack of organization about getting reports out on time or at all, it is likely that there are other corners being cut and mistakes are being made.

When cutting the original deal, it is important to get as much detail as possible on the royalty report. Negotiate for unit sales by territory, not just global worldwide numbers, because the more information you have, the deeper you can probe and ask questions before a potential audit, and the more effective any audits undertaken will be. Here are some top tips from Media Forensics about how to examine your reports:

- One easy thing to do is divide gross revenues by units sold, so if you know the title is selling at \$39.95 and you are seeing greater discounts than an average 25% for U.S. and 45% in Europe, this is a flag.
- Just check the basic math of the report. There is a presumption that people are using some kind of sophisticated accounting program. But you would be surprised at how many common, human-introduced errors exist in the reports companies send out, let alone the underlying data.
- Is the rolling reserve being calculated correctly? Review reports quarter to quarter. When it is taken on one quarter, is it added back correctly in the quarter it is recouped?
- If the developer does the math, asks the questions, and applies common sense and they either don't get answers -- or the answers don't make

sense -- then don't be afraid of threatening an audit to get the answers you need. If necessary, follow through on that threat.

- If you are contemplating doing a new deal with an existing publisher of your work, an audit can also be a tool to gather great intelligence about price points, average discounts, how net sales and MDF are calculated, and cost of goods before negotiating your next deal.

Once you have decided that an audit may be warranted, you simply provide the contract and royalty reports to Media Forensics, then they will give you an estimate of how long it would take and how much it will cost. Naturally, you should negotiate your contracts to provide that the publisher will pay for the reasonable costs of an audit in the event that errors are found greater than 10% in favor of the developer. But, either way, the financial risk of requesting an audit is quite small. Of the aforementioned 50 audits that Media Forensics has done, only one recovered less than the cost of the audit itself.

So there you have it ... a quick-and-dirty primer on why you should audit and some startling statistics to back it up. If you are already reaching for your royalty folder, then my job is done. If you want Tim Christian to give you a hand digging a little deeper, you can **click on his name in the e-newsletter** to generate an e-mail. Please be sure to tell him that Ed sent you as I'm sure he'll appreciate the referral.

I sincerely wish you both -- as always -- *Good Hunting!*