

Don't Be Surprised by Software Vendor Audits

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As new software license revenue slows for many software vendors, expect increased audits from the vendors to ensure compliance with their license agreements. Include audit protections in your agreements with the vendors.

WHAT YOU NEED TO KNOW

Your negotiation leverage is highest before you sign your first license agreement with a software vendor. Ensure that you have included equitable provisions in the agreement regarding how all the aspects of a software audit will be conducted.

STRATEGIC PLANNING ASSUMPTION(S)

Through 2005, software vendors will double the number of audits performed as a method of increasing their revenue (0.8 probability).

ANALYSIS

Most software vendor license agreements include an audit clause. Examples of these clauses are as follows:

- The software vendor reserves the right to audit the use of the software by the licensee no more than once a year at the software vendor's expense. All audits will be conducted during regular business hours. If such an audit discloses an underpayment of fees, the licensee will pay the underpayment along with interest accrued. The licensee will also pay reasonable costs and expenses of the audit if the audit shows that the licensee has underreported license use. (Similar to PeopleSoft's license agreement.)
- At the software vendor's written request, but not more than annually, the licensee will furnish the software vendor with a document signed by the licensee's authorized representative, listing the number of users and designated systems that have the software installed. The licensee is responsible for implementing reasonable means to monitor compliance with this agreement. The software vendor reserves the right to audit the customer's use of the software no more than once a year. Such an audit will be scheduled at least 30 days in advance, will be conducted during regular business hours and will not unreasonably interfere with the licensee's business. If such an audit reveals an underpayment of fees, the licensee will promptly pay such license fees. (Similar to Siebel Systems' license agreement.)
- During normal business hours and at any time the software vendor's proprietary information is being used, the software vendor or its authorized representative has the right, upon reasonable advance notice, to audit utilization of such software to ensure compliance with the terms of this agreement. If proprietary information is given to business third parties pursuant to this agreement, the licensee will secure the right for SAP to audit such business third parties. Upon the software vendor's reasonable request, the licensee will deliver a report to the software vendor, as defined by software vendor, evidencing the licensee's usage of the software licensed under this agreement. (Similar to SAP's license agreement.)
- Upon 45 days written notice, the software vendor may audit your use of the programs. You agree to cooperate with the software vendor's audit and provide reasonable assistance and access to information. You agree to pay within 30 days of written notification any underpaid fees. If you do not pay, the software vendor can end your technical support, licenses and this agreement. (Similar to Oracle's license agreement.)

Audits are not pleasant. Normal work is disrupted as purchasing records, license agreements and other documentation are researched to record what software the enterprise has properly licensed and what the usage rights are to such software. Because many contracts are vague in their usage rights and are subject to reinterpretation as technology and business requirements change (e.g., whether the software can be used for Internet access), there can be significant management time involved in discussing issues, as well as the risks involved in the audit.

At worse, the audit can prove that the enterprise is under-licensed and, with negotiation leverage at its lowest, the costs can be significant. Another alternative is that the enterprise may discover that it is over-licensed. Although no additional license fees will be due, the money that has been paid out for maintenance and support for these unused licenses is wasted. Depending on the type of purchasing strategy — decentralized vs. centralized — or purchasing policy an enterprise uses, on average, the majority of enterprises with more than 5,000 technology users are over-licensed. The best case is to have an effective asset management program in place before the audit (see "Three Tools of an IT Asset Management Program," DF-14-4502).

Each organization needs to spend time with its legal and technical groups to define standard clauses to be included in every significant software agreement that will provide protections in case of an audit. Issues to be defined include:

What Is the Proper Minimum Time That Should Be Required Before the Software Vendor Can Perform an Audit?

Generally, a contract will give 30 to 45 days notice. Ensure that your contract gives you a minimum of 30 days notification. However, these additional provisions need to be included:

- The notice must be written and sent by certified mail or a recognized overnight carrier.
- The notice must be sent to the enterprise's legal department or other high-level management group.
- The enterprise must have the right to delay the audit for a legitimate business reason (e.g., a retailer with significant amount of business during the Christmas season should be allowed to postpone the audit to another time).

Who Will Perform the Audit?

- Specifically exclude the rights of organizations such as the Business Software Alliance and the Software Information Industry Association from conducting the audit. These organizations receive their fees based on penalties charged because of noncompliance. The software vendor is often more concerned with maintaining a good relationship with the enterprise.
- Approval must be obtained from the enterprise as to who will conduct the audit (the software vendor or a public accounting firm). Some smaller, specialty firms may be less expensive than the larger firms.
- A confidentiality agreement must be in place with the party conducting the audit.
- Include how the fees will be paid for the audit. Often, the enterprise will be responsible for the fees if it is more than 5 percent or 10 percent out of compliance.

How Will the Audit Be Conducted?

- Details and documentation that reflect the process and how the software usage will be measured must be provided at least 30 days before the audit is conducted.
- The assistance that will be required from the enterprise's personnel needs to be listed with an expected list of responsibilities to be performed.
- Auditing software must first be run in a test environment to ensure that it is compatible with the software being run.
- In some large enterprises, the vendor may conduct an audit by using a "sampling" methodology. There are obvious dangers with this. If sampling is used, ensure that you agree in advance with the vendor that the resulting data can be trusted as a picture for the entire enterprise.
- Consequential damages should be addressed if the audit causes disruption to the enterprise's production system.

What Happens When the Audit Results Are Presented?

An enterprise should have 90 days after the results of the audit are presented to correct any problems without being penalized. For example, software that was left on unused servers may just need to be removed. Software may have been downloaded in error (some software vendors include unlicensed software with their software updates) and may not be in use. Enterprises should have the opportunity to delete this software rather than have to pay for it.

Some software may be subject to compliance issues. In other words, there may be issues that prevent accurate measurement to determine whether the software is within the usage rights stated in the license agreement. This is common for concurrent licenses because the contractual requirements may require usage at the multiplexing front end, and the auditing software may not be able to provide such measurements.

In some cases, issues cannot be resolved with the vendor. Whether the issue will be resolved through arbitration or through the courts should also be discussed with your legal department. Keep your legal department involved in any audit at the onset, rather than only involving your technology department.

Payment Terms and Resolution

Most software vendors will expect to be paid for under-licensed fees within 30 days after the completion of the audit results. In addition to the license fees, most vendors expect you to pay "reasonable costs of the audit" if you are more than 5 percent or 10 percent out of compliance. Because audit fees can vary widely, depending on who performs the audit, you may want to put in a "not to exceed" cost of the audit in the contract.

Other Recommended Suggestions for Handling Audits

- Ensure that you have a very clear definition of usage in the contract, including how usage will be measured in the event of an audit.
- Propose a clause that will require you to provide the software vendor with an annual report of your actual usage according to the contract language you negotiate.
- Allow for potential overusage within the annual period and base additional fees on your annual "true-up" report. This would allow you to purchase additional licenses on an annual basis, rather than having to track usage throughout the year.

- Negotiate terms that establish the additional license and maintenance fees when more licenses are required.
- Limit audit rights to once every three years, rather than once annually, if possible.

(For specific information on Microsoft audits, see "Microsoft Software Review: Precursor to a Formal Audit?" E-13-6232.)

Key Issues

What are the latest trends and innovations in strategic sourcing and procurement?

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