Is the recession increasing revenue leakage risks?

The ever-present risk of revenue leakage is all the more ominous in today's chilly economic climate. Licensors should ensure they have a robust licensee risk assessment in place to guard against this threat

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The outlook today for the global economy is not particularly glowing. Nowhere is this more evident than in the United States. According to US government statistics, in the last three months of 2008 the US economy suffered its biggest slowdown in 26 years.

US gross domestic product (GDP), the broadest measure of the nation's economic activity, fell at an annual rate of 3.8% in the fourth quarter, adjusted for inflation. This is the largest drop in GDP since the first quarter of 1982, when the economy suffered a 6.4% decline.

Companies utilising a licensing model to generate revenue from their intellectual property may feel that they are ahead of the game, but they too are vulnerable to the current recession. Now more than ever, aligning oneself with the right licensee can have a significant impact on a licensor's revenues. Under a core licensing model, there is dependency upon the licensee to generate sales to drive the licensor's royalty revenue. With this comes the additional need to understand the state of your licensee's business and what reliance you can place on its sales, forecasting or, in extreme cases, ability to continue as a going concern in today's business world.

Finding oneself in this environment to begin with is difficult enough. Add the potential for "revenue leakage" and the equation becomes that much more challenging to solve. Based on our experience, it is estimated that as much as 80% to 90% of a licensor's portfolio has revenue leakage regarding underpaid royalties by the licensees.

The causes of revenue leakage are numerous, from simple spreadsheet miscalculations to misinterpretations of the agreement which lead to under-reported sales or over-reported deductions.

The impact of the prevailing economic climate, combined with the omnipresent risk of revenue leakage, is reason enough for all licensors to have a robust licensee risk assessment in place.

Establishing a risk assessment for your portfolio of licensees

The need to understand licensees' ability to continue to generate sales and remain compliant with the terms of the licensing agreement is clearly more critical than ever. Performing a periodic risk assessment of the licensees within your portfolio is considered a best practice and should be part of a robust licensing compliance programme. The results of such an assessment can provide valuable information that places the licensor in a much stronger position to mitigate risk or proactively address a potential negative impact on a valued royalty stream.

While there are numerous aspects of a complete risk assessment, we highlight three general categories and tie each to the impact it may have on the current economy. As we outline a general approach towards defining the risk factors, consider assigning a "risk rating" to each of the categories you choose to incorporate into your assessment. The risk rating should be made up of both a qualitative and, where relevant, a quantitative set of measurements. By combining both the qualitative and quantitative measures, you can then simply assign an overall rating to each category (eg, low, medium or high).

In many cases you will have to make a subjective judgement call when assigning a risk rating. The benefit of going down this path to begin with is to make your analysis more robust, thoughtful and transparent within your organisation.

Industry risk factors

At a high level, an effective risk assessment should start with an analysis of the overall industry with which your licensing is aligned and will allow you to analyse numerous aspects of your licensing strategy. The assessment should identify unique industry accounting, unique reporting practices and unique industry standards. This step will help you to understand the impact that some of these issues may have as they relate to your definition of net sales, and more specifically how they may impact on certain items you may consider allowed as deductions to sales.

Also as part of the assessment, you should understand the macro and micro-economic factors and how they may impact on your licensees. A better understanding of a specific industry's growth rate may affect your negotiation of the royalty rate that you would hope to achieve or accept. The sophistication of the legal and regulatory environment, and its related enforcement, provides you with an understanding of how much legal risk or exposure you may be taking on.

The number and strength of competitors to your licensee will also come into play as you attempt to anticipate the future sales that your licensee will be able to generate. Many of these industry risk factors are being affected by today's economy. For instance, a macro and micro-economic study of the healthcare industry may yield fundamentally different results from a study aligned with the retail industry. With these variables comes the need to evaluate such areas as guaranteed minimum payments and covenants as they relate to your licence agreements.

Specific licensee risk factors

As you further progress from an industry to a specific licensee risk assessment, your analysis will become more granular. Due to the nature of the relationship you have formed with the specific licensee, your diligence becomes that much more detailed. Specific areas of analysis should include issues such as the following:

- Size and complexity of the entity.
- Diversity of the entity's operations.
- Geographic dispersion.
- Key customers.
- Corporate activity.
- Related-party transactions.
- Nature of the business.
- Company history.
- Public or private.
- Ownership/board of directors.
- Reputation in industry.

Let us now take a closer look at a few of these areas. Performing an analysis related to the diversity of the licensee's operations can lead to an understanding of the significance that your particular product/brand has in relationship to the licensee's overall business. The more significant that your product/brand is to the licensee and the more reliant that the licensee is on your product/brand, the higher the risk due to the need for your product/brand to sell well in order for the licensee to maintain profitability and possibly even stay in business. This would result in a higher rating under a risk assessment.

Additionally, it is crucial to look at how key customers may influence your risk assessment. It is particularly important not only to analyse the financial viability of your licensee, but also to undertake deeper analysis by examining its key customers. Due to the dynamic state of the economy, more and more companies are announcing that they are going into bankruptcy or closing their operations.

Through analysis of your licensee, you should determine whether a majority of its business is concentrated within a select number of customers. If you can identify such an instance, you should then expand your analysis to include those customers' financials and better determine their short and long-term viability. This will give you transparency into understanding the potential impact that a customer may have on the licensee's business. As you complete the licensee risk factors, you will gain further clarity into the process. Although this is somewhat judgemental, it is intended to provide further clarity into your licensing strategies.

Licence agreement risk factors

The actual agreement is the last area of analysis that we examine with regards to a risk assessment. Within this area, you will conduct the most detailed analysis of your licensing programme. Similar to the licensee risk assessment, there are various areas

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of analysis aligned with a specific licensee agreement risk assessment, some of those being:

- Volume of royalty dollars.
- Quantity of the product being sold.
- Agreement territories.
- Agreement term(s).
- Single or multiple products.
- Negotiators (are they still employed with the licensor/licensee?).
- Results of prior royalty audits.
- Complexity of the agreement.
- Grey market risks.
- Net sales definition.

While all of these areas lend themselves to analysis under an effective risk assessment, let us now look at one of these areas in more detail. The complexity of the agreement can be a big driver as it relates to your risk assessment. Consideration should be given to many aspects of the agreement and its make-up. Certain areas that warrant specific questions as they relate to the complexity include the following:

- How well is revenue defined (units v dollars; gross v net)?
- How clearly are deductions defined?
- What are the revenue triggering events?
- Are there royalty percentage variables?
- Are there guaranteed minimums?
- How are sales to the licensor handled?
- Is product bundling allowed?
- How are related-party transactions handled?
- What are the terminating events and how clearly are they defined?
- What are the consequences of termination (ie, disposal of inventory)?
- What are the covenant requirements?
- What are the reporting and record-keeping requirements?
- Are there non-economic requirements (ie, customer approvals)?

All of these areas need to be assessed when looking at assigning a risk to the structure of your agreement. With every aspect, on an annual basis, revisit your risk ratings to determine whether there is a need to reassign your ratings. For instance, we would probably assign a slightly different risk rating to those licensees doing business exclusively in the US today from those doing business one year ago. Additionally, as market conditions change, you may add certain criteria to your risk assessment or determine that a more or less detailed analysis is required. Certainly this is recognised if one were to look at a licensee from an ongoing concern perspective today as against one year ago.

This process has many moving parts. We have discussed assessing your risk as a licensor at a high level by looking at the industry as a whole, becoming more granular by looking at your specific licensees and finally looking in greatest detail at your individual licensee agreements. Each of these areas would probably have a fundamentally different risk in today's world as against one year ago, mostly as a result of prevailing economic conditions. Yet the key in any economic environment is to have a discipline programme – which, if done effectively, would include a risk assessment.

Benefits of a risk assessment programme

As expected, companies are looking at every dollar – both of revenue and of expenditure. Companies are also trying to locate additional revenues or cost savings.

For those companies that own intellectual property, an area of growing focus is to establish a robust licensing compliance programme, through which you systematically examine licensee reporting

of royalties for completeness and accuracy of royalty payments. An effective licensee risk assessment plays a vital part in such a programme and, some would argue, is instrumental to starting a programme off on the right foot. By applying a comprehensive risk assessment to the front end of a compliance programme, licensors can essentially prioritise those licensees, which may include providing a field examination of the historical royalties versus those under which a form of desk procedure analyses would suffice.

A holistic compliance programme would include periodic royalty audits, as well as desk procedures – the risk assessment is again a vital part in getting such a programme up and running. The selection of which licensees to audit is critical to that success, as it will better align you with those licensees that may not be in compliance with the terms of your agreement(s). Under an effective programme, a risk assessment helps to drive a robust methodology for this selection. *iam*

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