

Keeping a close eye on licensing

An effective post-agreement licensee monitoring strategy is an excellent way for companies to maximise the value of their revenue streams; as with so many aspects of a successful business relationship, communication is key

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Today's highly competitive market, combined with the ongoing global economic slowdown, means that companies seeking to maximise the value of their revenue streams should be closely monitoring their licensing arrangements at all levels within an organisation – from managers to the board of directors. Implementing an effective post-agreement licensee monitoring strategy is one tool your company can use to increase cash flow and profitability.

The challenges that licensors face with licensee compliance are consistent across many industries, geographies and private and public companies of all sizes. Without an end-to-end view of a licensee monitoring process, the risk to an organisation of inadvertent misreporting at best, and intentional under-reporting at worst, is increased. An effective post-agreement licensee monitoring programme is built upon three main areas of activity:

- Agreement and support document retention practices.
- Periodic licensing programme risk assessment and enhancement.
- A routine licensee inspection programme.

Understanding individual roles and responsibilities

Before you can assess and enhance the effectiveness of a post-agreement licensee monitoring programme, it is important to understand and define the roles and responsibilities of key resources involved in designing and executing the fundamentals of the programme. From the licensor's perspective, there are three primary parties in a licensee monitoring programme:

- The licensor corporation or entity.
- In-house or outside counsel.
- Accounting or consulting firms.

The licensor company is the heart of any licensing monitoring programme. Key responsibilities of the company include developing the technology, brands or products to be licensed; managing the economics of the intellectual asset; maintaining the contracts; and sustaining mutually beneficial relationships with licensees and business partners.

Not all companies utilise outside counsel in the process; however, at a minimum, in-house counsel should be involved to advise on the legal aspects of the business relationships, help negotiate terms with business partners, draft agreements and, if unavoidable, protect rights through litigation.

Accounting and consulting firms are often used to perform independent inspections under the "right to audit" clause in agreements, provide an accounting perspective on key contract language and terms, and help companies to assess and implement effective licensing programmes.

Each of these parties' roles and responsibilities often overlap. The key to reducing misunderstandings in a licensing programme, and thus minimising risk to the organisation, is communication. Because

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the licensor's business teams typically receive the self-reported licensee information and tend to know their business partners the best, it is important that there is a feedback loop between all parties to share information.

An effective agreement retention programme

Before a company can implement an effective monitoring programme, it must have a process for accumulating and understanding all of its agreements and supporting documents. Establishing a set of agreement management guidelines and communicating those guidelines throughout the organisation is one of the building blocks of an effective monitoring programme. Without ready access to all agreements, addendums, amendments and side letters, it is difficult to monitor compliance with specific terms and complex clauses that affect your business. Further, establishing a central repository for agreements increases the likelihood that templates containing the most current approved language and terms will be used and established guidelines will be followed.

In order for agreement guidelines to be sustainable in practice, it is important to assign responsibility for the agreement management process. The owner of this process will be able to establish the level of agreement and document management sophistication that the organisation can sustain while evaluating the cost benefits of implementing additional best practices, such as imaging contracts, implementing a contract database and automating the tracking of key dates and terms. However documents are managed within the licensor's organisation, it is important to establish guidelines that will add consistency and standardisation to the process.

An effective risk assessment programme

The second building block of an effective agreement monitoring programme is a periodic risk assessment and enhancement programme. A key differentiator in risk assessment programmes is taking an internal perspective as well as an external one. An internal perspective incorporates the priority that a company places on identifying the main areas of risk for its specific businesses, the maturity or robustness of its licensing compliance efforts and how well its internal processes and controls are monitoring the overall licensing activity.

Key areas of risk may be different for every company. However, some common risk factors which affect many companies and may specifically impact on licensing-related activity include the following:

- The location of the licensee.
- The number of licensees.
- The complexity of the agreements.
- The number of transactions.

Assessing the sophistication and maturity of all post-agreement monitoring activities against an established set of criteria is an important step toward achieving an effective post-agreement monitoring programme, thus increasing the ROI of the intellectual asset and reducing the overall risk to the organisation.

As a company matures some common characteristics will begin to emerge. A mature licensee monitoring programme will consistently contain many of the following elements:

- A consistent company culture beginning with 'tone at the top'.
- An integrated team approach from executives and legal to business people and sales.
- Dedicated budget and resource

allocation for routine risk-based proactive inspection activities.

- A commitment to analyse regularly data received from licensees.
- Zero tolerance for non-compliance with key terms and clauses.
- A systematic and sophisticated approach to business intelligence.

The amount of resources that companies invest in their post-agreement monitoring programme covers a broad spectrum. As these activities begin to work together, companies begin to see a consistent ROI from their licensee monitoring efforts and a corresponding lowering of risk for under or unreported revenue.

Evaluating licensee risk to your company

There are many methods and levers that can be used to evaluate the risk to your organisation of a licensee's non-compliance with your licensing agreements. Three key factors that impact on the likelihood of non-compliance are:

- The total spend and number of transactions generated by the contract.
- The complexity of the calculations underlying the royalty base.
- The level of difficulty in complying with key clauses and terms and licensee-specific business environment factors.

As the frequency of the transactions and amount of spend generated by the contract increase, so does the likelihood of misreporting. Historically, greater attention is paid to quarterly, semi-annual or annual transactions, due to their infrequent nature. Frequent transactions often involve more routine and automated processing protocols, which increase the likelihood of systemic and system update errors.

Similarly, the more complex the contract terms and licence fee calculation components, the greater the likelihood of misreporting. The absence of certain clauses or language such as "right to audit" or "books and records" clauses can also increase risk. Typical complexities include tiered and regional pricing, pricing by feature and licence fee calculations that involve interpretation of certain accounting terms, such as revenue, income, profit, sale or deductions.

In addition, particular attention should be paid to provide examples of complex calculations. Agreement language should also be easily measurable in the normal course of business and not require additional systems or expertise to measure. For example, one risk mitigation practice is

to have an independent financial person review the accounting terms and provisions in the agreement to help reduce the risk that the actual results of the calculations performed by the licensee will have unintended results.

Finally, it is important to monitor certain of the licensee's business attributes. The following qualitative factors can have a direct impact on reporting accuracy:

- Whether there has been high turnover in the licensee reporting process.
- Whether there has been a recent system change that may have caused data to be lost or queries modified.
- Whether the licensee has been focused on developing new products that were not originally contemplated in your agreement.
- The nature of the control environment in the rest of the organisation.

An effective inspection programme

An effective inspection programme is routine and licensee selection must be well thought out in regards to licensee risk, potential for ROI and time since the last inspection occurred. The following topics exemplify specific points to consider when implementing an inspection programme as part of the post-agreement licensee monitoring activities.

The inspection team approach

Whether your inspection is being performed by internal resources or independent third parties, an effective monitoring programme needs an inspection process that is based on a forensic approach. Because all licensees' business environments are unique and all contracts have individual nuances, a check-the-box approach to licensee monitoring will not yield the highest ROI.

Equally important to a forensic approach is a focus on and awareness of the licensor and licensee relationship. Recognising that in most instances both companies wish to continue to work together, maintaining and often enhancing your business relationships through increased transparency and accountability is a key component. Selecting the right internal resources or professional services firm to help bridge the gap between expectations and requirements is an important decision in developing an effective monitoring programme.

Once you have evaluated the licensees on a risk basis and determined whether the inspection will be executed by in-house or independent resources, the focus turns to preparation for the inspection.

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Internal preparation

Communicating internally to sales teams and other internal stakeholders is important because buy-in from all internal teams is essential. Their contact with licensees may influence their perceptions of the inspection process and will help to alleviate the fears and hesitation that some licensees may feel.

One effective practice is to host an internal call between the inspection team, the sales or account team and the other internal stakeholders to provide an opportunity for all parties to share concerns they may have and background information about the licensee relationship. They can then identify specific areas on which to focus or challenges that the inspection team should be aware of prior to the field work.

Once all the pertinent licensee information is gathered (eg, agreements, licence fee reports, payments and internal discussions), it is important to establish a work plan and budget to monitor progress. This will allow you to adjust the programme to increase effectiveness on subsequent inspections.

External preparation

Preparing for an inspection will save time and money. There are a few areas in particular where proper planning prior to field work will drive an effective inspection process. These include the following:

- A kick-off call from the inspecting team to the licensee.
- A licensee information request document.
- A planned site visit.

Usually the first interaction the inspection team has with the licensee is the introductory kick-off call. This first impression is important not only to outline the process and set expectations, but also

to put the licensee at ease by establishing a non-confrontational tone for the inspection. In order to increase efficiency, the kick-off call should also address a number of procedural and administrative elements. Having a discussion regarding the need for a non-disclosure agreement or other formalities upfront will help to ensure that access to licensee data in the field is available when you arrive.

An effective information request will ensure that the inspection team can:

- Validate that the requested datasets are complete and accurate.
- Ensure that all the relevant data points used to calculate the licence fees or royalties are available for testing.
- Provide insight into licensee business practices, product strategy and goals.
- Identify the key individuals involved in the licensing process from end to end.

Scheduling the on-site portion of the inspection is highly dependent on the timing and completeness of the information provided as a result of the information request. To minimise the direct impact on day-to-day operations of the licensor and licensee, the licensee site visit should be condensed into one visit, if possible. In order to accomplish this, it is important to receive as much of the requested data in advance of the site visit and allow time to validate data completeness, analyse the information and develop questions before the site visit begins.

At the end of the site visit, providing the licensee with an opportunity to address any potential findings helps to build a feeling of mutual respect and stronger validation of findings. Because of the direct interaction between the inspection team and the licensee, as well as the reporting processes and controls, the inspection report should

include a section discussing observations and recommendations on how the parties can increase the effectiveness of the controls in place and provide greater transparency in the overall licensing process.

Analysing qualitative and quantitative metrics helps to evaluate the effectiveness of the programme and identify areas where opportunities for improvement may exist. A number of licensee analysis inputs can be obtained from a proactive inspection programme that can help to evaluate the risk of under-reported or unreported revenue from your licensee and to develop more effective contracts going forward. Such inputs include:

- Percentage of unreported and under-reported royalties.
- Comparison of actual revenue to projected revenue.
- Reporting system changes.
- High turnover.
- Complexity of calculations related to business language terms.

Putting it all together

Before you embark on a post-agreement licensee monitoring programme, it is important to establish a set of objectives in order to help you to meet your goals and expectations. As you become more sophisticated, the programme's objectives should evolve accordingly. Several common objectives must be agreed upon in order to evaluate the effectiveness of the monitoring programme:

- Evaluate and rank the risk to your organisation of non-compliance with key terms and clauses in your licensing agreements.
- Build thresholds for comparing

reporting accuracy.

- Determine what key quantitative and qualitative clauses are important to inspect compliance with routinely.
- Design a mechanism to evaluate fair contract interpretations for key terms.
- Build a mechanism to increase accountability and transparency.

Frequently there is a disconnect between the amount of revenue generated from licensing agreements and the number and level of company and licensee resources responsible for managing agreement compliance and royalty reporting. Companies should never assume the accuracy and completeness of their licensee or self-reported revenue without first sending a "trust but verify" message to their licensees.

Companies should not hesitate to implement a licensee monitoring programme because they fear alienating licensees or business partners. Royalty inspections need not be adversarial or burdensome if planned and executed effectively. In addition to executing a well-designed royalty inspection programme, companies should consider implementing an effective agreement and document retention programme and a systematic risk assessment programme that incorporates a risk-based approach for identifying which licensees to examine. These activities will increase the likelihood of an effective post-agreement licensee monitoring programme. **iam**

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Mr Scavo has extensive experience providing evaluation and analysis services on numerous asbestos and long-tail claim liability and property insurance matters. In addition, he has worked in the firm's insurance regulatory and compliance practice, assisting clients in identifying opportunities to improve their compliance programmes and responding to market conduct exam requests from state regulators.

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