

Key advisory issues

IP owners – leaving big money on the table

Underreported licensing fees and misinterpreted contract terms – along with insufficient compliance monitoring of licensing agreements – are combining to cost IP owners millions in lost revenue.

While it is a priority for companies to put systems in place to monitor and control their daily activities, including systems to ensure that revenues are collected and accounted for, it is a different story when it comes to royalty income. In fact, the majority of technology executives participating in PricewaterhouseCoopers' "Exploiting Intellectual Property in a Complex World" survey (PricewaterhouseCoopers' *Technology Executive Connections*, Volume 4, June 2007) indicated that as IP owners they have no active compliance programmes in place to monitor licensee activities and revenue reporting.

Even in cases where a compliance programme does exist, all too often no one in the organisation is charged with ownership and responsibility for verifying the royalties reported by licensees, and few have the internal clout to implement and govern its activities. According to the same survey, the leading approach for monitoring intellectual property at technology firms is to rely on C-suite executives for IP management, with 38 per cent of companies following this route. Another 36 per cent of respondents said that responsibility lies with line or business-unit executives, while only 21 per cent rely on a separate specialist unit for the management of intellectual property. "But," says one executive participant, "it's important to note that at some firms the scope of these units is very narrowly focused, with some concentrating solely on generating licensing agreements."

This begs the question of why so many otherwise savvy companies fail to put in place a proactive and consistent royalty compliance programme and an executive or group whose sole role is to monitor and control the programme to ensure that maximum value is extracted from licensed intellectual property. Regardless of whether or how their companies are structured to

manage intellectual property, 71 per cent of survey respondents say that a focus on short-term results inhibits the development of more sophisticated processes for managing intellectual property, and 66 per cent say that current accounting practices understate the value of their intellectual property.

Trust versus mistrust?

Some clients are reluctant to audit licensing reports for fear of damaging the relationship with their partners. Their take on things is that such relationships should be based on trust. Our take is this: trust – but verify! Underreporting is not always driven by duplicity; in fact, frequently the problem stems from accounting errors or cultural and language difficulties that result in, for example, the misinterpretation of contract terms. It is essential for the two parties to identify differences in contract interpretation and reporting early in order to allow the changes in the agreement or procedures that allow for objectives to be achieved. Starting a rolling programme of licence examinations as a matter of course early on in the contract period, when presented in that context, should not ruffle any feathers. In fact, it will quite often result not only in an enhanced revenue stream, but also in improved relationships with business partners. Without sufficient and appropriate oversight, issues such as unpaid royalties or breaches of IP usage rights go undetected.

What, why and how companies license intellectual property

From large international software companies to fashion brands, character brands, publishing firms, artists and performers, companies worldwide engage in licensing tangibles and unique, valuable intangibles including innovative technologies, brands, know-how, customer lists or simply a certain 'look'. If it has value, it can generate licensing revenue and boost a company's bottom line.

Regardless of size and the degree of sophistication, many organisations have an IP framework along the following lines:

- The sales or marketing team identifies opportunities to license the intellectual property.
- A suitable (and usually trusted) licensee is identified.
- In-house legal counsel get involved in drafting contracts that set out the terms of the relationship, including:
 - which piece of intellectual property is being licensed;
 - how and where it can be used; and
 - how the royalties payable to the licensor are to be calculated.
- Licensees begin production and the IP owner receives royalty reports as stipulated in the contract (typically monthly or quarterly).
- Royalties are paid accordingly.

So everybody is happy – or are they?

This framework sounds relatively straightforward, but often it is not so simple. Much depends on trust and integrity. Given that licensees self-report to the licensor as to how much royalties they must pay based on their review of their own accounting records, common sense indicates that there must be a step in the process where someone checks to see that royalty returns have been received and assessed for completeness. Mistakes cost money – sometimes a lot of money, even exceeding the seven-figure mark.

Most instances of underreporting of royalties stem from routine accounting errors, contract misinterpretations and the like, rather than deliberate omissions. That said, there are times when things do turn ugly. Whether driven by greed or by market pressures, a few unscrupulous licensees may aim to cut costs at the licensor's expense. Unfortunately, when it comes to cost cutting, the easiest cost to cut without affecting the end product is royalties payable to the licensor. This is especially true in mature or competitive industries where products have low barriers to entry and production costs have already been cut. The extent of underreporting royalties varies from market to market and from industry to industry. Some underpay by just a small amount, while others underpay by a lot more. Vigilance is critical if companies are to make the most of the value in their intellectual property.

Too many companies with licensed intellectual property still do not have a compliance programme – and even if they do, they do not have managers in place to make sure it is working effectively. As evidenced in the

statistics that emerged from the survey, all too often IP owners rely on sales, marketing or even legal counsel to keep an eye on things. As it turns out – possibly due to busy work schedules or because no one has looked at the IP cycle objectively – little monitoring actually happens. This is particularly true for organisations where intellectual property is not a major or primary revenue stream (eg, companies that license their brands to manufacturers of a range of consumer products, from sunglasses to MP3 players).

Often companies admit that although monitoring intellectual property is something they think they should be doing, they have not yet gotten around to it. Even worse, some companies think they are monitoring their intellectual property, when in fact they are not.

However, even when companies do have a compliance manager in place, they must recognise the complexities of IP compliance. Few measures are available to help IP rights owners assess whether the royalties reported by their licensees are reasonable. Publicly available market data on product sales is often unavailable, incomplete or unreliable. To exacerbate the problem, large organisations can have hundreds, if not thousands, of licensees spread around the world, and few IP owners have local presence to monitor things on the ground. It is no wonder, then, that many compliance managers say they are overwhelmed or unsure of where or how to start, or how to measure the risks. Various aspects of the process can be confusing, leading to mistaken assumptions. For example, sometimes licensees that report only small levels of sales are deemed to be insignificant and are therefore excluded from the review programme. It is important to know what to look for and where to look for it.

To complicate matters, things are not always what they seem

A major global IP owner recently explained to us that while publicly it has an active royalty enforcement company, privately no such programme actually exists. This is not the first time we have heard this – even in very large companies, unpaid royalties can run into the tens or hundreds of millions of dollars, all of which goes undetected by the oblivious IP owner.

Moreover, in emerging markets that are key for many IP owners, licensees can be more aggressive than in mature markets with high governance standards in place. All too often, they have been known to report either only a small amount of their licensed sales or, in a worst-case scenario, none at all. To illustrate: a licensee of an electronics manufacturer in one emerging country recently admitted that his company maintained two sets of books: one depicting tax records with recorded sales

substantially lower than they actually were, and the real-world books that were kept in a windowless building where the factory workers stayed, hidden away from the prying eyes of the tax auditors.

Often IP owners based in the United States or Europe with licensees located in Asia have little presence in, or understanding of, markets where significant revenues arise. Such remote stakeholders are unable to monitor what is due to them – and unscrupulous licensees know it.

So by now you are convinced that the challenges are legion. A sound monitoring programme, with an executive or unit dedicated full time to overseeing it, can go a long way towards helping to control royalty reporting and extract the full value from intellectual property.

A sound monitoring programme – pulling it together and reaping the rewards

A truly effective licensing compliance programme requires a collaborative effort from IP owners and their advisers. Taking the time to incorporate clear goals and objectives that are aligned with a wider IP strategy and the overall business strategy will bring tangible benefits throughout the whole process – from creation, logging and monitoring to generating the revenues due. Leading companies often engage external advisers with specialist knowledge and experience in compliance management to design, implement and administer effective royalty examinations on a rolling basis.

Even a small start can be effective

Sometimes just making licensees aware that you have a programme to monitor royalty reporting may increase your royalty revenues. IP owners that are developing a monitoring programme for the first time should announce the programme to all their licensees. Recently such an announcement resulted in a licensee reviewing its historical reporting and, on identifying problems with the amounts previously reported, promptly sending a cheque for the underreported royalty to the licensor. (Naturally, the amount was then reviewed for accuracy.) Of course, this is the exception rather than the norm, since most misbehaving licensees wait for the licensor to knock on their door – and all too many licensees have been waiting a long time for that knock. Still, it is indicative of the rewards that these programmes and the people who monitor them can bring to IP owners.

Things are looking up

Since intellectual property is a key driver of value, those companies that undervalue intellectual property and do not focus on its management are undermining their own efforts. Despite the aforementioned dearth of compliance

managers and programmes, there is hope. As evidenced in the “Exploiting Intellectual Property in a Complex World” survey, executives are slowly realising that intellectual property is increasingly essential to their businesses and they are becoming more active in its management. We hope that you are, or soon will be, among them.

In our licensing management and contract compliance practice, companies are increasingly presenting sophisticated royalty monitoring programmes – particularly in the software and technology sectors, where IP revenue is the lifeblood of the organisation. These companies spend millions of dollars on their programmes, which in turn generate significant sums in return. The success story below is a prime example of the added value that comes from such an investment.

A new compliance manager and cutting-edge monitoring programme pay off

Whereas compliance programmes typically identify problems on the licensee side of the partnership, surprisingly this time the problem unexpectedly lay with the licensor itself.

A newly appointed compliance manager asked us to work with him to develop and implement an effective programme to track and control licensing royalties. The newly minted programme was soon up and running, enabling the compliance manager to identify millions of dollars in royalties that had been duly reported by licensees over a period of several years – but that had gone uncollected because the licensor had inadvertently failed to send out invoices for the amounts due.

Just a few weeks after investing in the compliance manager and system, the licensor’s bottom line was enhanced by a major influx of long-lost revenue. To say that the compliance manager and the programme had proven their worth to the company several times over is an understatement.

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Brian McGinley has specialised in forensic accounting since 1998 and brings a depth of experience in IP compliance, financial investigations and commercial disputes gained serving corporate clients, regulators and government bodies across Europe, the United States, Latin America and Asia. Based in China, he advises clients in the software, telecommunications, entertainment, pharmaceuticals and consumer products industries on IP issues. He has spoken on the topics of trade secret protection and royalty revenue leakage.

Brian D McGinley

Associate director – forensic services
Tel +86 10 6533 7363
Email brian.mcginley@cn.pwc.com
PricewaterhouseCoopers LLP
China



Melanie Butler has over 18 years' experience with PricewaterhouseCoopers, providing assurance and advisory services across numerous industries with an emphasis on entertainment, media and technology. Ms Butler's specialist areas include assisting companies in maximising the value of their IP rights through the development and implementation of licensing enforcement programmes; designing and implementing best business practices and strategies for managing, monitoring and enforcing intellectual property; and acting as an expert witness in arbitration and court proceedings regarding licensing enforcement best practice.

Melanie Butler

Partner, Europe, Middle East and Asia
leader, licensing management and
contract compliance practice
Tel +44 20 7804 5158
Email melanie.butler@uk.pwc.com
PricewaterhouseCoopers LLP
United Kingdom



David Marston, a partner with the firm since 1997, has a breadth and depth of international consulting experience, with specialised expertise in IP matters, including maximising IP monetisation, licensing compliance issues, contractual licence agreement issues, consulting on software asset management and IP risk assessments. He works primarily in the software and technology industry, and also serves clients in the telecommunications, life sciences and branded goods sectors. Mr Marston has served as a neutral arbitrator in numerous arbitrations related to purchase price disputes and other accounting issues, and often testifies in both federal and state courts as an expert witness.

David L Marston

Partner, US leader, licensing
management and contract compliance
practice
Tel +1 415 498 6585
Email david.l.marston@us.pwc.com
PricewaterhouseCoopers LLP
United States

