# Licensing in the Boardroom 2008

## Putting a stop to IP licensing revenue leakage

**PricewaterhouseCoopers LLP**


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# Putting a stop to IP licensing revenue leakage

Intellectual property may be the currency of tomorrow, but gaining control over licensing agreements – and the related tracking processes and controls – is today's imperative

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According to a recent PricewaterhouseCoopers paper, *Technology Executive Connections: Exploiting Intellectual Property in a Complex World*, more than half of the executives questioned for a recent PwC report do not believe that they are extracting the full value of their IP. And they'd be right.

Over the last five years, we have performed more than 1,000 examinations of licensing agreements. We looked at the aggregate data by country of licensor, by country of licensee and by industry in order to identify the trends. But no matter how you cut the data, the trend is the same: in over 90% of those examinations, we identified misreported royalties.

The trend towards IP licensing is escalating, making it more important than ever to manage licensed IP as the strategic asset that it is – reviewing agreements, tracking compliance and maximising licensing revenues. That means knowing what you should have versus what you actually have, and taking steps to fill the gap and plug any potential revenue leakage.

*"Until recently, we tended to keep our patents in a drawer, collecting dust. Now we are marketing these to other companies. They are very valuable."*
Executive at a European telecommunications company
PricewaterhouseCoopers' IP Technology Survey

**Knowing what you have**

Most collaborative agreements have contractual requirements for parties to self-report financial information to partners – typically in the form of revenue payments or expenditure reimbursement. These obligations usually require the reporting partner to monitor the relevant financial transactions and to record, process and report them completely and accurately to the other party. But familiarity can cause problems. Self-reporting agreements are so interwoven into the corporate DNA that they are all too often overlooked, causing liabilities to get lost within the framework of a company's accounting systems. Ask yourself whether you have a complete and accurate inventory of your company's contractual agreements with financial reporting obligations. Do you know how much you paid out on and received from them this year, and how much you expect to pay out on them in subsequent years? Do you thoroughly understand the risks and liabilities if you fail to comply with the financial terms of the agreements? If not, it's time to find the answers.

**Managing your IP licensing agreements as a strategic asset**

The vital role of IP management.

The overwhelming majority of respondents to PricewaterhouseCoopers' IP Technology Survey say that IP management is vital to the success of their companies and will become even more important over the next several years. Nonetheless, more than 60% of executives say that their companies could extract significantly more value from their intellectual property by means of active IP management. Executives in general do not express a high degree of confidence that their companies are doing

all they can, or all they should be doing, to maximise the usefulness of their IP assets.

Best-in-class companies do not underestimate the value in their agreements; rather, they manage their IP as a strategic asset. To maximise and exploit revenues from their royalty agreements, they put in the necessary effort early on in the process to effect a well-drafted licensing agreement – one with the correct terms and conditions clearly spelled out to avoid contract misinterpretations.

The challenges are many. In some parts of the world, licensees do not respect royalty agreements to the same extent as in others and have been known to turn a blind eye to their contract obligations. For the most part, though, misreported royalties are due to accounting errors, clerical errors or legitimate contract misinterpretations rather than intentional duplicity. Contract language is complex and confusing to begin with. If you stir differences in language and culture into the mix, and add to that conflicting mindsets – with licensors seeking to maximise royalties received and licensees seeking to minimise royalties paid – you have a recipe for reporting misstatements.

Say, for example, that an issue arose during negotiations that caused the negotiating parties to incorporate some particular nuance or intention into the agreement. Let's assume that the negotiator for the licensee does not personally administer the agreement, but instead pushes that responsibility down to a mid-level accounting or sales person who is not aware of, or does not quite grasp the nuances of, those extenuating aspects. The royalties reported by the licensee will not, in that case, reflect the intentions of the negotiating parties.

To avoid agreement misinterpretations – whether due to differences in language, culture or mindset, or to accounting or clerical errors – leading companies are incorporating best practices such as these into their IP licensing strategy:

- Do your homework. Take a strategic approach to selecting the right partner. Since trust is a key factor in solid partner relationships, due diligence – especially with respect to integrity and reputation in the market – is crucial.
- Establish clarity at the outset. Agreement discrepancies due to misinterpretation can soon grow into full-fledged royalty income disputes that can cost a great deal of time, effort and, all too often, hundreds of thousands of dollars (indeed, even millions) down the road.
- Pay attention to contract details. Missing or ignoring even a small detail in an agreement can result in substantial financial losses.
- Assess your approach to emerging markets. Review existing agreements to ensure that licensees are paying their fair share and to determine whether compliance activities need to be revved up.
- Appreciate the local factors. Misreporting may be masked where local practices are used that are significantly different from expectations in the licensor's home markets. Similarly, cultural insensitivity and a lack of local language skills can prolong an examination or damage the relationship.
- Have an effective enforcement policy in place. This includes, but is not limited to, the use of audit rights on a recurring basis. The audit-rights clause should spell out your right to bring in a third party to examine the books and facilities of your licensee. We recommend language that states: "In cases where there has been underreporting of X%, the licensee must not only pay the corrected amount, but also bear the cost of the audit."
- Conduct a royalty examination early in the contract period. It is wise to begin a rolling programme of consistent recurring examinations as soon as one year into the contract period – when any identified self-reporting discrepancies can be more easily corrected, causing far less emotional and bottom-line stress than if you were to wait 10 years to conduct the first royalty examination.

Some licensors say they are reluctant to activate the audit-rights clause lest they damage the trust-based relationship that they have built with their licensees over the years. From where we stand, this is a fallacious perception. We have seen royalty examinations actually improve a relationship – for example, in cases where the licensor suspects the licensee of fraudulent practices, but an examination determines that underreporting is actually due to legitimate accounting or clerical errors or misinterpretation of the agreement. Our recommendation: trust, but verify.

### Understanding the challenges – reaping the rewards

Licensors often ask us what they can expect should they license their IP to a company

based in a particular country. Our answer is always the same: the issues are always the same. No matter where in the world you do business, you'll be challenged by systems that are not designed for royalty tracking and reporting, jargon-laden contracts, conflicting mindsets, language and cultural differences that further cloud contract interpretation, and other complexities of that nature.

Nearly two-thirds of respondents to PricewaterhouseCoopers' recent IP Technology Survey say that IP protection in emerging markets is inadequate. Executives believe that it is almost impossible to protect critical IP completely in some countries. As for the future, they anticipate a moderate improvement in the quality of IP enforcement in most emerging markets. However, some executives doubt whether IP will ever be fully protected in emerging markets. We are seeing clients around the world challenged by this issue.

According to the survey, attempts to protect IP in China present a considerable challenge, the source of which is complex and includes many factors, such as the ability of Chinese manufacturers to bring derivative products to the global market at significantly lower price points; the insistence of the Chinese government on transference of IP intangibles to local manufacturing plants; uncertain outcomes to the rights of IP owners that occur in Chinese courts and among law enforcement entities; and high levels of IP transference occurring through employee movement from other geographies followed by redeployment in China. Taking a fatalistic approach, many foreign technology companies treat these IP obstacles as the cost of doing business in China.

*"We use our IP to differentiate our products and solutions in the market; we put together complete packages of products and technologies that can't be matched by our competitors. To meet demand, our company has had to expand its use of China-based contract manufacturing. Consequently, in China it has become a daily struggle to protect ourselves from IP theft. Nothing can eliminate IP theft or attrition entirely, however, there are steps that can help. First and foremost, the company does everything it can to select only trusted partners for licensing agreements. The company always makes provision for occasional audits of the relationship. Finally, we mark our products with code identifiers so that we can tell the fake from the genuine. Then we employ a law firm to go after illegitimate products."*
Executive at a large European technology engineering company
PricewaterhouseCoopers' IP Technology Survey

## Navigating through the complexities

Whether you are a licensor or a licensee – and no matter where in the world you have licensing agreements – chances are you may be struggling in one way or another with the complexities of royalty examinations.

All too often, some of the books and records are missing, particularly when the royalty examination takes place five or 10 years into the contract period. Various discrepancies, cultural attitudes, contract misinterpretations and other extenuating circumstances can also be barriers to arriving at fair and equitable findings.

## Differences in contract interpretation often muddy the waters

*"In some cultures, a licensee may consider a contract to be the beginning of a negotiation as opposed to a legally binding agreement. Issues can also arise around how the licensee defines the product-related costs it reports as deductions from reportable revenue. And the sheer complexity of licensed technology can create problems when determining which specific products or modules are subject to royalty payments. Finally, if a licensed technology product becomes commoditized, this can drive down the licensee's selling price and depress its profits to such an extent that it can no longer afford the royalty fees."*
PricewaterhouseCoopers: *How Inaccurate Self-Reporting Affects your Business Liability* (2007)

## Specialised knowledge spawns innovative solutions

More often than not, there are grey areas that make royalty examinations far from straightforward. When cultures collide and discrepancies arise, often what is needed is an innovative approach. Although for the most part, we work on behalf of licensors, here is one example where a thoughtful approach and an innovative solution resulted in a fair and equitable resolution for a licensee in Japan.

A US licensor engaged an accounting firm to conduct a royalty examination at one of its licensees, a Japanese manufacturing company. In the course of the examination, the auditor determined that the licensee had reported its royalties using an intra-company sales price, even though the royalty agreement between the two parties stated

that the selling price to be used as the basis of the royalty calculation was to be the arm's-length price to an unrelated purchaser. As a result, the auditor concluded that the licensee had underpaid its royalties by multi-millions of dollars. The licensee – astounded at the staggering amount of royalties that the licensor's accounting firm had calculated (extrapolated based on a small sample) as having been underpaid – asked PwC to analyse those findings to determine how the figure had been arrived at and whether it was valid. Having undertaken its own careful review, the licensee felt that the actual number was far lower.

After six months of negotiations with the licensor, the licensee asked PwC to step in and help. Having analysed the detailed sales data (tens of thousands of transactions), PwC determined that the licensor's royalty auditor had estimated an arm's-length unit price by using an average unit price based on a small sample that was not representative of the actual product mix sold by the licensee. It had calculated a large finding using these estimated arm's-length unit prices and extrapolating across the entire sales in the audit period.

PwC recalculated the royalties based on the sales data from licensee-affiliated companies to third-party customers and concluded that the licensee had underpaid its royalties by less than one-tenth of the amount originally calculated by the licensor's accounting firm. We presented the source information, our methodologies and findings to our client, the licensor and its accounting firm, explaining why our findings were so vastly different from the results of the original examination.

At the end of the day, all concerned agreed that the licensee would pay additional royalties based on our calculation methodology – a number that was indeed less than one-tenth of that calculated by the licensor's accounting firm.

For companies operating in the fast-moving world of technology – indeed, for most companies across the board – IP is the currency of tomorrow. But gaining control over licensing agreements, and the related tracking processes and controls, is today's imperative.

Critical success factors include the following:

- Recognise the value in your royalty arrangements.
- Treat your IP as the strategic asset that it is.
- Incorporate licensing best practices into your IP strategy.
- Select the right partner.
- Invest time and effort upfront to avoid costly surprises and turmoil later.
- Implement a consistent, recurring programme of royalty examinations to identify and correct misreporting errors early in the contract period, and maintain vigilance throughout.

The time to stem the flow of leaking revenue and start capturing the full value from your licensing agreements is now. The sooner you begin treating your IP as a strategic asset, the sooner you can achieve a positive impact on your bottom line.

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