

Partner compliance and dealing with revenue leakage

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Licensing in the Boardroom 2006

Key licensing issues for senior executives

Partner compliance and dealing with revenue leakage

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As organisations face ever-increasing pressure to grow revenues and expand their global reach, they often turn to a strategy defined by licensing and other forms of strategic alliance. To minimise the risk of revenue leakage related to these types of agreements, it is critical that organisations place greater emphasis on monitoring the compliance of partners. Alarming, though, the results of PricewaterhouseCoopers' 2006 Licensing Competitiveness Study show that many organisations appear to have a false sense of security in this regard.

The study surveyed organisations in the biotechnology (a subset of life sciences), entertainment and media (E&M), and technology sectors. Approximately 37% of these organisations believe that they suffer from revenue leakage. However, this percentage contradicts the results of licensing examinations that we have performed, which suggest that over 80% of agreements suffer from some form of revenue leakage.

The most common causes of non-compliance are differences over contract interpretation and the lack of appropriate reporting controls implemented by licensees, which are often overlooked unless licensors exercise the audit rights clause that is standard in most licensing agreements. Failure to exercise audit rights may explain the disconnect between the beliefs of survey respondents and the actual results of audits.

Although the life sciences, E&M, and technology sectors experience the same general issues related to non-compliance, many of the root causes are unique to the environments of the individual industries. The following sections will discuss the most significant compliance issues currently faced by each sector.

Life sciences

The life sciences industry, more than just about any other, is dependent upon strategic alliances. The need for pipeline products in large pharmaceutical companies, combined with the biotechnology industry's resource requirements, has created an environment in which more than 700 new strategic alliances are signed every year. Given the number and complexity of these deals, companies should focus attention on the following most common partner-related compliance issues:

Reporting of co-development expenses

Co-development agreements are among the most popular alliances in the life sciences sector. Often, biotechnology and pharmaceutical companies agree to share the costs related to the development of a compound using their different processes, with the ultimate goal of sharing in the commercial success of their combined efforts.

While the aim of such agreements is to share expenditures equally, there are often differences between the accounting language used in the agreement and the practical application of that terminology by the partners. For example, a recent contract called for Company A and Company B to charge their collaboration for their "actual labour and benefits, plus a predetermined overhead factor". However, the agreement did not provide a specific definition for the items to be included in the benefits costs. Company A included employee bonuses in benefits, while Company B excluded this cost, assuming it was included in the overhead factor. If Company B had not exercised its right to examine Company A's books and records, it would not have discovered the inconsistency in reporting and, as a result, recaptured several million dollars when it subsequently billed the collaboration for its bonuses and applied the overhead factor.

Global considerations

Many life sciences royalty and co-promotion agreements involve partnering with large, global pharmaceutical companies, primarily to leverage their global marketing and distribution capabilities. As a result, the global pharmaceutical companies are typically required to accumulate extensive revenue-related information – including gross sales, returns and rebates from many countries – in order to calculate payments due to its partners. Two of the more common difficulties companies encounter in accumulating this information in a manner consistent with the agreement's terms are:

- Lack of communication. In many cases, only the corporate location has access to the actual accounting terms of the agreement. The finance departments in the various countries often send only summary-level financial information to the corporate parent for inclusion in the contract reporting. The lack of detailed understanding of the specific contract terms leads to reporting mistakes that can remain undetected. Additionally, cultural differences and language barriers often contribute to inaccurate reporting.
- Accounting for rebates. The types of rebates that are granted to customers can vary widely from country to country. Therefore, a very detailed description of the types of allowable deductions is required, as well as consideration of the accounting rules in different countries.

Accounting for gross to net sales in the United States

Over 45% of global pharmaceutical revenues are generated in the United States, which subjects companies to complex rules related to accounting for revenue, particularly with respect to rebates. There are a wide variety of rebates and other adjustments, requiring companies to make estimates that often require significant adjustments when they are "trued up" to actual. The information to "true up" the adjustments may not be available until several months (or longer) after the expense for rebates is initially recognised.

Many accounting systems are not designed to account for adjustments on a product-by-product basis, so the benefits of any adjustments are often overlooked in royalty reporting. Since most royalty and co-promotion payments are derived from a contractual definition of net sales, it is imperative that the language used to define the adjustments and gross sales be clearly defined. This is important not only to identify

and clarify the specific deductions that may be included, but also to assure that reconciliations be performed to adjust any royalty calculation to actual on a product-by-product basis, to reflect the actual performance of the product.

Entertainment and media

The world of entertainment and media – in which companies distribute content globally using a variety of distribution relationships – is facing a period of unprecedented change. Never before have consumers and businesses pushed so hard and so fast to accelerate change in the distribution of content, a phenomenon that is resulting in new products, new ways of delivering service, new processes, new technology, new billing mechanisms, new trading partners, new ways to measure service, new opportunities for convergence, and so on. All of these issues spawn new leakage points that will result in lost money.

Licensors often suffer revenue leakage due to a variety of reasons, including the following:

- Significant contractual interpretation issues. Agreements are often negotiated by corporate teams that are frequently disconnected, geographically and culturally. Licensors face challenges both in dealing with their external licensees and regarding inconsistencies in the processes and procedures that govern their geographically diverse organisation.
- Underreported net sales. Because the traditional distribution model often includes the production and distribution of products by a licensee, licensors suffer revenue leakage from underreported production of units, inappropriate product categorisation, and inappropriate use of promotional items of product.
- Marketing expenditures. Entertainment and media agreements often contain marketing expenditure requirements. Licensors face difficulty in assessing licensee compliance because of a lack of accounting for expenditures on an individual product level by the licensees. Licensees' accounting systems are frequently not designed to capture expenditure information at an individual title level.
- Lack of processes and controls. Licensors often suffer revenue leakage because of a lack of robust licensee processes and controls to capture intellectual property usage. The effectiveness of an entertainment and media licensee's processes and controls can vary

drastically depending on the business maturity and regulatory and cultural environment of the distribution partner. With the emergence of new distribution channels, licensors are now entrusting their intellectual property to companies that have limited or no experience in distribution, billing, collections, or royalty calculations for entertainment and media content.

- **Content security.** Distribution of digital content provides the opportunity for inappropriate use of content without significant degradation in quality, creating a host of security issues for entertainment and media licensors. Licensors face challenges in maximising their opportunities to distribute content while simultaneously protecting the content from unauthorised use.

Maximising revenue through the global proliferation of entertainment and media requires licensors to work proactively with their licensees in structuring agreements that allow for clarity in definitions and provide robust reporting requirements. During the negotiation phase, licensors should also evaluate the effectiveness of policies and procedures employed by the licensee to capture intellectual property use. This all translates directly into the entertainment and media company's ability to monitor and minimise revenue leakage.

Technology

Among the many obstacles and challenges companies face in the current technology licensing environment, one of the most difficult issues is partner compliance, which often leads to sizeable revenue leakage or even a significant loss in the value of important intangible assets. These issues are varied and complex; however, the following issues are important to consider:

Overseas business environment

Since the same technology is often licensed to multiple companies in a variety of countries, significant challenges include the ability to understand different business environments – which leads to the added complexity of contract interpretation, including the negotiation phase and logistics.

Some common questions include: how is a contract viewed in a foreign country? Does a contract carry the same weight in China as it does in the United States or Europe? Certain overseas licensees may consider a contract the beginning of a negotiation as

opposed to a legally binding agreement and are likely to interpret terms aggressively to suit their business situation. However, the licensee may value the relationship and negotiation process more than the written contract. To be successful, licensors must understand this cultural difference and make appropriate adjustments in their negotiations. Many of the cultural and logistical issues can be overcome by performing negotiations in person. Some of the risks in this area may also be mitigated by negotiating lump sum payment licences, arranging continuous analysis of royalty payments, and maintaining consistent communication with the licensee.

Contract interpretation issues

Contract interpretation issues in technology licence agreements often relate to the product costs reported by the licensee as deductions from reportable revenue. The definition is often broad and ambiguous and leads to questions such as: What is includable in material cost? Should it include only material costs or be fully burdened with overhead? If overhead is allowed, should it include only plant overhead versus corporate overhead? Should manufacturing variances be reflected? Such unresolved questions can obviously have a drastic impact on royalty payments.

Identification of licensed technology

Most licensed technology is extremely complex, a fact that often creates problems when determining which specific products (or portions of products) are subject to royalty payments in accordance with the terms of licence agreements. This is particularly difficult when the intellectual property applies to a group of components performing a technological function, as opposed to a single component. For example, if the licensed technology is related to functionality, how does a licensor know that all components are being captured in the licensee's reporting process?

As a result, appropriate reporting by licensees often requires proper reporting by engineers of all relevant components to the finance, accounting, and legal teams, in order to properly update the list of royalty-bearing components as products evolve. Licensors should evaluate whether or not a licensee has adequate controls around this reporting process. This concern is amplified when dealing with language barriers, small start-up licensees with antiquated accounting systems and lack of staff, and in markets where accounting standards are lax or even nonexistent. Licensors should establish an

information-sharing relationship with their licensees that allows the licensee to discuss product details, thus becoming familiar with the products and their functionality and allowing for more effective negotiations. Licensors can also focus on keeping up with product evolution through internal analysis of royalty reports and related information, internet research, attending trade shows, and performing other similar due-diligence activities.

Another issue to consider as products and technologies evolve is whether current licence terms allow licensees to be profitable. At some point a licensed product can become commoditised, driving down the licensee's selling price. Manufacturing efficiencies may not be enough to keep pace with the reduced sales prices, resulting in licensees not being profitable enough to pay the royalty fees and possibly becoming non-compliant. Such a situation can obviously result in permanent damage to a relationship; therefore, companies should consider reworking such agreements or setting new standards across a region. In most cases, licensors will face much less compliance-related risk if both the licensor and licensee take away some value from the relationship.

Technology licensors can reduce revenue leakage related to their overseas licensee by recognising the impact of different business environments and adjusting accordingly; paying close attention to product evolution; and closely observing market situations where licence terms are prohibitive to a licensee's profitability. Licensing technology overseas introduces a unique set of risks, but by committing appropriate resources to monitoring and compliance, licensors can significantly reduce the risk of revenue leakage in these markets.

Minimise revenue leakage by exercising audit rights

As noted above, revenue leakage is clearly an issue that does not discriminate among industries. Although the issues are broadly similar, each industry has its own unique issues that must be considered by licensors. Based upon the nature of these issues, it is evident that many of them are not transparent to licensors and, therefore, can only be discovered upon exercising audit rights to inspect the books and records of a licensee. Unfortunately, too many organisations fail to exercise these rights and, as a result, will continue to suffer from revenue leakage.



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