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Self-reporting contract compliance: a hidden liability in your business?

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Self-reporting contract compliance: a hidden liability in your business?

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With an increasingly collaborative and connected marketplace, most organisations have a large number of contractual agreements with a wide variety of business partners. Such collaborative agreements may include licensing, supply, profit-sharing, cost-sharing, joint venture and contract manufacturing agreements. However, it is likely that a large percentage of agreements have undetected reporting issues associated with them, which could result in either additional payments to partners or additional revenue for your company.

How can this be? Most of the collaborative agreements mentioned above have contractual requirements for parties to self-report financial information to partners, most commonly in the form of revenue payments or the reimbursement of expenditures. The contractual obligations typically require the reporting partner to monitor the relevant financial transactions, and to record, process and report them completely and accurately to the other party.

Sounds simple, but based upon our experience of performing examinations of partner compliance with contractual reporting, we estimate that more than 80% of these agreements contain issues related to the misreporting of financial information, which typically results in previously unknown liabilities for the reporting partners and is primarily due to a lack of appropriate controls over the reporting process. These statistics come as a surprise to many organisations that believe that they have sufficient controls, especially after spending the time and resources to become compliant with the provisions of the Sarbanes-Oxley Act of 2002, Section 404 (SOX or 404). While compliance with SOX provides reasonable assurance that there are no material weaknesses that could result in a material misstatement of the financial statements, such compliance does not necessarily provide for sufficient controls over contract compliance reporting, which could result in significant, but not necessarily material liabilities. Later, this concept will be explained in more detail.

In addition to traditional royalty agreements, every industry has unique types of collaboration agreement. For example, a broadcaster or publisher may have content deals with a rights owner. A life sciences or pharmaceuticals business could have co-development agreements. A technology company is likely to include licensing deals with developers. Each of these is just one example of the types of agreement typical for those industries and is described in more detail in the accompanying information panels.

In every case, these contracts are an everyday part of doing business in that particular industry. However, this familiarity is part of the problem. Self-reporting agreements are so much a part of the corporate DNA that they are all too often overlooked – resulting in liabilities that get hidden within the framework of a company's accounting systems. Try asking yourself: how many collaboration agreements does your business have? Do you have an accurate and complete inventory of contractual agreements that have financial reporting obligations? How much did you pay out on and receive from them this year? How much do you expect to pay out on them next year? And what are the risks and liabilities if you fail to comply with the financial terms of the agreements?

Taking a closer look

If the answers to these questions are not readily to hand, it is prudent to take a closer look. And when you do so, you might be surprised by what you find. Too many

Life sciences: co-development agreements

The life sciences industry, more than just about any other, is dependent on 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 many hundreds of new strategic alliances are signed every year. Among the most popular are co-development agreements, under which 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. Common problems include reconciling two different accounting systems to account for the same types of expenditure which may not be clearly defined by the contract. If the two companies interpret this question differently, such a discrepancy could, over time, amount to several million dollars.

Entertainment and media: content royalties

Entertainment and media companies distribute content globally using a variety of relationships, often by licensing their content to third parties in return for contractually agreed payments. Rapid technological advances and changing consumer demand are driving innovation in products, service delivery, processes, billing mechanisms, service measurement and convergence – to name just a few. All of these changes spawn new leakage points that can result in lost money. Licensors often suffer revenue leakage due to a variety of reasons, including differences in the interpretation of contracts across borders and cultures; under-reporting of net sales by licensees; poor content security resulting in piracy; and licensors' own lack of robust licensee processes and controls to capture intellectual property usage. The risks are even greater with the emergence of new distribution channels, meaning licensors are often entrusting their intellectual property to companies with little or no experience in content distribution, billing, collections or royalty calculations.

companies, even the largest and most complex, have never created a formal inventory of their self-reporting contracts. Even more worrisome is the fact that a wide range of shortcomings – such as a lack of consistent oversight, loss of key staff, basic misunderstandings of contract terms and failures in communication between various departments – often mean that the financial aspects of these contracts may not be tracked with sufficient rigour, or that payments made under them are simply wrong.

The issue is compounded by the complex mix of factors in these contracts. For example, a typical mobile sector agreement might involve a mobile operator paying 10% of net revenues on each handset it sells to a technology developer whose proprietary IP has been implemented in the device. Suppose that the operator says it sold 2 million handsets at US$150 each, and has deducted US$3 million of items from gross revenue to arrive at net revenue from which to calculate royalties. However, are you certain that it was really 2 million handsets? Has the sale price been accurately recorded in every case? Were the right items deducted from gross sales to arrive at the royalty base? Have the royalties been calculated correctly?

The intellectual property owner has the right to ask these questions and may send independent accountants to check that everything is in order related to the financial terms of your agreement. In most cases, it isn't. As previously noted, when our Contract Compliance team analyses self-reporting contracts, we find errors or issues in over 80% of them. In cases where the licensee has been making the same error for a number of years, the discrepancy between the amount that has been paid and what should have been paid can often run into many millions of dollars.

Not just a financial liability

Non-compliance is clearly a major financial liability for the licensee. But it is also much more than that. On top of the financial implications of making good on the error, the non-compliance threatens to undermine the

Common causes of non-compliance

The primary reasons for the high rate of non-compliance with self-reporting contracts include:

- Lack of appropriate controls over the reporting process.
- Simple – and avoidable – mathematical and clerical errors.
- Failure to apply basic contract terms.
- Ambiguous and unclear wording in agreements.

These issues are primarily the result of a lack of a centralised and consistent approach to the financial oversight of these agreements. This is caused by:

- A failure to dedicate appropriate resources and oversight.
- Lack of communication or coordination among various departments, including legal, business development and finance.
- Lack of understanding of contractual obligations.
- Turnover in key personnel.

Technology: multi-country technology licensing royalties

While the causes of problems with technology licensing agreements are varied and complex, the result is invariably revenue leakage or even a significant loss in the value of important intangible assets. One common problem, resulting from the fact that the same technology is often licensed to multiple companies in a variety of countries, is differences in contract interpretation. 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 commoditised, 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.

ongoing relationship with the licensing partner and – if it becomes public – can cause severe reputational damage. All of these impacts are highly negative for the business involved. But there is also a further and potentially even more worrisome liability: the potential implications of not complying with Section 404.

The requirements of 404 by now are familiar to many US publicly traded companies, as well as foreign private issuers. In simple terms, it requires management to assert to the effectiveness of the internal controls underlying their company's financial reporting, and threatens criminal sanctions against companies and individuals found to have misrepresented this effectiveness. In so doing, it has escalated management's own liabilities around corporate financial reporting to a new level.

The advent of 404 has companies undertaking a programme to identify the risks related to material misstatement in their financial statements and the effectiveness of the controls addressing those risks. This process, which enables management to sign the 404 assertion, has of necessity been applied enterprise-wide, cutting across business units and functional boundaries. And it has highlighted in many cases how various parts of the business tended to operate on a siloed basis, failing to talk or report to one another effectively.

The implications for self-reporting contracts are clear as these agreements give rise to financial transactions that must be reflected on the financial statements. However, given the siloed structure and culture of many companies, we often find that the teams in contract management, legal and operations do not communicate sufficiently with finance, and with one another, on the reporting aspects of these contracts. As a result, while the types of control required by 404 are designed to provide reasonable assurance that there are no material weaknesses, our experience shows that they often are not sufficient in detecting compliance related to specific terms of individual partner agreements and often result in previously undetected liabilities to the business.

Are your partners complying?

Aside from the compliance issue around outbound self-reporting contracts, there are clearly further implications for those businesses that – as licensors, for example – are the recipients of payments under these types of agreement. As previously mentioned, our investigations reveal that the self-reporting agreements in question are not being complied with in full; this should ring alarm bells for those businesses on the other side of such contracts.

If any of your business's contract partners are failing to self-report accurately under your agreements with them, then the likelihood is that you are losing out financially. Are you exercising your rights under the audit clauses of your contracts?

When exercising your audit rights, it is important to understand that non-compliance with self-reporting agreements is usually not deliberate, but more often results from companies' internal silos, misunderstanding

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If you have any concerns around your company's self-reporting contracts, a good first step is to ask yourself these questions:

- Does our company have a thorough inventory of all agreements that require self-reporting?
- Do we have an appropriate level of review and oversight over the preparation of reports to partners? Does that oversight include a centralised approach?
- Have we ever been subject to an audit by a contract partner? If so, did it have findings of misreporting?
- Do we have a formalised policy for communication from legal and/or business development to finance, including amendments to agreements?

of contract terms and simple mathematical or clerical errors. In cases where you discover non-compliance in a partner, it is wise to bear this fact in mind. If the business relationship works for both parties, then shortcomings in financial self-reporting on one side should be kept in perspective – and approached jointly as a problem that the two parties can work through together. We often find that after such a process, the relationship between the parties becomes strengthened as the results of the removal of reporting uncertainties.

Conclusion: steps to take

Many financial executives and company directors do not even realise that potentially unforeseen liabilities around self-reporting contracts might exist within their organisations. The hidden nature of these liabilities, and the fact that they can grow rapidly over time, means that companies should move proactively to establish whether they exist and – if so – to find out how big they are. Otherwise, the likelihood is that the partner in the agreement will ultimately perform a compliance audit and discover the problem for itself. It is clearly better for a company to identify the issues itself first – giving it time in which to decide on the best course of action regarding both the business partner and the regulators.

Since the root of most of the issues that we identify is directly the result of a lack of a focused and consistent approach to monitor both the compliance over the reporting process as well as the compliance of partners, we recommend that companies should change the disparate nature of the oversight approach that typically exists, especially in decentralised organisations, and replace it with a more centralised function responsible for compliance oversight. This approach is also likely to result in more effective cross-function reporting and communication, and tighter and more proactive internal controls.

In summary, self-reporting contracts are a fact of business life – and all too often a source of hidden liabilities. Where these liabilities are not being effectively controlled, they have the ability to grow significantly over time. With the advent of Sarbanes-Oxley, the liabilities involved have extended from being essentially financial in nature to regulatory.

To overcome these obstacles, all businesses must have a firm grip on their self-reporting agreements.

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