

## Ensuring Proper Royalties: Monitoring Licensee Compliance to Licensing Requirements

### Introduction

Unlike most business processes and functions for which companies can implement controls to manage their risk, licensors must trust and rely on the internal control environment of their licensees to ensure intellectual property (IP) is protected and they are compensated fairly. Licensors must maintain professional skepticism to determine how to monitor the effectiveness of the licensee's controls surrounding the protection and utilization of their IP while maintaining a symbiotic relationship.

Consider the following example: In the first quarter of 2007, a consumer electronics company that manufactures and distributes products through multiple channels discovered it had been paying royalties to the incorrect licensor. This had been occurring since the inception of the licensing agreement nearly two years earlier, with approximately \$1.2 million disbursed incorrectly. All three companies involved were publicly held. The occurrence of such a major error raises many questions:

- How did this happen?
- Why did internal controls as mandated by Section 404 of the Sarbanes-Oxley Act fail to catch this error?
- Did any red flags emerge for the licensor when it did not receive required royalty payments?
- With regard to the company receiving incorrect royalty payments, was there a significant shift in royalty revenue from this licensee to this company? Did anyone at this company notice or wonder why?

The following discussion offers guidance to individuals responsible for licensing programs and for those responsible for monitoring compliance to licensing requirements. It includes information on the most common types of licensed IP, common compliance components in most license agreements, typical licensing channel relationships, common licensing risks, and leading practices in effective licensing programs. Additionally, it highlights some examples of the types of analytics utilized in monitoring a licensing channel.

Although this white paper was written with licensors in mind, companies that license IP have a stake in ensuring that their licenses and royalty-reporting processes are adequately controlled and free from error. In view of this, many of the concepts discussed here can be used by licensees to improve their own processes.

## Common Types of Licensed IP Rights

Most organizations go to great lengths to ensure their IP assets are protected. Accordingly, agreements for the use of IP vary significantly and range in complexity. Following are types of IP rights that are most frequently licensed:

- **Patents** are used to protect technological inventions, which typically provide advantages over existing technology.
- **Registered trademarks** deal with branding of products and services. Typically, this involves the registration of a name or logo.
- **Registered and unregistered designs** are utilized to protect appearance: both “shape” and “configuration” (e.g., a creative packaging configuration or the shape of a camera lens).
- **Copyrights** are rights that exist automatically for original creations in artistic, musical, literary or dramatic arts.

It is common for a single licensing agreement to contain multiple IP rights. In addition, compliance components in licensing agreements vary based on the type of IP right that is licensed. For example, patent right agreements are more likely to focus on the use of the patent in the manufacturing process, whereas trademark rights may be more concerned with how the product is packaged, labeled and marketed. In general, trademark brand licenses have more compliance components and ambiguities than patent license agreements.

## Typical Compliance Components of Most Licensing Agreements

To ensure IP rights are protected but also utilized to gain monetary benefits, licensing agreements include numerous components. The following is a list of sections in most licensing agreements that require some form of compliance from licensees:

- **Rights granted** – Defines the IP rights that are licensed, including how they are paid for and can be utilized. These are usually specific in nature, and define and describe the IP in precise detail or reference the patent numbers assigned by the applicable patent office, or any other legal reference to show validity of the IP rights.
- **License restrictions and other limitations** – Identifies any restrictions the licensor places on the rights to utilize the IP. For example, this section may restrict the IP use by the licensor’s competitors or clearly define approved distribution channels.
- **Payments, reports, royalties and records** – Defines how the licensee is to calculate, pay and report the use of the IP; this may define additional records that the licensee is required to maintain. The type of IP rights licensed will determine the type and level of detail in the records maintained.
- **Right to grant sublicenses, assign or transfer** – Defines if sublicense, assignments or transfer rights are applicable. Also defines the restrictions placed on the granting of these rights, such as to whom the rights can be transferred and what role the licensor is to play in that process.

- **Territory** – Defines the territory that is granted to the licensee (generally, this is specifically identified). Export regulations, if applicable, are another important component, and may be included in their own section because of the strict legal requirements.
- **Terms of the agreement** – Defines the beginning and ending dates of the agreement and any triggering events that may change the terms of the agreement.
- **Improvements** – Defines how the licensee is to treat improvements made and/or patented during the term of the license by either the licensor or licensee. Also outlines what obligations are present in the agreement, such as whether to include future technology under the present license or to have it fall under the reservation of rights to the licensor.
- **Auditing and inspection clauses** – Defines audit clauses, including how often audits can be performed and by whom, the look-back period that can be audited, and what the consequences are if underreporting occurs.
- **Quality assurance requirements** – Defines requirements to ensure that the licensed IP meets approved use and product quality specifications. Additionally, a component to ensure that advertising and promotional activities are consistent with the licensor's requirements may be included. Typically, as part of this section, the licensor maintains rights to inspect the licensee's product, packaging, advertising and so forth to ensure they meet the licensor's expectations.
- **Representations and warranties** – Defines both sides' capability of entering into the licensing agreement. Simply put, licensors represent that they have all the rights to the IP, and it works as prescribed. In turn, the licensees represent that they have the knowledge, infrastructure and expertise to use the IP rights to the mutual benefit of both parties.
- **Default and termination** – Defines the legal procedures to terminate the agreement and the protocol to be followed by both parties, including how termination costs and expenses are to be handled. In many cases, a separate section may exist for defining arbitration proceedings in the event of default or breach.

In reviewing all of the components of a typical licensing agreement, the need for certain skills becomes apparent. To establish or administer an effective licensing program or monitor compliance of licensees effectively, companies must have the requisite skills or access to resources possessing a deep understanding of the following:

- Accounting, finance and auditing standards
- The IP (e.g., copyright, trademark, patent) that is licensed
- The industry and corresponding supply chain and sales channels in which the licensee operates
- Contract, patent, trademark and copyright law

### Typical Licensing Channel Relationships

Because brands maintain value in almost every industry, licensing also exists in every industry. As a result, much of the focus on corporate strategy has been based on how to maximize brand value. Managers are only limited by their own creativity in finding additional revenue channels through brand utilization.

Standard types of licensing arrangements include:

- **Traditional** – The licensor contracts with a manufacturer, which becomes responsible for abiding by the terms of the licensing agreement.
- **Direct or source** – Licensor grants a license agreement to a manufacturer or supplier for a specific operation and period determined by both retailer and licensor. The retailer is more heavily involved in this type of licensing, which allows it to refer key suppliers or manufacturers.
- **Direct-to-retail** – The licensor contracts directly with the retailer, which becomes the licensee. This allows the retailer to have hands-on control over the product's sourcing, design and construction. This type of licensing continues to trend upward as retailers with private label products license other brands or celebrities to promote their products. For example, well-known retailers, such as Wal-Mart, Walgreens and Costco, use celebrities (e.g., interior designers, stylists, sports figures, chefs, animated characters) to build their store brand programs.

Given that specialized staff is required to license IP effectively, it is common for brand-holding companies with product or brand expertise to maintain a portfolio of brands. These brand management companies engage in the licensing process, design, marketing and forecasting of future trends. In much the same way that a distribution company knows logistics, these companies understand how to create brand value and equity. They ensure the brand image is protected and meets consumer expectations. Revenues for these companies are almost exclusively sustained from licensing the brands they own at all levels of the supply chain – from raw material suppliers to retail channels.

### Common Licensing Risks

Obviously, the goal for IP owners is to ensure that their IP is protected, and they are adequately compensated for its use. This being the case, the goal of the licensing compliance department is to ensure risk exposure is mitigated both internally through the process of choosing licensees and contracting, and externally through monitoring and auditing licensees. The following are the key risks that licensors face and need to monitor and control:

- The licensor may not be compensated fairly or accurately for use of the IP.
- The licensor could lose control over the licensed property.
- The reputation of the brand could be hurt by the actions of the licensee.
- The licensor might not receive royalty payments because of the licensee's poor cash position or bankruptcy concerns.
- The licensor can be held legally liable for the misconduct of the licensee.
- Licensed property may be counterfeited.
- The cost of royalty compliance can become an expensive overhead item.
- The brand may evolve on a different path than strategically designed.

Many of these risks are more easily controlled than others. As is the case in most risk analysis, finding the balance between the cost and benefit of mitigating the risk should be addressed. As companies address these risks, it is essential to add adequate infrastructure and sound processes.

### **Leading Practices in Effective Licensing Programs**

Generally, the contracting and licensing life cycle is manual in nature. Rightfully so, it is likely that negotiating agreements with third parties will always be a manual process as each party vies for what is in its own best interests. Through this process, unique, nonstandard and complex arrangements can be created. Systematizing may not always be effective, and can become costly and time-consuming. Consequently, many companies work to implement manual procedures to complement their manual process. However, as the scale of the licensing program accelerates, this becomes very difficult to control and administer. The following leading practices can assist licensing departments as they deal with this issue:

1. The creation of contract content and other contract terms and conditions are integrated throughout the organization. Relevant departments have input, and the most favorable terms for the company are established.
2. Licensing agreements are standardized to the extent possible, and are drafted to avoid ambiguous or subjective clauses.
3. A contract management system is utilized to provide a consolidated system so licensors can manage the licensing of rights, verification of royalties and so forth.
4. Licensee royalty reporting is automated, allowing the licensor the ability to monitor royalty reporting and identify potential issues in a timely manner.
5. Licensor has an ongoing royalty audit practice to ensure integrity in licensing channels.
6. Controls exist to ensure that IP and brand integrity are safeguarded.
7. Licensor has used standard due diligence procedures in developing licensing channels and selecting licensees to ensure the brand is protected, and ROI is maximized.

In accordance with the aforementioned leading practices, the following self-assessment questions can help when assessing the viability and scalability of licensing programs:

#### **Licensee Selection**

1. What types of licensing arrangements are in place (channel, by each partner, category of partners, etc.)?
2. How are partners qualified to ensure they meet expectations (quality, geography, etc.)?
3. How are licensing partners monitored to ensure they continue to meet expectations?
4. Are international licensees handled differently than domestic?

#### **Monitoring Licensee Portfolio**

1. What risk assessment procedures are utilized around the licensing process and portfolio of contracts?
2. What metrics, analysis or other indicators are monitored to ensure that the licensee is in compliance with contract terms and conditions?

3. Have any licensee audits been performed? How many? How often?
4. What controls are in place to ensure that brand proliferation does not occur, and the brand is adequately protected?
5. Are gray and/or black market channels monitored?

#### **Licensee Reporting and Analysis**

1. What are the processes and tools needed to recalculate any licensing fees that are due?
2. How does the licensor ensure that payment received matches the royalty report?
3. What communication channels exist with the licensee to ensure contract interpretation is consistent between licensor and licensee?
4. How do licensees report and pay royalties (e.g., are standard-reporting templates used)?
5. What are licensees required to report? Is the data reported at the right level to perform sufficient analysis?
6. Is the data reported by licensees analyzed?
7. Are key indicators and other metrics used to monitor the accuracy of royalty reporting?

#### **Contracting**

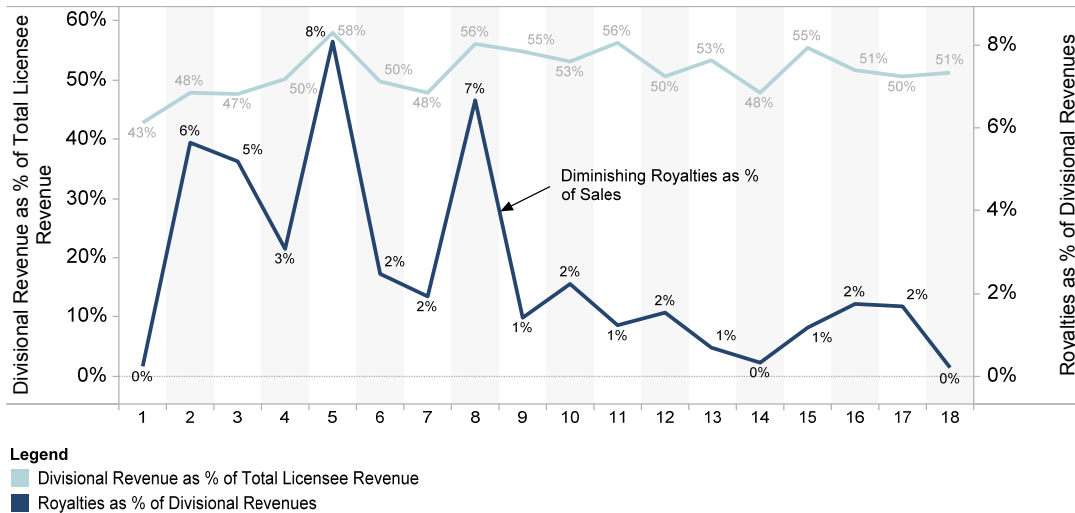
1. Are standard boilerplate contracts utilized, or is there significant contract customization with each licensee?
2. Is a contract management system used?
3. Does the contract management system include contract terms and conditions monitoring (e.g., royalty payments, contract expirations)?
4. How often are contracts renewed?
5. What are the differences in the process between contract renewals and a new licensing relationship?
6. Who are the key stakeholders/departments in the contracting process?
7. Do contracts specify reporting requirements that are in sync with external financial reporting requirements?

#### **Monitoring Licensee Royalty Reporting**

Effectively monitoring licensing partners can promptly alert licensors to potential concerns, ensure the licensing compliance group is efficient and effective, increase the ROI of the licensing department (by decreasing costs and increasing recoveries), and help to maintain integrity with channel partners. The following are analytical examples that can be used to monitor channel partner relationships.

### Example 1

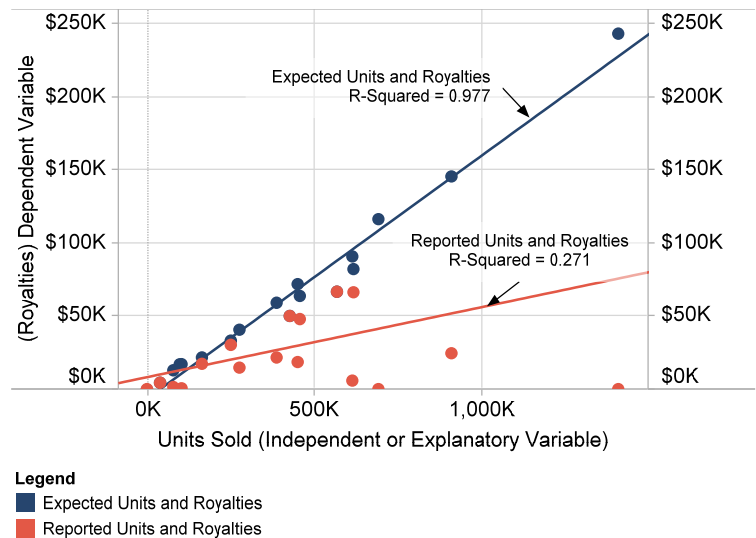
The licensor performed an audit of a licensee in 2005 and discovered significant underreporting of royalties. As a result, the licensor began to continuously monitor the licensee, utilizing the accompanying graph, which plotted royalties reported as a percentage of total licensee divisional revenues compared to licensee divisional revenues as a percentage of total company revenues. (This data was available in the reporting requirements of the licensee and in the licensee’s filings with the SEC.)



The downward trending royalty percentage in this chart triggered an additional audit of the licensee in 2007, which again identified a significant underreporting of royalties. This monitoring was effective because the licensor was aware of the market share maintained with its IP, and knew a strong correlation should exist between the licensee’s divisional sales (whose sales were based on products utilizing the licensor’s IP) and reported royalties.

### Example 2

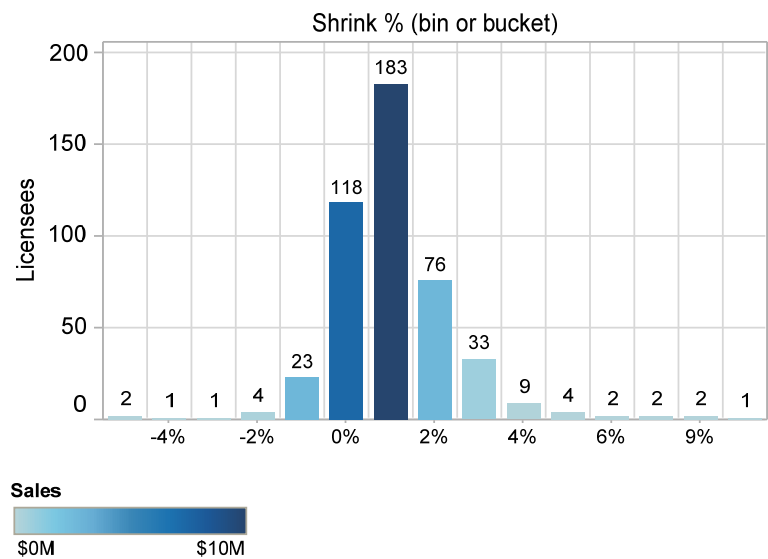
Typically, there is some independent or explanatory variable that drives royalties and can be obtained through external sources or through the licensee reporting process. If this variable can be determined and obtained, stronger correlation models can be developed, similar to the graph in this example.



This model compares units (units sold should explain royalties reported, thus being the explanatory variable) and expected royalties versus what actually was reported. A few red flags are identified. However, the most obvious one is that in the licensee’s actual royalty reports, a weak correlation exists between units sold and royalties reported ( $r^2 = .27$ ). In the hypothetical model, a strong correlation is expected ( $r^2 = .98$ ). Due to foreign exchange rate fluctuations and other allowances (e.g., discounts, promotional allowances), a perfect correlation was not expected. This type of analysis has predictive qualities and can be very effective in identifying licensees that may be misreporting.

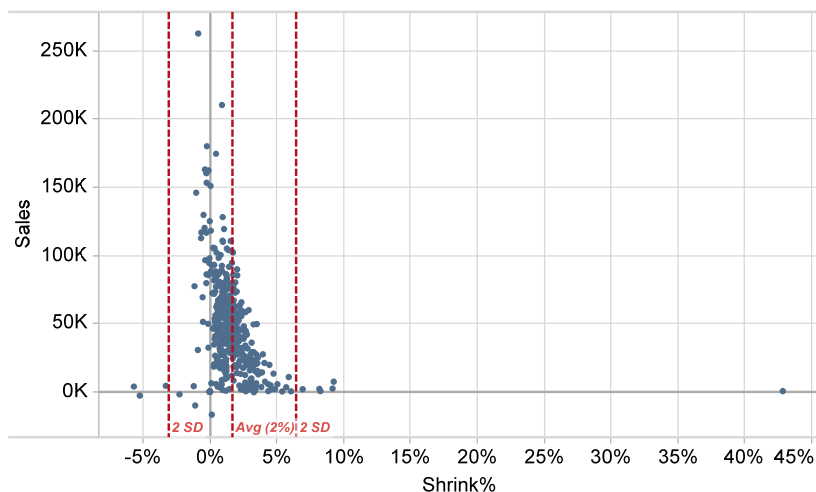
### Example 3

The last graph uses basic statistical models and is valuable if there is a large portfolio of homogeneous licensees. This model can be utilized to compare all licensees in the population against each other to identify outliers. These models are most effective in utilizing continuous (numerical) data. For instance, the model in this example distributes the number of licensees by average shrink percentage. As is common with a population of data points this size, the graph takes the form of a normal distribution.



In this model, each licensee is placed in “bins” or “buckets” based on its average shrink percentage or z-score (measurement of how far a single licensee is from the mean of all franchisees). Z-scores are measured in standard deviations; as such, a z-score of two means that a data point is two standard deviations from the normal or population mean. Licensees with the highest absolute z-score value are outliers. In this case, licensees on the right side of the graph have the highest shrink percentage (and also the highest z-score) and are different from normal licensees. These would likely be the licensees that may be experiencing operational issues or may have misreported royalties. When running these models, it is common to use multiple continuous data points (e.g., sales, returns, COGS, expenses, discounts, shrink, etc.) to understand outliers on vital data components.

To the right is another alternative from the same data set in a scatter plot format. This example more visually shows where each licensee sits relative to one another. Compared closely, these two graphs are very similar. If a distribution line were drawn around the data points on the scatter plot, the curve of the line would likely mirror the histogram distribution of the previous graph. Additionally, lines have been included that identify where the population average and two standard deviations (SD) are. Licensees between the average and the two SD line have z-scores between zero and two, and licensees to the right of the two SD line have z-scores greater than two and so on. It becomes apparent who the outliers are. Some of these outliers may be explainable, while others may warrant research and investigation.



## Conclusion

No company wants its licensing processes and controls to be similar to those of the consumer electronics company featured in the introduction to this white paper. Clearly, if senior management is relatively oblivious to common risks that exist in licensing arrangements, the potential for licensing problems increases. When companies are involved in the entire process to ensure IP assets are managed effectively, licensing processes and controls will be more reliable. Only then can licensing agreements be monitored effectively and royalties protected.

## About Protiviti

Protiviti ([www.protiviti.com](http://www.protiviti.com)) is a global business consulting and internal audit firm composed of experts specializing in risk, advisory and transaction services. We help solve problems in finance and transactions, operations, technology, litigation, governance, risk, and compliance. Our highly trained, results-oriented professionals provide a unique perspective on a wide range of critical business issues for clients in the Americas, Asia-Pacific, Europe and the Middle East.

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## About Protiviti's Consumer Products and Services

Protiviti serves retail companies around the world by helping them identify, measure and manage the risks inherent in their industry. Our experts have the skills, talent and experience to detect red flags, pitfalls and – most importantly – opportunities in retail.

Protiviti's professionals specialize in making risk management capabilities and infrastructure practical and value-adding for retailers. We help retailers assess their capabilities, identify areas for improvement, and collaborate closely with their teams to implement solutions. Our consultants have previous experience with many leading companies across all sectors of the retail industry. Moreover, they are well-versed in the relevant business and industry-specific issues that retail organizations confront in their day-to-day business. We provide solutions that address the root causes of these challenges – not just the symptoms.

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