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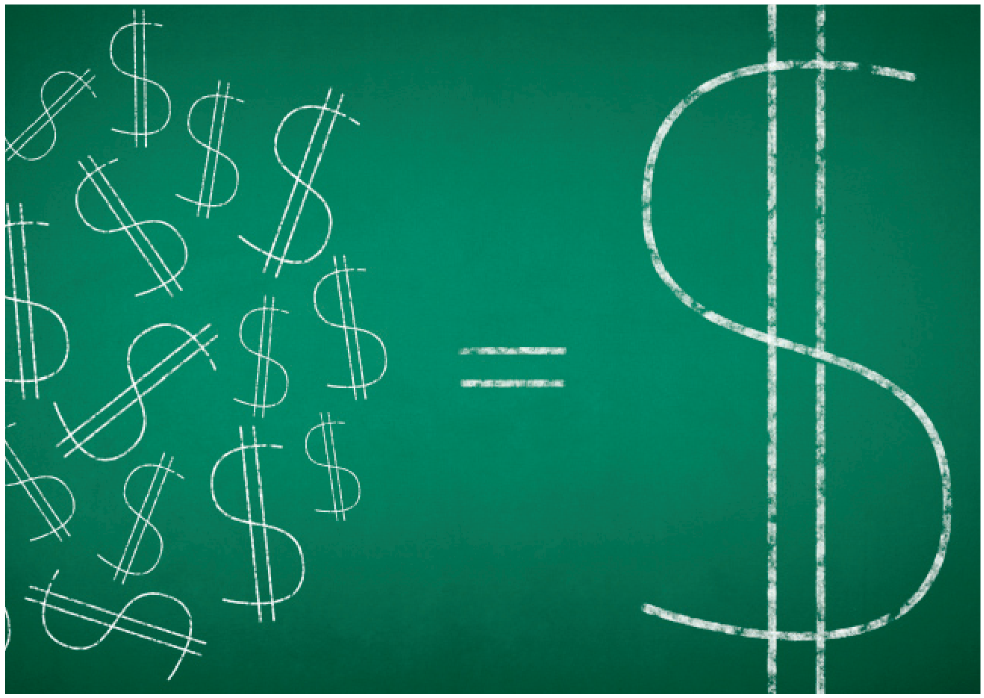
ISSUES & INSIGHTS

Audit Your Licensees to Collect Royalty Payments



Electronics manufacturers know that the velocity with which products move from development to market is a determining competitive and success factor. Thus, U.S. companies turn to outsourced manufacturers in Asia and other parts of the world to develop licensed technology for them, reducing costs and increasing speed to market. But when licensing your technology to an overseas manufacturer, bear in mind that cultural differences and other factors can lead to poor controls to identify licensed technologies and then count and report their use. When this happens, royalty revenue is often lost. In the following article, Armanino McKenna Audit Partner Matt Perreault discusses how companies can identify and collect additional royalty payments owed to them from buyers without destroying customer and business relationships.

For many manufacturers, getting products to market fast is a key factor in competitive positioning and ultimately, success. And increasingly, U.S. manufacturers are engaging in licensing agreements with overseas manufacturers who will rapidly and more cheaply move the licensed technology into production and distribution ahead of the competition.

In this rush to market, there is explosive growth in the number of technology licenses granted by U.S. companies to manufacturers in Asia and other parts of the world. Due to cultural differences and diverse business practices between nations, as well as because of language barriers and less sophisticated capture and reporting systems at companies in those nations, the overseas manufacturer licensees may not have proper controls to identify, count and report the use of licensed technologies accurately. That means that significant revenue from royalties owed to you, the licensor, is left uncollected.

Leaving money on the table is never good and so maybe you're looking into how to enforce your royalty agreements more effectively. But with extremely compressed cycles of product development, the window of opportunity to enforce royalty agreements is also much shorter and the technologies are obsoleted faster. Maybe a company you granted licenses to disappeared or is so financially weak that it cannot pay 100 percent of amounts due. If you wait too long to audit and enforce royalty agreements, you could lose significant revenue and place otherwise good customer relationships at risk by pursuing interest and other penalties on products (possibly shipped years ago),.

Do not assume that your licensees are reporting the right numbers. They could be under reporting due to human error, ethical lapses or for any number of other reasons. The good news is that there are ways you can enforce your licenses without losing customers or destroying business partnerships.

What to Do

Here are some suggestions for companies contemplating a push to enforce royalty agreements:

Make sure contracts contain penalty clauses – This includes interest and payment of audit fees. Be sure to understand the terms of your agreements and periodically review them to eliminate ambiguities in language (terms like pay "promptly" or in a "reasonable" amount of time, should be replaced with a cited number of days).

Develop a more robust database of licensees – Create a risk profile for all licensees and customers based on key characteristics like geography, size, etc. Identify and focus on high-risk licensees with more frequent and in-depth audits of reported figures

Be sure you can identify and understand non-compliant customers – See what your organization can do to increase compliance reporting by licensees/customers and/or pursue enforcement through regulatory channels for suspected non-licensees.

Continually update licensees on their reporting obligations and definitions of what is applicable under license agreements – For instance, maintain a SharePoint site or a portal where contractual agreements can be viewed by customers. Send regular emails to licensees to remind them to view these agreements for compliance and to annually reconfirm terms and conditions of contracts. Also, in this space, provide examples of licensee violations to clarify what is acceptable under agreements, such as examples of what qualifies for reduced royalty rates.

Engage an expert outside third party consultant that has experience auditing licensees and identifying issues – A professional third party can support your effort by performing royalty audits, reviewing contracts for potential issues and provide recommendations. Additionally, a third-party expert can be placed between you and your customers so that relationships can be preserved.

Adopt a program of continuous improvement around licensing – Apply continuous improvement methods to communicate, capture and audit royalties due under agreements.

Costs

The costs associated with royalty audits are not necessarily small, but if you are able to recover revenue on a recurring basis that is say, five times the cost of the audit, the ROI is clear. If you are uncertain of benefits to be gained by auditing, ask your 3rd party auditor if they will agree to work on a contingency basis. There are also costs driven by in-house legal review, accounting and IT staff to support reporting and compliance efforts. Consider modifying your contracts to specify that licensees pay audit fees in the event of under-reporting.

Benefits

Some benefits of performing royalty audits include:

- additional revenues added to your current reporting period and additional cash flow from audit findings.
- improved future compliance
- improved contract language
- reduced likelihood of material weakness cited by outside auditors
- reduction of tension between the customer and the licensor due to third-party consultant playing the role of "bad cop" while licensor company plays "good cop"
- sales staff can retain and preserve customer relationships

Case Studies

Here are a couple of brief case studies from the Armanino McKenna archives which illustrate the added revenue and savings that a royalty audit can uncover and enforce:

A Silicon Valley company engaged us to do a royalty audit of a multi-national billion dollar licensee with sophisticated reporting systems. We discovered the licensee had simply been entering the improper parameters when capturing sales data, omitting certain channels of distribution and geographies. The return to the client was $268,000 in additional legitimate royalty payments. The client also recovered their full audit fee because of contract language specifying that clients pay audit fees.

In another recovery, the customer/licensee misunderstood the terms of the agreement and believed they were only responsible for reporting units sold to end-users rather than units sold to OEM customers. In this case, there was a significant language barrier in the customers' ability to understand the term "end-user" as defined in the agreement. Also in this case, web conferencing and screen sharing technologies enabled us to conduct a thorough audit and avoid costly travel to Asia. Use of video conferencing and screen sharing can enable the licensor to audit a much higher number of licensees more rapidly and at a fraction of the cost of an on-site visit. In this case, we recovered $82,000 for the client and the full audit fees were again paid by the customers.

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