

Keeping royalty contracts on track



Every day, businesses lose countless dollars without even realizing it. The reason? In many cases, revenue can vanish because vendors, distributors, and licensees unintentionally fail to meet contractual obligations. Inaccurate third-party reporting can stem from highly complex contracts that do not clearly identify key requirements or responsibilities, or from changed circumstances, mistakes, or deliberate misstatements. Whatever the cause, the need to manage risks related to your third-party relationships is critical to achieving full control over your costs—and revenue.

If your organization licenses its intellectual property, royalty revenue likely is a key contributor to your bottom line. It's important to consider how well you are monitoring compliance of your third-party contractual relationships, identifying errors, and ultimately helping to recover lost revenue or overcharges. KPMG's Contract Compliance Services (CCS) professionals help determine compliance of your third-party contractual relationships to help protect your bottom line.

Royalty compliance engagements

While most licensees do not purposely underreport the amount of money they owe, KPMG estimates that as much as 70 percent of self-reporting by business partners or customers is inaccurate, based on more than a thousand contract reviews previously conducted by our CCS professionals. Our royalty compliance reviews help clients recover lost royalty revenue resulting from inaccurate and incomplete self-reporting by licensees.

Common errors

KPMG's CCS professionals have identified issues of contractual noncompliance or misreporting more than 90 percent of the time while conducting contract compliance reviews. Several factors contribute to this prevalence, including:

- Deductions from gross revenue that are not allowable per the agreement
- Royalty calculations for bundled products that are not clearly defined in the agreement
- Missed products due to the introduction of additional products and/or manufacturing facilities
- Intercompany sales not being captured in the data gathering process for royalty calculations
- Licensee applying incorrect royalty rates per the contract due to tiered or changing rates
- Rate changes not being captured when pegged to indices such as the Consumer Price Index
- Differences in contract interpretation.

How KPMG Can Help

KPMG's CCS professionals seek out the root causes of underpayments and offer recommendations to help prevent potential future losses and strengthen the underlying licensing relationships. We specialize in a nonadversarial facts-based approach that helps clients identify significant cost recoveries and other improvement opportunities, while respecting business relationships. Key potential benefits of a royalty compliance review program include:

- **Improved** monitoring of business relationships
- **Enhanced** controls and internal process consistency
- **Measurable** return on investment (ROI)
- **Better** protection of intellectual property.

KPMG's royalty engagement approach

We develop an understanding of our client's licensing activities by obtaining answers to questions such as:

- How much royalty revenue do you generate per year? How many licensees do you have?
- How do you license your intellectual property? On a percentage of (net) sales basis? Per units sold?
- May licensees bundle licensed and unlicensed product for sale? Does the agreement address bundling?
- Does your royalty revenue come directly from licensees, or are there sublicensing arrangements?



KPMG's Contract Compliance Services

KPMG was the first "Big Four" accounting, tax, and advisory firm to set up a dedicated CCS practice. For more than a decade, our CCS engagements have been helping companies across all industries identify and recover millions of dollars arising from noncompliance. Today, more than 450 full-time contract specialists in KPMG member firms in the United States, United Kingdom, Australia, and across Europe, Africa, Asia Pacific, and Latin America help clients with their contract management in order to increase performance and decrease risk.

Our CCS assistance features:

- **Integrated international teams:** KPMG's integrated international CCS teams comprise diversely skilled U.S. and global professionals with deep experience and specific industry knowledge of intellectual property and contract compliance issues.
- **Cross-cultural versatility:** We understand regional cultures and business practices as well as the language and cultural skills to operate effectively anywhere.
- **Contractual complexity:** We understand the complexities and nuances of a wide range of contract terms and conditions as well as the challenges of processes and procedures used by third parties attempting to comply with contractual requirements.
- **Multidisciplinary strengths:** Our professionals draw on skills from diverse disciplines—auditing, forensic accounting, information risk management, and complex data analysis, among others.
- **A nonadversarial approach:** KPMG structures CCS reports to present facts and critical details in a manner that facilitates resolution with your partners. Our nonadversarial approach helps avoid confrontation and mistrust, leads to quicker and more successful resolutions, and protects vital business relationships.

This approach has been successful on more than 1,000 CCS engagements.



Case study one: Global joint venture

A large American retailer had a joint venture deal with a Japanese retailer that self-reported sales and royalties to the American company and remitted quarterly payments. The American company was interested in how business was being conducted by the joint venture with respect to its products and engaged KPMG to do a royalty compliance review.

Our approach

KPMG obtained sales data at the transaction level for the test period 2005 through 2010. KPMG ran queries at the transaction level and recalculated royalties due to the American retailer, resulting in \$7.8 million in potential under-reported royalties from the Japanese retailer to the American retailer.

Results

KPMG learned that when its retail clients engage in joint ventures with international companies, the international companies sometimes tend to misinterpret the agreements between the parties and report royalties based on their own accounting practices that are often different from the terms of the joint venture agreement.

- Do your license agreements contain potentially ambiguous contract terms that could be misinterpreted by a licensee?
- Do the terms of the audit clause enable an appropriate audit scope? Is there an audit fee pass-through provision?
- Do you have suspicions with respect to a licensee or the accuracy of its royalty payments?
- Do you have a royalty compliance program in place? Are you using external audit firms?

We emphasize strong communication

KPMG structures CCS engagements to provide informed communication at all levels:

- **Planning and coordination:** We establish open communication and understand client expectations.
- **Scope of work:** We work with our client to identify key risks and agree on the engagement scope.
- **Pre-fieldwork data collection and analysis:** We gain an understanding of the agreement, obtain client and third-party data and documentation, conduct planning meetings, perform preliminary analysis, and develop a detailed work plan.
- **On-site fieldwork:** We conduct an opening meeting to discuss fieldwork objectives and provide process transparency. Fieldwork is customized to address specific objectives and may include interviews, completeness testing, system testing, documentation of royalty reporting processes, and determination of preliminary findings. We commonly conclude fieldwork with an exit meeting to summarize open data requests, establish next steps, and agree on the timing of open items.
- **Post-fieldwork and reporting:** After fieldwork, licensees generally provide additional information to address preliminary findings. Upon completion of our post-fieldwork efforts, we report to our client.



Case study two: Wireless technologies

Our client developed wireless technologies used in mobile devices and wireless networks. It partnered with many of the world's leading wireless companies, and utilized its license compliance program to gain insight into the royalty reporting of its licensees.

Our approach

KPMG first developed an understanding of how the technology could be identified in various products. With royalties based upon a flat fee per unit depending upon region sold into, quantity sold, and device type, we conducted interviews and collected accounting data to identify sales that met these criteria. We also explored potential risks associated with sublicenses and affiliates.

Results

KPMG identified noncompliance with the license agreement resulting in underreported royalties exceeding \$20 million for the review period. Examples of misreporting included instances of the licensee taking unallowable deductions against royalties, nonreporting on certain brands, incorrect reporting of royalty rates relating to dual-mode devices, and nonreporting of sales by the licensee's affiliates.

Working through differences in contract interpretation

If the licensee and licensor have divergent understandings of key contractual terms, they commonly disagree on the royalties owed. Because our nonadversarial approach focuses on the collection and analysis of facts, we often can help the licensee and licensor identify the source of disagreement, such as a previously unknown agreement, communication, or practice. This also enables the parties to more clearly understand the nature of their disagreement and focus their negotiation on the elements of greatest significance. Toward this end, clients sometimes request that we report our findings based on alternative contract interpretations provided by the licensor and licensee. In short, our nonadversarial approach can help business partners resolve different interpretations without conflict.



Contact

We are available to describe our approach in greater detail and share leading practices. For more information about Royalty Reviews, please contact:

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