FORENSIC

Managing and Monitoring Licensees

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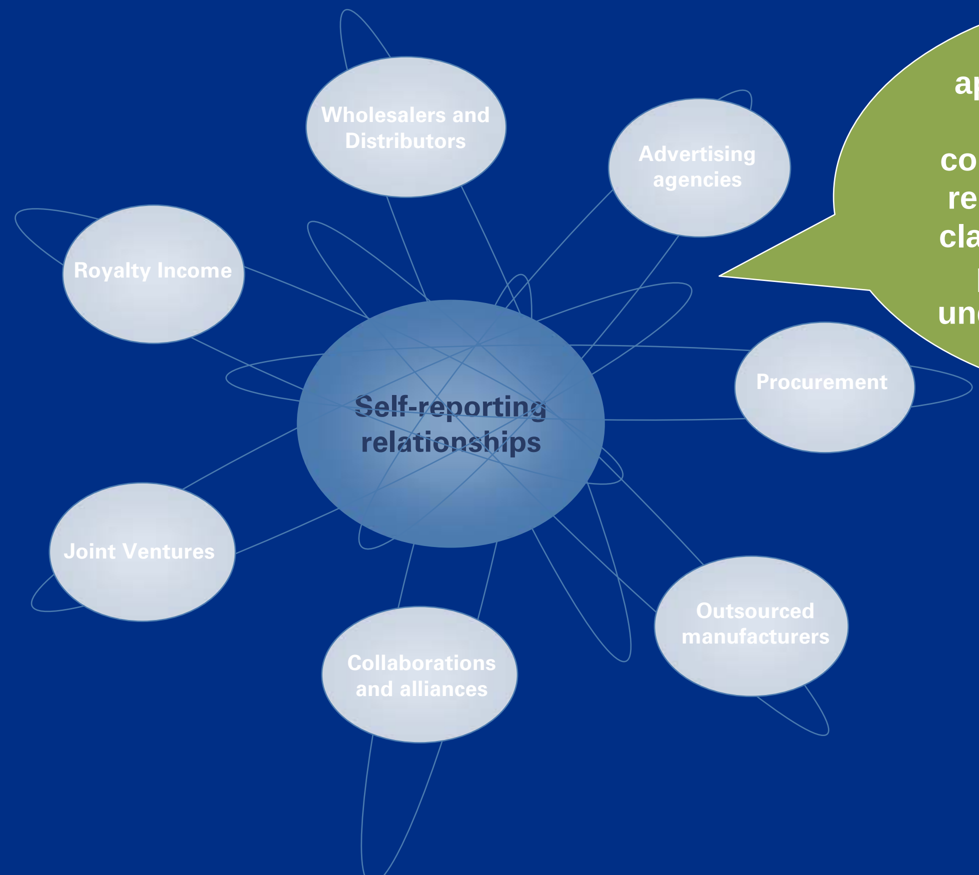
ADVISORY

AUDIT ▪ TAX ▪ ADVISORY

Introduction

Partner Selection → Contract Vetting & Structuring → On going monitoring



KPMG has found approximately 75 percent of third parties to have committed errors in their self-reporting, filed inappropriate claims, charged inappropriate prices, or unintentionally under-reported by as much as 20%

Partner Selection

Partner Selection → Contract Vetting & Structuring → On going monitoring

Not only are the capabilities and experience of potential business partners important, but so too is their reputation.

Past behaviour of a partner can be a good guide to the future

What processes do Licensors go through in order to select the right partner?

Do you know who you are doing business with?

License Agreements

Partner Selection → Contract Vetting & Structuring → On going monitoring

Often the people involved in negotiating the terms of the license agreement are not those involved in the actual drafting of the agreement or the day to day operations. As a result, ambiguities and different interpretations can arise.

Strategic Intent → Contractual Form → Actual Process

- Definition of royalty bearing sales
- Allowable deductions
- Revenue by indication

Audit Clause

Poor Audit Clause

The *Licensee* will keep and maintain records of sales made pursuant to the license granted and such records will be subject to an audit.

Good Audit Clause

This is an example of an audit clause that reduces ambiguities and defines various terms, however, we do not prescribe that this is the best audit clause to use in any agreement

The *Licensee* and its affiliates will maintain all records relating to the purchase, sale, storage and disposition of licensed products, including those existing in electronic form ("Records") for a period of not less than three (3) years from the date of purchase.

Records will include, at a minimum, master files, product numbers/codes, description, quantities purchased/manufactured, shipped, sold and on-hand at period end, customer or supplier name, address, date of purchase or sale, cost of purchase or sale price, and delivery address.

Such audit may include, without limitation, records pertaining to distribution arrangements including any claims submitted to the *licensee* or upfront discounts granted by the *licensee* in relation to any incentive programs the *licensee* has participated in (e.g. special pricing, chargebacks etc), stock rotation, returned products, ship from stock, eligibility for and use of marketing and development funds (MDF), and other special price or credit transactions if applicable pursuant to clauses in this agreement.

In the event that an audit determines any financial discrepancies or a breach of any obligations, *the licensee* will reimburse the *licensor* within 60 days of any improperly claimed or paid amounts identified by the independent auditor and in addition reimburse the *licensor* for the costs of the audit.

Monitoring the licensees

Business as usual

Partner Selection → Contract Vetting & Structuring → On going monitoring

In House

- Press articles
- Annual accounts
- Industry trends
- Analytical review
- Ask questions!

Audit

- Run as a programme
- Different techniques – i.e. Questionnaire – Japan US $3.5m.

> KPMG's experience has shown that the majority of licensors do not actively monitor royalty statements against internal and external market information.

What does a licensee audit look like?

Partner Selection → **Contract Vetting & Structuring** → **On going monitoring**

Partner Internal Controls

Systems Evaluation

Quantification Testing

Isolate Weaknesses and Assess Impact on Contract Compliance

Visit Preparation

Obtain Prep Documentation

Perform Initial Analysis

Conduct Prep Meetings contracted party

On-Site Visit

Benefits:

- Recovery of under/over payments or claims
- Improved reporting

Conduct Kick-off Meeting

Perform Interviews

Both Substantive & Forensic Testing

Compile Findings, & Develop Recommendations

Conduct Exit Meeting

Test Data:

- Parallel to claims, sales payment process
- Sales, manufacturing claims reporting
- Independent of the core process

Post Visit Wrap-Up

Create Final Report

Assess Impact on contracted party

Common Findings/Issues

- Licensor has never audited licensee
- No audit clause, poor audit rights or dispute resolution clause but no general audit clause
- Contract terms are ambiguous/unclear
- Reports/management information required to be provided by licensee on a regular basis is not provided
- Deductions made to gross sales unallowable or based on a method not allowed (i.e. accrual v actual)
- Products not classified by licensee as “licensed” under the agreement and therefore omitted from reported royalty bearing sales
- Incomplete or inaccurate sales figures reported (i.e. “average price”, omitted division sales, samples excluded, paid v invoiced)
- Marketing and advertising expenditure not spent correctly or insufficient spend
- Sales made outside of authorised territory
- Legal expenses deducted which relates to IP other than licensors
- Incorrect royalty percentage applied (i.e. stepped royalties, side letters/amendments)
- Licensor has not charged late payment interest on late royalty payments where interest clause exists, or contract does not contain such clause

KPMG

Contact us

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