Intellectual Property Auditing: A Road to Riches

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As intellectual property (IP) and other intangible assets assume an increasingly important role in the value of an enterprise, there has been a corresponding increase on the focus of how such assets are accounted for and reported in financial statements, and the degree of understanding and scrutiny that company boards and directors need to exercise regarding them. However, businesses often do not know what IP assets they own, let alone being able to exploit, value and account for them. In this paper, Sharyn Ch’ang and Marina Yastreboff outline their approach to the identification and protection of IP through the new discipline of IP auditing.

INTRODUCTION

In the new knowledge economy, intellectual property (IP) has become an important strategic issue. For many companies, IP has come to embody their core competitive advantage, which in turn is a key factor in creating business wealth. Even so, for many companies the management of IP is still largely divorced from business strategy and in many instances remains hidden from or unknown by the core decision makers within those companies.

IP assets include patents, trade secrets, trade marks and know-how. These assets can be regarded as “knowledge with value” in a legally exploitable and protectable form. However, before these assets can be legally protected and exploited for commercial advantage, they must first be identified and recorded. This paper sets out the importance of IP Auditing and provides an overview of the IP Audit methodology developed by the authors.

INTELLECTUAL PROPERTY – AN INTANGIBLE ASSET

IP is a type of intangible asset that can be created or acquired by a business (see Figure 1). Unlike tangible assets, such as plant, equipment and goods, IP assets are not physical in nature – indeed, they are inherently invisible. But the difference between tangible and intangible assets does not end there. Tangible assets, are vigorously identified, valued and reported in the balance sheet. Generally, IP assets are not. However, like tangible assets, IP assets must be systematically identified, protected and maintained to maximise their intrinsic value and strategic advantage, and minimise the risks of third-party abuse or inadvertent loss.

As Figure 1 illustrates, there are seven types of IP recognised under Australian law. There are national IP statutes for each type of IP, except for confidential information, which relies upon the rules of the common law rather than legislation. IP laws are conferred and operate on a country–by-
country basis – there is therefore no single system that grants you a “worldwide patent” or a “worldwide trade mark”. However, subject to certain formal requirements, Australian created IP rights are recognised in most countries overseas by virtue of Australia’s membership to a number of multilateral IP treaties.

Likewise, for foreign IP owners from countries that are also signatories to these IP treaties, subject to certain pre-requisites, Australia reciprocally grants these IP owners the same corresponding IP rights in Australia as they have in their own countries.

Notably, each type of IP law protects a different aspect of innovation or intellectual creation. For example, copyright laws protect originally developed works including computer programs, manuals and graphic designs; trade mark laws protect your brand and aspects of packaging; and patent laws seek to protect the rights of inventors of new or improved devices, substances, methods or processes. Multiple IP rights can also subsist in a single product. Take the example of a software developer who has developed a new and innovative program for processing and authenticating traveller’s cheques. Copyright will subsist in all the original source code developed, and any novel aspects of the functional source code may also be eligible for protection as a business process or software-related patent.

A qualified IP lawyer or patent attorney may help to combine the different types of IP to provide you with maximum, cost-effective protection.

THE RISE AND RISE OF IP
In recent years the percentage of company value attributable to intangible assets has increased dramatically. For example, over a 20-year period from 1978, intangible assets grew to account for more than 73 percent of the Standard & Poors 500 stock index (see Figure 2).

As IP and other intangible assets assume an increasingly important role in the value of an enterprise, there has been a corresponding increase on the focus of how such assets are accounted

1 Australian Accounting Standard AAS 18 “Accounting for Goodwill”. Examples of unidentifiable assets include market penetration, effective advertising, good labour relations and a superior operating team.
for and reported in financial statements, and the degree of understanding and scrutiny that company boards and directors need to exercise regarding them.

On the accounting front, two new accounting standards, FASB (Federal Accounting Standards Board) 141 and 142, were recently introduced in the US\(^3\). These new standards require all companies with US GAAP (Generally Accepted Accounting Principles) requirements to identify and value their IP, and to include those valuations on their balance sheets to provide investors with greater certainty regarding the value of those corporations. It is a widely held view within the Australian accounting profession that in the next couple of years, the International Accounting Standards Board and the Australian Accounting Standards Board will adopt these new US rules, and this will in practice mandate a more rigorous identification and valuation of both acquired and internally-generated IP assets for all Australian companies.

In recognition of the impact that IP can have on the strategic, financial and competitive aspects of business, IP management is also making a more frequent appearance on corporate boardroom agendas as a topic for review and action. Indeed, where a company suffers a material loss in value due to insufficient attention given to the management of IP assets, it is conceivable that corporate officers and directors could face potential liability for a breach of their fiduciary duties.

Another indication of the increased visibility of IP within a business are the newly created and, dedicated roles – such as IP Director, Commercialisation Director, Technology Asset Manager – and the corresponding IP management responsibilities of senior business executives in both new and old economy enterprises.

**BENEFITS OF MANAGING YOUR BUSINESS IP**

The first step towards the proper management of the IP within your business is the identification of your IP assets. This is followed by their protection and an assessment and uptake of utilisation or commercialisation opportunities. When executed effectively as part of an overall business strategy, these aspects of ‘IP governance’ can deliver your business an array of commercial and bottom-line benefits (Table 1) including improved:

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\(^3\) On 29 June 2001, the United States’ Federal Accounting Standards Board unanimously approved the issuance of Statements of Financial Accounting Standards No. 141 “Business Combinations”, and No. 142 “Goodwill and Other Intangible Assets”.

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### BENEFITS OF STRATEGIC IP MANAGEMENT

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<tr>
<th>Improved accountability of resources</th>
<th>Improved operational performance</th>
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<tr>
<td>• Know what IP is owned</td>
<td>• Enables more informed decision making by management because you understand what IP assets you own, or need to operate your business, and their value</td>
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<td>• Know what IP results from investment in R&amp;D</td>
<td>• Enables more accurate internal and external financial reporting</td>
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<td>• Know what IP is core, secondary or surplus innovation</td>
<td>• Enables sharing of significant and incremental innovations within a business – domestically and internationally</td>
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<td>• Cost-effectively protect IP on a timely basis to minimise risk of third-party abuse and inadvertent loss</td>
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<td>• Assists in compliance with directors’ duties</td>
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<td>• Assists in more accurate reporting and cost-effectiveness of development costs and investment</td>
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<th>Improved financial performance</th>
<th>Improved risk management</th>
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<tr>
<td>• Unlocks hidden or under-performing value of IP</td>
<td>• Preserves the opportunity to use and commercialise IP by minimising risk of failing to identify and protect IP on a timely basis</td>
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<td>• Opportunity to generate cash from licensing or sale of non-earning IP</td>
<td>• Minimises risk of failing to renew IP assets protected by registration</td>
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<td>• Enables increase in profits through cost savings, increased revenue or improved access and utilisation of tax benefits</td>
<td>• Minimises risk of legal action for infringing third-party IP if proper IP management processes implemented. The risks include not only potentially significant damages and legal costs if an adverse decision is made, but damaged corporate reputation, product recalls or redesign, wasted marketing costs, executive down time and even royalty payments to competitors</td>
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<td>• Enables better earnings visibility, internally and externally, which can create positive stakeholder and capital markets sentiment, and increase shareholder value</td>
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<td>• Enables valuation of IP and inclusion of IP assets on balance sheet</td>
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<th>Enhanced competitive advantage</th>
<th>Improved opportunities for growth and strategic investment</th>
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<td>• Captures the innovation that makes you competitive</td>
<td>• Enhances your business reputation as an innovator, market leader, employer of choice for recognising staff innovation, and profitable business</td>
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<td>• Legally able to block competitors out of your markets, e.g. through patent filing</td>
<td>• Enhances access to debt or equity funding to continue strategic initiatives by protecting, valuing and even mortgaging IP assets</td>
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| • Enables the creation of an envelope of protection for core IP assets through strategic leveraging (protection and searching) of the IP legal system | • Enhances attractiveness as business partners for alliances or joint ventures with third parties which respect the use you make of your IP assets |}

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**Table 1: Benefits of strategic IP management**
• Accountability of resources
• Operational performance
• Financial performance
• Risk management
• Competitive advantage and
• Opportunities for growth and strategic investment.

IP AUDITS
Given the inherent invisibility of IP and the different ways in which IP rights are developed or acquired by a business, it is readily understandable why businesses are often unaware of the IP assets they create and use, and fail to realise the benefits these assets can bestow. An IP audit, and periodical audits thereafter, are essential management activities. The message is clear:

Identification of your key IP assets is critical to effective asset management. After all, how can you protect and manage, let alone exploit, IP assets that you are not even aware that you own, or worse, you think you own, but do not?

The Business Council of Australia agrees, acknowledging that:

“Australian companies need to undertake IP audits, and address the issue of IP at senior levels”

The Business Council’s view also resonates strongly in statements made about the importance and value of IP in the public sector. For example, the recently published Commonwealth IT IP Guidelines which focus on the management of IT-based government assets similarly declare:

“It is desirable that IP be recorded, valued, managed and utilised to best effect, as with any other asset.”

Despite the rising importance of IP, IP audits are not yet a commonplace management activity within business or government. There are numerous possible explanations for this, although the most common is that management has been generally naïve regarding IP and has not recognised the importance of IP as a business asset. However, IP audits are now increasing in frequency, particularly for the more progressive and strategic-thinking Australian government and private sector enterprises.

WHAT IS AN IP AUDIT?
The principal goal of an IP audit is to systematically identify and record the IP that a business has acquired or developed in-house, and determine the extent of the business’ ownership of those assets. The key audit objectives can be summarised as follows:
1. To identify and record existing and hidden IP acquired or developed by the business.
2. To determine the origin and legal ownership of the IP identified.
3. To identify and evaluate the adequacy of:
   • Strategic integration of IP management within the business’ overall corporate strategy and operations;
   • Internal policies and practices for the identification, protection and treatment of IP including operational management issues regarding trade mark and brand use, confidentiality,

invention disclosures, employee recognition and incentives, hiring and exit interview procedures and documentation;

- Legal protection for the IP identified.

4. To “value” the IP identified. Valuation is a complex exercise. Depending upon the scope of the audit and the type of IP assets identified, it may be appropriate to undertake only:
   - A qualitative valuation which describes the benefits that the IP asset brings to the business; or
   - A qualitative and quantitative valuation, the latter being an attempt to quantify the potential economic value of the asset through its use, sale or exploitation.

**CONDUCTING AN IP AUDIT – WHAT IS INVOLVED?**

The proprietary methodology (see Figure 3) developed and used by the authors comprises three stages and nine modules.

![Figure 3: Proprietary IP audit methodology](image)

The scope of the IP audit will depend on the reasons why a business wishes to conduct the audit. For example, if the audit is being conducted as a precursor to the purchase or acquisition of another business, Stages 2 and 3 would be limited to identifying, valuing and reporting on the ownership and title of IP assets held by the target business, and the Organisational Diagnosis module may not be relevant. However, if the IP audit is conducted as part of the formulation or review of the business’ overall asset management strategy, each of the above modules are recommended. In summary, the three stages of the IP audit address the following:
Stage 1 defines the scope of the audit and focuses upon the identification of IP assets developed in-house, acquired and used within the business, and seeks to uncover key areas of risk or concern from an IP governance perspective. The business is also assessed in terms of its policy and procedures for managing its IP and its value.

Stage 2 involves a substantive audit of each of the IP assets identified. At this stage, the following issues concerning ownership and protection are addressed:

- What has been developed or acquired?
- Who created and developed the IP?
- Who owns the IP and the extent of ownership interests (e.g. sole or joint ownership)?
- Are there any restrictions on the business’ use of the IP (e.g. time, territory or application)?
- Is the IP protected and, if so, is the type and term of protection adequate?
- What have been the costs of protection?
- Is the IP fully or only partially developed?
- To what extent has the IP been commercialised?

Answers to Stage 1 and 2 questions are found by interviewing key personnel across different departments of a business (from R&D, operations, IT and engineering to marketing, tax and finance), about business practices and outputs, and reviewing a range of documents including:

- Legal agreements including in-license, out-license, non-disclosure and confidentiality agreements, contractor, joint venture or other similar partnership or development agreements;
- IP asset registers (if any); and
- Works and know-how created by employees, contractors and partners in the course of working with the business, including copyright materials such as software, manuals and marketing collateral, brands, innovative business processes, inventions and confidential information that the business believes delivers or has the potential of providing some economic benefit.

Stage 3 involves the analysis and reporting of the outcomes of Stages 1 and 2, including recommendations concerning the effective management of IP and collation of a portfolio of the IP assets of the business. Depending on the scope and purpose of the audit, a qualitative and if appropriate, indicative quantitative valuation of the identified IP assets may also be undertaken at this stage.

Critical knowledge resulting from an IP audit conducted as outlined above, includes valuable information regarding the:

- IP assets that a business owns and has a right to use
- Defects in IP ownership or protection
- Risks that use of certain IP constitutes infringement of others rights
- Importance of IP to the current and future profitability of the business, through proper management and exploitation of commercialisation opportunities
- Improvements in the treatment and handling of IP within the business.

WHEN TO DO AN IP AUDIT?

IP audits should be undertaken as part of general asset or operations management – indeed it should become a routine activity of your internal audit program. Review audits should also be conducted periodically to ensure compliance with policies and procedures put in place to address IP governance issues, and to update IP registers with new IP developed or acquired.

However, IP audits are also undertaken by businesses preparing for an ASX listing, or in contemplation of a joint-venture arrangement, start-up, business sale or acquisition – for, in addition to verifying the existence and ownership of IP assets, an audit may reveal hidden or additional value within a business that has not been previously recognised.
Create new business opportunities
Whether your initial IP audit uncovers a lot or a little IP, you will have taken the first critical step to ensuring you have the opportunity to profit from your investment in innovation. Aim to emulate world’s best practice in IP management. For those businesses that do, the rewards can be substantial. As the Business Council of Australia has observed:

“Companies that can leverage their intangible assets create new business opportunities that are not defined by traditional business models”5

In today’s competitive global economy, enterprises of all sizes and in all industries are constantly under pressure to create new opportunities and new revenue streams from existing business assets, and strive for sustainable profitability. A systematic approach to IP governance is integral to achieving such success, and the logical starting point is the conduct of an IP audit.


TEN TIPS FOR SOFTWARE DEVELOPERS WHEN AUDITING COMPUTER-SOFTWARE-RELATED IT

• Prepare a list of all software products developed, acquired and used
• Identify the owners of the software and the creators of each software product
• Classify software products as core, secondary and surplus to your business
• Ensure the development history and final version of all software products is clearly documented and safely archived – this serves as vital evidence of originality should any dispute arise downstream
• Identify the different types of IP associated with your software products (e.g. trade marks, domain names, other copyright works such as computer manuals and marketing material)
• Review contracts with employees and contractors to determine whether you own IP rights in software they have developed
• Review the use made and placement of IP attribution statements (e.g. © (copyright) notice)
• Review your own licence agreements to ensure appropriate IP ownership, warranty and indemnity provisions have been included to protect your interests and minimise your risks
• Review your licensees’ compliance with your software licence terms and take action if any infringements are identified
• Review third-party software licence agreements to determine whether any licences you rely upon are legally effective, current and permit use of the software in the manner used

REFERENCES
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BIOGRAPHICAL NOTES

Sharyn Ch’ang is a partner of Ernst & Young and leads the firm’s multi-disciplinary Intellectual Wealth Management™ practice which specialises in the identification, protection, commercialisation and valuation of intellectual property assets. An IP lawyer by background, Sharyn has been at the forefront of developments of “IP Governance” in Australia since the mid ’90’s, and amongst other things, has developed a proprietary IP audit methodology to assist clients identify their IP assets. Having worked in-house with IP savvy businesses such as IBM managing its IP, and engaged as a professional advisor to a range of private and public sector enterprises, Sharyn brings a unique practical and technical experience to the discipline of IP management.

Marina Yastreboff, formerly of Ernst & Young Law, is a specialist intellectual property lawyer and trade marks attorney with Intellectual Currency.