

IP Audit: Way to a Healthy Organization

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This article aims to study intellectual property audit and its importance in the management of intellectual assets of organizations. IP audit is vital for academic and research institutions as it improves transfer of technology and reduces uncertainties in IP matters. At the same time, it is significant for corporates not only to remove uncertainties in IP but also help in IP protection and compliances. With the increasing interaction of companies and universities or public funded research institutes, review and assessment of not only their intellectual assets but also their IP policies have become imperative. Such an audit helps organizations to avoid the pitfalls and maximize value of the intangible assets possessed by these organizations without the fear of any unwarranted legal proceedings.

Keywords: IP audit, IP assets, intellectual property, intangible assets

With the transition of the world economy from an agrarian and industrial to a knowledge based one, importance of the intellectual property (IP) has significantly increased. According to a recent global survey of IP monetization techniques, 94 per cent CEOs and CFOs said that the management of intangible assets is an important management issue.¹ Earlier IP was primarily seen as a defensive measure but with the success of companies like IBM, Texas Instruments and Proctor & Gamble with large IP portfolios, things are gradually changing. IP is no longer just a legal issue but has become a topic of hot debate in the board rooms of organizations. Thus, in this era of knowledge economy too much is at stake and it is very important for the organizations, both business and research organizations to protect their intellectual capital in a proper and adequate manner. At the same time, there is always a risk of running over somebody else's rights. The efficient protection and management of the IP, therefore, plays an important role in the overall growth of the organization, keeping them ahead of the competition in the market place. On the other hand, mismanagement of intellectual assets may mar business interests. A recent report by Pricewaterhouse Coopers², gives a clear picture of the status of IP management in companies. According to the report, most executives believe that IP management is very important to the success of their company but at the same time feel that it is often treated as a legal, not

a strategic issue. Many of them also felt that current accounting practices understate the value of IP.

Intellectual assets are most of the times not reflected in the books of the organizations; thereby not presenting the true value to its potential partners, investors or consumers. This happens mostly unknowingly. However, effective management of IP plays an important role in the success and failure of businesses all over the world, wherein auditing and reviewing of intellectual assets are important components. IP audit is usually regarded as a first step in the management of intellectual assets.

What is an IP Audit?

IP audit literally means review or assessment of the IP of an organization. IP audit can be defined as 'systemic review of the IP owned, used or acquired by a business so as to assess and manage risk, remedy problems and implement best practices in IP asset management'.³

IP audit is a useful mechanism for inventorying the intellectual assets and the IP owned, used, licensed in or licensed out or acquired by an organization. An effective audit is crucial to the internal review and revision of the IP strategy and IP policy of an organization. Besides, during the course of an audit, the auditing team is likely to uncover potential areas of conflict with third parties. It helps in the assessment and evaluation of the strengths and weaknesses of the organization. It also helps in the documentation of the technologies that already exist in the organization as

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well as those that are in various stages of development, leading to the development of IP strategy.

Of the large amount of information³ analysed in an IP audit, some significant ones are:

Use or disuse of IP assets, actual owners of the IP assets in the company's possession, infringement issues whether by the company or against the company, suitable actions to be taken *vis-à-vis* each IP asset to serve the relevant business goals of the company.

Why is an IP Audit Important?

Before discussing the importance of IP audit, it would be useful to list out certain facts related to economic impact of IP⁴:

- In the US, nearly 40 per cent of the market value of an average company is absent from its balance sheet whereas in the EU more than half of all large companies leave IP outside the scope of internal audits.
- In 2005, Qualcomm generated 58 per cent of its US\$ 5.7 billion revenue from the sale of Qualcomm-designed wireless chips, manufactured by third parties under contract.
- Since 1993, IBM made US\$ 1 billion from licensing non-core technologies which would otherwise not have been used.
- Honeywell International uses a separate company, Honeywell Intellectual Properties Inc, to manage its IP portfolio. Recently, it licensed its LCD technology to competitors such as Sanyo, LGC, Philips, and Chungwa Picture Tubes.
- In 2002, Korea exported technology worth US\$ 0.6 billion and imported technology worth US\$ 2.7 billion through licensing, R & D sharing and joint ventures. Besides, since 2002, Korea has increased its R&D expenditure from 2.6 per cent of GDP in 1998 to ~3.4 per cent in 2004.
- In New Zealand, SMEs account for 37.3 per cent of GDP and have the highest profits per employee, but most SMEs are unaware of the value of their IP or the fact that there is a good chance that it is being infringed.
- US company Texas Instruments earns more from licensing its unused patent rights than from its products.
- US companies have a fiduciary responsibility to manage IP rights and to report actual company

value rather than just book value under the Securities Exchange Act, 1934.

- In an EU survey, 28 per cent of companies had no provision for IP ownership in their standard employment contract.
- 50 per cent of EU companies have no strategy for managing their IP rights beyond mere filing or renewal payments.
- Dow Chemicals, as a result of IP audit, achieved an immediate savings of US\$ 50 million in taxes and maintenance fees on unneeded patents and US\$ 25 million from patent licensing revenues in 1994 (ref. 5).

Some of the facts stated above give sufficient reasons as to why any organization should consider conducting an audit of its intellectual assets. IP audit helps in analysing the strengths and weaknesses of an organization. IP audit also helps in finding out if the organization is actually infringing on other's IPRs. Detecting infringement at early stages may eventually prove a boon for the organization, leading it to stop violation, seek a licence or even design around.

Today, organizations see intellectual property audit not only as a balance sheet for intangible assets but also, more importantly, as a self-evaluation that the organization constantly and consistently engages in to determine the value of its own assets, determine how to best capitalize on those assets, and keep abreast of changing values of its assets in the face of the ever-changing economic and legal ecosphere.⁶ An example which reiterates the importance of IP audit is the project IP Genesis⁷ at the French Industrial Property Office wherein the office offers a free IP audit to SMEs who are not using the IP system, especially the patent system. This encourages these SMEs to consider IP in a strategic fashion having received expert advice. The service was used by 464 French SMEs in 2005, the vast majority of which were for SMEs with between 1 and 20 employees. The level of satisfaction with the project was high and 51 per cent of participating firms subsequently applied for some form of registered IP protection. Clearly, the increase in the levels of IP is not a measure of success in itself, but indicates that the firms who had participated in the scheme had increased awareness of IP and its applicability to their business.

When should an IP Audit be Conducted?

The importance of IP audit largely depends on the time and the purpose of its being conducted. An IP

audit is usually conducted when there are any mergers/ acquisitions or any transfer of technology taking place. Broadly, an IP audit based on the purposes can be of three types⁸:

(1) General purpose IP audit, (2) Event driven IP audit and (3) Limited purpose IP audit

General Purpose IP Audit

IP audit conducted for general purposes is perhaps the most simple of all and can be conducted at any time without any specific purpose. Usually, an IP audit is done in any of the following circumstances:

- (i) Before establishing a new company; since it is important for a start-up company to be aware of intangible assets it owns or needs to protect
- (ii) When a business is considering implementing new policies, standards, or procedures relating to IP
- (iii) When a business is considering implementing a new marketing approach or direction, or is planning a major reorganization of the company
- (iv) When a new person becomes responsible for IP management.

Event Driven IP audit

Event driven IP audit is usually conducted on specific occasions. It is also known as 'IP due diligence', when conducted on behalf of a third party to assess the value of the intellectual assets owned by the company and the potential risks associated with it. This sort of comprehensive audit usually provides detailed information on the financial, commercial and legal aspects of the company, which may eventually affect the transaction. Event driven IP audit is done in the following contexts:

Merger & Acquisition or Joint Venture

A proper IP due diligence should be conducted before entering into negotiations for mergers and acquisitions or joint ventures. It could lead to a significant increase in value of the acquired or merged company and at the same time reduce the costs of acquisition or even cancel the deal owing to problems with the IP of the target company.

One of leading examples is that of the Volkswagen and BMW-Rolls Royce.⁹ The saga began in 1973 when Rolls Royce Plc sold Rolls Royce Motors to Vickers, a British company. In 1998, Vickers decided to sell Rolls Royce Motors and in the process Volkswagen (£430 million) outbid BMW (£340

million). However, Volkswagen later realized that it had only bought the people, plant and the processes and not the 'Rolls Royce' brand, which was with Rolls Royce Plc, the parent company.

Later that year, BMW bought the rights to the 'Rolls Royce' brand from the parent company, for £40 million. Thus, while Volkswagen owned the machinery BMW owned the name. They reached a settlement that from 1998 to 2002, BMW would allow Volkswagen to use the name and the logo. But from 1 January 2003, Volkswagen was forced to surrender production to BMW.

On the contrary, in the Tata – Ford deal, the deal included that Tata Motors obtained the rights of both the Jaguar and Land Rover brands amongst other things like the components, the technology, etc. for US\$ 2.3 billion. Tata Motors was more successful in its acquisition since, they carried out a proper due diligence before acquiring Ford Motor's Jaguar and Land Rover brands.¹⁰

Thus, the above two cases clearly emphasize the difference in the results, of doing due diligence before merger and acquisition.

Financial Transactions

Examples of financial transactions may include loans, initial public offerings, or any other transaction directly or indirectly involving intellectual property. The IP audit may help a potential customer in making his decision.

Assignment or Transfer of Intellectual Property

An audit should be conducted separately, by both the parties involved in the transfer or assignment of the intellectual assets involved in the transactions.

Licensing of Intellectual Property

A potential licensor should conduct due diligence to check whether the licensee actually owns the IP in question and that there are no existing licences which would interfere with the deal. On the other hand, a potential licensee should conduct audit on its part to determine the scope of the licence.

Launching a New Product or Service

Before launching a new product or service, entering in new markets abroad or even expanding business in new markets through outsourcing, a due diligence or more specifically a freedom-to-operate study should be undertaken to ascertain that the launch of new products or services is not infringing the rights of other competitors already present in the market.

Purpose or Focused Audit

A limited purpose IP audit is usually conducted for a specified purpose, such as:

Significant Change in Law

An IP audit is done by the organizations to check whether the intellectual assets owned by the organizations are in alignment with the new IP laws of the country. For instance, in the light of amendments made in the IP laws of India post 2000, an audit should necessarily be conducted to re-evaluate the assets owned by the organizations.

Bankruptcy, Layoffs

Prior to filing for any bankruptcy, laying off employees, closure of a significant department of business or the entire business, a due diligence should be conducted on employment contracts of the laid-off or dissatisfied employees and also check what IP related information was accessible to the employees.

If the audit is being conducted for the first time to review the assets owned by an organization, the results may be quite surprising for the organization. If the audit has been conducted previously, the organization should include it in the best practices to be followed so that it is conducted on a regular basis.

Who Conducts an IP Audit?

Who should conduct an audit depends on the nature and scope of the audit. Ideally, it should be conducted by a team comprising at least one IP lawyer, a technical member and any other member from the company having sufficient knowledge of the facts and issues involved in the audit. If help from any external counsel is sought, the counsel must have sufficient understanding of the technology involved in the audit. Thus to obtain best results, the audit team should have basic understanding of the technology, the manner in which business is conducted and the future plans of the company. In order to avoid any future complications, it is best for the audit team to sign a non-disclosure agreement before starting the audit.

How is an IP Audit Conducted?

Before commencing an IP audit it is necessary to determine the nature and extent of the audit. Preparing an audit plan in advance will help in achieving best results out of IP audit.

Collecting Information

Collecting as much information as possible about the company before commencing audit is very

essential. Primarily, the following information is sought before an IP audit:

(i) The company’s regular interaction internally as well as externally and the impact such interactions has on the intellectual assets owned by the company, (ii) intellectual assets of the company, including business strategy with all the associated documents of relevance like company profiles, brochures, advertisements, etc., and (iii) the status of the IP owned by the company including disputed matters and the IP infrastructure, namely if the IP expertise is in-house or external. The extent of the knowledge of the employees regarding the company’s IP policies and strategies is also very important.

Preparing an Audit Plan

Once all the background work has been done and the information has been collected, the next step would be to prepare an audit plan. The audit plan should include things like purpose of the audit, scope of the audit, time schedule which the audit will follow, the audit team and the form of final audit report to be produced. If the audit is being conducted for any specific purpose, the departments of the business which are to be audited should also be covered.

Conducting an IP Audit

Each audit should start with identifying all the intellectual assets of the organization, followed by disputes relating to IP, moving on to identification of problems with enforcement and finally identification of any unprotected intellectual asset.

Before finally commencing the audit it is best to prepare a checklist, so that the chances of missing out on any important step are minimized. The checklist should include reviewing of IP strategy of the company, auditing of agreements, IP portfolio, information flow and analysis of the information gathered. Though, it is customary to follow a standardized checklist so that nothing is omitted even inadvertently in undertaking an IP audit, such checklists should necessarily be adapted to the particular industry, company, purpose and scope of the audit. Further, the actual questions that should be asked in an IP audit will often evolve from the preliminary findings of the audit. Therefore, the details of every audit will be distinctive with regard to situation and circumstances.³

Review of IP Strategy of the Company

An audit should begin with review of the IP strategy employed by the company. IP audit during

the review of IP strategy should also include the documentation of all the existing technologies as well as the technologies which are in various stages of development. IP strategy adopted by the company will help in the understanding of the company's stand and approach towards IP.

Audit of Intellectual Assets Owned by the Organization

The second, important step of the audit involves identification and review of the intellectual assets of the organization; IP that has already been protected and that which ought to be protected. Intellectual assets include the assets produced by the organization as well as the assets acquired or used by the organization. This will address not only the ownership issues but also address the question of existence of adequate systems to protect these assets. Some of the important points to remember while auditing the assets are:

Nature of the Organization

The audit team should bear in mind the nature of the organization for which the audit is being conducted. It would be advisable to verify the documents of incorporation in case of the corporations, as to what powers they have to deal with the IP originating out of that organization. This should also be followed in case of universities and public funded research institutes.

Nature of Ownership

This would determine whether the ownership is sole or joint ownership. It would also ascertain whether the company is an assignee or licensee. If the company is a licensee, then it is necessary to know whether it is an exclusive or non-exclusive licensee. The term and duration of such ownership then becomes important.

Nature of Restriction

There could be several restrictions involved in ownership in the form of assignment or licence such as non-compete clauses, territorial restrictions or time-bound restrictions.

Legal Status of IP Assets

The legal status of the IP assets of the organization is of utmost consequence. The status of any kind of litigation that the organization might be involved in should be analysed with abundant caution. The outcome of these might be devastating for the organization. A case in the point is the famous

Polaroid v Kodak patent infringement lawsuit involving instant cameras, which eventually lead to the closure of the entire business of Kodak. Instant photography was invented by Polaroid Corporation and the technology was protected by them with 12 strong patents. Attracted by the Polaroid's dominant position in the business of instant photography and a 15 per cent of all the camera sales in the United States, Kodak seeking to grab a slice of profits, sought to design around Polaroid's patents and launched its instant camera. Within seven days of the launch, Polaroid slapped Kodak with a lawsuit for infringement. The Court held Kodak guilty of infringing seven of Polaroid's patents. The 14 year long legal battle resulted in the payment of damages of the order of US\$ 925 million to Polaroid. Kodak was also forced to shut down its US\$ 1.5 billion manufacturing plant, lay off workers, spend nearly US\$ 500 million to buy back 16 million instant cameras sold, US\$ 100 million in legal fees and to write off a decade-long R&D effort.⁵ All this eventually destroyed Kodak's instant camera business and drove it out of the market for 15 long years. This case drives home the significant role of IP audit in shaping R&D strategy.

Typical Intellectual Assets owned by an Organization

Patents

The audit should include all the granted patents, patent applications and unfiled disclosures which are due for filing. The process should also include compliances with laws of other countries, in case of foreign filings. The process also includes review of lab books, reviewing the practices followed by the company in conducting prior-art and Freedom to Operate (FTO) searches, reviewing the payments of annuities and payment of royalty(ies) in cases of licensing-in patents/technologies/ other IPR. Further, the audit team should also review the importance of patents owned by the organization, for example, reviewing the patent ecology, including the forward and backward citations of the patent, and also the patent-linked market structure and/or size, competitors and their profile, etc. The audit team should also review the legal opinion given to the organization on various aspects of the patent.

Trademarks

The audit should include all the trademarks and service marks which have been registered, pending or yet to be applied for. Unlike other forms of

intellectual property rights, trademarks last forever with the payment of nominal maintenance fees. Trademarks can play a crucial role in the fortune of the company, e.g., the brand value of the Coca Cola trademark is US\$ 6.7 billion. Harley Davidson, for instance, rebuilt the company on license fees, which at one time was 50% of the income. The fees came from licensing the Harley Davidson trademark for use on products other than motorcycles.¹² A due diligence should be conducted before launching a new trademark (brand) to avoid linguistic traps. One such case is the famous Coca Cola case, where when Coca Cola was introduced in China, it was named as Ke-Kou-Ke-La which roughly meant 'bite the wax tadpole' or 'female horse stuffed with wax', depending on the dialect. Other things which need to be taken care of are whether the trademarks filed in other countries comply with the national laws and whether the maintenance fees are paid on time. The audit should also review whether non-conventional marks if any, owned by the organization are also taken care of especially with respect to the laws relating to non-conventional marks which are different in different countries. Due care should be taken for important marks and unimportant ones should be phased out. The audit should also evaluate the findings of watch dog cells established to monitor the activities of the third parties.

Copyright

Copyright subsists in every literary material including brochures, pamphlets, etc. The audit should ascertain whether the copyright has established on the every literary material they own. More important is to assess whether permission has been sought from the authors of the work for every copyrighted material used by the company and that the author has been duly acknowledged, if the organization does not own those materials.

Trade Secrets

Trade secrets generally include know-how, new product plans, manufacturing processes, advertising plans, customer lists, cost and pricing data, financial statements and projections, computer software, even salary of employees or anything which gives the organization its competitive advantage. For example, the formula of Coca Cola is a trade secret and among most important intellectual assets of the company. In India, there is no law for the protection of trade secrets, instead in case of any breach; remedy is usually under

the common law. An IP audit should check if due care has been taken to protect the trade secrets.

Domain Name

The audit should review whether the organization has got its domain name registered with the domain name registry and it is not misused by any other. Due care should be taken to see that the domain name has not expired and must be renewed regularly for a reasonable period of time.

Plant Variety

The first thing to examine is whether the crop/plant variety in which the organization is dealing has been notified by the Protection of Plant Varieties & Farmer's Rights Authority. The audit should review all the pending applications as well as the applications which are ready for filing. Applying for registration and protection under this law is not a mandatory requirement and the organization must be made aware of weighing the options of going in for protection by registration under the law or by way of a trade secret which is especially important when dealing with hybrids. In this context, the issue of licensing versus compulsory licensing should be duly reviewed by the organization.

Designs

The audit should review all the designs which have been registered; pending registration and which are worth protecting but not registered. In India, the design protection is for 10 years and further renewable for a period of 5 years. The audit should review whether all the registration fees have been paid and which designs are worthy of renewal for a further period of 5 years. For unprotected designs, the primary decision would be regarding the nature of protection, i.e., through design or copyright.

Auditing of Agreements

Once intellectual assets have been audited, the next step would be to audit various agreements relating to IP. These contracts involve not only licences related to IP, but also agreements with employees, contractors, partners, competitors, suppliers, customers, distributors, etc. and could be one of the following:

Licensing or Assignment Agreements

Licensing and assignment agreements are one of the most efficient ways to get the most out of the intellectual assets. All such agreements should be reviewed to ensure that all stipulations are being complied with.

Employment and Contractor Agreements

The audit should review the employment and contractor agreements for the provisions relating to the transfer of IP originating as a result of their employment/contract. Further, the audit should review the clauses imposing restrictions on the employees/contractors on the use or disclosure of the confidential information accessed during the course of employment or the contract after the completion or termination of the employment/contract and the extent and scope of the non-compete clauses in the contract.

Collaborative R&D and Joint Venture Agreements

This involves review of the clauses in the agreement as to who will own the intellectual property originating out of the collaboration/joint venture and who will own the IP once the collaboration/joint venture ends. Other agreements that are also included in the audit are distributor agreements, franchise agreements, non-disclosure agreements, material transfer agreements, royalty agreements, benefit sharing agreements, etc.

Auditing of Information

An IP audit cannot be complete without auditing the flow of information within the organization's hierarchy. It plays an important role in the decision making process. Information gathered and data generated from the departments of an organization such as marketing department, R&D department, sales department, etc. all together help the decision makers in the organization to take informed and calculated risks for the betterment of the company.¹³

Analysing the Information Collected

Once the audit is completed, the audit team analyses and evaluates the information collected during the audit. The information collected is viewed in the light of the best practices based on which recommendations are made. The audit team prepares the audit report keeping in mind this analysis. The results of the audit may actually add a new dimension to the IP policy and strategy of the organization.

Preparing an Audit Report

The results of the audit are compiled in the form of a report. The report contains the objective of the audit, the audit plan, method of conducting audit, the time taken, analysis of the results, the exposed defects and the recommendations based on the analysis. If the audit was conducted for any specific purpose, the report should take care of that as well. The results of the audit

are kept confidential since the audit may disclose the information that the organization may find damaging to its reputation.¹³ Nevertheless, an authentic audit report could be highly useful in case any litigation related to the IP covered in the report arises.

Once the audit is complete and all recommendations have been made, the audit team conducts a re-orientation training session for both the employees as well as the senior managers. This would facilitate individual retrospection by the employees with respect to their involuntary day-to-day actions or responses which may affect IP management by the organization, ensure greater awareness of intellectual property within the organization and also a proper follow-up of the recommendations made in the audit report. The audit team can also help the organization in the creation of an in-house IP cell, if the organization does not have one. The team can also help in the formation of intellectual asset (IA) management team. Once an in-house IP cell has been created or IA management team has been formed, they can be charged with the responsibility of reviewing and monitoring IP policies, practices and procedures.

Conclusion

IP audit is an important tool in the management of intellectual assets of the organization. The audit benefits both IP owners as well as buyers. One of the biggest advantages of IP audit is that it not only gives an advance warning of the infringement but it also helps in the formulation of the business strategy. It is in the interest of organizations to conduct comprehensive IP audits occasionally to determine the kind IP assets they possess, the nature of IP protection needed, potential IP conflicts, and analysing licensing opportunities.

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