



## AUDIT, DUE DILIGENCE AND VALUATIONS

South Africa

**Adams & Adams**

Intellectual Property  
Audit, Due Diligence and Valuation

CAPE TOWN

PRETORIA

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## IP: part of the capital of a business

The capital of a successful business enterprise is generally composed of **working capital**, **fixed assets** and **intellectual capital**. This is a combination of assets used by successful companies for expanding their participation in industry and for maximising their profits.

**Working capital** and **fixed assets** are generally commodity type assets that all businesses possess and exploit. However, a company that possesses and exploits only these assets will enjoy limited success and modest earnings because of the competitive nature of business and because other businesses have access to the same asset categories. A business that sets its sights on the generation of superior earnings must have something else - something that sets it apart from other businesses, ie. the asset category referred to as **intellectual capital**.

The **intellectual capital** of the business includes its **intellectual property**.

The intellectual capital of a business constitutes a significant component of its total asset base; the value of the intellectual capital could exceed the value of the fixed assets of the business or its working capital. It has been recognised that the intellectual capital of a business provides the most potent - and most effective - impetus to its earning power.

## IP and other concepts defined

The term **intellectual capital** is generally used to denote all of the intangible assets within an entity. Intellectual capital is more than intellectual property; it has been defined as the **aggregate of intellectual property, human capital, and other intangible assets**.

X **Intellectual property** (IP) is a relatively clearly delineated legal concept, including both statutory and non-statutory (common law) rights such as patents (inventions), designs, trade marks (registered and unregistered), business and trade names (company names, domain names), copyright, confidential information (trade secrets, technology, know-how), etc.

- X **Human capital** represents the employee intellect of the business, ie. the know-how and 'institutional' memory of the business, providing the capacity to generate more intellectual property and other intangible assets.
- X **Other intangible assets** in this context denote the codified or otherwise recorded bodies of specific knowledge to which the business can assert ownership, including business systems and knowledge, IT systems, distribution networks and supplier sources (for goods and services), administration and management systems, training capacity, knowledge and expertise (of markets, products, client profiles and preferences), licences, franchises and other contracts (eg. leases), and probably also goodwill (ie. the power to attract customers).

The strategic value of intellectual capital is evident if it is understood as **knowledge that can be converted to value or profit**. However, to place a monetary value on intellectual capital is not so easy.

### IP audit and due diligence

In order to place a monetary value on the intellectual capital of a business, three essential steps are involved:

- X a full **audit** is required. This involves compiling a comprehensive and accurate inventory of all of the components of intellectual capital to be found within the business;
- X a **due diligence** investigation is then conducted into aspects of validity and ownership of those components; and finally
- X a **valuation** is made, by determining a fair value for those components by a recognised valuation process.

Apart from the advantage of having a reliable value representing the intangible assets of the business, auditing and due diligence procedures entail several other benefits:

- X **Identify and categorise** the different intangible components together making up the intellectual capital of the business. This is particularly important in regard to non-statutory and non-registration IP rights; IP owners seldom recognise the importance of keeping records of their unregistered rights. A full inventory is beneficial also in the case of statutory and registered IP rights; IP owners often fail to keep an up-to-date record of patents, trade

marks and industrial designs, reflecting renewals, amendments, etc.

- X **Clarify ownership** of, and the right to use, the IP or other intangible items. In the case of non-registration rights, such as copyright, know-how, etc. reliable information is essential to substantiate any claim or enforcement of rights, yet records are seldom created or kept to reflect particulars regarding authors, creators, assignments, licences, etc. Even in the case of registration rights, such as patents, accessible and reliable information regarding inventors, licences, assignments will be of benefit.
  
- X **Review and enhance** the validity of IP rights. It is not uncommon for information which may compromise the validity of a registered IP right, to come into the hands of the IP owner after the registration of the right has been completed. Examples are prior art in the case of patents; prior use by a third party of a similar mark in respect of the same goods or services in the case of trade marks; weak links in the chain of ownership of the rights; etc. The advantage of identifying and correcting such defects before they are located and exploited by a rival, is evident.
  
- X **Review of enforcement** measures and efforts to combat infringing activity or dilution of rights by others. A right is as useful to its owner as its ability to be enforced. Regular assessment of the enforceability of IP rights and a perceived readiness to enforce such rights are the first steps in discouraging infringers and combating infringement.

- X **Assist in strategic planning**, for example by planning and promoting the creation or acquisition of further IP rights. By reviewing the IP rights held by a business, the need for and/or the opportunities to acquire further IP rights can be identified.
- X **Economic valuation** of the IP rights and other intangible assets held by the business will be based on reliable information.

### When to do IP audit and due diligence

Although an IP audit and due diligence investigation are always useful as part of a 'stock-taking' procedure, these procedures are particularly valuable and in fact essential when a business intends embarking on commercial transactions involving the following:

- X mergers and acquisitions
- X joint ventures
- X privatisation
- X stock exchange listing
- X financing
- X valuation of assets; and
- X in anticipation of the expected capital gains tax.

### Auditing procedure

An audit process includes an investigation of each different business area or division of a business to **locate and identify the intellectual property** within the business, distinguishing between different geographic areas of business as intellectual property rights are in most cases territorial in ambit. This entails compiling inventories of:

#### Registered IP rights

(in respect of different countries)

- X trademarks
- X patents
- X designs
- X cinematograph films
- X defensive company names.

- The list is compiled from
- X agents' records
  - X client's records
  - X records at the relevant Registries.

#### **Unregistered rights**

- X trade marks (including trading styles)
- X copyright works
- X domain names
- X confidential information (technology, know-how and other information)
- X the results of research and development projects.

#### **Duration/time periods**

- X determination and recordal of the lifespan and expiry dates of all IP rights, registered or unregistered.

#### **Ownership of IP rights**

verified with reference to

- X all background facts relating to origination
- X names of creators/inventors and original applicant
- X relevant employment and other contracts
- X chains of assignments/title
- X all name changes and other relevant documents
- X hypothecations, deeds of security, security interests, legal attachments.

#### **Due diligence procedure**

The next step would be to conduct a due diligence investigation of the audited intellectual property. This involves critical re-checks and assessments of various aspects, such as:

- X prima facie validity of existing IP registrations and unregistered rights
- X current status and renewal
- X history and registration process including prior art and citations
- X searches conducted and results
- X licensing records and control, licence periods and renewal
- X vulnerability of the IP to infringement claims or validity attacks
- X risk assessment and the formulation of a plan to enhance the validity of each category of IP rights.

In particular due diligence investigations should entail the following **validity checks** in respect of specific categories of intellectual property:

**Trade Marks**

- X re-check of status
- X inherent and relative validity of original entry
- X inherent and relative validity of current entry
- X chain of title and assignments
- X vulnerability on the basis of non-use
- X dilution, considering prior and concurrent use by third parties.

**Patents and designs**

- X procedural correctness
- X novelty, results and coverage of searches, examinations in other countries
- X utility, other statutory requirements
- X enforcement history, scope of claims
- X merit of challenges (if any).

**Copyright**

- X originality (creation process, skill and effort)
- X authored by qualified person/country of first publication
- X availability of authors to testify
- X existence and details of records of first reduction to material form
- X proof of claim of title (documentation on assignments, licences)
- X employee works, outside contractors
- X marking of works/copies.

**Confidential matter**

- X recordal of know-how
- X security and safety, safeguards against unauthorised disclosure
- X access by employees and others
- X employee contracts (confidentiality, restraints)
- X breaches of confidentiality.

In addition to validity, the following should be investigated:

### **Licences**

- X in-and-out licences and registered users
- X compulsory licences.

### **Infringement**

- X present/past infringements by third parties
- X present/past infringements of third party rights.

### **General policies and procedures**

- X identification, protection and maintenance of new rights.

### **Valuation procedure**

Although IP assets have certain special qualities, being intangible and invisible, their value, like other property, is financially quantifiable; they can be traded and commercialised; and they can play a dominant role in establishing and enhancing shareholder value. In fact, the value of a company's IP rights can exceed the value of its physical assets.

The purpose of valuation is to determine a **fair value** for the IP. The value is not necessarily equivalent to the price or cost of acquiring or creating the IP rights; it is generally accepted that a more realistic quantification is to equate the value to the sum total of all future benefits to be derived from the IP, valued at current rates and compressed into a single payment.

The criteria in determining valuation figures should be:

- X that of a willing buyer and a willing seller
- X the market sector involved and the strength of the market
- X the functional, technological, economic and legal life of the asset
- X whether the asset is to be valued as part of a going concern or on a liquidation basis.

## Valuation methods

There are well-recognised and accepted methods for estimating the fair market value of intellectual property of all types. The cost, market, and income approaches are grounded on well-recognised financial principles and have reached sophisticated levels of application.

Of these methods, the cost approach has limited usefulness whereas the market approach can provide a fair indication of value within the context of an active IP market. At present the income approach is the best and most credible alternative for IP valuation in the South African market.

These different methods can be summarised as follows:

- X **Cost/replacement approach:** the estimate cost to replace the IP asset, or the historical cost for acquiring the IP is used to determine the value. This approach seeks to determine the future benefits of ownership by quantifying the amount of money that would be required to replace the IP. The basis underlying this approach is the principle of substitution, ie. the value of the IP is equated to the cost to re-create it.
- X **Market approach:** comparable transactions in the marketplace are used to determine the value. This method is rarely used in South Africa, since the country does not have an active IP market.
- X **Income approach:** the anticipated income derived from goods or services employing the IP, taken over a period and discounted to a present value, is used as a base figure representing total turnover. The income derived from the IP component of the goods and services is calculated on the basis of a reasonable royalty on the total turnover, the reasonable royalty being that payable by a third party licensed to use the IP.

This method of evaluation therefore entails three distinct steps:

- X determination of a total projected income stream. Turnover history may be relevant in this determination;
- X determination of a reasonable royalty rate;
- X determination of a suitable discount factor. Factors which should be taken into account are inflation, liquidity, real interest rates and a risk premium (which measures the relative risk).

## Factors relevant to valuation

The following factors are relevant to and should be taken into account in determining future income:

- X nature of the goods or services employing the IP
- X extent of the IP monopoly
- X technical and market trends
- X development speed and durability of the product
- X brand loyalty
- X ability to line-extend to meet market trends
- X period of marketing and goodwill created
- X extent and efficacy of competitive products
- X extent of counterfeiting and availability of grey goods
- X export/import restrictions/incentives
- X political factors and economic outlook
- X costs of exclusivity (including advertising, public relations, quality control, legal expenses, development costs).