

The Auditing Implications of Adequately Maintaining and Policing Intellectual Property

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This paper discusses the lack of apparent understanding regarding the importance of adequately maintaining and policing intangible assets. Legal aspects of maintaining intellectual property are addressed, and real-world examples are used to illustrate the importance of such maintenance. The auditing implications regarding maintenance of intellectual property are vast, including possible impairment of a purchased intangible asset, issues of going-concern, and issues of legal liability. The article discusses tools that are available for companies to use to police their brand names and other intellectual property. Auditors can also use these tools to develop their own processes for assessing intangibles.

We recently met with the new CFO of a publicly-traded company who had just assumed responsibility for the company's portfolio of trademarks and other intellectual property. He contracted with us to analyze the company's brand portfolio, which was considered a material asset of the company. We immediately conducted some trademark clearance searches to determine whether there was any third-party activity regarding the brands included on the company's list of assets. We quickly found that various parties had indeed used and actually registered brands similar to (or in some cases practically identical to) those listed as assets by the company. It became clear that there had been no policing of the portfolio, and no action had been taken to enforce any rights to the assets the company assumed it had owned. As a result, these intellectual-property assets had essentially been allowed to turn to waste, and their value was significantly impaired.

Upon learning this news, the CFO asked how much it would cost to fix the damage. If some of it could be fixed (which was impossible to determine up front), the estimates ranged from a quarter of a million dollars to several million dollars. The CFO now was left with a bigger question. Would this issue necessitate a restatement? He went to the CEO regarding his findings, and the company "went private" within three months. Clearly this was material!

Intellectual properties, such as brands and trademarks, are increasingly critical to companies. The emergence of the World Wide Web, global adoption of new information-related technologies, and the growing importance of brands and unique content have all led to a material change in the composition of

balance sheets for many companies. Auditing procedures often fail to adequately address intangible assets. Our focus in this article is to highlight the particular problems associated with auditing trademarks and service marks and to suggest potential solutions to those problems.

Trademarks function as designations of the source of goods in the minds of consumers. Service marks function as designations of source in the same manner for services. The term “brand” includes both categories (goods and services) and can refer to anything from word marks and design marks to sounds or even smells that function as marks. Brands allow consumers to identify company names, product names, and services as originating from a particular business and to make a quality association with the goods or services. Ultimately this association is a key factor that drives corporate profitability and market value.

Many companies that rely so heavily upon these brands, however, fail to understand how to legally protect their brands. For a brand to be legally protected and recognized as a property right, it must be used as a mark, preferably with the “tm”, “sm” or ® symbol at the bottom right hand corner of the mark, as applicable. Best practices also include registration of the brand with the United States Patent and Trademark Office (or a similar office in the country in which the company is registering). Brands must then be continuously in use in commerce in order for legal rights to be maintained over them. Another critical legal requirement to maintain a brand is an active policing system with a regular review of third-party applications for registrations on not only a state and Federal basis, but also on an international basis. The policing system also includes a regular review of unregistered use by unauthorized third parties. Any discoveries of unauthorized use should be accompanied by a cease-and-desist letter from the rightful owner of the brand.

It is vital that brands be policed not only on the state and federal levels, but also on the international level. To illustrate, in an acquisition transaction a few years ago, we were contracted by the acquiring company to assess the intellectual property of the target company. We found that the target company, a publicly-traded company, had failed to register its key brands in most of the countries in which it was operating. This failure meant that third parties could actually register the same brand in those countries and then proceed to exclude the company from using the brand in that country. The target company had also failed to register domain names at the country level to cover local marketing and operations. After we reported our findings to the acquiring company, they lowered the offering price by 20 percent based on this information and pointed out that the target company’s officers and general counsel may have a liability issue.

As this story illustrates, failure to file and police brands could lead to company’s loss of the right to use those brands in the future. Many countries outside the U.S. are “first to file”, which means the failure to search, clear, and file a brand with the government can result in being excluded from that market. Third parties may, themselves, secure rights over those brands. In a worse-case scenario, the company that originally developed or purchased those brands could actually face an infringement lawsuit from the parties that secured those rights after the brands were not properly maintained. Furthermore, the company could face lawsuits from shareholders for a breach of fiduciary duty as a result of failing to adequately protect material company assets.

The auditor, too, could face lawsuits for failing to adequately test for the existence and value of those assets. Auditors often fail to understand the necessary steps involved in the legal protection of the brands of their audit clients. The challenge for auditors is that a highly valuable mark on the balance sheet, even a house mark (one that appears on and identifies all of a company’s products), may not be adequately maintained or policed. If this is the case, the value of the asset could be significantly impaired or may be legally lost already, even if a Federal registration remains in place. This means that auditors should introduce a substantive review of the company’s brand protection and maintenance processes in an audit of a publicly listed or a pre-public company. The same is true of any private companies that may require an audit for third party financing or other purposes for which the audit opinion is to be relied upon. Failure to do so could lead to an erroneous opinion on the fairness of the company’s financial statements or, as the opening story illustrated, it could have a bearing on the company’s ability to continue as a going concern.

The auditor's task is to test for the existence and value of a brand. There are a few practical means to address this for material brands. The auditor could request an opinion of legal counsel regarding the level of protection and strength associated with the brands being audited. With the historical lack of information easily accessible to auditors, this is typically what they have been forced to do. The legal counsel with this knowledge, however, is frequently the same party responsible for legally protecting, maintaining, and policing the brands, so it effectively becomes a situation where legal counsel is auditing his or her own work. Appointment of a new and independent intellectual-property attorney may be appropriate in those situations.

A second method to assess material brands would be to retain a valuation firm with sufficient expertise to conduct searches, independent of the company's legal counsel, to determine the status of the legal protection of the brand. This can provide an independent data set for review by the auditor. The output of these searches is typically qualitative and based on certain assumptions and can, therefore, provide its own challenges for the auditor.

With emerging technologies, the audit challenges inherent in retaining an independent firm have been addressed. There is now web-accessible software available that provides auditors with a quantitative and well-defined snapshot of the status of any brands that they may be auditing. This software searches terabytes of data within proprietary databases and the web to create comprehensive reports with a scoring system that suggests whether the company's brands are well maintained or in danger. This output provides auditors with a valuable tool to effectively and efficiently include an audit of brand management within their scope. With these emerging technologies, auditors can develop their own firm processes to analyze the results of their own use of these tools. This can add a new dimension of work and a new potential profit center for audit firms that embrace such emerging technologies.

Considering the increasing value of intellectual property, it is in the best financial interest of all companies to ensure their intangible property is well documented, fairly valued, strongly protected, and well maintained. Since the passage of the Sarbanes-Oxley Act in 2002, this is even more important for publicly-traded companies, because they are required by law to account for their intellectual property assets in periodic filings with the SEC. The Sarbanes-Oxley Compliance Journal specifically states that it is "prudent for every public company to implement some form of 'best practices' and disclosure processes and controls" with regard to its intellectual property. This places a burden on auditors of such companies to determine, or at least inquire, as to what constitutes "best practices" for such assets and to ensure that they are being both followed and disclosed.

Intangible assets are no longer a small or immaterial class of assets. In today's digital economy, they are likely to continue to increase in value and importance. Informing and training audit staff fully on what creates legal rights in intellectual property assets, as well as how they may be diluted, weakened or lost, allows audit firms to more adequately undertake the audit of intellectual property. It also ensures that generally accepted auditing standards are maintained in an increasingly global and digital economy.