

# A step-by-step guide to the principles-based innovation test

This guide will help you to decide whether a start-up company passes the principles-based innovation test set out in Division 360<sup>1</sup> of the Income Tax Assessment Act 1997. In addition to the 'early stage' tests<sup>2</sup>, the principles-based innovation test is one of two alternative innovation tests a company must satisfy to qualify as an early stage innovation company (ESIC). An eligible investment in an ESIC provides tax incentives for the investor. It is the investor's responsibility to determine whether the company qualifies as an ESIC at the 'test time'. The 'test time' is immediately after the investor is issued with new shares by the company.

A company qualifies as an ESIC if it meets the early stage tests and one of two 'innovation' tests, which are:

- the 100-point innovation test<sup>3</sup>, or
- the principles-based innovation test<sup>4</sup>.

This guide will help you to determine whether a company meets the ESIC principles-based innovation test. It includes examples and case studies to show how the test is applied in practice.

*The activities and products outlined in the examples in this guide are for illustration only. The activities they show might not necessarily be considered current innovations.*

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<sup>1</sup> Subparagraph 360-40(1)(e)(i),(ii),(iii),(iv) and (v),

<sup>2</sup> Paragraph 360-40(1)(a)(b)(c) and (d)

<sup>3</sup> Paragraph 360-40(1)(e) and Section 360-45, ITAA 1997

<sup>4</sup> Subparagraph 360-40(1)(e)(i),(ii),(iii),(iv) and (v)

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# The five conditions

To meet the principles-based innovation test, the company must meet each of the five conditions below. If one or more of the conditions is not satisfied by the company, it does not qualify as an ESIC under that test. It may, however, qualify by using the 100 point innovation test to meet the innovation requirement.

The five conditions are:

1. The company must be genuinely focussed on developing for commercialisation one or more new or significantly improved products, processes, services or marketing or organisational methods;
2. The business relating to the innovation has high growth potential;
3. The company can demonstrate it has the potential to successfully scale the business;
4. The company can demonstrate it has the potential to address a broader than local market, including global markets, through the business; and
5. The company can demonstrate that it has the potential to have competitive advantages for the business.

## Condition 1: The company must be genuinely focussed on developing for commercialisation one or more new or significantly improved products, processes, services or marketing or organisational methods

This condition comprises three interacting elements that must be addressed. The elements are:

- a new, or significantly improved, product, process, service or marketing method or organisational method - an innovation;
- 'developing for commercialisation'; and
- 'genuinely focussed'.

These elements are discussed below.

## What is new or significantly improved?

A new, or significantly improved, product, process, service or marketing or organisational method is considered to be an 'innovation' in the context of the ESIC provisions<sup>5</sup>. This interpretation of the term 'innovation' is consistent with that used by the Chief Economist, Department of Industry, Innovation and Science in the Australian Innovation System Report<sup>6</sup>. In that report, innovation was described as "the implementation of a new or significantly improved product (good or service), or process, a new marketing method, or a new organisational method in business practices, workplace organisation or external relations".

In order to determine whether a potential innovation is something new, or is a significant improvement to something that already exists, it must be compared to the products, services, processes or methods that may or may not exist in the intended market for the innovation. The relevant market used to make this comparison is referred to as the 'addressable market'. An addressable market may include a new market created by the innovation.

A product, process, service or method will be new or significantly improved where it is innovative relative to its addressable market.

In this context, 'new' means novel to or introduced to the addressable market for the first time; whereas 'significantly improved' means having a significant degree of improvement in relation to the addressable market but excludes minor changes or improvements.

Changes to products, processes, services or methods that are unlikely to meet the threshold of being new or significantly improved include, but are not limited to<sup>7</sup>:

- customising an existing product, process, service or marketing or organisational method;
- minor updates, modifications, adaptations, enhancements or extensions to products, processes, services or marketing or organisational methods already in existence in the addressable market and which do not involve a significant change in their functional characteristics or intended purpose (e.g. a routine update to existing equipment or software);
- changes to pricing strategies;
- changes to goods resulting from cyclical or seasonal change;
- wholesalers, retailers or distribution businesses trading in new products.

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<sup>5</sup> Division 360, Income Tax Assessment Act, 1997

<sup>6</sup> Australian Innovation System Report, 2016, Office of Chief Economist, Department of Industry, Innovation and Science; Organisation of Economic Cooperation and Development (OECD) and Eurostat, Oslo Manual: Guidelines for Collecting and Interpreting Innovation Data, 3rd Edition, 2005, page 46,

<sup>7</sup> Organisation of Economic Cooperation and Development (OECD) and Eurostat, Oslo Manual: Guidelines for Collecting and Interpreting Innovation Data, 3rd Edition, 2005, 198-204

## **Addressable market**

The addressable market is identified by making a realistic and objective assessment of the company's intended market for its innovation. It includes identification of the immediately accessible market to which the innovation will initially be introduced, or a new market which may be created by the innovation.

Factors in identifying the addressable market may include the location of the company's potential customers and the geographical area that it will serve. For example, if the company is focussed on commercialising its innovation by seeking to serve customers in Australia, then Australia is its addressable market.

Other features which may assist in identifying the company's addressable market include:

- (a) product market (that is, the nature and characteristics of the goods or services);
- (b) the type of customer or industry to be served (for example, wholesale or retail, mining or communications)
- (c) the timing of supply (for example, seasonal, or peak vs off-peak).

## **Types of innovation**

### **Product innovations<sup>8</sup>**

A product innovation is the introduction of a good or service that is new or significantly improved with respect to its functional characteristics or intended uses within its addressable market. This includes significant improvements in technical specifications, components and materials, incorporated software, user-friendliness or other functional characteristics. Design changes alone, or merely utilising different materials to manufacture a product will generally not be considered to be an innovation if functionality is not significantly improved.

A product innovation might be:

- new goods or services using new knowledge or technology (e.g. the first digital camera, or the first transportation service accessed via smart phone application)
- new products combining existing knowledge or technology (e.g. the first portable MP3 player, which combined existing software standards with miniaturised hard drive technology), or
- a new use for a product with only minor changes to its technical specifications.

Some examples of significant improvements in existing products include:

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<sup>8</sup> Organisation of Economic Cooperation and Development (OECD) and Eurostat, Oslo Manual: Guidelines for Collecting and Interpreting Innovation Data, 3rd Edition, 2005, 156-162

- household goods that incorporate software that improves their user-friendliness or convenience, such as technology to stream music to a hi-fi system.
- food products with specially developed nutritional characteristics, such as the development of a grain with a higher insoluble fibre content and lower glycaemic index
- products with significantly reduced energy consumption, such as energy efficient refrigerators
- replacing inputs with materials that have improved characteristics, such as the introduction of breathable or fire-resistant textiles in clothing, light but strong composites, smaller and more efficient computer components and environmentally friendly plastics.

Existing services can be significantly improved through<sup>9</sup>:

- the way that services are provided, such as greatly improved speed and ease of use of internet banking services or increased coverage and connectivity of telecommunications services
- the addition of new functions or characteristics to existing services.

### Example

BusTracker Pty Ltd is developing software that will allow bus users to track buses, plan journeys and pay their fares via an app.

BusTracker's goal is to partner with public transport providers to integrate their services in Australian cities. BusTracker's addressable market is the Australian market. While the public transport authority in Perth is their target customer, BusTracker plans to market the platform to other Australian cities.

BusTracker must consider whether its product is new, or a significant improvement in the Australian market. Other suppliers offer similar location-based apps to public transport authorities and passengers in Australian larger cities.

At the relevant time for applying the ESIC test, the ability to offer integrated fare payments provides BusTracker's app with capabilities that its competitors in the Australian market do not offer. The functional characteristics of BusTracker's product are a significant improvement on the payment services currently available. That is, the innovation is the integration of the payment system with the location based app - neither the payment system nor tracker is a 'new' product or service in itself.

BusTracker is developing a significant improvement in the Australian market.

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<sup>9</sup> Ibid, para 161

### **Example**

PQ Technology Pty Ltd is a new wholesale distribution company specialising in wearable technology products. It begins to sell a new product from one of its offshore suppliers.

Even though the product is new to the Australian market, PQ Technology has not developed a new or significantly improved product for commercialisation. Therefore, it does not meet the principles-based innovation test.

### **Process innovations<sup>10</sup>**

A process innovation is the implementation of a new or significantly improved production or delivery method. This includes significant changes in systems, techniques, equipment or software.

Production methods include the systems, techniques, equipment, or software used to produce goods or services. For example: automating all or part of a production line.

Delivery methods are concerned with logistics and would include the systems, techniques, equipment and software to source inputs, allocate internal supplies, or distribute final products. For example: introducing a bar-code inventory register and goods tracking system.

A process innovation might be designed to decrease the cost of producing or delivering each good or service, to increase quality, or to deliver new or significantly improved goods or services. Process innovations can also involve systems, techniques, equipment and software in ancillary support activities (e.g. purchasing, accounting, computing and maintenance) if the intention is to improve the speed, efficiency or quality of the activity.

### **Example**

Happy Heart Pty Ltd is a start-up company that will sell a generic version of a blood pressure medication. Happy Heart plans to sell its pharmaceuticals to a global market, pending regulatory approval.

At the relevant time, Happy Heart is developing a new manufacturing process that will significantly decrease manufacturing costs compared with the global market. This is a process innovation that significantly improves on those used by others in Happy Heart's addressable market.

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<sup>10</sup> Ibid, paras 163-168

## Marketing method innovations<sup>11</sup>

A marketing method innovation is the implementation of a new or significantly improved marketing method involved in product design or packaging, product placement, product promotion or pricing aimed at better addressing customer needs, opening up new markets, or re-positioning a company's product within the market, with the objective of increasing sales.

A marketing method innovation may include:

- a significant change in product design as part of a new marketing concept. This includes changes to the product's form or appearance (without necessarily changing the product's function), changes in packaging where that is the main thing that determines the product's appearance (such as for a detergent/washing powder). However, a product design change of this type that is not also accompanied by an innovation or significant improvement in the product's functionality will generally not be considered to be an innovation. For example: a fundamentally new bottle design for a body lotion, intended to give the product a distinctive look and to appeal to a new market segment may not be considered to be an innovation. Whereas product design changes which also include significant changes in the form, appearance or taste of food or beverage products may be considered an innovation. For example, the introduction of new flavours for a food product which targets a new customer segment.
- a significant change in product placement, involving new sales channels or the use of new concepts to present products. For example: the first use of exclusive retailing, direct selling or product licensing.
- new concepts to promote goods or services. For example: the first use of a personalised information system, obtained from loyalty cards, to tailor the presentation of products to individual customers.
- new pricing strategies to market goods or services. For example: the first use of a new system to implement surge pricing when demand is high.
- new ways of connecting with customers. For example: the first use of a location device to monitor when customers are near stores to enable advertising of sales to be sent to those customers.

### Example

Super Power Pty Ltd is a start-up company developing an app to help their Australian customers to increase their energy efficiency.

Among other things, the app will identify inefficient appliances and advertise a new model to the customer, displaying the amount that the customer could save each year by

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<sup>11</sup> Ibid, paras 169-176

switching products. The customer will be able to purchase the new appliance and arrange delivery of the appliance within the app.

This is a marketing method innovation, in that Super Power is developing a method that represents a significant improvement in product promotion when compared to what is in use in the Australian market at the test time.

### **Organisational method innovations<sup>12</sup>**

An organisational method innovation is the implementation of a new or significantly improved organisational method in the company's business practices, workplace organisation or external relations. These innovations can be aimed at increasing organisational performance by reducing administrative or transaction costs, improving labour productivity, or reducing the cost of supplies.

This can involve:

- a significant change in business practices, involving new methods for organising work routines and procedures. For example: the first use of new practices for employee development, such as an education and training system or database of best practices within a company.
- a significant change in workplace organisation, involving new methods for distributing responsibilities and decision-making among employees of a division of work and between organisational units, as well as new concepts for structuring of activities.
- a significant change in organising a business' external relations, involving new ways of organising relationships with other businesses, customers or public institutions.
- a significant change in customer service delivery. For example: the first use of digital voice recognition software to replace call centres responding to customer queries.

Developing a new managerial strategy, or engaging in merger and acquisition activity, will not in itself count as an organisational method innovation. However, developing a new business franchise model may do so.

### **Is the company genuinely focussed on developing an innovation for commercialisation?**

In order to satisfy Condition 1, the company must be 'genuinely focussed' on developing an innovation for commercialisation.

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<sup>12</sup> Ibid, paras 177-184

## Developing for commercialisation

Condition 1 requires the company's focus to be on developing the relevant innovation for commercialisation.

In this context 'developing' refers to the process of creating an innovation or causing it to change or evolve, to the point where it can be commercialised. It includes a range of activities such as proof of concept activities, market research, prototyping, pilots and user testing, setting up manufacturing and marketing processes, and other activities to prepare for the launch of a new or significantly improved product, process, service or method.

'Commercialisation' refers to commercial exploitation of an innovation through the sale, introduction or implementation of that innovation in its addressable market, which directly leads to the generation of economic value for the company. For ESIC purposes, the meaning of commercialisation therefore includes innovations which are implemented within a company which also deliver economic value and revenue for the company through the innovation's potential to deliver high growth, scalability and competitive advantages to the company. These economic benefits are discussed in later sections which address conditions two to five.

It is not sufficient for the company to have an innovative idea (for example, an idea derived from R&D activities) or an innovation (for example, a registered patent), or to merely have the possibility or opportunity of developing an idea or innovation for commercialisation. It must develop the idea or innovation sufficiently beyond the pre-concept stage. This can be demonstrated by the company undertaking activities and taking tangible steps with the intention of commercially exploiting the innovation.

'Developing for commercialisation' does not include:

- R&D activities which are experimental activities conducted for the purpose of generating new knowledge or information and not for commercial exploitation; on their own, these activities are unlikely to demonstrate an intention to develop the idea or innovation for commercialisation;
- activities involving implementation of the innovation to other parts of the company or its business after its initial implementation or introduction to the company or its business;
- activities in the innovation's addressable market where the company has already made its first sales and is no longer developing the innovation (i.e. the innovation is commercially accepted and any development activity undertaken is for minor changes or improvements).

'First sales' does not include prior activities such as user-testing, trials or pilots with potential customers. By making its first sales, a company can demonstrate some market acceptance of its innovation through commercial sales in its addressable market. Whilst achieving this may be indicative of the cessation of development activities, it is not determinative. The primary consideration is whether the innovation is still being developed, even if sales have started.

### **Example**

Molar Bear Pty Ltd is a start-up company developing a new, less wasteful process to manufacture toothpaste that qualifies as an innovation under condition 1.

Molar Bear will implement the new manufacturing process in-house, rather than licensing it for use by other companies. As implementing the new process will generate economic value by giving Molar Bear a cost advantage over its rivals, the company is developing the process for a commercial purpose.

### **Genuinely focussed**

The phrase 'genuinely focussed on developing' looks to the activity on which the company is truly concentrating and focussing its attention. To satisfy this condition the company's intention and purpose must be considered with respect to its activities. Central activities of the company must be conducted with the intention of developing its innovation for commercialisation.

Some of the ways in which a company may demonstrate that it is 'genuinely focussed' include:

- the company profile;
- statements by the directors and members of the company;
- documented decisions of its board and members;
- detailed strategic, business and marketing plans;
- documented financial plans, including budgeted cash flows forecasting how funds are intended to spent.

In addition, undertaking certain activities may embody the company's intention and indicate that it is genuinely focussed on development for commercialisation. For example:

- incurring significant expenses;
- hiring specialist staff
- investing in equipment and specialist resources; and
- taking steps to protect intellectual property rights existing in the innovation.

Practical evidence which may indicate that the company is genuinely focussed on developing for commercialisation are set out in Table 1.

## Condition 2: The business relating to the innovation has high growth potential

Growth potential is a company's ability to generate larger revenue, expand its workforce, increase production and broaden its market in the future.

Innovative start-up companies are different from many traditional small businesses because they have the ability to experience high growth within a market or markets. This contrasts with typical small to medium sized businesses such as cafés, local retail stores or local service providers, which generally serve a particular local area.

To meet this condition, the company must have the potential to significantly increase its economic value through expansion. It may do this by developing new products, broadening its customer base through use of more effective marketing or other methods that grow the business from a niche market to a large volume operation, or by entering new markets.

The company may demonstrate that its business has high growth potential by evidence of interest from potential customers and development of strategic relationships in the market.

Practical evidence which may demonstrate the company's high growth potential is set out in Table 1.

### Example

Allen Co is a company that is developing a new mobile app that provides specialised on-demand concierge services for its users. While Allen Co is initially testing its service in Melbourne, it can demonstrate its high growth potential through its ability to expand the services to all major cities in Australia, and beyond.

The company has outlined this expansion strategy in its business plan, and has started to contact service providers in other major cities. Therefore, Allen Co can demonstrate that the business relating to its innovation has a high growth potential.

## Condition 3: The company can demonstrate it has the potential to be able to successfully scale the business

This condition builds on the previous condition. The additional element here is that not only is the innovation capable of being commercialised with high growth potential (condition 2), but the company must also demonstrate that it is or will be capable of scaling up its business to fill that potential. Scalability means that the operations can grow (i.e. are scalable). The activity must be of a kind that is not prevented from significant growth by elements intrinsic to its nature and that the business does not face any inherent restriction from multiplying in its size and scale. This ability to grow must be demonstrated to be substantially more than conventional organic and incremental

growth. Scalability will result in the company having operating leverage, where its existing revenues can be multiplied while incurring a reduced or minimal increase in operating costs.

A company may demonstrate scalability of its business model through detailing the means by which growth will be achieved and forecasts activity and revenue multiplying over time.

Practical evidence which may demonstrate business scalability is set out in Table 1.

#### **Example**

Siegel Pty Ltd is a start-up manufacturing company that is developing a new formula for a food product which extends its shelf life.

The company intends to establish its own manufacturing plant as the demand for its product grows. If production increases, the cost per unit will reduce, as the business leverages the existing operating costs of the plant.

Siegel can demonstrate that it has the potential to successfully scale up its business.

#### **Example**

Balthazar Pty Ltd is a new local service provider of dental care. The company's growth strategy is to expand the number of its clinics. However, as Balthazar opens more clinics, its operating costs (such as rent and wages) increase in proportion to the additional revenue generated. Consequently, Balthazar does not meet the principles-based innovation test as it does not have the potential to successfully scale up its business.

## Condition 4: The company can demonstrate it has the potential to be able to address a broader than local market, including global markets, through the business

The tax incentives are targeted at start-up companies that are capable of supplying to broad markets, including global markets, rather than to companies that focus on local markets.

The company must have the potential to serve a market that is broader than a local city, area or region in order to satisfy this condition. While the company does not need to be able to serve the innovation's broader market at the test time for qualifying as an ESIC, its business must be capable of being adapted to supply a broader market (whether state, national, multinational or global) in the future.

A company may demonstrate ability to address a broader than local market through various business documents including its business plan, marketing plan (and other supporting documents), and arrangements with potential suppliers, manufacturers, distributors or customers operating in the broader market.

Practical evidence which may demonstrate the company's ability to serve a broader market are set out in Table 1.

### Example

Allen Co, the developer of the new mobile app providing on-demand concierge services, plans to initially test and sell its new product to Victorian consumers. If the test is successful, it has the ability to adapt its product for the Asia-Pacific Market.

Allen Co demonstrates the potential to service a broader than local market and to adapt its business to access global markets.

## Condition 5: The company can demonstrate that it has the potential to have competitive advantages for the business

A competitive advantage is an attribute that allows a company to outperform its competitors (including any new competitors), generating greater value for the company and its shareholders.

The two broad sources of competitive advantage are:

- differential advantage, where the company's product or service can deliver benefits to customers greater than those offered by competing products or services.
- cost advantage, where a company has a lower cost per unit than its competitors.

### Differential advantage

A differential advantage is a unique feature, benefit or characteristic that a business offers which sets it apart from its competitors in its addressable market.

Factors which should be considered to ascertain whether a differential advantage exists include:

- the level of value provided to customers relative to competitors
- whether the product is rare
- whether the product is capable of being imitated
- whether there are readily available substitutes for the product.

For example, a start-up company may have a 'first mover' advantage, in that it is the first to sell a new category of products or services in the addressable market. This may allow the company to establish a strong position in the market by building an early base of customers that would be less likely to switch to later entrants, by accumulating expertise, or by securing access to a limited resource (such as agreements with significant customers).

### Example

SLIS Tech Co is developing a new peer-to-peer service-providing website for the Australian market. A competition analysis of the marketplace showed that their website's marketplace platform was faster and easier to navigate than their competitor's websites.

SLIS Tech Co has identified that this feature will allow the company to outperform its competitors. In addition, the company has taken initial steps in developing the platform and has also started to engage with service providers to be part of the website's network. As a result, STS Tech Co can demonstrate that it has the potential to have competitive advantages.

## Cost advantage

A company has a cost advantage if it has the ability to produce a product or service at a lower cost than its competitors, thereby allowing it to offer its product or service at a lower price than its competitors or to generate a higher profit margin on its sales. This could be the case if, for example, the company has gained efficiencies through its use of technology in its production process.

## For investors

### Determining whether a company meets the principles-based innovation test

If you are an investor and intend to claim the early stage investor tax incentives, you should conduct your own self-assessment or due diligence of the company. As a first step, you should establish whether the company meets the [early-stage test requirements](#) before considering whether it satisfies either of the innovation tests, being the principles-based innovation test or 100 point innovation test. You can conduct your own due diligence by:

- asking the company to provide documents that demonstrate that it meets, or will meet, all of the tests at the test time, and
- keeping these documents as part of your records to support your claim for the early stage investor tax incentives.

The table below provides some practical examples of the type of information, including documents that you could ask a start-up company when you are considering whether it meets the principles-based innovation test. You will find that some documents address more than one condition of the principles-based innovation test. These examples are indicative only and not exhaustive.

Table 1

Condition	Types of Information, documents, activities and examples
<p><u><a href="#">Condition 1 - The company must be genuinely focussed on developing for commercialisation one or more new or significantly improved products, processes, services or marketing or organisational methods</a></u></p>	<p><b>'New or significantly improved products, processes, services or marketing or organisational methods'</b></p> <p>Innovation strategy, setting out:</p> <ul style="list-style-type: none"> <li>• description of innovation including whether new or existing, extent of novelty, intended purpose, functionality</li> <li>• -concept design;</li> <li>• market analysis (demand, opportunity, size, customer type)</li> <li>• identifying any intellectual property rights and protection of such rights.</li> </ul> <p>Marketing plan</p> <ul style="list-style-type: none"> <li>• market research analysis (demand, opportunity, size, customer type)</li> <li>• pathway to addressable market</li> </ul> <p>Product/Service profiles</p> <hr/> <p><b>'Developing for commercialisation'</b></p> <p>Value proposition, setting out:</p> <ul style="list-style-type: none"> <li>• why the customer wants to buy the product, process, service or method ; or</li> <li>• how the company benefits economically from the product, process, service or method.</li> </ul> <p>Development/Commercialisation plan, setting out:</p> <ul style="list-style-type: none"> <li>• objectives</li> <li>• key activities (e.g.: proof of concept, prototype, user-testing, pilot, launch)</li> <li>• key financial, physical and human resources</li> <li>• timeline with key milestones</li> <li>• IP strategy</li> <li>• financial plan</li> </ul> <p>Marketing plan</p> <ul style="list-style-type: none"> <li>• market analysis (demand, opportunity, size, customer type)</li> <li>• pathway to addressable market</li> </ul> <p>Financial models including cash flow and revenue projections</p> <p>Entering into commitments (e.g. financial, contractual, legal or human resources) to develop the innovation for commercialisation.</p>

	<p><b>'Genuinely focussed'</b></p> <p>Company profile which is prepared for external stakeholders and describes the company's history, structure, governance, purpose, product/service offering, expertise, performance and reputation</p> <p>Minutes of company members and directors' meetings which document company and management decisions</p> <p>Statements by company members and directors which document the intention of the company with respect to the innovation</p> <p>Business plan which is prepared for internal and fund-raising purposes and includes more detailed information than the company profile, with supporting documents such as financial plan, budget forecasts, marketing plan etc</p> <p>Financial plan or financial statements, including forecasted cash flow projections demonstrating that a high proportion of expenditure will be directed to innovation and development</p> <p>Agreements which protect the intellectual property related to or in the innovation, such as non-disclosure and non-compete agreements with company members, officers, employees and third parties</p> <p>Engagement of technical or specialist resources</p> <p>Registration of intellectual property rights</p> <p>Investment in fixed or intangible assets related to the innovation or its development</p>
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<p><b><u>Condition 2 The business relating to the innovation has high growth potential</u></b></p>	<p>Business plan includes more detailed information than the company profile, with supporting documents such as financial plan, growth projections, budget forecasts, marketing plan etc.</p> <p>Marketing plan or other market strategy information which addresses the following questions:</p> <ul style="list-style-type: none"> <li>• Who are the potential/target customers and where are they located?</li> <li>• Will the business attract one off or repeat customers?</li> <li>• What is the potential size of the market and how is it trending?</li> <li>• What level of growth does the company project and what are the drivers of this growth?</li> <li>• What research has been undertaken (e.g. product surveys or interviews) to support the above responses?</li> <li>• What strategies does the company have in place to expand, including as a business (e.g. workforce)?</li> </ul>
<p><b><u>Condition 3 The company can demonstrate it has the potential to successfully scale the business</u></b></p>	<p>Business plan/strategy which includes cost and price modelling, expansion strategies and addresses these questions:</p> <ul style="list-style-type: none"> <li>• How will the company scale up its production to serve broad markets?</li> <li>• Does the company have operating leverage (meaning that as it expands production, its revenues multiply while its operating costs are reduced or minimally increased)?</li> </ul>
<p><b><u>Condition 4 The company can demonstrate it has the potential to address a broader than local market, including global markets, through the business</u></b></p>	<p>Marketing plan which addresses these questions:</p> <ul style="list-style-type: none"> <li>• Can the company serve a market that is broader than a local city, area or region?</li> <li>• Will the company be able to adapt its business to supply to national, multinational, or global markets?</li> </ul> <p>Third party arrangements which demonstrate potential or established relationships with suppliers, manufacturers, distributors and customers operating in the broader market.</p>
<p><b><u>Condition 5 The company can demonstrate that it has the potential to have competitive advantages for the business</u></b></p>	<p>Business plan which addresses these questions:</p> <ul style="list-style-type: none"> <li>• Does the company have the potential to have competitive advantages in the market?</li> <li>• How will the company sustain these competitive advantages?</li> <li>• Are there barriers to entry to the addressable market and how will the company address these barriers?</li> </ul>

## Keeping records

The documents should show that tangible steps have been or will be taken by the company in relation to each of the conditions. The company can provide existing business documentation that demonstrates that it meets each of the conditions of the test.

The table above lists examples of business documents that could be used to demonstrate that a company meets one or more of the requirements of the principles-based innovation test. The content of some of these business documents are described in more detail below.

Evidence of tangible steps that satisfy the parts of the principles-based innovation test is more probative, for example, if the company has already made contact with suppliers or distributors in another market etc.

## Company profile

A company profile is usually prepared by a company for external stakeholders such as potential investors, suppliers, customers or media. A company profile usually will include:

- A mission statement which summarises the company's purpose;
- The CEO/Director statement explaining the purpose, goals, achievements and position of the business in the current business environment;
- Company history, structure and corporate governance – in a start-up company this should highlight the experience and goals of the founding members;
- Overview of product/service offering, including achievements and challenges;
- Awards, certifications and accreditations, for example, registered patents, accredited processes, licensing;
- Profiles of key personnel, including consultants and contractors, particularly in respect of those personnel who hold key experience, skills and knowledge necessary for the innovation to succeed.

A company profile may not include financial information. A potential investor in an ESIC should separately request up-to-date financial statements in respect of the company.

## Business plan

A business plan is the blueprint for how the business will run and contains the strategies for achieving the business' goals. It usually includes one and three year plans for the company. If you are a potential investor, you may find this [Business Plan Template and Guide](#) useful.

Particularly in respect of a potential ESIC, a business plan should address relevant questions such as:

- what is the product or service innovation?
- what is the addressable market for the company's product or service?
- what level of growth is anticipated in future, and what will drive this growth?

- what are the company's strategies to achieve this growth?
- what is the company's sustainable competitive advantage?
- how does the company plan to scale up the business as it grows?

### Commercialisation strategy

A commercialisation strategy sets out the steps that a company will take to move its business from concept to marketplace.

A commercialisation strategy may address relevant questions such as:

- what activities is the company undertaking to develop the innovation for commercialisation?
- what features will the product or service have, in comparison to those offered by competitors?
- does the company have operating leverage?

### Competition analysis

A competition analysis is an assessment of the strengths and weaknesses of current competitors and potential competitors who might enter the market. It also considers barriers to entry to a market, for example, government regulatory requirements, access to necessary infrastructure (eg, ports, rail), or access to marketing and distribution channels (eg, foreign e-commerce sites).

A competition analysis may address relevant questions such as:

- what products and services do competitors offer, or what processes or methods do they use?
- does the company have the potential for sustainable competitive advantages in the market?

### Other documents

Other documents that could assist in demonstrating that a company qualifies under the principles-based innovation test include:

- evidence that the company is taking steps to protect its intellectual property rights, for example, use of non-disclosure agreements, copyrighting material, registering registrable intellectual property rights such as patents and trademarks. This may assist in showing that the innovation is new or significantly improved for the company's addressable market, or it may be a strategy that the company is using to sustain a competitive advantage over its competitors
- financial projections, which may show that the company has operating leverage. This may include cost and price models
- a marketing, manufacturing or monetisation strategy
- the conclusions of the company's market research

- evidence of relationships with suppliers, manufacturers, distributors and customers, such as non-disclosure agreements, letters of intent, memorandum of understanding, term sheets and contracts.

## Changes that could affect ESIC status

It is the investor's responsibility to determine whether the company qualifies as an ESIC at the point in time immediately after the investor is issued with new shares (referred to as the 'test time').

Investors should therefore keep up-to-date with any changes in the company's circumstances that occur before they invest which could affect their eligibility to the incentives.

For example, a company may be developing a product that has one key feature that is new to the addressable market. If the company removes this feature from the product it is developing before an investor is issued with equity interests and cannot meet the principles-based innovation test, the investor will not be entitled to the tax incentives.

If changes in circumstances beyond the company's control occur after the shares are issued to an investor, this will not affect the investor's entitlement to the tax incentives.

### Example

Rutimech Pty Ltd is a start-up company developing a new custom alloy for specialist applications. Rachel applies the tests to the company and her own circumstances and considers that she will be eligible for early stage tax incentives if she invests in the company. Following this, she purchases new shares in Rutimech.

Unfortunately, market conditions change after Rachel makes her investment, and Rutimech finds that it is unable to continue commercialising its new product. As the tests apply at a point in time immediately after the shares are issued to Rachel, this does not affect her entitlement to the early stage investor tax incentives.

However, if Rutimech was not genuinely focussed on commercialising the innovation at a point in time immediately after the shares were issued to Rachel, she would not be entitled to the tax incentives.

## Case studies

Note: the activities and products outlined in these case studies are for the purposes of illustrating the concepts in the legislation and the administration of the principles-based innovation test. As they are being used for these illustrative purposes, they may not necessarily represent an activity that is viewed by the ATO as a current innovation.

## Companies that would pass the principles-based innovation test

### **Case study 1: Super Power Pty Ltd**

Super Power Pty Ltd is developing a platform that residential customers can use to improve the efficiency of their energy use. It is looking to attract funding from investors and is considering whether it would qualify as an ESIC for the purposes of the early stage investor tax incentives.

#### **Step 1: Is Super Power genuinely focussed on developing for commercialisation one or more new or significantly improved products, services, processes or marketing or organisational methods?**

Super Power plans to initially test and market the platform in New South Wales. If the test is successful, it intends to sell the platform across Australia. Therefore, its addressable market is the Australian market.

Super Power conducts market research and finds that there are apps available in the Australian market that allow residential customers to switch home appliances on and off remotely and which track efficiency of appliances.

Super Power identifies two features of its platform that are new or significantly improved in relation to the Australian market.

The first feature is that the app has an 'energy saver mode' that will adjust the customer's use of appliances automatically to optimise usage throughout the day. This will link with real-time information provided by the electricity service provider on levels of demand and the load profile of electricity generation, in order to provide the customer with discounted energy prices.

Similar systems have been implemented overseas, but no competitor is offering a platform with this feature in the Australian market. This is a product innovation that is new or significantly improved in relation to its addressable market.

The second feature is that the app will identify appliances that are running inefficiently and advertise a new model to the customer, displaying the amount that the customer could save each year by switching products. The customer is then able to purchase the new appliance and arrange delivery of the appliance within the app.

This is a marketing method innovation, in that it represents a significant improvement in product promotion that is not currently in use in the Australian market.

Super Power has been taking tangible steps that are directed towards the sale of its platform, such as:

- conducting market research and developing a business plan
- developing a design for how users will experience the app
- working to build a relationship with electricity service providers and electronics retailers in several Australian cities.

It also has a business plan that sets out the key steps it will take to commercialise the platform.

Super Power can show that it is genuinely focussed on developing the innovation for a commercial purpose.

**Step 2: Does the business relating to Super Power's innovation have high growth potential?**

Super Power can demonstrate that its platform has the potential for high growth within a broad addressable market. Its platform is not confined to serving a particular local geographical area.

The factors it has identified that will drive this growth include:

- rising energy costs and greater environmental awareness are leading to demand for solutions that help customers to be more energy efficient
- the success of similar platforms overseas
- the platform's ability to enter markets across Australia.

**Step 3: Can Super Power demonstrate that it has the potential to successfully scale up the business?**

Super Power will incur significant costs to develop the platform. However, as its customer base grows, the cost per unit will reduce. This means that it has operating leverage. It has the potential to successfully scale its business to supply to broad markets.

**Step 4: Can Super Power demonstrate that it has the potential to be able to address a broader than local market, including global markets, through its business?**

Super Power's platform is capable of addressing a market that is broader than a local city, area or region. Its platform can be readily adapted to serve global markets. It has identified New Zealand as a market that it could expand into, if it is successful in Australia.

**Step 5: Can Super Power demonstrate that it has the potential to have competitive advantages for the business relating to its innovation?**

Super Power has a differential advantage, in that it has unique features that offer benefits which are not currently available to Australian residential consumers. It plans to sustain this competitive advantage by securing key relationships with electricity service providers and by rapidly building its brand recognition in the market once its app is launched.

**Demonstrating that it meets the principles-based innovation test**

Super Power meets the requirements of the principles-based innovation test. It can use existing business documents such as its business plan, and the plan for the design of its app, in order to show that it meets these requirements. These documents address all of the steps in the test and in particular, have undertaken tangible steps/activities to meet the steps of the test, that is, market research, relationship building etc.

## **Case study 2: Magnifique Pty Ltd**

Magnifique is developing a new cosmetics product range, which includes a number of nail polishes.

### **Step 1: Is Magnifique genuinely focussed on developing for commercialisation one or more new or significantly improved products, services, processes or marketing or organisational methods?**

Magnifique identifies its addressable market as the Australian market.

The nail polish product that Magnifique is developing will be contained in a bottle with a striking design. The bottle is significantly larger than those of other nail polishes and it evokes the image of a sea shell.

Unlike other similar products that are available on the market, it is intended to be displayed as a decorative item, rather than to be kept in a cabinet. The materials and the design of the bottle are intended to appeal to a new luxury segment of the market. This forms part of Magnifique's strategy to charge a much higher price for a premium product.

Magnifique is implementing a marketing method that is new or significantly improved in relation to its addressable market, as it will implement a fundamentally new product design when compared to what is in use in the Australian market.

Magnifique is genuinely focussed on developing the product for sale in the Australian market. It is taking tangible steps that will lead to the sale of the product, such as developing a business plan, contacting potential retail outlets and distributors, and applying for a design right for the product's appearance.

### **Step 2: Does the business relating to Magnifique's innovation have high growth potential?**

Magnifique has the potential to rapidly expand its business to serve a broad addressable market. The product will form part of a dynamic range of premium cosmetics that Magnifique plans to sell. Magnifique will use several sales channels for this product range, including direct selling to consumers online using a subscription service. It has begun to establish relationships with retail outlets and distributors.

Magnifique's product line appeals to customers in the luxury segment of the cosmetics market. Its strategy to achieve a significant share of this market in Australia is detailed in its business plan.

### **Step 3: Can Magnifique demonstrate that it has the potential to successfully scale up the business?**

Magnifique has the potential to successfully scale up its business. As it expands its sales, it will be able to generate increased revenue with only a minimal increase in its operating costs. As Magnifique plans to mainly sell its products directly online, its costs per unit will be low.

### **Step 4: Can Magnifique demonstrate that it has the potential to be able to address a broader than local market, including global markets, through its business?**

Magnifique is capable of addressing a market that is broader than a local city, area or region, and it can adjust its business to supply to global markets. Marketing the product range online will allow it

to easily enter new markets, and it plans to eventually offer global shipping of its product to US, Europe and Asia-Pacific.

**Step 5: Can Magnifique demonstrate that it has the potential to have competitive advantages for the business relating to its innovation?**

Magnifique has competitive advantages that are sustainable, in that it offers a product that has a unique and striking design that appeals to the luxury segment of the cosmetics market. It plans to protect this advantage from imitation by registering a design right over the appearance of the product.

**Demonstrating that it meets the principles-based innovation test**

Magnifique provides a copy of the proposed design of the bottle, its business plan and competition analysis to potential investors on a confidential basis, in order to demonstrate that it meets the principles-based test. These documents address all of the steps in the test.

**Find out about:**

Registering [Designs](#)

**Companies that would not qualify under the principles-based innovation test**

**Case study 3: Employment Law Link Pty Ltd**

Employment Law Link Pty Ltd is a start-up company that is developing an app that lawyers can connect with potential clients about employment law matters.

**Step 1: Is Employment Law Link genuinely focussed on developing for commercialisation one or more new or significantly improved products, services, processes or marketing or organisational methods?**

The company is initially testing the app in Victoria, though it is seeking to serve the Australian market. Therefore its addressable market is Australia.

A competitor, Legal Beagle, is currently operating in Sydney. Legal Beagle provides an app that connects lawyers with potential clients. This app can be used to connect with lawyers in relation to a range of matters. Clients can connect with an employment lawyer through Legal Beagle's app. While it has a different design to Legal Beagle, Employment Law Link's app offers similar features to its users.

Consequently, Employment Law Link's app is not new or significantly improved in relation to the addressable market. This means that it does not satisfy the principles-based innovation test.

However, if Employment Law Link instead offered a feature that allowed clients to seek an on-demand video consultation with a lawyer through the app, this could be considered a significant improvement compared to the Legal Beagle app.

## **Case study 4: Quick Fashion Pty Ltd**

Quick Fashion Pty Ltd is looking to set up a retail store in central Sydney. These stores will place QR codes on each product which customers can scan on their mobile devices, allowing them to easily locate their size and to pay for their items.

### **Step 1: Is Quick Fashion genuinely focussed on developing for commercialisation one or more new or significantly improved products, services, processes or marketing or organisational methods?**

Quick Fashion identifies their addressable market as the Sydney market. A system where customers can use their mobile devices to locate and buy products using QR codes is not currently in use in retail stores in that market. This offers benefits to customers by increasing the store's user-friendliness and the ease with which they can find and purchase clothes.

Quick Fashion will be implementing a new or significantly improved process innovation for the Sydney market.

Quick Fashion is developing its innovation for commercialisation, as it is taking tangible steps to launch the store and to implement the system. This includes entering into lease negotiations.

### **Step 2: Does the business relating to Quick Fashion's innovation have high growth potential?**

Quick Fashion does not have the potential for high growth within a broad addressable market, as it is confined to serving customers at its store. As it fails this step, Quick Fashion does not qualify under the principles-based innovation test.

Even if Quick Fashion was planning to launch a chain of stores, its operating costs (such as rent and wages) will increase in proportion to the additional revenue generated. This type of business would usually grow over time, rather than being able to scale up quickly to address a broad market.

While it is using innovative methods, Quick Fashion's business model is comparable to a traditional small business, rather than to an innovative start-up with high growth potential.