

SUBJECT: From IFRS to IPSAS: making sense of the EPO's finances
Study: Differential Accounting

SUBMITTED BY: President of the European Patent Office

ADDRESSEES: 1. Budget and Finance Committee (for information)
2. Administrative Council (for information)

SUMMARY

This document is submitted by the staff representatives via the President of the European Patent Office, in accordance with Article 9 (2.2) (b) of the Administrative Council's rules of procedure (see CA/D 8/06).

The EPO does not meet the definition of a GBE as defined by the IPSAS, because it only meets three out of five required criteria. The EPO is therefore a public entity and shall apply IPSAS.

Applying IPSAS for the EPO would lead to the recognition of a receivable for future national renewal fees, thereby substantially increasing the assets and reduce the currently negative net assets/equity position.

Although the EPO has a budget implementation statement, its budget report is not fully in compliance with IPSAS because an immediate comparability of budgets and financial statement is not possible. The adoption of IPSAS would therefore increase transparency and comparability of the EPO's financial situation thereby providing a consistent basis for decision making needs.

The IFRS based accounting model the EPO is largely identical to IPSAS. A transition to IPSAS would therefore just require an adoption of the specific public sector elements of IPSAS.

Differential Accounting European Patent Office

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1 Management summary

The Staff Representation of the European Patent Office (SR-EPO) contracted the Institute of Public Management at Zurich University of Applied Sciences (IPM-ZUAS) in order to examine the financial reporting framework of the European Patent Office (EPO)¹. The issues to be examined are all in the area of the so-called Differential Accounting, i.e. about the question whether or not sector specific accounting standards and principles are more feasible than the generally accepted principles in the private sector.

The European Patent Organisation has a public character and therefore the question is raised whether the EPO should apply the International Public Sector Accounting Standards (IPSAS) instead of the currently applied International Financial Reporting Standard (IFRS). The Scope of IPSAS is defined in Preface 12 and the issue to be examined in the context of the EPO is whether the EPO can be regarded as a Government Business Enterprise (GBE) or not. IPSAS excludes GBEs from its scope and mandates them to adopt private sector standards, namely IFRS². IPSAS specifies five criteria, which all need to be met to lead to the conclusion that the entity is a GBE.³ The EPO does not meet the definition of a GBE as defined by the IPSAS, because it only meets three out of five required criteria. The EPO is therefore a public entity and shall apply IPSAS.

Unlike IFRS, IPSAS differentiates between exchange and non-exchange revenues, which lead to different accounting treatment. This distinction is necessary because public entities have exchange transactions (delivery of goods and services in exchange of revenue) as well as non-exchange transactions in the form of taxes and transfers between public sector entities (no services or goods in exchange for revenue). The EPO has an array of different revenues and financing transactions, which are examined in this study with the exception of other revenue and income.⁴

First, the procedural fees related to specific activities (among others fees for search and examination) should be qualified as revenue from exchange transactions since the EPO receives a compensation (fee) for rendering a specific service. These kinds of revenues shall be recognized by reference to the stage of completion of the transaction at the reporting date.

The categorization of a second type of fees considered is less clear. The procedural fees related to the period of the patent granting process (designation fees and renewal fees for patent applications) have elements of an exchange and non-exchange transaction. On the one hand the patent applicants are the counterpart of the transaction and on the other hand it is the Contracting States, and not the EPO which need to provide the necessary legislation to protect European patents. However, regardless of the classification as exchange or non-exchange, the appropriate accounting treatment is to recognize designation and pre-grant renewal fees upon invoicing.

Thirdly, the EPO's share of the national renewal fees (further referred to as "national renewal fees") is owed and paid by the Contracting States because each Contracting State is paying in its own right and not on behalf of the patent holders. In addition, it's the contracting state guaranteeing the protection of the patents/inventions. These two elements indicate that the national renewal fees are transfer payments from the Contracting States to the EPO and therefore non-exchange transactions. In the case of the EPO this would lead to the recognition of a receivable for future national renewal fees, which would substantially increase the assets and reduce the currently negative net assets/equity posi-

¹ For accounting and reporting purposes the European Patent Office is identical with the European Patent Organisation, as they are an economic entity.

² IPSAS Preface 12, IPSAS 1.5, 1.12

³ IPSAS 1.7

⁴ Notes 3 and 5 of the Income Statement 2008

tion. This effect would according to Note 4 of the financial statement indeed be large enough to turn the net assets/equity position into positive figures. National renewal fees compensate the EPO for the work in the patent granting process and therefore would, under IPSAS, be recognised as an income in the accounting period, in which the work is performed. This is opposed to the current practice, where the national renewal fees are only accounted as an income when they are actually received. Since the actually received renewal fees correspond to the granted patents when the EPO was much smaller, the way of recognising under IPSAS would better reflect the actual operational performance of the EPO.

Regarding the national renewal fees an additional issue is to be considered. This kind of fee is paid in local currency and is subject to currency volatility. IPSAS requires that such a gain or loss arising from a change in the fair value of an asset shall be recognized in the surplus or deficit. Currency volatility therefore cannot be avoided. A self-insurance scheme defining an earmarked position within net assets/equity could counterbalance the volatility in the income statement.

Budget reporting is important in the public realm and that is the reason why the IPSAS-Board has adopted IPSAS 24 which has no counterpart in IFRS. Although the EPO has a budget implementation statement, its budget report is not fully in compliance with IPSAS 24 because an immediate comparability of budgets and financial statement is not possible. The adoption of IPSAS 24 would therefore increase transparency and comparability.

Apart from IPSAS 24 (Budget) and IPSAS 23 (Non-exchange transactions), there are no other major differences between IPSAS and IFRS. Therefore a transition from IFRS to IPSAS would be achievable relatively easily for the EPO.

2 Scope of the study

The Staff Representation of the European Patent Office (SR-EPO) contracted the Institute of Public Management at Zurich University of Applied Sciences (IPM-ZUAS) in order to examine the financial reporting framework of the European Patent Office (EPO). The issues to be examined are all in the area of the so-called Differential Accounting, i.e. about the question whether or not sector specific accounting standards and principles are more feasible than the generally accepted principles in the private sector. Differential Accounting theory argues that governments and international organizations feature some transactions, which are in their economic substance sufficiently different from private sector transactions to make different accounting principles more feasible than the adoption of private principles. As the examination of Differential Accounting is based on transactions, this study will examine relevant transactions in order to determine the appropriate accounting standards and principles for the EPO.

The relevant transactions, which are examined closely hereafter, are mainly revenue or financing transactions. The study examines which is the economic substance of main revenues of the EPO, as well as the financial flows between the Contracting States and the EPO. As there is an array of different revenue and financing transactions, the examination of the various transactions is likely to have a mixed result. The authors of the study will base their conclusion and recommendation on professional judgement, as accounting and reporting principles leave a certain amount of professional discretion.

Besides revenue transactions, Budget Reporting will be the second area which is examined by this study. Budgeting is genuinely different between private and public sector entities and therefore an important indicator for Differential Accounting. Public sector entities generally use their budgets predominantly as authorization procedures, while private sector entities also heavily use them for targeting and incentive schemes. This significantly influences the reporting about budget implementation.

The study is, however, not following a purely conceptual approach. It is reflecting the relevant generally accepted accounting standards, the International Financial Reporting Standards (IFRS) and the International Public Sector Accounting Standards (IPSAS). The EPO is currently presenting its financial reports in accordance with IFRS; however, Differential Accounting could possibly lead to the conclusion that IPSAS might be more appropriate for the EPO. Therefore, the study also examines the impact of a possible transition to IPSAS.

In the following text, EPO stands for European Patent Organisation and not for European Patent Office. It is not necessary to distinguish between the European Patent Office and Organisation in the following study since they are an economic entity and they therefore produce just one set of financial reports.

3 Financing and revenues of EPO

3.1 Financing of the EPO – is the EPO a Government Business Enterprise (GBE)?

Differential Accounting, like any other area of academic discussion, does not provide clear cut answers in this case. Some issues remain controversial, even after years of research. However, one of the widely accepted results is that commercial or business like entities should rather use private sector standards, even if they are controlled by governments. Such entities are commonly referred to as Government Business Enterprises (GBE).

Following this principle, IPSAS excludes GBEs from its scope and mandates them to adopt private sector standards, namely IFRS⁵. Therefore, it shall be examined whether or not the characteristics of a GBE apply to the EPO. IPSAS⁶ specifies the following criteria, which all need to be met to lead to the conclusion that the entity is a GBE:

(a) [It] is an entity with the power to contract in its own name;

(b) [It] has been assigned the financial and operational authority to carry on a business;

(c) [It] sells goods and services, in the normal course of its business, to other entities at a profit or full cost recovery;

(d) [It] is not reliant on continuing government funding to be a going concern (other than purchases of outputs at arm's length); and

(e) [It] is controlled by a public sector entity.

According to Article 4 and 5 of the European Convention on the Grant of Patents (European Patent Convention; EPC) the criteria (a) and (b) are clearly met. The EPO is an autonomous entity “with the most extensive legal capacity accorded to legal persons under the national law”. It has the “authority to grant European patents” as their main line of activity. Whether the activities truly are businesses in the strict sense of the word is examined in criteria (c) and (d), further down.

The EPO is controlled by the signatory states of the convention (“Contracting State”), which are acting through a Conference of Ministers and an Administrative Council (Articles 4 and 4a EPC). The Contracting States are public sector entities; therefore criterion (e) is also met.

Less clear is the situation of criteria (c) and (d). Article 37 and 38 EPC makes it clear that EPO is not solely financed by its “own resources”, but by different types of contributions by the Contracting States (Article 37 b, c and d) as well as borrowing and project funding by third parties. The term “own resources” is further defined as “income from fees and other sources” (as well as different types of reserves). National renewal fees, which will be examined more closely in section 2.2 of this study, are, however, not “own resources” because they are captured by Article 37 (b) and not by Article 37 (a). Bottom line, the EPC leaves no doubt that the Contracting States have to make financial contributions in one way or the other. On the other hand, there is no reference to full cost recovery, let alone profits.

⁵ IPSAS Preface 12, IPSAS 1.5, 1.12

⁶ IPSAS 1.7

The analysis of the actual financial situation in the years 2006 to 2008 supports the preliminary conclusions drawn from the assessment of the EPC. Table 1 shows that, although there were no special contributions in order to balance the budget, the “organization’s own resources” according to Art. 37 (a) EPC accounted only for about 60 or 75 percent of the revenues, depending on whether financial revenues are included⁷. The most important position which is not included in “own resources” are the national renewal fees according to Article 37(b) which account for more than 20 percent of the total revenues in all three years examined. Therefore there is continuing government funding in the sense of criterion (d) of the IPSAS GBE definition.

	2008		2007		2006	
	millions EUR	percentage	millions EUR	percentage	millions EUR	percentage
Procedural fees	839	55%	747	54%	701	55%
National renewal fees	327	21%	300	22%	281	22%
Other revenue	45	3%	44	3%	37	3%
Other income	21	1%	13	1%	12	1%
Work performed and capitalised	2	0%	2	0%	2	0%
Financial revenue	303	20%	284	20%	244	19%
Total Revenues	1'537	100%	1'390	100%	1'277	100%

Source: Financial Statements EPO

Table 1: Sources of revenue EPO

The actual percentage of procedural fees is even lower and accounts for only about 55 percents of the total revenues. The total cost of the provision of the services is substantially higher than the procedural fees in all three years. This is a strong indication, that the services are sold at less than full cost recovery and therefore also criterion (c) of the IPSAS GBE definition is not met.

Bottom line, the EPO does not meet the definition of a GBE as defined in IPSAS, because it only meets three out of five required criterions. The EPO is a public entity.

In addition, although this is not a mandatory criterion in IPSAS, this conclusion is also supported by the function of the budget. There is no indication at all, that the budget is used in the same sense as in a commercial entity, e.g. as a target for sales. The function of the budget, namely the authority defined in Article 43(1) of the EPC, is following the typical pattern of public sector entities⁸. This typical pattern is also recognized in IPSAS 1.24 and IPSAS 24.

3.2 Revenues of the EPO

As discussed in the previous section, the EPO has different sources and types of revenue. These sources and types are stipulated in the EPC. The actual amounts are presented in the annual financial statements and the notes to these statements. In order to make a professional judgement about the appropriate accounting treatment, the various types of revenues have to be analysed based on their economic substance. The analysis of economic substance examines,

- (a) Whether the revenue is from an exchange or non-exchange transaction;

⁷ The EPC remains silent about the classification of financial revenues, but they are probably included in the term “other sources” in Article 38 (a) and therefore also in Article 37 (a) EPC.

⁸ Bergmann (2009) 44

- (b) In which moment the asset is received and the revenue can be recognized;
- (c) If it is from an exchange transaction, whether the services are delivered in the same or a different accounting and reporting period;
- (d) If it is from a non-exchange transaction, whether there are conditions attached.

This analysis is often referred to as the asset-and-liability-approach⁹ of revenue recognition and measurement, because it examines assets and liabilities to draw a conclusion about revenues. It is also important to distinguish recognition and measurement. Recognition is the event in which revenue is captured by the accounting and reporting system, measurement is the valuation technique applied to calculate the amount presented at the reporting date.

The asset-and-liability-approach is generally accepted by the accounting profession and the basis for both IFRS and IPSAS. Both standards define revenue as the inflow of what is defined as an asset¹⁰. The definition of an asset is generally slightly different in the IFRS and IPSAS, not only in respect of revenue recognition:

- IFRS: future economic benefits are considered;
- IPSAS: future economic benefits or service potential are considered.

This difference reflects that public sector assets are valuable, even if they generate non-economic benefits¹¹. However, this distinction is not relevant for the EPO as all the revenues are paid with cash or cash equivalent and not by barter.

The distinction between exchange and non-exchange revenues only exists in the public sector standards, because non-exchange transactions are typical for this sector. Commercial entities typically have exchange revenues, because their economic activity is the delivery of goods or services in exchange for the revenue. Public entities also have exchange transactions, when they deliver goods and services similar to commercial entities. However, some of their transactions are clearly not related to the delivery of goods and services. Typical examples include taxes, fines or transfers between public sector entities. In all these cases, the payees can't claim some kind of goods or services in exchange. The payment has to be made because defined circumstances, e.g. residency, breach of law etc. are met. Transfers between public sector entities are often allocation measures, e.g. redistribution between affluent and poor communities. In the context of international organizations, contributions from members are in most instances classified as non-exchange¹², because it is not related to an exchange of goods and services *directly* to the member states. Obviously, there are usually also mechanisms for non-exchange revenues which should reflect the relative importance or use. Usually, the amount of a fine is related to the degree of the offence, taxes are related to economic welfare, and transfers to other public sector entities, including international organizations, may depend on the population, the number of phone lines or other socio-demographic indicators. This could lead to the false conclusion, that these are exchange transactions because services for the residents or telephone subscribers are purchased. This is, however, not the case as the resident or the subscriber does not directly receive goods or services from the international organization.

⁹ Sometimes it is also referred to as „balance sheet approach“, which is, however, less precise

¹⁰ IAS 18.7; IPSAS 9.11, 23.12

¹¹ Typical examples are local roads, which usually cannot be sold, cannot be charged for use but nevertheless are valuable for the local community.

¹² Publicly available is the 2008 financial report of the World Food Program (WFP) which classifies all revenues from member states as non-exchange. A similar treatment – although with a few exceptions – is envisaged by WHO and PAHO, as well as other UN organizations. The UN has decided to adopt IPSAS.

The lack of exchange obviously changes the accounting and reporting treatment, as there is no reciprocal transaction which could be used for the measurement of the revenues. Typically, exchange transactions rendering services are measured based on the stage of completion of the service¹³. If a service is provided over several years, the revenues are allocated between the years based on the percentage of completion (PoC).

Non-exchange transactions, per definition, have no completion because there is no exchange of defined services which could be completed. They are usually recognised upfront, once the receiving entity obtains control of the asset¹⁴. If there are conditions, which could lead to an obligation to return the asset, they are separately recognized as a liability.

The different accounting treatment of exchange and non-exchange transactions results in material differences of the amounts presented both in the balance sheet and the income statement. Non-exchange transactions generally increase revenues and assets in early periods, while exchange transactions spread the asset recognition and thus the revenues over longer periods of time. In both cases, annual instalments reduce the effect of measurement.

3.2.1 Analysis of EPO revenues

The analysis of EPO revenues has revealed that there are four basic types of revenues:

- (a) Procedural fees related to specific activities of the EPO (e.g. search and examination fees);
- (b) Procedural fees related to the period of the patent grant process (e.g. renewal fees of pending application and designation fees);
- (c) National renewal fees; and
- (d) Other revenues and income, including financial revenues.

The basic types generally include various revenue line items defined in the EPC and presented in the financial statements and notes. However, these line items are similar in the economic substance and therefore fall into the same category of revenues.

The largest item in the category (d) is financial revenues, but other revenues include project funding, rental income and others. These revenues and incomes usually arise from exchange transactions (IPSAS 9), but other specific standards (Financial instruments¹⁵, Leasing¹⁶) should also be considered in recognizing and measuring these revenues and incomes. However, a detailed analysis is not conducted here because it is beyond the scope of this study.

¹³ IAS 18.20; IPSAS 9.19

¹⁴ IPSAS 23.76

¹⁵ IPSAS 15 und IAS 39; revised IPSASs based on IAS 32, 39 and IFRS 7 effective 01 January 2010

¹⁶ IPSAS 13

3.2.1.1 Procedural fees related to specific activities

This type of revenue includes the following line items, as presented in the financial statements:

- (a) Procedural fees for filing and search;
- (b) Procedural fees for international searches;
- (c) Procedural fees for examination and grant;
- (d) Procedural fees for international preliminary examinations;
- (e) Procedural fees for opposition, appeal and protest.

First, we need to analyze whether the different procedural fees related to specific activities are revenue from an exchange or non-exchange transaction. By definition revenue belongs by definition either in the category of exchange transactions or non-exchange transactions, but IPSAS 23.11 is aware of transactions where it is not immediately clear whether they are exchange or non-exchange transactions. In such cases an examination of the substance of the transactions is necessary.

The scope of IPSAS 9 (Revenue from exchange transactions) encompasses rendering services, the sale of goods and the use by others of entity assets yielding interest, royalties and dividends. IPSAS 9.11 defines exchange transactions more specifically as transactions in which one entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of cash, goods, services, or use of assets) to another entity in exchange.

In the financial statement the fees are classified according to the different kinds of activities, for examples filling, research or examinations. These activities can be qualified as services according to IPSAS 9, for which the EPO claims compensation in the form of fees. The conditions of IPSAS 9.11 are met since the EPO receives fees (increases the assets) and in exchange the EPO renders services (value) to the applicant. However, one may argue that the applicant doesn't receive an equal value for the paid fees. In this context, it needs to be clarified that equal value doesn't mean equal cost. If equal cost were a condition for an exchange transaction, the qualification of the procedural fees as an exchange transaction would not be that clear, since the income balances the expenses in average after around eight years maintenance time. The criterion in IPSAS 9, however, is clearly equal value. This is fulfilled because one can assume that the benefit (or value) of a potential patent is at least equal to the amount of the procedural fees. Otherwise the applicant for a patent would not be willing to pay the fees. This is typical for exchange transactions.

Furthermore the appendix of IPSAS 9 lists several examples of services which can be regarded as exchange transaction, for examples admission fees, initiation and entrance fees, science and technology research and processing court cases. Firstly, among the examples there are several types of fees, which reinforce the argument that fees should generally be qualified as revenue from exchange transaction. Second, the processing fees for court cases (example 4) are similar to the service of the EPO concerning the term "equal value". A complainant is willing to pay the process of court cases even though the outcome of the process is unknown. In the best case her/his expenses are compensated and the claim(s) rewarded, whereas in the worst case the complainant will only incur expenses.

In conclusion, the procedural fees of the EPO should be qualified as revenue from exchange transactions and more precisely as revenue from rendering of services according to IPSAS 9.23.

In the second step of the analyses we need to determine in which moment the asset is received and the revenue can be recognized. The following exhibit shows the moments of the inflows of the fees and delivering the services.

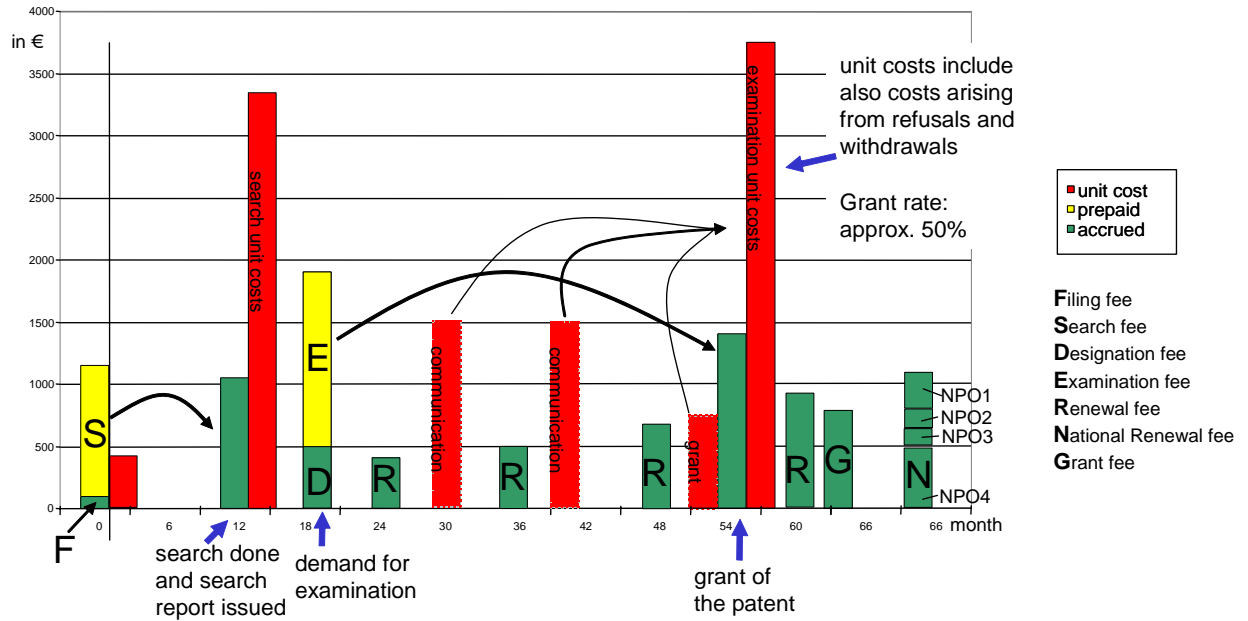


Exhibit 1: Fees and services of the EPO (Source: SR-EPO)

IPSAS 23.19 stipulates that the revenue associated with the transactions should be recognized by reference to the stage of completion of the transaction at the reporting date, which “is referred to as the percentage of completion method” (PoC-Method). Under this method, revenue is recognized in the reporting period in which the services are rendered.”¹⁷ As the figure above shows, the inflow of the fees and the rendering of the services do not occur in the same reporting period, therefore the procedural fees should be recognized as revenue in the statement of financial position over the period during which the service is performed. Further, the PoC-Method entails recognition in the statement of financial position under the position “Prepayments”.

3.2.1.2 Procedural fees related to period of the patent grant process

This type of revenue includes the designation and renewal fees for patent application. As already mentioned in chapter 3.2.1.1, revenue belongs by definition either in the category of exchange transactions or non-exchange transactions. Two elements determine whether the fees are an exchange or non-exchange transaction. The first element of the analysis examines the counterpart of the transaction. The name of the fees clearly indicates that the counterparts of the transactions are the patent applicants. The immediate relationship between the EPO and the applicant paying the fee indicate exchange nature.

The second element of the analysis is the nature of the service in return. While the designation fee could be seen as service similar to the filing service, which we classified as exchange in the previous section, we come to the conclusion that it is rather related to the number of Contracting States which will eventually protect the invention (retrospectively) if the patent is granted. We therefore examine them together with the pre-grant re-

¹⁷ IPSAS 9.20

newal fees. Pre-grant renewal fees are not directly tied to an activity such as search or examination. The service rendered is the maintenance of the legal status of the application and, eventually, once the patent is granted, a retrospective protection of the invention in the period covered by the pre-grant renewal fee. As we will extensively examine in the next chapter, the legal protection of the invention is granted by the designated Contracting States and therefore it can't be regarded as an exchange transaction between the EPO and the patent applicant according to the second element.

The analysis leads to a contradictory result: one element standing for an exchange transactions, whereas the other standing for a non-exchange transaction.

However, regardless of the type of transaction, pre-grant renewal fees are due annually, as long as the application process takes. The total amount of pre-grant renewal fees therefore can't be estimated in advance. If they are recognised annually, when they are invoiced, this is the appropriate treatment both for exchange and non-exchange revenues. For exchange transactions it is appropriate, because it is a fairly good proxy for the percentage of completion (PoC). For non-exchange transactions it is also appropriate, because the EPO only controls the asset (i.e. receivable) once the invoice is issued. If the application process terminates any earlier, there is no control of the asset. Recognition upon invoicing is the appropriate treatment.

For designation fees, there could possibly be a small difference whether they are exchange and non-exchange. Because the amount concerned is relatively small, the difference would be not material. The recognition at the moment of invoicing appears acceptable in this sense.

Bottom line, procedural fees related to the period should be recognized as revenue when they are invoiced, regardless whether they are exchange or non-exchange transactions.

3.2.1.3 National renewal fees

This type of revenues includes the EPO's share of the national renewal fees: "Each Contracting State shall pay to the organisation in respect of each renewal fee received for a European patent in that State an amount equal to a proportion of that fee."¹⁸

In analyzing whether the national renewal fee is an exchange or non-exchange transaction, the economic substance of the transaction between EPO and National Patent Offices (NPO) is crucial. The first element of this analysis examines the counterparty of the transaction. Unlike the procedural fees this type of revenue is owed and paid by the Contracting States rather than directly by the applicants/patent holders. The wording of Article 39 (1) EPC makes it clear that the Contracting State is paying in its own right and not on behalf of the patent holder. Obviously, the measurement is normally based on the renewal fees collected by the Contracting States, but there are minimum amounts according to the second sentence of Article 39 (1) EPC. In the decision CA/D 3/97 the Administrative Council defined these minimum amounts "at 15% of the average of the renewal fees of all contracting states". By referencing the minimum amount to the fees of the collections from the other states, and not, for instance to the number of European patents in the respective state, it becomes clear that this is a contribution from the Contracting States and not from patent holders. These measurement principles are typical for modern transfer systems. Such systems usually measure the transfer amount with some kind of "cost-by-cause" principle, instead of more static measures. However, it's still a transfer and not a price charged for the delivery of services.

This leads to the second element of the analysis, the service in return. For this, the nature of European patents needs to be examined. Article 2 and 3 EPC make it clear at the

¹⁸ Article 39 (1) EPC

very beginning of the convention that European patents are only effective in those states in which they are requested. This process is called Designation and governed by Article 79 EPC. The invention is only protected in those states which are designated and the designation fee is paid for. The service in exchange for a European patent is therefore dependent on the designation. In fact, it's the Contracting States, and not the EPO, which need to provide the necessary legislation to protect European patents. The EPO is only providing a single uniform process for the granting of patents, not for the enforcement of legal protection of patents. Legal protection is provided by the Contracting States. Therefore, once the patent is granted, the immediate relationship between the applicant and EPO comes to an end¹⁹. This is another argument against exchange in favour of non-exchange nature of the transaction. In fact, this case is identical in economic substance with Example 10 of IPSAS 23.

National renewal fees compensate the EPO for the work in the patent granting process and therefore would, under IPSAS, be recognised as an income in the accounting period, in which the work is performed. This is opposed to the current practice, where the national renewal fees are only accounted as an income when they are actually received. Since the actually received renewal fees correspond to the granted patents when the EPO was much smaller, the way of recognising under IPSAS would better reflect the actual operational performance of the EPO.

Bottom lines, the National Renewal Fees are payments for non-exchange transactions.

As discussed in section 3.2, the accounting and reporting treatment of non-exchange transactions is different from the current treatment, which would be appropriate for exchange transactions²⁰. According to IPSAS 23.12, 23.44 and 23.76 the recognition of a non-exchange revenue is based on the inflow of an asset²¹. An asset shall be recognised, if there are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. As for the controlling of the resources, IPSAS states that:

“an announcement of an intention to transfer resources to a public entity is not of itself sufficient to identify resources as controlled by a recipient [...] the entity will need to establish enforceability of its control of resources before it can recognize an asset. If an entity does not have an enforceable claim to resources, it cannot exclude or regulate the transfer's access to those resources.”²²

Unlike national public entities, international organisations cannot claim juridically the debt owed and therefore an international organisation would never be able to fulfil the enforceability clause, if it was limited to juridical procedures. However, there are political mechanisms which enforce treaties such as the EPC. Such forms of enforcement are equally captured by IPSAS 23.33. An other aspect of the term controlling is that IPSAS is based on the principle of “de lege lata”, which means that laws, regulations or other binding arrangements as they exist are decisive in order to determine if an entity controls the inflows of resources. In the context of EPO it means that the EPO controls the inflow of resources (renewal fees), even though the member state can change the amount of the renewal fees in the future.

There is an asset, a receivable, based on the national renewal fees for patents granted in the past. The asset and the corresponding revenue are initially measured at fair value,

¹⁹ Unless in cases of opposition, limitations and appeals procedures

²⁰ It is also appropriate under IAS, which do not distinguish exchange and non-exchange transactions.

²¹ Except to the extent of a corresponding liability arising from a condition. However, there is no evidence of conditions in this case and therefore such liabilities are not examined any further.

²² IPSAS 23.33

namely in the case the asset is a receivable (IPSAS 23.42, 23.48 and specifically for receivables 23.83). Fair value is defined as the amount for which an asset, i.e. a receivable, “could be exchanged between knowledgeable, willing parties in an arm’s length transaction” (IPSAS 9.11); however, the preparer has to define the appropriate accounting policy (IPSAS 23.83). In this case, where the receivable lasts for many years, an actuarial estimate which reflects the life expectancy of the patents as well as the time value of the money appears adequate. This might in fact be the same estimate currently used for the disclosure in the notes of EPO’s financial statements (Note 4).

Under IPSAS the actuarial estimate of the net present value of the future National Renewal fees needs to be recognized as a revenue and an asset once the patent is granted, while it is only disclosed under the current accounting policies.

3.3 Volatility of financial statements

The national renewal fees are paid in local currency and are subject to currency volatilities. Also other factors like economic growth, applied discount rate etc. introduce volatility. Since the expected amount of future national renewal fees is very high compared to the balance sheet and the income, small volatility already has an impact on the financial result of EPO. What kind of solutions does IPSAS provide?

According to IPSAS 4.32 exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statement shall be recognized in surplus or deficit in the period in which they arise. In addition, IPSAS 9.10 refers to IAS 39 in the cases of revenues arising from changes in the fair values of financial assets: A gain or loss arising from a change in fair value of financial asset shall be recognized in profit or loss.²³ Both standards lead to the same result by recognizing the differences in profit or loss.

Volatility cannot be avoided and gains/losses from currency fluctuations shall be recognized in surplus or deficit.

Although there is no explicit solution in IPSAS, a so called self-insurance scheme for currency volatility could be envisaged. The self-insurance balances currency volatility through net assets/equity. Gains from currency fluctuations could be used to build up an earmarked position within net assets/equity, which could be used up to cover losses from currency fluctuations. However, the creation of such an earmarked position requires a change of the Financial Regulations.

²³ IAS 39.55 et seqq.

4 Impact of a change from IFRS to IPSAS

4.1 Distinction between IFRS and IPSAS

IPSAS is converged with International Financial Reporting Standards (IFRSs) by adopting them to a public sector context when appropriate. The IPSAS-Board has been attempting, wherever possible, to maintain the accounting treatment and original text of the IFRSs unless there is a significant public sector issue which warrants a departure and deals with public sector financial reporting issues that are not dealt with in existing IFRSs.²⁴ The following exhibit shows that all IPSAS, with the exception of the autonomous IPSAS 22, 23 and 24, are based on corresponding IAS.

Sources of IPSAS

IPSAS 1	IAS 1		IPSAS 14	IAS 10
IPSAS 2	IAS 7		IPSAS 15	IAS 32
IPSAS 3	IAS 8		IPSAS 16	IAS 40
IPSAS 4	IAS 21		IPSAS 17	IAS 16
IPSAS 5	IAS 23		IPSAS 18	IAS 14
IPSAS 6	IAS 27		IPSAS 19	IAS 37
IPSAS 7	IAS 28		IPSAS 20	IAS 24
IPSAS 8	IAS 31		IPSAS 21	IAS 36
IPSAS 9	IAS 18		IPSAS 22	-
IPSAS 10	IAS 29		IPSAS 23	-
IPSAS 11	IAS 11		IPSAS 24	-
IPSAS 12	IAS 2		IPSAS 25	IAS 19
IPSAS 13	IAS 17		IPSAS 26	IAS 36

Exhibit 2: IPSAS – IFRS concurrence table

The main differences between IPSAS and the corresponding IAS are listed at the end of each IPSAS. The differences often originate in different terminology and definition but there are other material differences. One of them – which is relevant for the EPO – is the different discount rate for the actuarial assessment of a postemployment benefit obligation:²⁵

“IAS 19 requires entities to apply a discount rate based on yields on high quality corporate bonds consistent with the currency and estimated term of the postemployment benefit obligations. The requirement in IPSAS 25 is that entities apply a rate that reflects the time value of money. IPSAS 25 also contains a requirement that entities disclose the basis on which the discount rate has been determined.”²⁶

The provision for the postemployment benefit obligation needs to be calculated annually; therefore no additional cost would arise from this difference. At this point, no statement can be made on the monetary effect of such a change.

Apart from the differences which stem from divergences from IFRS/IAS, the main differences lay unquestionably in the autonomous IPSAS 22, 23 and 24. IPSAS 23 (Revenue from non-exchange transactions) was already addressed in chapter 3.2.1.3 and the main impact – as was shown - would be in recognizing the national renewal fees as an asset. IPSAS 22 establishes requirements for governments which elect to disclose information about the general government sector (GGS). IPSAS 22 is therefore not relevant for the

²⁴ IPSAS Preface 18

²⁵ IPSAS 25.91

²⁶ IPSAS 25 Comparison with IAS 19

EPO. For that reason, IPSAS 24 remains to be analyzed in order to assess the impact of a change from IFRS to IPSAS. This analysis will be conducted in the next chapter.

4.2 Budget Reporting according to IPSAS

Unlike in private sector enterprises, the budget in the public sector is not only a tool to deploy strategic plans, but also part of a formal, legal authorisation of any expenditure. In many countries the budget is called a new law and is approved in the very same way as a new law, in order to reflect this status.²⁷ The IPSAS-Board emphasized the importance of budgeting in the public sector by adopting IPSAS 24 (Presentation of budget information in financial statements), which has no counterpart in IFRS.

Budget is also a core element in the EPC since it is the main part of its EPC Chapter V "Financial provisions". The relevance of budgeting has encouraged our conclusion of chapter 3.1 that the EPO should not be classified as a government business enterprise.

IPSAS 24.14 requires the following:

[...] "an entity shall present a comparison of the budget amounts for which it is held publicly accountable and actual amounts either as a separate additional financial statement or as additional budget columns in the financial statements currently presented in accordance with IPSASs. The comparison of budget and actual amounts shall present separately for each level of legislative oversight:

- (a) The original and final budget amounts;
- (b) The actual amounts on a comparable basis; and
- (c) By way of note disclosure, an explanation of material differences between the budget for which the entity is held publicly accountable and actual amounts, unless such explanation is included in other public documents issued in conjunction with the financial statements and a cross reference to those documents is made in the notes."

According to Article 69 of the Financial Regulations, the financial statement relating to the annual accounts shall comprise financial statement, budget implementation statement and analysis of operating income and expenditure structure. The EPO has also decided to publish a separate financial statement comparing the budget with the actual amounts, which is conforming to IPSAS 24.14. The budget implementation statement extensively shows the comparison between original and final budget as required by IPSAS 24.14 lit. (a). It also includes explanations of material differences between the budget and actual amounts and therefore is in compliance with lit. (c). However, the actual comparison is not in compliance with IPSAS, since the EPO currently presents the financial statement and the separate budget comparison in totally different formats with totals not adding up to the same amounts as in the financial statement. In addition, an appropriate level of aggregations is lacking in the budget implementation statement²⁸, which is relevant to the decision making needs of the users.²⁹

By adopting IPSAS 24, transparency and comparability of the financial reporting would be enhanced substantially.

4.3 Transition from IFRS to IPSAS

As we have shown, IPSAS differs from IFRS mainly in the field of budget reporting and revenue from non-exchange transactions (Taxes and Transfers). The IPSAS-Board has introduced these two standards because reporting and transfers represent specific public

²⁷ Bergmann (2009). p. 8

²⁸ IPSAS 24.25

²⁹ IPSAS 24.26

sector needs. Reporting and transfers are likewise relevant to the EPO and therefore it is appropriate for the EPO to apply IPSAS instead of IFRS. In case of the EPO this would lead to the recognition of a receivable for future national renewal fees, which would substantially increase the assets and reduce the currently negative net assets/equity position. This effect would probably be large enough to make the net assets/equity position positive.

The other main effect is the immediate comparability of budgets and financial statements due to the IPSAS specific requirements on budget reporting. This reflects the importance of budgets in the public sector, which is a distinctive characteristic of the private sector.

Bottom line, the accounting issues of the EPO with its public sector characteristics is better addressed with IPSAS. IPSAS reflects specific characteristics such as non-exchange transactions, while maintaining the well known and widely accepted IFRS/IAS guidance where there is no public sector specific reason to depart from IFRS/IAS.

IPSAS is based on IFRS and therefore a transition from IFRS to IPSAS wouldn't be very painful respectively wouldn't be an expensive project. Many other reform projects of implementing IPSAS – at sub-national, national level or by international organisation – were far more vast since their prior accounting model was based on cash accounting. There is no huge step to be made from cash based accounting to accrual based accounting in the case of the EPO. Most transitional work is probably needed to harmonize budgeting and accounting and in reviewing the revenues.

Bottom line, with its IFRS based accounting model the EPO has an excellent starting situation that is very close to IPSAS and therefore just needs to adopt to the specific public sector elements of IPSAS.

5 Conclusion

An adoption of IPSAS is recommended because the EPO does not meet the definition of a GBE as defined in IPSAS 1.7 and therefore is within the scope of IPSAS. In this way the accounting model of the EPO would profit from the specific public sector solution of IPSAS.

IPSAS differentiate exchange (IPSAS 9) from non-exchange transactions (IPSAS 23). IFRS doesn't know the category of non-exchange transactions and as a consequence, recognition and measurement of revenue should be reviewed based on the IPSAS's dichotomy of exchange and non-exchange transactions. This would allow the recognition of an actuarial estimate of discounted future national renewal fees.

Budget reporting of the EPO has to be in compliance with IPSAS 24 which enhances the quality of budget reporting to the public sector needs.

Apart from the adoption of the autonomous IPSAS 24 and IPSAS 9 most of the work done for the adoption of the IFRS remains untouched. For this very reason, the transition from IFRS to IPSAS should not be too demanding or resource consuming.

References

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