

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

SUBMITTED BY: President of the European Patent Office

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

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#### 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).

In 2003 the Office decided to adopt IFRS (International Financial Reporting Standard) as its accounting system. At the time the obvious alternative, the IPSAS (International Public Sector Accounting Standard), was still relatively undeveloped. However, since then considerable progress has been made with IPSAS. In particular IPSAS 23.31 allows for the inclusion of the fair value of future renewal fees. This makes IPSAS far more suitable for the specific financing structure of the EPO. IPSAS also better fits the mission of the Organisation as a public service. The Central Staff Committee pleads for a change.

The document has been reconsidered in the light of the study attached as Add. 1.

This document replaces CA/159/09 issued in Aug. 2009. Changes are indicated by grey hatching.

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## I. HISTORICAL BACKGROUND

The IFRS is a loose set of standards issued by the International Accounting Standards Board (IASB). IFRS has been developed primarily for publicly accountable enterprises. It may, however, also be applied to public sector entities. IFRS calls for so-called accrual accounting, as opposed to the former cash based accounting. In view of the Office's long-term commitments, accrual accounting is certainly the right approach for accounting.

IFRS is not the only accrual accounting standard. US-GAAP, HGB (used in Austria and Germany) and IPSAS (International Public Sector Accounting Standards) are examples of other accrual accounting standards. Of the above accounting standard, IPSAS is the only one that has been designed specifically for the needs of public sector entities.

Like IFRS, IPSAS is just a loose set of standards, each addressing a particular accounting problem. The IPSAS is issued by the International Federation of Accountants (IFAC). IFRS and IPSAS are closely related standards: most of the IPSAS differs from IFRS only in the terminology used. IPSAS is not as complete as IFRS, because IPSAS was first issued only in 2000 whereas IFRS dates back to 1973. In case IPSAS does not provide a standard to a particular accounting problem, IFRS may be used instead (see IPSAS 3.12 and 3.15 ).

In 2003, when the Office decided to apply IFRS, IPSAS was also considered. The relevant document (CA/92/03), refers to the IPSAS Preface §12, as stating that IPSAS applies only to national, regional and local entities, and hence not to an international organisation like the EPO. The arguments brought forward in CA/92/03 can, however, be questioned.

The IPSAS Preface §12 actually reads:

*"The IPSASs are designed to apply to the general purpose financial statements of **all** public sector entities. Public sector entities **include** national governments, regional governments..."* (emphasis added).

In other words: the preface does thus not exclude international organisations. The fact that the United Nations, NATO, WIPO, OECD and the European Institutions have since decided to apply IPSAS shows that the Office's view in this respect is not shared.

CA/92/03 further justifies the choice of IFRS stating that the EPO is comparable in many aspects to commercial enterprises since it is self-supporting, it provides services, the cost of which is covered by its own revenues (mainly fees) but not by subsidies, it has assets and liabilities, and it generates income and expenses.

CA/92/03 further states that the financial structure and accounting policy of the EPO are comparable to that of a commercial enterprise. Since IPSAS requires the application of IFRS for Government Business Enterprises (GBEs), the Office decided in favour of IFRS. The criteria applied by the Office for determining whether or not the EPO is a Government Business Enterprise (GBE) are, however, neither consistent nor in line with the IPSAS.

IPSAS defines GBEs as public sector entities that perform activities that are, in substance, no different from those conducted by private sector enterprises. Examples are public transport, water, gas electricity suppliers etc. and some financial institutions (IPSAS 1.12). According to IPSAS, IFRS is to be applied for GBEs, whereas for true public administration entities, IPSAS shall apply.

IPSAS 1.7 lists five criteria for determining when an entity is a Government Business Enterprise and should thus apply IFRS instead of IPSAS. Government Business Enterprise (GBE) means an entity that has all the following characteristics:

- (a) is an entity with the power to contract in its own name;
- (b) has been assigned the financial and operational authority to carry on a business;
- (c) sells goods and services, in the normal course of its business to other entities at a profit or full cost recovery;
- (d) is not reliant on continuing government funding; and
- (e) is controlled by a public sector entity.

Concerning criterion (c): obtaining a patent is not merely a question of money as the term "to sell" implies, but primarily a question of merit. The EPO does not "sell" patents. Even if one were to assume that the activities the EPO provides could be described as "selling the service of search and examination", the procedural fees are far from full cost recovering.

It is clear that the total expenses for the patenting procedure must on the long run be covered by the procedural fees and the renewal fees together. In order to ensure low procedural fees for the applicants, particularly for SMEs, a part of the renewal fees is used for balancing the expenses.

Criterion (c) of the definition of a GBE in IPSAS 1.7 is thus not fulfilled.

The post-grant renewal fees which provide a substantial part of the EPO's income are an essential part of the EPO's financing structure. These fees are not levied by the EPO but by the Contracting States, who transfer an amount corresponding to a part of the received national renewal fees to the EPO in order to ensure cost coverage (Article 37(b) EPC and Article 39(1) EPC). These payments thus correspond thus to government funding but not to any sales of services.

Criterion (d) of the definition of a GBE in IPSAS 1.7 is hence also not fulfilled.

## **II. FURTHER DEVELOPMENTS IN IPSAS**

Since the Office made the decision to adopt IFRS rather than IPSAS dramatic progress has been made in the latter with the publication of IPSAS 22 to 24 in Dec. 2006. The new standards address accounting problems typical for, and only encountered in, accrual accounting in the public service. Consequently, these standards have no corresponding standard in IFRS. Particularly IPSAS 23, which deals with income from so-called non-exchange transactions (taxes, fees, subsidies and similar) and IPSAS 24, which deals with budget reporting, appear very relevant for the EPO.

IPSAS 24 sets standards for budget reporting. Budget reporting is an important exercise for public entities as it allows the policy makers and the public to verify whether public funds are spent correctly. Budget reporting is an important exercise in the EPO where the President has to show to the Administrative Council that the money available to the EPO has been spent in accordance with the previously approved budget. IFRS has been designed for profit-oriented enterprises. Consequently it has no corresponding standard principally because disclosing detailed information about exactly what part of the budget is assigned to what activity could provide potential competitors with strategic information.

The budget reporting currently prepared by the EPO is an activity which is done independently from the financial statements. In the EPO, this has led to apparent inconsistencies between the budget report and the financial statements. Under IPSAS, the budget report becomes an integral part of the financial statements.

Adopting IPSAS 24 could thus improve the quality and stringency of the EPO's budget reporting thereby providing the decision makers with consistent information.

IPSAS 23.31 allows for the inclusion of the fair value of likely future income as an asset. This means that IPSAS would allow the Office to account for future renewal fees.

As in any other patent office in the world, the EPO keeps the processing fees for a patent application at a level sufficiently low in order not to discourage filings. The losses made in the early stages of the procedure are compensated for by later stage renewal fees. For pending applications, IFRS requires that the accrued costs and the prepaid procedural fees are included as expenses and liabilities. Only when concluding the procedure, the prepaid fees are accrued as income which at that time cover less than 50% of the accrued costs. Under IFRS, the resulting deficit must thus be included in the financial statement since it is already effective, while the net present value of the future renewal fees, although forming an integral part of the financial design of the patent system, may not. The main reasons for this exclusion are that the duration of maintenance of the patents is uncertain and the national renewal fee levels are decided by the Member States and hence out of control for the EPO. This results in huge liabilities for the EPO since the patent financing system relies on the future renewal fees.

Consequently, using IFRS as the accounting standard, gives an unrealistic picture of the financial situation of the EPO.

IPSAS 23.31 allows for the inclusion of the fair value of future renewal fees in the balance sheet as an asset. With the newly issued IPSAS 23, IPSAS thus has become the only accrual accounting system that is compatible with the philosophy of financing the patent system.

### **III. CONCLUSION**

Accounting standards (IPSAS) that are specifically adapted to the needs of the public civil service and that, contrary to the IFRS, are compatible with the fee system of the EPO are now available.

Since most of IPSAS has a correspondence in IFRS, changing from IFRS to IPSAS should not require a major effort.

The Central Staff Committee therefore strongly suggests that the Organisation considers a change from IFRS to IPSAS.