

Intellectual Property: a Lever to Stimulate Economic Growth of Small and Medium-Sized Enterprises

Accounting Aspects

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Summary:

With its Single Market Act (2012), the European Commission has identified twelve principal levers to boost growth, competitiveness and social progress. Two of them are intellectual property and financing of small and medium-sized enterprises (SME), which the Commission considers to have the potential to give a new impetus to the Single Market. Intellectual property is a key element of the innovation policy of the enterprises. However, innovations and effective protection of intellectual property appear to be amongst the most serious problems of Bulgarian small and medium-sized enterprises. A research of the Bulgarian Chamber of Commerce and Industry, conducted this year in July, reveals that 53% of the companies do not invest in innovations; Bulgaria holds the 93rd place in the Global Competitiveness Index 2011-2012 among 139 countries and the 92nd place in the Best Countries for Business 2012 ranking among 134

countries. Of considerable importance for the management of innovation activities of SMEs is the cognizance of the essence and scope of intellectual property accounting items, respectively intangible assets. Some of the prerequisites for the proper accounting treatment of this specific resource group are: good cognizance of the quality characteristics of separate groups of intangible assets; the development of classification and recognition criteria; the regulation of measurement bases; the regulation of accounting and disclosure requirements. In the light of the problematic issues outlined above, an effort was made in this paper to present some theoretical, practical and applied aspects with regard to:

- the potential and the role of intellectual property as a key element for the sustainable economic growth and competitiveness of small and medium-sized enterprises;
- the identification of essential characteristics, scope and structure of the intellectual property of small and medium-sized enterprises for accounting purposes.

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Introduction

Intellectual property is a key lever for innovation processes in small and medium-sized enterprises. Its role and significance for stimulating economic growth, competitiveness and social progress motivated the European Commission to define it in the Single Market Act of 2012 as one of the twelve fundamental "building blocks". Intellectual property is as important as raw materials or industrial basis: between 44% and 75% of the European enterprises' resources are connected with it. This is a strong comparative advantage of the EU. It is therefore essential for European competitiveness that most of the member states achieve unitary patent protection, and the goal for the year 2013 is to grant the first unitary patents.¹ The first step towards providing unitary patent protection within the EU framework is the elaborated in *Blueprint for intellectual property rights – 24/05/2011*. The leading motive for its elaboration is that "intellectual property rights are vital for Europe's 25 million small and mid-size businesses - protecting their

investment in new products and services, helping them secure access to financing and increasing fair competition."

1. Intellectual property – driving force for innovations and economic growth in small and medium-sized enterprises

The exploitation of intellectual property potential for the development and economic expansion of small and medium-sized enterprises in effect presupposes the following:

- a good knowledge of its inherent characteristics and types;
- a sound protection of the rights on intellectual property objects.

Intellectual property protection appears to be a considerable incentive for innovations, new discoveries and creative works, as well as for the enterprises' expansion and growth. It helps them attract investments for innovations, increase their market value and participate in the development of new markets. Generally speaking, SMEs which exploit their intellectual property rights more extensively achieve better economic results and higher market value than those who fail to do so.² The Report of the International Chamber of Commerce highlights the importance of intellectual property protection, saying that it "is important for small and medium-sized enterprises, not only for multinational companies. In some cases small and medium-sized companies, which rely

¹ Single Market Act 2012. Available at: http://ec.europa.eu/internal_market/smact/index_fr.htm/IP/11/470 and MEMO/11/240 of 13 April 2012 [Accessed August, 15 th, 2012]

² Report of the International Chamber of Commerce (ICC). The report provides evidence from developed and developing economies on the strong correlations between intellectual property protection and GDP, employment, tax revenues, direct foreign investments and the development of technologies. Available at: <http://www.icc-bulgaria.bg>. [Accessed August, 15 th, 2012]

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on intellectual property, report higher growth of up to 20% compared to similar enterprises imparting less importance to intellectual property."

- knowledge and application of the main commercial forms of technological transfer of innovations – the sale of patented invention rights, licensing and know-how agreements, turnkey projects, joint ventures, trade with knowledge-intensive articles, joint research and development projects;
- knowledge and use of non-commercial forms of technological transfer of innovations – technical and scientific information from scientific and academic literature, patent descriptions, technical standards, referring publications, magazines, etc; publications of materials from conferences and symposia and direct exchange of opinions during discussions;

- joint fundamental research and free-of-charge results exchange, etc.;
- availability of managerial potential and knowledge of markets;
- investing a share of the profit in innovations and/or providing sources of funding for innovation projects;
- the availability of reliable, objective and high-quality accounting information about intellectual property objects and their management.

What are the actual conditions and the tendencies in the innovation processes for the Bulgarian small and medium-sized enterprises? Unlike the enterprises in the leading EU member states, the intellectual property of the Bulgarian SMEs has a minimum or zero relative weight in their balance sheet totals. A survey of the Bulgarian Chamber of Commerce and Industry (BCCI), conducted in July 2012³

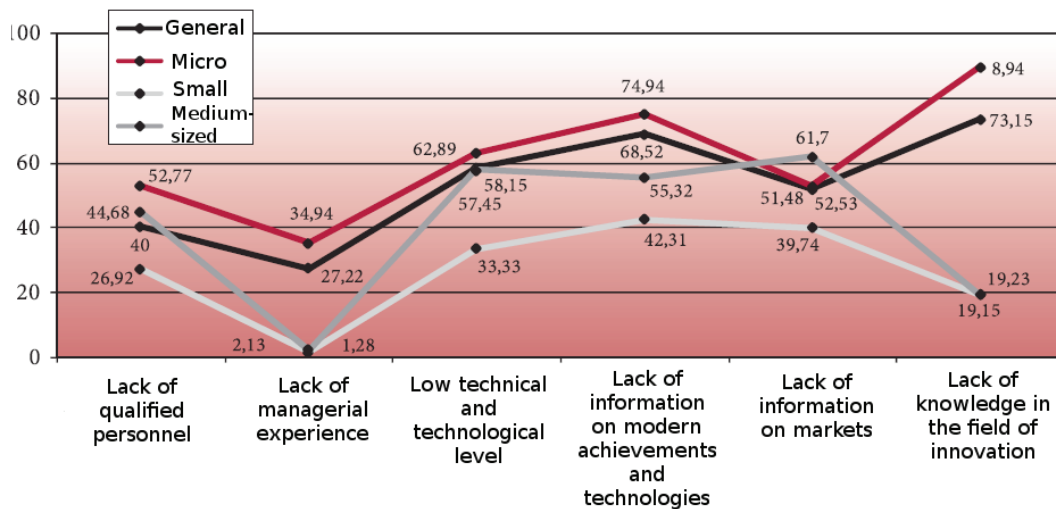


Fig. 1. Internal factors constraining innovation in Bulgarian micro, small and medium-sized enterprises.⁴

³ The major part of the enterprises participating in the survey come from the industry sector (60%), followed by the services sector (22%) and those working in the sector of commerce (18%). Available at: www.bcci.bg [Accessed August, 15 th, 2012]

⁴ Study of the trends in the innovation processes in small and medium-sized enterprises. Available at: www.arcfund.net/fileSrc.php?id=2529 [Accessed August, 15 th, 2012]

reveals that 53% of SMEs do not invest in innovations. The survey was prompted by the need to improve our country's disadvantageous position in the international rankings regarding the Innovation Index. The survey also finds worrying facts about the potential economic growth of SMEs in Bulgaria: only 27% of the enterprises use innovations (their own implemented developments prevail), about 18% of the BCCI members consider that innovations are not applicable to their businesses, and 2% specify that they do not need to implement scientific developments in the performance of their business activities. As for the trends in development of innovation, 28% of the studied enterprises tend to allocate up to 5% of their profit to this activity, 18% are willing to invest up to 50% in innovations, and 9% would never take such a step. Only 5% of the surveyed enterprises would spend more than half of their profit on innovation activities. The fairly easy way of "copying" and the insufficient information

and knowledge in this field have prompted the majority of managers to decide against innovation and patenting. Figure 1 presents some internal factors constraining the innovation processes in Bulgarian small and medium-sized enterprises.

Despite the unfavourable trend regarding the implementation of innovation processes in our country, there is another serious problem which hampers the use of intellectual property intended to ensure the economic growth of the Bulgarian small and medium-sized enterprises – that is the effective innovation protection. The greater part of the SMEs encounter serious difficulties related to unfair competition, limited opportunities for the implementation of research and development activities (at a high level and on a large scale) and considerable costs on registration and maintenance of patents. Last but not least, the loopholes and problems in the effective national legislation and standards regarding intellectual property, as well as the difficulty in finding partners for

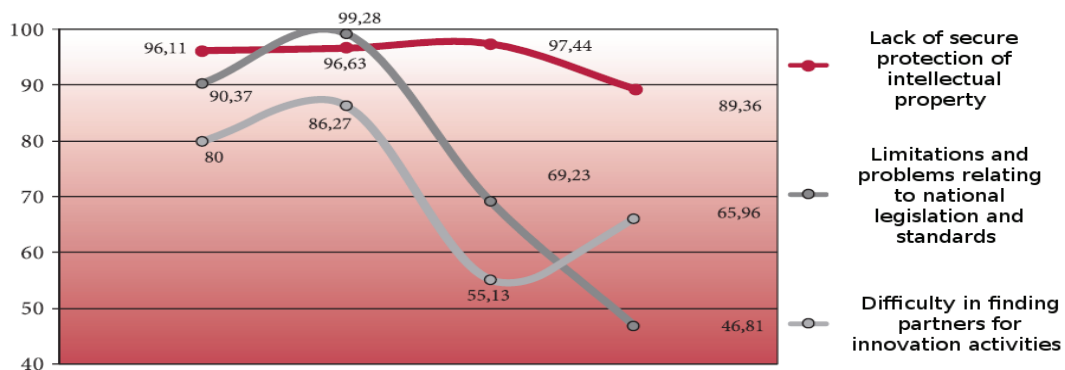


Fig. 2. External factors constraining innovation in small and medium-sized enterprises⁵.

⁵ Study of the trends in the innovation processes in small and medium-sized enterprises. Available at: www.arcfund.net/fileSrc.php?id=2529[Accessed August, 15 th, 2012]

innovation activities have an adverse impact on innovation. Figure 2 presents the basic external factors impeding the innovation processes in Bulgarian small and medium-sized enterprises.

The inference made from the studied indicators in both diagrams is: high percentage for the factors "lack of information on modern achievements, technologies" and "lack of knowledge in the field of innovation"; lack of secure protection of intellectual property; limitations and problems relating to national legislation and standards. Overcoming these negative trends would open up the opportunity for the Bulgarian SMEs to develop the intellectual property "building block" and expand their business.

The first step in ensuring the Bulgarian SMEs' economic growth through acquiring and exploiting intellectual property potential is to overcome the loopholes in the national legislation and accounting standards. The comparison of the legal and accounting regulation of intellectual property rights shows that the accounting theory and practice still falls behind the legal regulation. Within the legal framework effective on the territory of our country, the protection of the rights on intellectual property objects is regulated by various legal tools such as:

- international agreements and conventions, ratified, promulgated and effective as part of our domestic laws;

- the provisions in the national legislation which regulate the origin and essence of intellectual property rights, the organization and the means for exercising them and the measures and procedures for their protection. These regulations are incorporated in the Constitution and in various special laws and bylaws on their application;
- legal provisions in regulations and directives of the EU institutions directly applied or introduced through domestic legal acts into the national legislation.

The principal issue at stake is the absence of unitary patent protection within the EU. The introduction of such protection will save time and money for SMEs and will provide the opportunity for them to use "open data-sharing/open innovation sharing". The thesis about data-sharing potential was promoted at the IP WEEK 2011⁶ International Forum. The central idea in the statements of many of the participants⁷ was that namely "thanks to open data-sharing/open innovation sharing real economic growth is possible both at macro and micro level." What is more, the unitary patent system will ensure the protection of companies' investments in new products and services, secure their access to funding and accordingly strengthen fair competition.

Unfortunately, accounting theory and practice fail to adapt at the same pace

⁶ IP WEEK 2011 Brussels (Belgium), 5-9 December 2011. Available at: cip.unwe.acad.

⁷ The statement was shared by more than 400 delegates from 53 countries and by 30 speakers from Europe, Asia, North and South America, including the chairpersons of the patent institutions of USA, China, Europe, Brazil, the Director General of World Intellectual Property Organization (WIPO), as well as by the managers of big international companies (IBM, L'OREAL, AUDI, PHILIPS, etc.). Available at: cip.unwe.acad/bg/?menu=546 [Accessed August, 11 th, 2012] [bg/?menu=546](http://cip.unwe.acad/bg/?menu=546) [Accessed August, 11 th, 2012]

as the legal regulation with regard to the accounting treatment of intellectual property.

2. Theoretical and practical application support points on intellectual property recognition and accounting in small and medium-sized enterprises

The recognition of intellectual property for accounting purposes, accounting organization and its presentation in financial statements for SMEs should be consistent with its unique and intangible nature. The distinguishing characteristics could be generally reduced to the following:

- the intangible nature of intellectual property is exposed by the fact that the product is actually information. The trade in intellectual products is in effect trade in the information they contain, not in their material medium or form;
- two major groups of sales transactions could be differentiated with respect to intellectual property items: a/ the traditional sales transaction, where an expropriation of intellectual product property occurs; b/ specific type of "purchase and sale" – licensing whereby the owner of the intellectual product grants another person (enterprise) the right to use the product;
- in licensing transactions, property expropriation does not occur because the owner of the intellectual product (patentee/ patent holder) remains unchanged. He only gives the permission (license) to another person to use the product under definite terms and conditions by concluding a licensing agreement. Another specific

characteristic of this transaction type is that "the buyer" could be not one but a number of persons (enterprises), each of which, along with the owner, makes use of the utility value of the licensed intellectual property. Other distinctive features of this transaction concerning the organization of accounting are: a/ the price of intellectual property items could be realized multiple times (sale of multiple licenses for one and the same item); b/ two possible types of prices for the same product; c/ the license price could be realized in advance, without actually obtaining the economic effect of its usage on the basis of which it has been determined; d/ regardless of the fact that the intellectual property is one and the same, each license issued for the product may have a different price.

In organizing their accounting of intellectual property, SMEs should address some problems present in the accounting literature and the effective legal acts. The problems could be generally summarized as follows:

- lack of clarity in the definition of the nature, scope and essence of intangible assets as accounting items in the national accounting theory and practice;
- discrepancy between the national accounting regulations and the adopted international conventions with regard to the main component of intangible assets – intellectual property, and more specifically with regard to: a/ the nature, scope and contents of intellectual property as an accounting item; b/ the contents and scope of intellectual property rights – they are classified

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- as a separate group other than reporting entities' intellectual property; c/ copyright and related rights, as there is no distinction with reporting entities' intellectual property;
- lack of clarity in accounting theory with respect to the recognition, assessment and presentation for accounting purposes of internally created intellectual property items, such as trademarks, geographical indications, copyright, etc., other than technology or prototype developments. As a rule, the recognition of internally created intellectual property products is conducted at two main stages (research and development activities), which fail to account for their specific origin;
- inadequate organization and methods of accounting of specific intellectual property items which do not satisfy the recognition criteria for intangible assets, from the multiple sale of which, however, the enterprises generate considerable revenues (for instance know-how, internally created trademarks and others).

At the core of the above specified problems concerning the scope and the structure of intangible assets is the lack of knowledge of the essential characteristics of reporting entities' intellectual property accounting items as regulated in the Convention Establishing the World Intellectual Property Organization⁸. The unification of the terminology used in national accounting and in international conventions concerning intellectual property items will be

the first step to resolve the discrepancies established in the accounting practice. Table 1 presents an attempt to compare the current accounting theory and practice in the classification of intellectual property items and a benchmark model of classification and information support, consistent with the Convention Establishing the World Intellectual Property Organization. Some proposals have also been presented with respect to the organization of accounting.

A mechanical approach should not be adopted when classifying the intellectual property of SMEs. The recognition for accounting purposes of each individual item should be subordinate to its legal and economic characteristics, as well as to the purpose of its acquisition. An example and an interesting item of intellectual property in this respect is computer software.

The third main problem in accounting and presentation of SME's intellectual property is the recognition of internally-created intangible assets. In the author's opinion, the internally-created items of intellectual property rights could be differentiated not only depending on satisfying the "development stage" threshold criterion, but also depending on their type and the effect they have on the reporting entity's financial result. The effect of these items' incorporation in the reporting entity's business activity should be sought in two main directions – innovation activities in the enterprise, and sale in the form of

⁸ For further details about the existing problems in the treatment of intellectual property and of intangible assets in the national accounting system and in the accounting practice, please see Pozharevska, R., 2012. Aktualni problemi pri determinirane na sashtnostnite haracteristiki, obhvat i stuktura na nematerialnite aktivni za schetovodni tzeli. Teoretiko-prilozhni aspekti. Sofia: Spisanie "IDES", br.2. (pp. 8-20)

Table 1. Comparative analysis between the current accounting theory and practice on the scope of meaning of the intangible assets item groups and a benchmark model in the formation of classes.

Accounting theory and practice at the present time ⁹	Benchmark model for structuring the accounting items "intangible assets"	Notes and proposals of the author
<p>Industrial property rights: rights owned or that could be used in a long-term perspective by the reporting entity regardless of whether purchased or created within the entity, such as:</p> <ul style="list-style-type: none"> • trademarks; • <u>copyright</u>; • trade names, • <u>mastheads and publishing rights</u>; • <u>licenses and franchises</u>; • patents 	<p>Industrial property rights:</p> <ul style="list-style-type: none"> • patents of inventions; • licenses • useful models; • industrial design; • factory marks, trademarks and service marks; • trade name (firm names); • appellations of origin of the products; • indications of origin; • computer programs and databases (but only in cases when they are a sub-system of a product or part of a method which is patentable). 	<p>The name of the group and of the homonymous account should be preserved, but <u>the meaningful scope of the group should be changed according to the Convention Establishing the World Intellectual Property Organization. Copyright, franchises, mastheads and publishing rights should be excluded from the group.</u> Analytical levels could be introduced for those specific items.</p>
<p>Long-term acquisition of intellectual property rights: rights analogical to those in the previous group, acquired on the grounds of agreements concluded with their creator (author and holder).</p>		<p>The group should drop off with its name and content, since <u>it includes items of various rights on intellectual property.</u></p>
	<p>Rights on literary, artistic and scientific works:</p> <ul style="list-style-type: none"> • copyrights on literary, artistic and scientific works (including computer programs and databases); • rights related to copyrights on literary, artistic and scientific works. 	<p>It would be advisable to introduce a new group (or two groups) with an identical name, as well as a homonymous account for reporting the items.</p>
	<p>New intellectual property items: intellectual property items created in a field of interdisciplinary character or in a new scientific field; new objects that are expected to be created through human creative work and intellect in the future and meet the recognition criteria of intangible assets. Sample items:</p> <ul style="list-style-type: none"> • rights applicable to satellite broadcasting and cable retransmission; • rights for e-commerce; • franchising rights; • rights on new plant or animal varieties , • selection achievements; • biotechnologies; • integrated circuit topology; • topographic signs; 	<p>Introduction of an individual group and of a homonymous synthetic active account.</p>

⁹ This is a presentation of the recommended classification in item 9 of NFRSSME 38 Intangible assets, effective as of 01.01.2008 .

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Accounting theory and practice at the present time ⁹	Benchmark model for structuring the accounting items "intangible assets"	Notes and proposals of the author
	<ul style="list-style-type: none"> • computer software, mask works and databases; • rights on traditional knowledge and skills; • marketing and analogous research; • business plans and company strategies; • Miscellaneous new items of intellectual property. 	
<p>Concession rights – rights obtained according to the respective legislative process.</p>	<p>Exploitation rights – rights acquired through administrative channels and based on exploitation agreement for a definite period of time and under specific conditions, including:</p> <ul style="list-style-type: none"> • Concession rights • Amounts accrued as a result of business transactions leading to increase of economic benefit of leased or placed at disposal non-current assets. 	<p>The group could be preserved or included in another group encompassing all exploitation rights acquired through administrative channels and according to law.</p>
<p>Technological rights – rights on recipes, <u>models, designs</u>, prototypes, instruments, matrixes, patterns and similar items which presume the usage of new technologies.</p>		<p><u>The items of this group are within the scope of the rights on literary artistic and scientific work, as well as of industrial property rights.</u> The group should not be identified as a separate group.</p>
<p>Intangible assets in process of development - this group involves intangible assets in process of development.</p>	<p>Intangible assets in process of development - this group involves intangible assets in process of development .</p>	<p>It would be advisable to introduce a homonymous account for reporting this specific intangible assets group.</p>
<p>Other intangible assets: real right (right to use and right in property of a building/ structure according to Property Law); amounts accrued on marketing or similar research, business plans or company strategies; amounts accrued as a result of business operations leading to increase of economic benefits from leased or placed at disposal non-current assets.</p>	<p>Limited real rights: This group includes limited real rights, obtained on the grounds of a notarial deed and specifically:</p> <ul style="list-style-type: none"> • right to use; • right to build and extend a building; • easement rights. 	<p><u>This group involves limited real rights, new objects of intellectual property and exploitation rights and in author's opinion should drop out of this scope.</u> Following the distribution of the respective items according to their economic and legal nature, a separate group "limited real rights" could be identified.</p>

Table 2. Recognition for accounting purposes of acquired externally-created computer software.

Purpose of acquisition	Recognition of an acquired externally-created computer software for accounting purposes
For personal use, when the acquired software does not constitute part of hardware equipment	<ul style="list-style-type: none"> • if it meets the threshold recognition criteria – as an intangible asset. In the process of recognizing it as an intangible asset: a/ if it is part of a patented invention – as an industrial property right; b/ on acquisition of fixed-period rights for software reproduction and distribution – as copyright on literary work¹⁰; c/ on acquisition intended to be used for manufacturing and administrative purposes – as right on new intellectual property items. • if it fails to meet the threshold recognition criteria – as a current expense.
For personal use, when the acquired software is part of hardware equipment	As a tangible non-current asset: property, plant and equipment.
For sale purposes	As inventory
For licensing purposes	As an intangible asset
For lease purposes	As an intangible asset

licensing and franchising transactions. The introduction of the additional criterion allows items which do not meet the threshold recognition criteria of intangible assets to be included in the classes, as they have a considerable contribution to the company net sale revenues. The exclusion and non-recognition of some intellectual property items for accounting purposes could result not only in underestimation of reporting entity's economic resources, but also in the mixing of income and expenses, both in the period they have been incurred and in later periods, when the entity will begin

taking advantage of the respective benefits. An attempt has been made at outlining the main classes of internally-created intangible items based on the following criteria: legal and economic nature of the resources and their possible effect on the net financial result of the SME.

Conclusion

Holding and exploiting intellectual property in SMEs is a major lever for innovation and new discoveries, as well as for the growth and expansion of SMEs. Intellectual property and its sound

¹⁰ Rights on computer programs, databases and internet sites in the international and national legislation with regard to intellectual property protection are treated as copyright on literary works. Computer programs could constitute a component of industrial property rights but only in cases when treated as an invention, and are a subsystem of a product or part of a method which is patentable. (Universal Copyright Convention of 1952; Agreement of trade-related aspects of intellectual property rights of 1994, Directive 91/ 250/EEC on legal protection of computer programs of 1993; Directive 96/9/EC of 1996 on the legal protection of databases; World Intellectual Property Organization Copyright Treaty of 1995. The documents are cited from: Borisso, B., M.Markova, 2002 (pp.59-66). Novi objekti na intelektualnata sobstvenost. Sofia: Universitetsko izdatelstvo Stopanstvo. UNWE.

Table 3. Classes of internally-created intangible items and their recognition for accounting purposes.

Recognition for accounting purposes	Class of internally-created intangible items
Internally-created items of intellectual property rights recognized as intangible assets	<ul style="list-style-type: none"> • items of the industrial property rights group – patented employee inventions, utility models, industrial design, geographical indications; • copyrights originating from labour and/or employment relations (the legal entities are the holders of the copyright) – periodicals as a whole, computer programs, internet sites, art-design; • rights related to copyright originating in labour and/or employment relations – programs of radio and TV organizations; • unpatented inventions; new or substantially improved materials, devices, products, processes, systems or services, prior to initiation of industrial manufacturing or usage; • similar to them items.
Internally-created items of intellectual property rights, subject of commercial deals, not recognized as intangible assets	<ul style="list-style-type: none"> • Company secrets (know-how) • internally-created trademarks
Other items not recognized as intangible assets	<ul style="list-style-type: none"> • costs for establishment of company marks • editorial imprints • customer lists • publishing rights • other similar accounting items

protection could help enterprises in attracting investments for their innovation activities, in increasing their market value and for their participation in the development of new markets. One of the main factors for the high-quality intellectual property management is the provision of reliable accounting information about intellectual items/intangible assets. The problematic issues, treated with respect to recognition and accounting of SMEs' intellectual property, do not exhaust the entire range of unclear or debatable cases. Hopefully this paper provides the grounds for further discussions on and solutions to accounting theory and practice in the

recognition and reporting of intangible assets and intellectual property.

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