

Accounting and Taxation of Internally Generated Intangible Assets

Ganeta Minkova^{1,2}

¹Institute of the State and the Law, Bulgarian Academy of Sciences, Sofia, Bulgaria

²Department of Geography and Geology, Sofia University 'St. Kliment Ohridski', Sofia, Bulgaria

Email address:

ganminkova@abv.bg

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Abstract: Capitalized intangible assets are part of the company's investing activities. Over the last 5 years, the 27 Member States of the European Union have increased their investments, including those in intangible assets. When a company has an experienced research team, it is able to create intangible assets without having to purchase assets or hire other organizations to create them. However, internally created intangible assets are treated differently for accounting and tax purposes than purchased ones. This study examines the differences made in the legislation in the treatment of the two sets of intangible assets, and attempts to uncover the reasons for this situation. The study aims to address: whether, and if so why, there should be differences in the treatment of internally generated and purchased intangible assets; whether the cost of internally generated intangible assets should be recognized for tax purposes, given that their carrying amount may be disputed, which may lead to litigation; whether internally generated intangible assets should be recognized when intangible asset incentives are granted. From a research perspective, the concept and different types of intangible assets are first considered. Secondly, their reporting for publicity purposes is analyzed, since the financial statements prepared by a company play an important informational role for other companies, for statistical purposes, for the listing of the company on stock markets, etc. Assets are recorded on the company's balance sheet, but are also accounted for in whole or in part as expenses that affect its financial result. The Republic of Bulgaria applies International Accounting Standards (IAS/IFRS) for large companies and groups of companies, but has also adopted National Accounting Standards (NAS) based on Bulgarian accounting tradition and concept. Thirdly, the taxation of intangible assets is examined in terms of corporate tax in Bulgaria rather than indirect taxation. The study focuses on the comparison of Bulgarian taxation and US taxation, as these are two very different models of legal technique in the design of direct corporate income tax. Despite the differences, the analyses indicate that the overall treatment of intangible assets for tax purposes shows similarities. The study does not employ an empirical method, as the analysis is conducted via doctrinal research and comparative study of normative acts and administrative practice. The study ends with conclusions.

Keywords: Internally Generated Intangible Assets, Purchased Intangible Assets, Recording, Taxation, Tax Reliefs

1. Introduction

According to OECD 2018 Progress Report on Preferential Regimes (Action 5 of the BEPS Plan) [7], income of intellectual property (IP) might be taxed on preferential terms. At the same time, the OECD also identifies some tax regimes as not harmful because they cover substance requirements like Belgium deduction for innovation income, France reduced corporation tax rate on IP income; Hungary IP regime for royalties and capital gains. [8] Although these

regimes are not detrimental, taxation of intangible assets is regularly being monitored by the Forum on Harmful Tax Practices. This shows that great importance is attached to intangible assets, especially when it comes to tax avoidance or evasion.

When considering the taxation of income generated from intangible assets, the OECD does not emphasize the manner in which these assets are derived by the entity – are they internally generated or purchased, or licensed, or even donated. According to the OECD, other factors constitute risks for income taxation, such as: negotiation of tax rate or

tax base, lack of transparency, exemption of foreign source income from taxation in the country of residence, licensing and purchase of assets to related parties. However, this study does not explore these aspects in detail as it focuses on the reporting and taxation of internally generated assets rather than on the issues of tax avoidance and evasion.

The topic is of interest because, according to Eurostat investment database, [20] the 27 Member States have increased their investment over the last 5 years as follows:

Capitalized intangibles are part of the company's

investment activities. However, as investments are not separated into tangible and intangible assets in the figures quoted, it is difficult to estimate the share of intangibles among the investments in all or one particular Member State. From the accounting and taxation perspective, there is also lack of data on the amount of expenditure, capitalization, revaluation and impairment of assets and the factors that affect their recognition.

Does the location of the paragraphs indicate that they follow the preceding one?

Table 1. Investments in the Member States and in Bulgaria.

Year	2018	2019	2020	2021	2022
Investment	2 863 615.3	3 115 483.3	2 971 535.6	3 205 648.6	3 592 851.8

Available data for Bulgaria are as follows:

Year	2018	2019	2020	2021	2022
Investment	10 544.9	11 455.1	11 750.2	11 616.6	12 992.9 (p)

(p) - (provisional)

Although intangible assets (IA) are not easily identifiable, data are available supporting the conclusion that *their size is growing rapidly*. One survey [9] states that from 1995 to 2019, the investment in intangible assets increased faster than investment in tangible assets, as the share of invested intangibles in 11 leading economies changed as follows:

Table 2. Ratio between tangible and intangible assets.

Countries	Year	Share of Tangibles	Share of Intangibles
Austria Denmark Finland France Germany Italy the Netherlands Spain Sweden the United Kingdom the USA	1995	69 %	31 %
	2019	60 %	40%

The same survey states that regardless of the sector, companies that invest more in intangibles grow revenues 6.7 times faster.

The increase of intangibles raises the following issues that the study aims to address:

- whether, and if so why, there should be differences in the treatment of internally generated and purchased intangible assets;
- whether the cost of internally generated intangible assets should be recognized for tax purposes, given that their carrying amount may be disputed, which may lead to litigation;
- whether internally generated intangible assets should be recognized when intangible asset incentives are granted.

The study analyses these issues mainly by comparing the Bulgarian Corporate Income Tax Act (CITA) [3] and the

accounting rules applicable in Bulgaria with the legislation of other states.

The study does not employ an empirical method, as the analysis is conducted via doctrinal research and comparative study of normative acts and administrative practice. Accordingly, the sources for analysis are limited to books, articles published in peer-reviewed journals, publications on the internet, opinions and interpretations of various institutions.

2. Concept and Types of Intangible Assets

Different accounting rules may be applied to assets, and various sets of accounting methods can be identified, which are used in Canada and the USA (Successful Efforts Method), in Australia (Aria of Interest Method) and in countries where International Accounting Standards (IAS/IFRS) are recognized as the accounting rules (Full Cost Method). [1] In Bulgaria, the IAS/IFRS apply *en bloc* pursuant to Art. 34(4) of the Bulgarian Accounting Act (AA) [2], which states that all entities may prepare their annual financial statements in accordance with them. According to paragraph 8 of the IAS 38, intangible assets are identifiable non-financial assets that have no physical substance. According to para. 10, the assets should be: separable; controlled by the entity; expected to provide future economic benefits. According to paragraph 2 of National Accounting Standard (NAS) 38 Intangible Assets, they are identifiable non-financial resources acquired and controlled by an entity that: have no physical substance, although they may be contained in a physical substance; are significant in their use; and are expected to generate economic benefits from their use. Therefore, there is no material difference in the concept of IA under IAS 38 and NAS 38. As the Bulgarian tax legislation does not introduce a concept of IA, in general, the definitions of the accounting standards apply.

Although different categorizations of intangible assets are possible, the preferred categorization in this study is into the following groups:

According to para. 119(a), (b), (d) and (e) and to para. 9 of NAS 38, *the first category* involves the traditional *intellectual property* as copyrights, patents, licenses and franchise, trademarks, trade names, publishing rights.

The second category covers scientific and non-scientific *research and development (R&D)* as described in para. 56-59 of IAS 38 and para. 2 of the NAS 38. Research and development may be part of the process of creating intellectual property, but for accounting purposes, it may also be a stand-alone operation. Typically, research does not result in the creation of an asset. For this reason, the legislator does not define the term 'research' for tax purposes. In contrast, *development may lead to creation of an intangible asset and there is an independent definition of it in Bulgarian tax legislation*. Under i. 24 of the SP of the CITA, 'development activity' shall be the activity of developing, designing, building and testing new goods, materials, manufacturing technologies and industrial systems and other industrial property items, as well as improving existing products and technologies.

The third category comprises *computerized databases and directories* (software) as referred to in paragraph 2. 119(c) of IAS 38 and para. 9 of NAS 38, where software is described as copyright. Since the beginning of the 21st century (especially over the last five years), the share of computerized information has been growing rapidly, making these assets of great importance. The difficulty in recognizing them as intangible lies in the fact that they often do not meet the criteria for being separable from computers.

The fourth category is technology rights, such as recipes, formulas, models, designs, prototypes, tools, dies, templates and the like, which involve the use of new technology. Although some of these may have physical substance, they are seen only as a means to improving or creating materials, devices, products, processes, systems and services.

The fifth category are assets recognized under i. 6 of IAS 38. Subsequent to initial recognition, a lessee shall account for an intangible asset held under a finance lease in accordance with IAS 38. Rights under licence agreements for items such as films, videotapes, plays, manuscripts, patents and copyrights are also within the scope of IAS 38.

The sixth category comprises concession rights - acquired under the relevant legislative procedure (i. 9 of NAS 38).

The seventh category involves crypto-assets. They use distributed ledger technology [18] and since they do not need an intermediary to take place, represent, therefore, a decentralized process. [23] As there is no specific IAS or NAS that regulates crypto-assets, an Interpretative Opinion of the International Financial Reporting Committee (IFRIC) helps to address the lack of a standard. The Committee's Interpretation Opinion (IO) on the accounting treatment of cryptocurrency holdings from 12th June 2019 is applied immediately from the date of its publication. [5] Under this IO, the possession of cryptocurrency should be accounted for in accordance with

IAS 38 or IAS 2 Inventories. However, not all crypto-assets are intangible assets or inventories. For instance, according to the proposed Regulation 'Markets in Crypto-Assets', [6] some services should be considered 'financial' if the criteria of Directive 2002/65/EC of the EU Parliament and the Council of 23 September 2002 concerning the distance marketing of consumer financial services, are met.

Assets categorized in all these groups can be either purchased or internally generated. Although there are other situations, they are treated differently from the mentioned above for accounting and tax purposes:

- (i) *The workforce* is a factor in increasing the efficiency and profitability of an entity. It is undeniable that if the workforce is well trained, the profits of the company are higher. On the other hand, the costs of recruiting and training employees are also greater. In Bulgaria the costs for workforce are recognized as expenses but not capitalized independently. Under i.4.6 of NAS 38, the costs of training staff to work with the intangible asset are not included in its initial valuation. They are recorded as staff qualification costs. The opposite of this, under Section 197 (d)(1)(C)(i) of the Internal Revenue Code of the United States, [22] the term "intangible asset" means also workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment. However, if it comes to internally recruiting or training of workforce, this situation does not represent an intangible asset for tax purposes (Section 197(2) of the IRC).
- (ii) *Internally generated lists of clients, market share or other similar costs* are also not recognized as intangibles because they are generally not controlled by the entity (i. 63 and 64 of IAS 38). In Bulgaria, the same decision is taken in connection to recording (i.3.4. of NAS 38). Since the corporation tax base is formed on the basis of the accounting financial result, there is no need to regulate with a special rule this situation for tax purposes. In contrast, Section 197 of the US Tax Code explicitly governs commercial books, records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers) *if they are not self-created*.

3. Rules for Recording of Intangible Assets

According to § 1, i. 8 of the Supplementary Provisions (SP) of the AA, "International Accounting Standards" include IAS/IFRS and the related IFRIC interpretations which are implemented on mandatory basis. However, the general reporting rule is laid down in Art. 34(1) of the AA, which provides that enterprises shall prepare their financial statements in accordance with the National Accounting Standards, adopted by the Council of Ministers. [4]

As described above, their wording and headings are similar to those of the IAS. In addition to IAS 38 and NAS 38, other standards that also regulate intangible assets (e.g. rights of drilling are recognized under IFRS 6 Exploration for and Evaluation of Mineral Resources) are applicable in Bulgaria. Therefore, the rules for recording of IA differ depending on the sectors of the economy in which enterprises operate.

In 2018, approximately 75% of companies in extractive activities (mining, oil and gas) capitalized 66% of the internally generated exploration and evaluation (E&E) assets on the balance sheet, representing 8 % of companies total assets, and 36.6 % of the companies recognized also impairment of these assets [1, 24]. As result, the capitalization of development costs in extraction industry contrasts to the relative lack of capitalization of internally generated intangibles under IAS 38. [13, 19, 21] This raises the question as to whether such a difference is justified from a taxation perspective.

Stakeholders and researchers [17] have suggested that the International Accounting Standards Board (IASB) should revise its view and change the IFRS 6 Exploration and Evaluation of Mineral Resources or deal with extractive activities as part of a broader consideration of intangible assets and research and development activities. The Board expressed its willingness to consult on replacing and amending IFRS 6. [10] The current wording of paragraph 10 indicates that IAS 38 provides guidance on the recognition of assets arising from development of extracting activities. *This example points out that intangible assets play different roles depending on the type of business, making it difficult to establish common definitions and standards for their recording and taxation.*

According to para. 55 and 57 of the IAS 38 and i. 3.3. of the NAS 38, *an internally generated intangible asset is recognized and accounted for depending on the phase of its creation.* An asset that is in the research phase of an internal project is not recognized as intangible because the entity cannot yet demonstrate that it has an intangible asset that is likely to result in future economic benefits. Costs generated in the research phase are treated as expenses. As mentioned above, an internally generated intangible asset that arises from a development activity (the development phase of an internal project) is recognized as an intangible asset when its creation and use meet certain requirements. The entity should demonstrate: the technical ability to complete the asset so that it is ready for use or sale; an intention to complete the asset and to use or sell it; the ability to use or sell the asset; the ways in which the asset will result in the generation of future economic benefits, including the availability of a market or its utility for internal use; the availability of adequate technical, financial and other resources necessary to complete the development, use or sale of the asset; and the ability to estimate the costs arising from the asset during its development. For instance, the costs of an internally generated intangible asset, such as salaries and other costs incurred to secure copyrights or licences or to develop

computer software, are included in the value of the asset (para. 62 of IAS 38). Costs initially recognized by the entity as running in the period in which they are incurred are not included in the value of the intangible asset.

According to para. 63 of IAS 38 and i. 3.4. of NAS 38, internally created trademarks, columns, publishing rights, customer lists and objects similar in content should not be recognized as intangible assets. Although this is a non-exhaustive list of situations in which an intangible asset may not be recognized, the basic idea is that these cases cannot be distinguished from business development expenditure as a whole.

4. Tax Treatment of Intangible Assets

4.1. General Rules

Since 1991 in Bulgaria the computation of taxable profit from business activities has been based on the rules and documents of commercial accounting (book-tax conformity). Thereof, in general, the classification of an asset as intangible for tax purposes depends on the accounting rules. Article 18(1) of the CITA, which establishes the relationship between accounting rules and corporate income taxation, states that the *tax financial result is based on the accounting financial result.* However, at the same time, in Bulgarian law *the taxation of an assets may differ from its accounting.* In this respect, entities are obliged to prepare a tax depreciation schedule. Although Bulgarian law on corporation tax includes in Article 51 an independent definition of tax intangible fixed assets, some of their features are similar to those established by the accounting rules - they are acquired non-financial resources which have no physical substance. However, the tax legislation also establishes additional conditions. The fixed assets are of a value which equals or exceeds the lesser of: the value materiality thresholds for the tangible fixed asset, as adopted in the accounting policies of the taxable person or seven hundred leva (about 350 Euro).

Under Art. 51(1), i. 3 of the CITA, tax intangible fixed assets are also any amounts charged as a result of business transactions leading to an increase in the economic benefits flowing tangible fixed asset which are leased or provided for use; the said amounts shall not form a tax tangible fixed asset. These are costs for improvements and reconstruction of fixed tangible assets owned by other persons. As the text does not distinguishing between improvements and reconstruction delivered by the taxpayer through its staff or by using other companies, internally created intangible assets in this case should also be recognized.

4.2. Internally Generated Amortizable Intangible Assets

If we compare Bulgarian tax law with that of the United States, we will find that the Internal Revenue Code of the US regulates in detail which internally generated intangible assets can be capitalized and which cannot. Because in the US (like in the other Anglo-American countries) the link

between recording and tax rules is weak, [11, 14-16, 25] Section 197 provides a broader list of intangibles. The general rule is that if intangible assets are purchased, they can be capitalized and amortized. *Thereof, most self-created by the taxpayer intangibles are not subject to amortization.* According to (c)(2), the term “amortizable intangible” shall not include any intangible, which:

- (i) is not: a license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof; any covenant not to compete entered into in connection with acquisition of an interest in business; a franchise, trademark, or trade name.
- (ii) and is internally generated.

Consequently, *according the USA tax law, the internally generated intangibles are not amortizable* if they are, for instance: workforce; business books and records, operating systems, or any other information base (including lists of current or prospective customers); publishing rights, formula, process, design, pattern, knowhow, format, or other similar item; composition of market or market share; deposit base in case of a financial institution; etc. However, this paragraph shall not apply if the intangible is created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Again, we have before us a non-exhaustive list of situations in which an intangible asset cannot be recognized, although the list is more comprehensive than that set out in IAS 38 or NAS 38.

As Bulgarian tax legislation follows the German tradition by establishing a strong link between accounting and tax rules, it does not regulate internally created intangible assets by way of listing. At the same time, by adopting the book-tax conformity principle, Bulgarian tax law accepts that *internally created trademarks, columns, publishing rights, customer lists and objects similar in content should not be included in the tax depreciation plan and depreciated. Therefore, despite the different legal technique, Bulgarian tax law is close to US law with respect to the main idea for recognition of internally generated intangible assets if it possesses rights to them legally recognized by institutions.*

4.3. Tax Depreciable Value

The general rule set out in Article 67 of the CITA is that all accounting expenses forming a tax amortizable asset, including all subsequent expenses, are not recognized for tax purposes. The accounting expenses may form a new intangible asset or they may be included in the value of a tangible or intangible asset that already exist in the tax depreciation schedule. The value of the asset available in the tax depreciation plan shall be credited with any subsequent expenditure that results in future economic benefits arising from the asset.

However, the rule established in Art. 67 of CITA is followed by exceptions. In accordance with Art. 69 CITA, the taxable person is entitled to debit the accounting financial result with the historical cost of an intangible fixed asset when the asset is created in result of development activity that has been commissioned under market conditions to a

scientific research institute or a university. In this case, the intangible fixed asset shall not be amortizable for tax purposes. The aim of this provision is to promote the participation of research organizations and universities in the development processes, as they suffer from insufficient funding. But the pursuit of this objective discriminates to some extent against the internal development of intangible assets where the entity has an experienced research team and does not need external intervention.

4.4. Annual Tax Amortization Rates

When determining annual tax depreciation, tax depreciable tangible and intangible assets are allocated to seven categories. An intangible asset may be categorized in either the fourth or seventh category.

In the case of software and the right to use software, the annual tax depreciation rate is 50 %. As in most cases it is difficult to distinguish between the physical carrier and the intangible asset, computers are depreciated at the same rate. However, the annual rate for some types of software can be as high as 100 %. According to Article 55(7) of the CITA, the annual tax depreciation rate may not exceed 100 % in the case of software or the right to use software included in the list referred to in Article 118(16) of the Value Added Tax Act (VATA). Upon Article 118 of VATA, registered and non-registered for VAT purposes taxable persons are obligated to report the supplies/sales they have made or provided by means of issuing a fiscal cash receipt from a fiscal device (fiscal slip) or by means of issuing of a cash receipt from an integrated automated system for commercial activity management (system slip), except where the payment is made through the bank or by way of a set-off. Fiscal devices and integrated automated systems for commercial activity management shall have the technical capability of establishing distance connection to the Bulgarian tax authority - the National Revenue Agency. Since this is an obligation to use a certain type of software that arises under a legal act, the asset can be depreciated within one year.

The annual tax depreciation rate for any other intangible fixed assets is 33.33 %.

As can be noted, the depreciation rates for intangible assets in Bulgarian tax legislation are much less than the rates for tangible assets, which can be considered as an unjustified difference. On the other hand, this simplifies the application of the tax law in cases where it might be disputable in which category an intangible asset should fall.

4.5. Tax Reliefs

As tax reliefs are considered State aid, their adoption must never produce a result which is contrary to the provisions of the Treaty on the Functioning of the European Union (TFEU).

First, the CITA provides incentives for investments in municipalities with unemployment rate above national average which is in line with Article 107(3)(a) of the TFEU. Article 184 of the CITA states that the taxable person is allowed to retain up to 100 per cent of the corporate tax due

in respect of the tax profit derived thereby from the productive activity carried out, provided that the tax retained is invested in tangible and intangible assets which form part of an initial investment project in municipalities with high unemployment. Under i. 29 and 47 of the SP of the CITA, "initial investment" shall be an investment in new tangible and intangible assets, which are eligible costs and for intangibles these costs are in assets obtained as a result of transfer of technology by the acquisition of patent rights, licences, know-how or other intellectual property. The term "acquisition" does not only mean purchase, as its meaning is broader. Thereof, it may be concluded that self-generated intellectual property can be recorded when investing the retained corporate tax, but this statement is disputable.

Second, Article 189 of the CITA regulates the retainment of corporate tax granted for an initial investment project of a taxable person which is a micro, small or medium-sized enterprise. The intangible assets included in the initial investment must have been acquired under market conditions not differing from the conditions between unrelated parties and must be depreciable. In this case, the legislator explicitly states that the assets must not only be purchased, but that this must happen in compliance with the arm's length principle. [12]

It seems that the legislator restricts the possibility of internally generated intangible assets to be accounted for when investing retained corporate tax in the cases of both Article 184 and Article 189 of the Income Tax Act.

5. Conclusion

This research conducted on the taxation of internally generated intangible assets allows several conclusions to be drawn:

- (i) Although the importance of intangible assets, including internally generated, has been growing in recent years, no action has been taken at international and national levels to review and amend existing accounting rules. This situation may cause distortions in the normal course of economic activities of companies and may lead to future disputes between taxpayers and tax administrations.
- (ii) Accounting and tax rules discriminate against internally generated intangible assets as they are more often treated as expenses, even though they may be used for a period longer than one financial year, in the same way as purchased assets. From this perspective, there is no reason to distinguish between the two sets of assets.
- (iii) Tax reliefs are only available for purchased but not for self-created intangible assets, with no clear concept of this distinction.

Further detailed study is necessary as to what amendments should be made and in which provisions to extend the scope of intangible assets that can be capitalized to internally created ones. This focus therefore remains as future work to be carried out by the legislator and academia.

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