Goodwill in the Light of Market Capitalization Statement

Daniele Gervasio

Abstract—**What is the best way, if it exists, on how the goodwill should be accounted?**

Despite the well purpose of the international accounting standards, the problem of a good disclosure of goodwill seems to be far for a solution.

The paper try to made a conceptualization of how goodwill is interpreted for different scholars, presenting as possible solution to the problem a new form of disclosure called Market Capitalization Statement.

Index Terms — goodwill, market capitalization statement, intangible assets

I. Introduction

ACCORDING to Godfrey et al. (2010) the need of accounting arises because there is a gap between the value of asset, revenues, costs, and all other inputs, and the information available. In a perfect world there is no need of accounting reporting, nor accounting theory. However, in the reality there is a demand, which come from a wide range of stakeholders, for financial information to fill gaps in their knowledge and reduce uncertainties about current and future value. The main goals of accounting theory are to explain why and how current accounting practices evolved, to suggest improvements, and to provide the basis for the development of the practice.

II. What goodwill is: "Residuum" concept vs "future excess profit" concept

A. About goodwill

"Goodwill has been a thorny problem in the discipline of accounting for many years" (Gynther, 1969).

What is Goodwill? And how should be treated by accountants?

As first, is a good thing conceptualize what goodwill is. Commonly it is defined as the present value of future excess profits that the entity will obtain. However, this conceptualization is considered incorrect, because, as argued by Gynther, this is "merely a rationalization of the method commonly used to calculate the value of goodwill". What does it means? It means that the definition is incorrect for describe what goodwill is, rather is how goodwill is calculated in practice.

Indeed the assumption is that there are some assets that are not listed in the balance sheet, but it doesn't mean that they do not exist. Future potential benefits are the reason for why tangible assets are listed, and the fact that there are "tangible" is only a proof of their existence, but it does not means that could exist other kind of assets, indeed concepts like "customers lists", or "excellent staff" are intangible assets which include future potential benefits.

Conceptually, the economic value of each asset is the net present value of its service potentials, and the value of the entity is the total net present value of all of its assets (both tangible and intangible), less the net present value of its obligations (Gynther 1969). If we were able to identify every tangible and intangible assets, the goodwill as such would not exists. But obviously is not possible to do it. It is quite difficult, and some mistake are also made, to calculate the present value of all tangible assets, but it is impossible identify and calculate with certainty all intangible assets.

What we can do is to calculate, with a complex and, in any case, subjective process, both the overall value of the entity and the present value of the tangible assets: in this case emerge that the difference between these two figures is our goodwill.

Following this approach, goodwill is conceptually different from the first definition above: it is considered as the present value of the intangible assets. This is the "residuum concept" of goodwill. In contrast there is the "future excess profit concept" of goodwill, which reflect the first definition, that consider goodwill as the present value of the excess of expected future profits over that considered to be a normal return on the total tangible assets. This concept is well described by Emery (1951) "goodwill is looked upon as the economic advantage of friendly and harmonious relationships enjoyed by a business firm throughout the different phases of its operations. This advantage evidences itself in the form of earnings in an amount greater than that expected in a typical firm in the industry with a similar capital investment."

The critique (Gynther 1969) moved to "future excess profit concept" of goodwill is that, without any attempt to identify the intangible assets, it will produce not only an erroneous measurement of the goodwill, but also on the future profit. For instance, a 10% of return is entirely produced by an intangible asset, but if the normal return is 10% the consequence are: no goodwill will recognized, and over-evaluation of the tangible assets, which means that in the future depreciation process they participate to the profit/loss with an incorrect value.

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However, despite those theoretical differences, in practice is not possible to calculate, with objectivity, the net present values of entities and of most assets. The consequence is that the supporters of the residuum concept have to use a form of the excess profits method to calculate Goodwill. Therefore the final result could be the same.

B. How account for goodwill: Impairment vs. Amortization

Believing that goodwill is the present value of future excess income, most holders of the excess profits concept insist on writing off such goodwill against the revenues during the period in which they calculated these excess profits, even if in those years do not diminish the expectation of excess profits. This assumption can be seen in the framework of the historical cost accounting, as perfectly stated by Emery (1951): "…This opinion [goodwill should be written off] is based upon a line of reasoning which starts with the premise that a payment for goodwill represents theoretically the present value of the "excess profits" accruing to the new owner as a result of the momentum of the earning power of the going business as it existed at the time of transfer. Such a concept necessarily implies a limited duration of life for the actual goodwill factors purchased. Therefore, since the writer conceives of accounting as essentially a process of matching costs, in the historical sense, against those revenues for which they can reasonably be considered responsible, the cost of a purchase of goodwill should be matched against the revenues which it is expected to bring in, such matching to be accomplished by periodic write-offs to income in those periods presumably affected."

Against that, Gynther (1969) underline that often happens that the intangible assets which constitute goodwill not only do no diminish their value, but they can increase it, because the entity carries expenditures to maintain, or even increase, these intangible assets. These expenditures are already ascribed in the statement of the profit, adding the amortization of the goodwill means write some costs that are not incurred, and as consequence the profit will be under-estimated.

As suggested by Gynther (1969), "goodwill must be treated for what it really is, and goodwill must at least be left intact as long as the earning power of the entity is unimpaired. Consideration must be given to amortizing Goodwill only when and if earning power diminishes".

Consideration about the goodwill's impairment, as scratched here by Gynther, will be displayed in the following sections.

C. The "true"nature of Goodwill

Gynther (1969) state that to understand the true nature of goodwill, we have to answer this question: "Why does excess earning power on tangible assets exist?"

Ma & Hopkins (1988) offer some insight to answer this question. They, embracing the thought of other authors like Chamberlain (1968), Katz and Khan (1969), or Miller (1973), point on the vision of the firm as a "dynamic open system". In this view is understandable why exists the "excess earning", which allow to obtain a net asset value that exceed the fair value of net assets.

The nature of the goodwill is analyzed (Ma & Hopkins, 1988) in three situations: (a) goodwill internally generated; (b) goodwill paid for the purchasing of another entity, when this entity will operate independently; (c) purchased goodwill when the purchased entity will be integrated, at least partially, with the purchaser.

a) This kind of goodwill emerges as difference between the enterprise value and the fair value of the identifiable assets. Furthermore, can be seen as the sum of two synergies: "dynamic" synergies, benefits from the interaction of the assets with the other sub-system of the enterprise; and "open" synergies, from the interaction in the enterprise's environment.

The existence of these two synergies, which exist from the operational use of the assets, make that the concept of internally generated goodwill is economically meaningful.

b) In this case the goodwill emerge as difference between the price paid by the purchaser and the fair value of the identifiable assets. As we can consider the price approximately equal to the enterprise value, also in this case the goodwill will be the sum of open and dynamic synergies as described above.

c) When the two entities interact, we can see other synergies. The first arise from the interaction between the sub-system of the two entities, the second is represented as the advantages that the purchaser can obtain (i.e. diversification that lead to a reduction of risk, or assuming the control of a particular resource), and third is the synergy that the "group" can develop in its environment. Those synergies, called "second level", cannot be summed in any meaningful way with those at the "first level" because they fill the same space and there are no clear boundaries between these two levels.

Also in this third case the goodwill is the difference between the price paid by the purchaser and the fair value of the identifiable assets, however here the purchasing price will be in the range represented by the "minimum" price, which is represented by the enterprise value, and the "maximum" price, which is the present value of the increasing of stream that the purchaser expects to obtain after the acquisition. While both minimum and maximum price are meaningful economic concept, the final price is affected by non-economic factors, like bargaining skills and knowledge asymmetry.

Said that, what emerges is that internally generated goodwill has a meaningful economic interpretation, while the purchased goodwill, when is different from the present value of the stream benefits, is not meaningful.

Despite this theoretical explanation, the reality is quite different, and the accounting rules allow to recognize the purchased goodwill and forbid the recognition of the internally generated.

What emerges is that not always is discovered a logical justification to this issues, as suggested by Ma & Hopkins (1988), "by choosing to identify this latter category of

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goodwill [purchased goodwill] exclusively with the purchased entity, accountants have opted for convenience rather than reality. The manifest danger is the practice of Alice-in-Wonderland accounting, which will lead inescapably to a loss of professional credibility in the business community".

III. What say the International Accounting Standards

The standard that have the main impact on the topic discussed are the IFRS 3 Business combination, the IAS 36 Impairment of assets, and IAS 38 Intangible assets.

A. *International Financial Reporting Standard 3*

This standard define goodwill as "An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized."

To do that, the acquirer shall recognizes the identifiable assets and the goodwill (or a gain from a bargain purchase) acquired, the liabilities assumed and any non-controlling interest in the acquiree, and determines what information to disclose, according to the rules contained in the IFRSs.

The first step is understand when this standard have to be applied. Several pages detail the cases that are under the application of IFRS 3, and which not. Other important steps for the application of this standard are the identification of the acquirer and the determination of the acquisition date. But is not the aim of this paper to analyze all the rule contained in the IFRS 3, only focus on the paragraphs about the treatment of assets, liabilities and, specially, on the goodwill that emerge from the business combination.

The recognition principle told us that "the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree". Identifiable assets and liabilities shall be recognised only if they meet the definition provided in the "Framework for the preparation and use of financial statements". The consequence of the recognition principle is that an asset or liability could be recognised in the financial statement of the acquirer, also if it was not previously recognised in the financial statement of the aquiree; for example, "the acquirer recognises the acquired identifiable intangible assets, such as a brand name, a patent or a customer relationship, that the acquiree did not recognise as assets in its financial statements because it developed them internally and charged the related costs to expense."

Relevant is also the measurement principle, which require that assets and liabilities shall be recognised at their fair value at the acquisition date.

However there are some exceptions to both recognition and measurement principle. For instance the Income taxes are evaluated in accordance to IAS 12, or Employee benefits in accordance to IAS 19, or the Reacquired rights, about it the paragraph 29 says: "The acquirer shall measure the value of a reacquired right recognized as an intangible asset on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals when measuring its fair value".

The acquirer shall recognize goodwill as of the acquisition date measured as the excess of (a) over (b) below:

a) The aggregate of:

i. The consideration transferred in the business combination.

ii. The amount of any non-controlling interest in the acquiree, measured in accordance with this IFRS;

iii. In a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquire. The resulting gain or loss, if any, is recognized in profit or loss or other comprehensive income, as appropriate.

b) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS.

The consideration transferred in the business combination shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer.

B. *International Financial Reporting Standard 36*

The paragraph 80 of IAS 36 says that "For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units. Each unit or group of units to which the goodwill is so allocated shall:

a) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and

b) not be larger than an operating segment as defined by paragraph 5 of IFRS 8 Operating Segments before aggregation".

So, in some cases the goodwill that relates with the cash-generating unit (CGU) is directly allocated to it, and other times is not direct allocated to the single CGU but to a group of CGUs.

In the latter case, when goodwill relates to a cash-generating unit but has not been allocated to that unit, the unit shall be tested for impairment, whenever there is an indication that the unit may be impaired, by comparing the unit's carrying amount, excluding any goodwill, with its recoverable amount.

Instead, when goodwill is allocated in the CGU in which relates, this cash-generating unit shall be tested for impairment annually, and whenever there is an indication that the unit may

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be impaired, by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit. If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity shall recognize the impairment loss.

In both case, when there is an impairment loss, it have to be recognized if, and only if, the recoverable amount of the unit (or group of units) is less than the carrying amount of the unit (group of units). The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:

a) first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and

b) then, to the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units).

These reductions in carrying amounts shall be recognized immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (for example, in accordance with the revaluation model in IAS 16). In this case the impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard.

The general rule content in IAS 36, about the reversing of an impairment loss, is that the entity shall asses if there any indication that an impairment loss recognized in prior periods may no longer exist or may have decreased. In these cases the entity shall estimate the recoverable amount of that asset.

However the paragraph 124 and 125 specific that: “An impairment loss recognized for goodwill shall not be reversed in a subsequent period. IAS 38 Intangible Assets prohibits the recognition of internally generated goodwill. Any increase in the recoverable amount of goodwill in the periods following the recognition of an impairment loss for that goodwill is likely to be an increase in internally generated goodwill, rather than a reversal of the impairment loss recognized for the acquired goodwill.”

This is one of the inconsistencies described before. Also in a framework of the current cost accounting (in which seems developed those standards) is not allowed the recognition of an internal generated goodwill. But this is not the only issue linked to these rules: a further analysis is made in the next section.

IV. THE BASIS FOR THE DEVELOPMENT OF THE PRACTICE

A. *Problems – practical application*

It is observed (see Tab.1) that Intellectual Capital (IC), considered as the sum of all the intangible resources and activities, has increased relevance in the defining entities’ value. For this reason regulators and researchers have paid ever more attention in how “improve information about IC by making it easier to treat its components (intangibles) as assets in financial statements (defined “intangible assets”), thereby increasing their visibility in financial accounting and reporting.”

In this context, the definition of intangible asset content in IAS 38 have been criticized to be too narrow, excluding the possibility of recognize several component of IC. The introduction of the IFRS 3 has been viewed with favor from who has endorsed the need of major disclosure regarding the IC components. Indeed, as described in the previous section, the IFRS 3 allows to disentangle the “black-box” of purchased goodwill (Brännström & Giuliani, 2009). However, despite this change in the accounting norms, seems that in the practice is not changed severely, as noted in the following tables.

	Average	Std Dev
Intellectual capital price	93,49%	2,58
Material fixed asset/purchase price	6,04%	0,23
Identified Intangible asset/Intellectual Capital	12,52%	0,27

Tab.1 Data from the firms listed on the Stockholm (SSE) and the Milano Stock Exchanges (MTA/MTAX) on June 19th - Brännström & Giuliani (2009).

Once recognized the relevance of IC, and once understood the scope of the IFRS 3, the expectation is to find a better disclosure of IC in the financial statement. In particular, the recognition of intangible assets in one of these three categories:

- Human Capital: the knowledge, skills, experiences and abilities that employees take with them when they leave the firm.
- Structural Capital: the pool of knowledge that stays with the firm at the end of the working day. It comprises the organizational routines, procedures, systems, cultures, databases and so on.
- Relational Capital: all the resources linked to the external relationships of the firm such as customers, suppliers or R&D partners, plus the perceptions that they hold about the company.

However, as displayed in Tab.2, it was not happened and the “firms have not used the opportunity represented by the IFRS3 to practically apply the suggestions of the IC community.”

	Avarage	StD
Relational capital	9,37%	0,23
Structural capital	2,29%	0,12
Intersectional capital	0,86%	0,88
Unspecified immaterial assets	7,56%	0,20
Goodwill	79,93%	0,31

Tab.2 Data from the firms listed on the Stockholm (SSE) and the Milano Stock Exchanges (MTA/MTAX) on June 19th - Brännström & Giuliani (2009).

It means that goodwill continue to be the “black box” without a clear explanation of its components. We can make just some hypothesis on the reasons for why it has happened: one possibilities is a result of a willing of the entities, which willfully do not want to identify and disclose intangibles considering their strategic nature; another explanation point to the difficulties in the identification and measurement of those

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intangible assets. In any case emerges that, despite the models proposed in IC accounting, which claim to identify strict boundaries to the different categories of intangibles, the reality is different and no clear boundaries of IC component can be shaped.

Furthermore, the weaknesses of IFRS 3 are not limited to an incomplete enforcement of its rules, as described above. But others and maybe several problems arise from the impairment.

B. Problems – impairment

As said at the beginning of this essay, several scholars have argued against the amortization of the goodwill based only on a pre-defined plan.

It was about four decades ago that Gynther (1969) stated that if the goal is to recognize the goodwill for what really it is, the amortization should be made only when it is really verified, and should be one of the evaluations on goodwill, like also a periodical recognition, revaluation and appreciation. Only in this way it is possible present the most relevant financial-position information for external decision makers.

When the International Accounting Standard Board issued the IFRS 3, it seems that those "requests" have been satisfied. But the future has gone a little different. As said just before the hoped clarity regarding intangible assets is already a chimera, and also the impairment process, which replaced the not appreciated amortization, displayed each own weaknesses.

Indeed some of the failure in the paradigm developed under the historical cost, like the theoretical distinction between internally generated and purchased goodwill, are maintained, and other issues are also added. These are: (a) the irreversible effect of an impairment; (b) subjectivity of the process; (c) distorting effects in the allocation on the CGU (Bloom, 2009).

a) IFRS 3 forbid to restore a value, once the goodwill is impaired. The reason is that a future restore is believed an internally originated goodwill, and as such cannot be recognized. However, considering the goodwill as the present value of the streams of increased benefits obtainable in the future from the entity purchased, means that to calculate such present value we need know both the stream, and the rate to discount this stream. If the goodwill is impaired, means that or the streams are diminished, or the rate (which depend of entity's risk) is increased. When occur the latter, it is possible that in the following years the risk return to the previous level. The consequence is that the stream will be equal in all period, the risk that will be the same of when the goodwill was recognized, but the goodwill will decrease, without any economic reason.

b) Impairment is always a subjective process. Indeed both the rates and even more the streams are chosen according to the sensitiveness of the evaluator. Furthermore, the forecasts on which is based the goodwill and its impairment could be subject a manipulation, and they cannot be audited, because no one could say that are true and fair. However if the forecast is revealed not realistic, the impairment as a method to provide useful information, will be considered a failure.

c) The third problem is linked to the use of cash generating units (CGUs) to recognize the goodwill. Indeed the norm says that goodwill shall allocated separately to each CGU. Problems arise when a single CGU is under-performing, in this case in practice we can see that is required to write off the goodwill assigned because the rules did not permit the remaining portion of goodwill to be written up to offset the loss, also if the overall goodwill is far in excess of its book value.

For those reasons, Bloom (2009) is lead to conclude that "there is little, if anything, which would make the current impairment regime worth maintaining".

C. What solution?

However there are some proposal on how enhance the treatment of those matters.

"In the profit statement, entries concerning the revaluation of Goodwill could be shown separately, and at the foot of the statement, so that they could be added back (or deducted) easily by those who might want to do so. Similarly, in the Balance Sheet, the Goodwill item(s) could be included after a subtotal of other assets." This is the sketched proposal of Gynther (1969), toward which he asserts another time the importance of provide information on the entity's financial position to external people that make decision in order to buy or sell or hold the shares. The author, in his old papers, was confident that new analysis and new techniques will be developed in order to evaluate all the assets with a much higher degree of precision than it was possible to his time.

A reinterpretation of this thought, but more structured and well-defined, has been made by Bloom (2009), which has developed the so called "Market Capitalization Statement" (MCS) in an attempt to find a way to furnish useful information about goodwill, without matter if purchased or internally generated.

The MCS is not seen as part of the traditional balance sheet, rather is seen as an independent statement, as the cash flows statement. Furthermore, this statement make more sense if related not to the performance of a single entity, but rather to performance of the whole group in which the entity be part, in accounting terms to the consolidated statement.

The underlying idea is that the value of a company can be approximated to its market capitalization, that could be determined easily and objectively. As consequence, also the drafting of the MCS is quite easy and objective. This statement takes the net value of tangible assets that is the value of balance sheet (which is composed in the same way with the only exception of goodwill and identifiable intangible assets), and separately are shown goodwill and intangibles. The latter are evaluated by the financial statement's drafters. Finally the goodwill attributable to the entity (as said before, entity interpreted as group) is calculated deducing from the market capitalization both the net value of tangible assets, and

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the value of the intangible ones.

Bloom identifies that MCS could lead these ten advantages:

1. Maintains the Balance Sheet in its traditional form (apart from the elimination of goodwill and identifiable intangible assets), for those analysts who consider it useful.

2. Provides, for the first time, information in the Annual Report as to the stock market capitalization of the company at the year-end, which can be directly compared with Balance Sheet carrying values at that date.

3. Highlights variations in enterprise value arising from market fluctuations.

4. Focuses attention on goodwill, even in cases where no goodwill has been purchased.

5. Continues to reflect the amount expended on the purchase of goodwill. If goodwill per the MCS is higher than purchased goodwill, there is a reasonable prima facie case that the value of purchased goodwill has been maintained, using an objective measure, namely, market capitalization. If goodwill per the MCS is less than purchased goodwill, there is a very strong indication that purchased goodwill has been impaired.

6. Does not distinguish between purchased and internally generated goodwill within the MCS, and thus recognizes that in practice they are usually both difficult to separate and complementary.

7. Enables the Balance Sheet to reflect, unambiguously, the book value of net tangible assets.

8. Removes the necessity to amortize goodwill over a period that, in practice, is usually arbitrary, thus relieving the Profit and Loss Account from arbitrary and incorrigible amortization charges, and from abnormal one-time charges resulting from large goodwill write-offs.

9. Removes the necessity to calculate impairment of goodwill, using arbitrary assumptions and subjective forecasts.

10. Indicates the relative importance of goodwill, identifiable intangible assets and net tangible assets as constituents of market capitalization.

In the opinion of the writer, the proposal of MCS could be very innovative. What I have found more interesting is the fact that there is no separation between purchased and internally originated goodwill. Indeed, as motived before in this essay, it seems that the distinction in these two components lake of economic justification. Also the feature that characterize the MCS, namely easy and objectivity, are well appreciated.

However, although in the whole I really appreciate some insight, I think that MCS has some weaknesses. The first point on the first assumption of the model, namely that the market capitalization depict the company's value. If it is true that is an objective value, is likewise true that it is always the same of a company's value?

In my own opinion there is also a second weakness. When Bloom talk about the identifiable intangible assets, do not make anything new than the IFRS 3. As already displayed, although this standard allows the recognition of several intangibles in the practice it is observed a very little application, while the goodwill still remains a "black-box". I have not found something new that could helping in the achievement to the goal of disentangle this black-box.

V. Conclusion

In this short essay has emerged the complexity of this issue, and why is more than a century that, despite several studies, researches, and analysis, is still full of problem and contradictions.

What is possible state with a little degree of certainty is that under the historical cost framework, the attempt to seek a correct method for periodical recognition, revaluation, appreciation and amortization of goodwill is unlikely to succeed. But it is not surprising, if we consider that the major critique moved to the historical cost model is its irrelevance and inability to provide useful information. However the advantages that are usually recognized to the historical cost are present also when we talk about goodwill: it is easy to calculate, it is verifiable and it is objective.

On the other hand there is the boundless word of the current value, which with its magnanimous objective to provide useful information, have continuously to struggle with own weaknesses due mostly to the presence of subjective evaluations. But not only subjectivity is the critique moved against this interpretation: the inconsistence with the practice and the unresolved problem of a recognition of internally generated goodwill are weaknesses already present in applying the norms developed in a current value framework.

The solution represented by the Market Capitalization Statement solves some of these problems, but as argued above, still remain some weaknesses.

End of all, in attempt to answer the question posed in the introduction, I think that does not exists a best way for account goodwill. Rather, exist better and worst ways and it depends on the objective that is assumed for the accounting and so, for the financial statements.

Since the goal of IASB is provide useful information in decision making to financial statements' readers, in my opinion they are following a good path, which could be improved adding the MSC as a new report.

Further researches are required to find a way on how disclose better the component of the goodwill, untangling this "black-box". Regarding the other problem, the absence of objectivity, in my opinion we will not find a solution, and we should accept to cohabit with subjectivity, since that, as state by Gynther (1969): "…objectivity is not a part of theory - it is merely a constraint in the application of theory."31

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Daniele Gervasio is an Assistant Professor of "International accounting” and "Audit and governance" at the University of Bergamo, Italy. He is the author of essays on International Accounting, Accounting History, Auditing and corporate governance.

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