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Goodwill accounting treatments and position on financial statements

KaissSarra *, NezhaBaghar**, Mounime El Kabbouri***

* PhD student at ENCG Settat University Hassan 1st, Settat, kaisssarra@gmail.com

**Professor at the ENCG Settat, University Hassan 1st, Settat

***Professor at the ENCG Settat, University Hassan 1st, Settat

***Absract* -- The paperpresents the changes in the standards SFAS 141 and 142 and IFRS 3 introduced by the IASB and before that by the FASB. Through this article, we will try to bring a deep insight on these changes and than proceed by a comparison of the two standards and finally discuss the difficulties, the advantages and the challenges of auditing towards contributions of the standards in the accountingtreatment of goodwill.More than that, the paper debates the position of goodwill on the financial statements of international firms of high-tech sector since the new accounting had a substancial effect on the information presented and utilized by the financial statement users and analysts.**

***Keywords*--Goodwill, accountingtreatment, Impairment test, Financial statements, fair value, amortization, purchase method, pooling of interest.**

I. INTRODUCTION

With the growing number of acquisitions in an external growth environment in continued emergence, the amount of goodwill has an increasing importance in the balance sheets of major groups at a global scale. The consideration or the goodwill accounting recognition occurs during the acquisition of intangible assets and mainly during business combinations.

Several studies have focused on the goodwill from its defintion and determining its nature to its accounting treatment and its impact on the financial statements.Indeed, accounting definition of goodwill is still a subject of debate around the world. We can define the goodwill completely only if the concept is perceivedfrom the accounting point of view(Henning 2000)

In goodwill accounting, debaters and standard setters had asked diferent questions about the nature of goodwill, the possibility of considering it as an asset, an economic asset, an accounting asset or a wasting asset.

In recent years, several accounting standards were issued by the IASB and before that by the FASB, one of the main changes is eliminating the amortization and opting for the impairment test introduced by SFAS142 and IFRS 3.

From another perspective, it's important to notice that by defining goodwill and determining the accounting treatment clearly we put quantitative impacts on financial statements in order to maintain how to value, impair or amortize and put also effects on stakeholders and capital markets..

In this paper, we will discuss the evolution of goodwill accounting, shed light on the changes introduced by standards and compare the similarities and also the diferences between the European and American standrads. On the other hand, we will give an overview on the position of goodwill on the financial statements.

To ensure the logical sequence of the ideas in this paper, it is important to first start with giving the definition of goodwill, presenting the previous treatment of goodwill and the field will be cleaned to an overview of the changes introduced by the standards in comparison to its past accounting treatment. Finally, the last section will be dedicated to discuss the position of goodwill on the financial statements illustrated in the sector of high technology.

II. RELATED LITERATURE

Subject of controversy for nearly a century, the problem of definition, evaluation and recognition of goodwill resulted in an abundant literature. In the following paragraph, we will try to shed light on literature of goodwill and how researchers have attempted to define itand treat it.

Actually, the defintion of goodwill was a subject of many researches (Bloom 2009, Colley and Volkan 1988, Johnson and Petrone 1998). Still, the concept remainsunclear (Henning 2000, Cooper2007, Courtis 1983). According to Hines 1988, Tompson 1990, an interpretative action is possible when the theoreticaldefinition of goodwill is made and details about itsaccounting are clarified.

As a matter of fact, accounting standards try to bringdetailsneeded to define the goodwill. Thus, studying goodwill in practiceis a part and a parcelofstipulating and applicating its accounting.

Matukavis, 2004 distinguishesbetween 2 types of value of goodwill according to the country to where the firm belongs.

1. In Anglo saxon legalsystems, goodwill isdetermined as being the difference between purchaseprice of the acquiredassets and shares and the market value of the buying in net property.
2. Continental type of country, goodwill isdefined as being the diferencebetween the purchaseprice of acquirer'sassets and shares and the carryingamount of acquirer's net assets.

Actually, severalresearcherswere interested in studying the goodwill accounting change. Indeed, academic research conducted reveal that the accounting under the old standards did not contribute to the information content of accounting data (Brown, Tucker, Pleiffer 1999 and Moehrle, Reynolds-Moehrle and Wallace 2001).In the pastliterature, the accountingtreatment for purchased goodwill isdividedinto 3 points of views, illustrated as below :

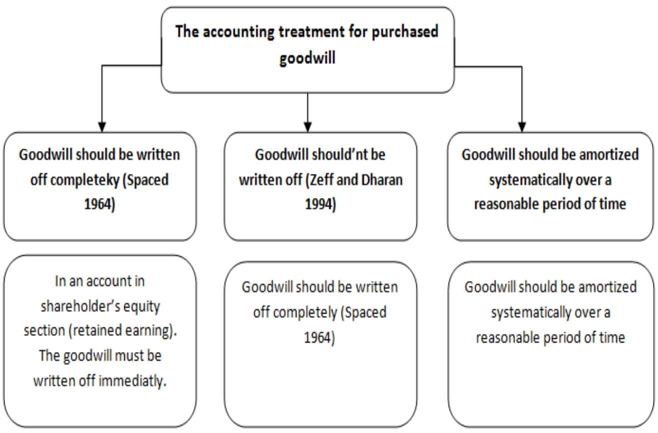

Fig.1: Pasttreatment of purchased goodwill

According to the IFRS From 2005 onwards, companies must carry out a goodwill impairment test. This latter will help to determine with more efficacy any decline in the value of the goodwill compared to the previous accounting treatment (Donnelly and Keys 2002).

Martory and Verdier (2000) attempted to establish a synthesis of practice on the recognition of goodwill under the old recommended instructions.

As far as the american standards are concerned, De Greling (2000) determines the evolution of US rules. After that, Roy(2006) details the remaining differences on the accounting for the impairment of goodwill and IFRS French GAAP.

Finally, Pham (2007) determines the preeminent issues related to goodwill witl the different accounting methods.

The new treatment of goodwill willprovide the analysts and users of financialstatements more and better information on the acquisition and intangible assets (Colquitt and Wilson 2002)

The problemwithaccountingtreatment of goodwill islinekd to the difficulty to identify the measurement and objective reached by accountingit.

III. WHAT IS GOODWILL

Several researchers and practioners have attempted for over a century to define goodwill and determine its treatment. According to H.Kaner in his book « the new theory of goodwill » it represents a « black box » easier to decompose but more difficult to construct.

The IFRS *3 « Business combination »* gives the followingdefinition to goodwill : « An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized».[1]

According to the paragraph 32 under IFRS 3, goodwill, as a going concern valuation, is recorded at the same time of purchase as the remaining between the excess of cost over the fair value of identifiable net assets, which are acquired.

The review of the definition of goodwill leads to the determination of its nature Thus, **Hendriksen (1982:407)**lists three definitions of goodwill designed from an accounting opinion, illustrated as follows:

- **The intangible concept**: the valuation of intangible attitudes towards the firm.
- **The super-profits concept :**the present discounted value of the excess of expected future profits over a normal return on the total investment excluding goodwill;

[1] Definition given by the IFRS 3 : http://www.academia.edu/4248207/IFRS_3_Business_Combinations

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- **The residuum concept:** The excess of the value of the business as a whole over the valuation of its individual tangible and intangible assets.

IV. GOODWILL ACCOUNTING UNDER THE NEW STANDARDS

- **SFAS 142 :**

SFAS 141 wasproduced on February 2001 to remplace ABP 16 in order to movefrom the pooling of interest or purchased method to only the purchased method.Thus, the principal objective of this standard is to improve the comparability of methods of accounting of business combinations.

Besides, SFAS 141 has broughtanother change to the ABP 16 to the extentthatit replaces goodwill amortization by the annualimpairment test.

Actually, Crosara and Zambon (2003)hadstudied the diferencesbrought by the new standard :

- Under the SFAS, The accounting of goodwill isbased on reportingunitsthen the standard betterrecognizes the synergies within the entity ;
- SFAS does not assume that goodwill has an unlimited life, thusitsamortizationdoes not reflect the economic reality of the assets. An impairment test isthereforerecommendedinorder to estimate the value of goodwill annually ;
- SFAS provides more specific and detailed guidelines regarding the impairment test of goodwill ;
- SFAS 142 requires a more completedisclosure for goodwill and other intangible assetssubsequent to their initial recognition.

More thanthat, the SFAS requires more details about disclosure for goodwill (Paragraph 46 of SFAS 142), by givingthese informations on the financialstatements :

-A description of the factorscausing the impairment

- The amount of the impairmentloss and the methodused to calculate the fair value of the relatedreporting unit (valuation technique)

- If the impairmentlossis an estimatethat has not been completedyet, all relative factorslikereasons, nature and amount of the adjustments made to the initial estimate of the loss in future periods.

- **IFRS3 :**

The european commission adopt the IFRS 3 in 2000 requiring all the member states to prepare the financialstatementsstartingfrom 2005 according to the IFRS 3. Actually the IAS 22 wasreplaced by the IFRS 3.

IFRS 3 replaces the amortization of capitalized goodwill by the impairment test following IAS 36 (Impairment of assets) of the book value of goodwill. We proceed by making the comparison between the recoverable amount and the carrying amount of goodwill from CGU. Petersen and Plenborg (2009) revealthat a majority of firmsassess the recoverableamount as the value in use and, hence, estimatesrely on management'sownassumptions related to asset valuation.Besides, the standard abondons the poolingmethod of accounting for the business combinations and insteadopt for the purchasedmethod.

In fact, the method of pooling of interestrecordsassets and liabilitiesbefore the acquisition date based on the book value, therefore, there will be no remaining cost compared to the book value, and no new goodwill isrecorded.However, the puchasemethodrecordsassets and liabilities at fair value. Goodwill is recognized on the basis of the difference between the cost and the fair value of the asset

As defined by IFRS 3, the goodwill isdefined as the differencebetween the purchaseprice and the fair value of identifiable tangible and intangible assets. To this end, internallygeneratedassets must beidentified and listedseparately on the balance sheet(Hadjiloucas and Winter, 2005).

- **Comparing the standards :**

European and americanaccounting standards have manysimilarities in the accountingtreatment of goodwill as illustratedbelow :

TABLE 1:

THE SIMILARITIES BETWEEN THE AMERICAN AND EUROPEAN STANDARDS

European standards	American standards
Purchased method to account for business combinations	Purchased method to account for business combinations
Fair value issued in the accounts	Fair value issued in the accounts

Eliminating the amortizationmethod and introduce the impairmentmethod (Thus, goodwill has an indefinite life)	Eliminating the amortizationmethod and introduce the impairmentmethod (Thus, goodwill has an indefinite life)

- ## Impairment test under the new standards :

Both of FASB and IASB have tried to develop the impairment test. To this end, we are leftwithtwomethods of treatment of the impairment test.

First, according to the FASB, goodwill continues impairmenttesting in two stages. However, the IASB calls for a one single step process. According to Holtermanin 2004, determining the value of assets to depreciate goodwilltakes an important character to complete the test.

❖ *Impairment test under the SFAS 142 :*

Under the SFAS, the impairment is issued in a two-steps process, the figure below illustrates these steps :

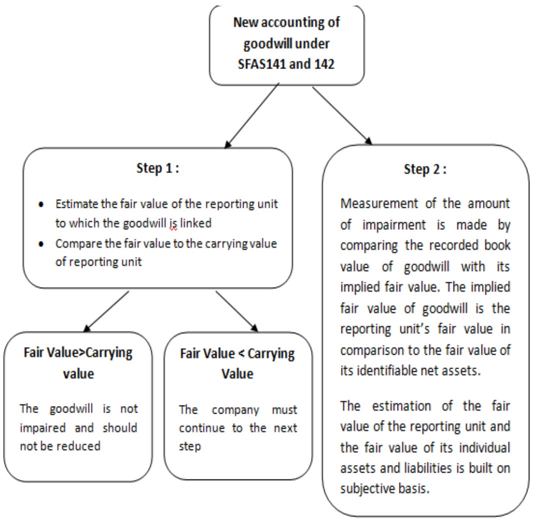

Fig.2: Goodwill impairmenttestunder SFAS 141 and 142

❖ Impairmentunder IFRS :

Under the IFRS, the impairment is a one-step process, the figure below sums up the process :

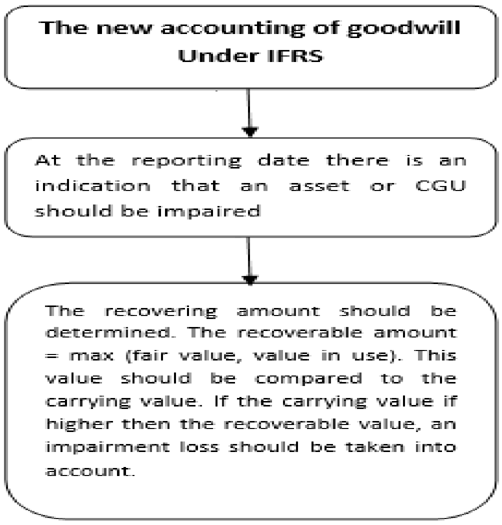

Fig.3: The goodwill impairmenttest under IFRS

❖ *Summary table :*

Analysis of both standards revealed some differences throughout the goodwill impairment process in terms of the process of impairment, its assignment and the value of reporting units versus the cach generating units.

TABLE 2:

THE DIFFRENCES BETWEEN THE STANDARDS IN TERMS OF IMPAIRMENT.

	FASB SFAS	IASB IFRS
Process of impairment	Twostepprocess	Onestepprocess
Impairment assignment	Assigns to reportingunits as an operating segment or a component of operating segment of a business.	Assigns to CGU as the samllest identifiable group of assets that generates cash inflows.
Value of Reporting unit vs CGU	uses the fair value, thus the value in exchange.	uses the highest of the value in exchange and the value in use.

V. POSITION ON FINANCIAL STATEMENTS

In order to betterreflect the position of goodwill in financialstatements, wewilltry to inventoryfirms of high technologysector in american, asian and european areasand makesomeremarks mainly about the position of goodwill on balance sheet so that we can surround the effects of adopting American and European standards as discussed above.

In the following table, we analyze on the balance sheet of each firm the position and significance of the amount of goodwill.

We chose the high-tech sector, as this is a promising sector in the midst of globalization and because of the importance nowadays of the information and intellectual capital. This sector will allow us to better visualize the importance of goodwill on the financial statements of the companies in question. It should also be noted that the selected sample sets its annual reports taking guidance from European and American standards described previously.

TABLE 3:

POSITION AND IMPORTANCE OF GOODWILL REPORTED ON BALANCE SHEETS OF HIGH TECHNOLOGY INDUSTRY (2015)

Name of the company	Title of amount	Amount (year 2015)	Significance (Compared to total assets)	Position in the balance sheet
Apple. Inc	Goodwill	5,12	2%	Second item under after property, plants and equipment
Samsung Electronics	Net goodwill	910,54	0,376%	First item under Intangible assets and preceding net other intangibles
Foxconn	Goodwill	338,19	0,274%	First item under Intangible assets and preceding net other intangibles
Amazon.com	Goodwill	3,76	6%	Second tem after property, aquipment and plant
HP	Goodwill	32,94	31%	Third item after long term financing receivables and other assets
Microsoft	Goodwill	17,87	9%	Third item after equity and other investments
IBM	Goodwill	32,02	29%	Sixth item after deferred taxes
Alphabet. Inc	Net goodwill	15,87	11%	First item under Intangible assets and preceding net other intangibles
Panasonic	Goodwill	461,99	8%	First item under other assets and after intangibles, net
Huwai	Goodwill and intangible assets	2,73	1%	First item under assets
Sony	Goodwill	561,26	4%	Second item under other
Dell	Net goodwill	9 253,00	20%	First item under Intangible assets and preceding net other intangibles
Toshiba	Goodwill and other intangible assets	1 124,61	18%	First item under other assets
Intell	Goodwill	11,30	11%	Fourth item after other long term investments
Alcatel Lucent	Goodwill	3 360,00	15%	First item of goodwill, intangibles assets under non current assets
Nokia	Goodwill	2 563,00	12%	First item after assets, under the non current assets

Upon first glance, we can notice the significance of goodwill on the balance sheets of selected groups, it is particularly companies like HP where goodwill represents a rate of 31% of total assets, followed by IBM with a rate of 29% and then Dell with a percentage of 20%.

Besides, the common position of goodwill on the balance sheets of our group is mainly under intangible assets. It should be mentionned that the logical agencement of assets on the balance sheet is order of liquidity. Indeed, in practice, the items appear in this order, in other words, the list starts with cash and ends with the least liquid asset.

Since, the intangible assets are the least liquid of all assets than it seems logic that intangbile assets and goodwill would appear in the last section of the asset balance sheet. This presentation will help to facilitate the calculation of operating ratios as the intagibles assets will be isolated from the current assets, in other words, this classification will help the finacial statements users, analysts and auditors in order to better evaluate and analyze distinctly the tangible assets firslty and the intangible assets and goodwill on the other hand.

VI. DISCUSSION :

The FASB hadviewed the goodwill'saccountingseveral times. One of the major changes isthat the goodwill accountinghadknownis SFAS 141 and 142 by gettingrid of poolinginterestmethod and eliminating the amortization of goodwill. SFAS 142 suggestsinstead of this latter the test of impairementannuallymaid in order to record the depreciation of goodwill once ayear.

In 2014, the FASB issued the ASU n°2014-02 whichwasdestinated to privatecompanies. Four elementswerediscussed in the meeting of march 2014 :

1. Amortize goodwill over the lesser of 10 years or the estimateduseful life of the goodwill asset ;
2. Amortize goodwill over the estimateduseful life and conductimpairment test as well ;
3. Write-off goodwill at the acquisition date
4. Continueonimpairmenttest instead of amortization

✓ Advantage of the new goodwill accounting

The new treatment of goodwill attempts to give more transparency to financialstatements about the acquisition. The advantages of thisnewtreatmentisthat :

It will help first of all the usersand analysts of fiancialstatements to have better information on intangibles. Actually, the amortization has the inconvenient of beingbased on time period estimation (time estimation islessreliable, Warman 2001) versus the impairmenttestingisbased on actualgoodwill's valuation.Wines and Fergson 1983 argue that in the past, firms do recognize intangible assets to decrease the effect of reported profit on the need to amortizegoodwill.Thus, the new treatment of goodwill will allow better visibility for users of financial statements regarding decision-making.

The logic behind analyzing goodwill impairment at the reporting unit level or even the cash generating unit is that most of the acquired assets and assumed liabilities typically become integrated into the company and are indistinguishable from the companies other assets and liabilities. Therefore, the goodwill is no longer related to just the acquired assets and assumed liabilities but associated with a larger component of the company, or the company as a whole.

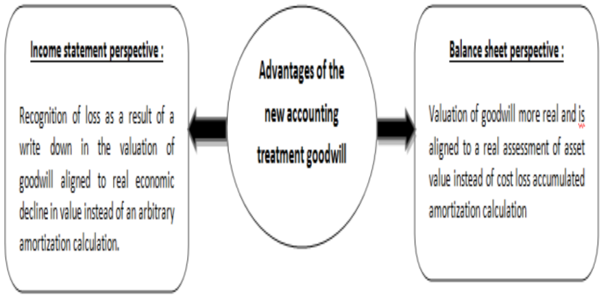

Fig.4: Advantages of the new accountingtreatment of goodwill

✓ Difficultieswith the new accountingmethod

The new IFRS treatment allows a broad creativity in accounting:

First of all, in the way of determining the CGU: In cases where a firm acquires another and the latter has a number of separate subsidiaries divisions or branches, hence, we tend to estimate a high amount allocated to the CGU.

To calculate the recoverable amount we have to calculate fair value less costs to sell and value in use of the unit but the identification of initial CGU could have a strong bearing on those calculations

To put it in a nutshell, major potential difficulties related to the new IFRS Goodwill accounting treatment:

- ❖ Subjectivity and major uncertainties related to identifying the level of recognizing the CGU
- ❖ More time and cost
- ❖ Not representing objective measures for many CGU.

According to Heltzler (2005), for example, in their study find evidence for the fact that the information content of the impairment of goodwill has not improved and at the initial adoption of SFAS 142 it was even weaker compared to the requirements of the previous standard. They also find that write-offs haven't become timelier.

Academic research point out that the implementation of goodwill impairment presents difficulties that could encumber its interest. Herz, Iannaconi, Maines,Palepu, Schipper, Schrand, Skinner and Vincent (2001), Massoud, Raiborn(2003), and Schevin(2005) undermine the benefits of depreciation highlighting the difficulties necessary for its implementation: Definition and breakdown of the CGU.

As far as the IASB is concerned, one of the major difficulty linked to the new accounting using the SFAS is that the two-steps process of impairment is complicated as much as it calls for several concepts, indeed, in the preparation for goodwill impairment some of the key items necessary include: identification of reporting units and carrying amounts, preparation of projections and discounted cash flow models with support of key assumptions and identification of market comparables. Besides, the subjectivity involved in determining the reporting units in the impairment testing makes it complex, time consuming exercise and limits its effectiveness.

- ✓ **<u>Auditing challenges :</u>**

Determining the value of goodwill is a delicatetask for auditors. The intangible nature of the goodwill makesitsdeterminationand the appropriateaccountingtreatmentverydifficult.

On the occasion of a statutory audit engagement, auditors are required to rule on the regularity, sincerityof the results of operations, financial position and the assets of the enterprise at the end of the year. So the first question that arises concerns the quality and sincerity of the information given by the management to the auditors of the economic justification of goodwill's value.

An empiricalstudy, conducted as part of research on the audit of goodwill over 35 CAC 40 companies, has highlighted the weakness of the information given to investors on the "substance" of the goodwill and the lack of accurate information to assess changes in its value over time. Risk areas related to the assessment of the value of goodwill are various, and itdepends on the time of the estimation whetherit's made at the time of entry of the acquiredcompany in the group's scope of consolidation or, over time, takingintoaccount the evolution of its value. In the first case, the determination of the value of goodwillisbased on a fairestimation of the fair value of assets and liabilities of the acquiredcompany. The question thatthen arises is the "quality" of the information given by the leaders of thiscompany on the elementsneeded to assess the value of assets (including on the intangible assets). In the second case, the evolution over time of the value of goodwill is a real problemassessment. Moreover, a major problem arises whenitcomes to appreciate the evolution of the value of goodwill over time, because of the confusion thatis made when the impairment test of the value between goodwill acquired and goodwill measured. [6] Jacques de Grelingdefends the thesis "at the impairment test, wewillmeasure all the acquired goodwill and goodwill recreatedsince the acquisition, as well as internallygenerated goodwill [...] and, in such conditions, itistotallyunrealistic to expectanyimpairment recognition. " It wouldthereforebe impossible to separate the initial goodwill of himthatisrecreated by the new owners.

As far as the goodwill accountingisconcerned, the auditorsmay face the following challenges :

- ❖ The managers or directorsmayrecognize a host of contingent liabilitiesthat,were not previouslyallowable (eg : future construction, reorganization…) and thereforeincrease the amount of goodwill in the accounts ;
- ❖ Auditors must verify The determination of the cash-generating units. Indeed, according to ias 36, the CGUs represent the smallest identifiable group of assets capable of generating cash flowsthat are largelyindependent of the cash-flowfromotherassets or groups of assets) whisharedetermined on subjective basis
- ❖ The assumptions about goodwill valuationused by the management and auditors have to be transparent to users of financialstatements.

VII. CONCLUSION

Academics and researchers have dealt with the subject of goodwillsince the 1890s. Goodwill represents a component that has taken a growing share in the balance sheets of major groups, especially after the growth number of mergers and acquisitions that occur in the 1990s, the accounting treatment of goodwill was the subject of abundant literature.

Throughout the paper, we attempted to provide insight on goodwill and the change in its accounting treatment and discuss the difficulties, advantages and challenges of auditors linked to its new accouting. More than, we tried to study the position of goodwill on financial statements after the adoption of the new standards as we believe that these new rules have had a substancial effect on financial reporting.

As far as the position of goodwill on balance sheet is concerned, we may notice that goodwill should be separated from the other assets and it is proven above that it is wise to distinguish tangible from intangible assets. In the group of firms of high technology studied previously we conclude that the amount of goodwill is increasingly significant throughout the years and that its impairment charge will be of a greater importance on the statements of income needed to evaluate the performance by investors.

We suggest that future studies further explore the effect of the accounting treatment of goodwill on earnings and especially on earning management in relation with the investors expectations (theory of agency).

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