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Goodwill Amortization in the Italian Civil Code: Estimation Poblems and a Methodological Proposal

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Abstract

In regulating the financial statements, the amortization of goodwill represents a complex problem that requires a careful assessment of the economic conditions of the firm and their foreseeable evolution. This study aimed to analyze the topic with specific regard to the Italian context, in order to identify the parameters useful for guiding the amortization processes, in compliance with the limits set by the legislation on financial statements. To this end, the study used a methodology based on the legal-economic analysis of the evolution of Italian legislation from 1882 to today and its effects on the economic valuations implied by amortization. The results show that the accounting for goodwill has changed over time, being characterized in the first phase by the prevalence of conservative accounting and by the consequent need to amortize goodwill in the shortest possible time. Subsequently, the accrual basis prevailed over conservatism, and today the basic rule is represented by the useful life of goodwill. The originality of this study lies in the multidisciplinary approach which, by combining the economic interpretation of the company with the legal rules on reporting, proposes an analysis model applicable in the practice of companies that prepare their financial statements according to the Civil Code.

Keywords: Goodwill amortization, goodwill useful life, legal-economic analysis, Italian companies, Italian Civil Code

Introduction

One of the problems that studies have mostly dealt with in the last twenty years concerns the identification of the best methodology – amortization vs. impairment (Ferramosca & Allegrini, 2021) – for the adjustment of the value of goodwill over time. This debate, still ongoing today (Chatterjee *et al*., 2022; Merrell *et al*., 2021), started with the adoption in 2004 by the International Accounting Standards Board (IASB) of IAS (International Accounting Standard) 36, with which the impairment-test only was introduced in Europe (Schatt *et al*., 2016). Italy too was affected by the introduction of IAS 36. Specifically, in this country there are two main categories of companies: (a) the so-called "IAS-adopter" companies, which, voluntarily or by legal obligation (mainly listed companies), adopt the IAS/IFRS (International Financial Reporting Standards) accounting principles; (b) companies that draw up their financial statements in accordance with the Civil Code, so-called "OIC (*Organismo Italiano di Contabilità*)-adopters", which apply the national accounting standards issued by the Italian Accounting Organization.

In the IAS-adopter companies, the adjustment of the goodwill value over time takes place according to the impairment test method, while in the OIC-adopter companies this adjustment is implemented according to the amortization technique. Despite their comparability (Gierusz *et al*., 2022), the two methods are based on different assumptions. The impairment test requires the annual verification of the existence of impairment losses and the recognition of those ascertained as a reduction in the value of goodwill (Li, 2011). Amortization consists of the gradual and systematic reduction of the value of goodwill, which is widespread over a relatively long period of time (Ding *et al*., 2008). This study refers in particular to OIC-adopter companies and aims to jointly analyze the relationships between the Italian rules contained in the Civil Code and the economic interpretations of goodwill, in order to identify a point of convergence useful for the adequate determination of amortization.

The duration of the period of time within which the amortization must be completed is a central issue for companies that do not use International Accounting Standards. However, although in Italy these companies are numerically prevalent and represent over 99% of the total (Aida Bureau van Dijk database), studies referring to the Italian context, which jointly use legal analysis and economic interpretation, are not particularly widespread. The study therefore aims to fill this research gap, formulating the following research question (RQ):

RQ: what are the economic analysis parameters useful for determining the duration of the amortization period, in the light of the provisions of the Italian Civil Code?

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Although the literature has highlighted the need to commensurate the duration of amortization with the useful life of goodwill, in the history of Italian legislation the rules for determining this duration have undergone considerable changes, thus demonstrating the still considerable complexity of the problem (Clor-Proell *et al*., 2022). This study analyzes the evolution of the issue in legal regulation ranging from the 1882 Commercial Code to the reform of the Civil Code in force since 2016. This reconstruction reflects the importance that in the civil-law countries of continental Europe, to which Italy also belongs, the regulatory provisions assume with respect to society (Varrone *et al*., 2020), in general, and the financial statements of companies, in particular, making the consideration of the regulatory prescriptions essential for the analysis of financial reporting.

In these countries, Codes prescribe pervasive regulations ranging from abstract principles to detailed procedures for applying accounting standards (Kothari, 2000). The financial statements are therefore strongly conditioned by the law, which places numerous constraints aimed at preventing excessive discretion in the evaluation and preparation of the financial reports. It follows that the economic vision of the company and the interpretation of its dynamics must always remain contained within the limits dictated by the rules, and can in no way exceed or violate them. Based on the reconstruction of the regulations in force, the study proposes a model useful for the analysis of the factors that must be taken into adequate consideration to appropriately determine the useful life of goodwill and the duration of the amortization.

Literature review and theoretical framework

Accounting for goodwill is one of the most controversial topics in financial reporting (Shahwan, 2011) whose ancient history dates back to at least the 19th century (Garcia *et al*., 2018). During this extended period, the phases of evolution of the literature were substantially marked by the changes that occurred in the legislation on goodwill and in the accounting standards for financial statements. Since the 2000s, following the introduction of IAS 36, the theories on goodwill have almost abandoned the issue of amortization, favouring the problems associated with impairment. These problems, still particularly topical for unlisted companies in continental European countries, were instead widely dealt with in the forty years between the 1960s and 1990s of the last century, during which the literature provided different interpretations.

According to Hall (1993), the duration of the amortization of goodwill is significantly influenced by the size of the firm and its leverage, while Henning and Shaw (2003) concluded that the duration of the amortization is predictive of the performance – in terms of profits and future stock – that the company that acquired the goodwill will realize after the acquisition.

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Furthermore, Duvall *et al*. (1992) showed how the choice of the amortization duration produces significant effects on the financial statements results, making the information on the criteria of this choice particularly relevant for investors. This result is also confirmed by Jennings *et al.* (2001) who showed how earnings before goodwill amortization are much more expressive of changes in share prices than reported earnings.

Similarly, Escaffre and Sefsaf (2010) showed that the possibility of choosing the length of the amortization period can induce companies to select the one that best suits their interests. However, it seems that the same behaviour has been adopted by companies even after the replacement of amortization with the impairment test, in an attempt to manage earnings volatility (Jahmani *et al*., 2010).

The problem of correctly determining the amortization duration was also highlighted by Ratiu and Tudor (2013), who pointed out that part of the literature suggests analyzing the components of purchased goodwill to avoid setting arbitrary periods. However, the difficulties associated with determining the amortization period do not make this procedure useless or less preferable than the impairment test. Indeed, as demonstrated by Churyk and Chewning (2003), goodwill has a positive relationship with firm value, while amortization of goodwill has a markedly negative relationship with equity values. This therefore reveals that the market appreciates goodwill as an asset of the company that decreases in value over time, and amortization is nothing more than the representation of this decrease.

As illustrated by Waxman (2001), in some cases the duration of goodwill is limited by law, regulation, agreement, or by the nature of the intangible (patents, copyrights, licenses, etc.), so the amortization can be commensurate with that duration. The problem of estimating the useful life therefore arises in cases where there are no limited terms of existence. In these cases, where the duration of goodwill cannot be traced back to the entire life of the company, but is limited in time (Massoud & Raiborn, 2003), the amortization period must be related to the estimated useful life of goodwill. Considering that goodwill expresses the excess income that the acquisition from which it arose will allow to obtain, a valid criterion for calculating the useful life "would be the time period selected by management to compute the present value of the excess earnings or cash flows" (Colley & Volkan, 1988, p. 39). Differently from these positions, part of the literature has also found that the amortization of goodwill (as well as the impairment test) is not necessary but, on the contrary, its elimination would be. The income statement would thus be freed from arbitrary amortization and from the weight of anomalous charges deriving from huge write-offs (Bloom, 2009).

The debate considered above is particularly useful for companies that still today amortize goodwill, such as the Italian ones analyzed by this study,

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and, more generally, such as the European ones that do not adopt the IAS/IFRS. With particular reference to the literature that has analyzed the topic within the Italian context (Ferramosca, 2019), a prominent position is occupied by classical Business Economics (Amaduzzi, 1963; Amodeo, 1951, 1965; Ardemani, 1958; Cassandro, 1950; De Gobbis, 1931, 1935; Masini, 1947; Zappa, 1910, 1920-1929), which this study uses as a theoretical framework. According to Business Economics, goodwill represents an intangible capital composed of factors thanks to which the assets of a company generate income higher than the normal amount. The importance of this definition lies in its ability to identify the elements that constitute goodwill, represented in particular by the excess income that it is able to generate and from which the company that bought it benefits. On closer inspection, in fact, the definition also contains the solution to the problem of determining the amortization period: given that goodwill materializes in the production of excess income, the duration of its usefulness corresponds to the period of time in which such over-incomes will be produced.

Methodology

The methodology used by the study was based on a legal-economic analysis, understood as a combined investigation of the legislation on financial statements with the economic interpretation of the firm. In general terms, the legal-economic approach considers the legal system not as an invariable set of data, but as a part of the economic analysis (Schäfer & Ott, 2022). Starting from this assumption, the method was developed in three phases: (a) the identification of the law provisions on goodwill in force in the period 1882-2022; (b) the derivation of the goodwill formulas from the definitions provided by Business Economics scholars; (c) the verification of the compliance of the formulas under (a) with the law provisions under (b).

As regards phase (a), the study traced the historical evolution of the Italian legislation on goodwill, following Preinreich's conceptual framework (1936). Although not focused on a civil-law system, but a common-law one, this framework was suitable as it analyzed the effects of the legal concept developed by jurists and courts on the valuation and amortization of goodwill. This analysis took 1882 as its starting point since the Commercial Code, which regulated commercial matters in Italy until 1942, dates back to that year. The research then went as far as 2022, in order to understand and interpret, also in the light of past legislation, the rules in force today on the amortization of goodwill.

As regards phase (b), the economic interpretation of goodwill was based on an analysis scheme in line with that of Cosmulese *et al*. (2017), which starts from the definitions of the economic literature to identify the determinants of goodwill. Furthermore, this research adds to the mentioned

scheme the transformation of determinants into formulas. Specifically, the research found that the theoretical framework of Italian Business Economics is based on a fundamental principle, according to which the duration of the amortization corresponds to the duration of the period in which the firm benefits from the excess income.

Based on this principle, the study developed a model of relationships summarized by the following formulas.

$$K\alpha = K_\beta + G \quad (1)$$

$$I_{K\alpha} > I_{K\beta} \quad (2)$$

$$OI = I_{K\alpha} - I_{K\beta} \quad (3)$$

where:
$K\alpha$ = capital of company α;
$K\beta$ = capital of company β;
G = goodwill;
$I_{K\alpha}$ = income produced by the capital $K\alpha$ of firm α;
$I_{K\beta}$ = income produced by the capital $K\beta$ of firm β;
OI = surplus income produced by goodwill.

In particular, formulas (1), (2) and (3) refer to the case of identical capitals K, belonging to two companies, α and β, operating in the same sector, of which the first has goodwill and the second deprive. The three formulas express how the same capital K is able to generate, in companies with goodwill, a higher income than that produced by companies without it, and the excess, i.e. over or surplus income, represents the contribution of goodwill to overall profitability. The considerations made are valid not only with reference to different companies, endowed with capitals that differ only in goodwill, but also in relation to the case of a single company, observed before and after the goodwill acquisition. In this second case, given that the object of the acquisition is not the goodwill as such, but the company as a whole, also the over income obtainable as a result of the acquisition must be attributed to the business acquired, and not only to the goodwill in it incorporated.

For the purpose of determining the economic duration of the goodwill, on which the amortization process is based, it must therefore be considered that the same goodwill may have a useful life to the extent that the business acquired is suitable – as a whole and once integrated into the existing company – to generate excess income in the future. Therefore, considering a firm γ with capital K at time t, before the acquisition of the business, and with capital K_1 at time t_1, after the acquisition, the conditions identified by formulas (4) and (5) occur:

$$I_{K1} > I_K \quad (4)$$

$$OI = I_{K1} - I_K \quad (5)$$

where:
I_K = income produced by capital K at time t;
I_{K1} = income produced by capital K_1 at time t_1;
OI = surplus income produced by goodwill.

In summary, and on the basis of the previous relationships, equation (6) expresses the duration of the amortization of goodwill:

$$A_p = T_n - T_1, \text{ and } (T_n - T_1) \neq \infty \quad (6)$$

where:
Ap=amortization period;
T_1=year of start of the production of excess income;
T_n=year of cessation of the production of excess income.

As regards phase (c), the study verified whether formula (6) had complied with the amortization parameters of goodwill established by law, starting from the 1882 Commercial Code up to today.

Findings

Legal-economic analysis

Through the legal-economic analysis, the study identified the following historical phases:

- the Commercial Code of 1882;
- the Civil Code in force from 1942 to 1990;
- the Civil Code in force from 1991 to 2015;
- the Civil Code in force from 2016 to today.

Furthermore, given that economic interpretation must always respect the limits set by the law, the study verified, for each historical phase, whether the theoretical framework developed by Business Economics – as summarized by the relationship model above – was compatible with the legal framework in force from time to time. This verification made it possible to test the continuity over time of the validity of the proposed relationship model and to demonstrate the applicability of the interpretations of the Business Economics also with respect to the legislation on financial statements currently in force.

The Commercial Code of 1882

The study examined the 1882 Commercial Code through a content analysis which revealed the absence of rules for the evaluation and

amortization of goodwill. Due to this lack (Caratozzolo, 2006), Business Economics explained how goodwill could participate in the production of income (Bianchi Martini, 1996). In Besta's theory (1909), goodwill represents an additional component of the firm's value, which adds up to the other assets, making the company more profitable than the average. In Zappa's thought (1910) we find almost all the basic rules, still valid today (Coronella, 2008) for determining the duration of goodwill:

1) an unlimited duration cannot in any case be admitted, but conversely there is a maximum limit to the amortization process, which coincides with the duration of the company, as envisaged by the social contract;
2) the contingent nature of the factors which together give rise to goodwill makes acceptable the rule, followed in practice at the time, according to which amortization must be carried out in the shortest possible time;
3) in the event that the goodwill does not produce the expected extra income, it must be removed from the balance sheet assets.

Similarly to Zappa, De Gobbis (1931) believed that only the goodwill for which a price had been paid to the seller of the company could be entered in the financial statements, thus excluding internal goodwill, i.e. self-generated by the business. In the interpretation of the scholar, the amortization process should have taken place on the basis of the estimate of the annual super incomes, the number of which was however unknown. Therefore, no general and constant rule could be established for the estimation of the duration and extent of super income. The only fixed rule to be used had to consist in excluding, in any case, that the goodwill could have a perpetual duration, with the consequent obligation to always subject it to amortization, since the series of expected future super income was always limited.

The equation (6)

$$A_p = T_n - T_1, \text{ and } (T_n - T_1) \neq \infty \quad (6)$$

was then verified.

The Civil Code in force from 1942 to 1990

The content analysis of the Civil Code, approved with the Royal Decree of 16 March 1942 and entered into force on 19 April 1942, has provided, as the only regulatory result on the subject of goodwill, the art. 2427, according to which "Goodwill can be recorded in the balance sheet assets only when a sum has been paid for this purpose in the purchase of the company to which it refers, and for an amount not exceeding the price paid. The goodwill value must be amortized over the next financial years, according to the prudent assessment of the directors and statutory auditors".

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Through the art. 2427, goodwill then obtained a specific regulation, in which the same basic canons developed twenty years earlier by Zappa's theory were found. Given that, pursuant to art. 2427, goodwill had to be amortized according to the prudent judgment of the directors and auditors, the only prescription was the reference to accounting conservatism, while no useful criterion was identified for the quantitative determination of the amortization rates (Amodeo, 1965). For this determination, the only references available to the corporate bodies were therefore the principles of Business Economics, and in particular: a) the expected duration of the extra income; b) conservatism in estimating this duration. From the combination of a) and b) it followed, ultimately, that the amortization should be completed in the shortest possible time, but compatibly with the expectations of future additional income. In fact, by virtue of the goodwill, the company obtains an income higher than the sum of the incomes of the parts that flow into it (Amaduzzi, 1963).

Therefore, the equation

$$A_p = T_n - T_1, \text{ and } (T_n - T_1) \neq \infty \quad (6)$$

was verified.

The Civil Code in force from 1991 to 2015

From 1942 until 1990, the goodwill regulation did not undergo any changes, while a significant revision took place with the Legislative Decree 127/1991, in implementation of Directives 78/660/EEC (European Economic Community) and 83/349/EEC. Specifically, the art. 2426 established that "goodwill [...] must be amortized within a period of five years. However, it is permitted to systematically amortise goodwill over a limited period of longer duration, provided it does not exceed the duration for the use of this asset and adequate justification is given in the explanatory note". The estimate of the duration of goodwill was therefore removed from the determination of directors and auditors, in favour of a conventional criterion according to which the amortization had to be completed within a period not exceeding five years. It followed that the only margins of decision granted to the drafters of the financial statements were limited to: a) the selection of the number of financial years, between a minimum of two and a maximum of five, within which to complete the amortization; b) the choice between fixed or variable amortization rates. It followed that, in this legal context, the preparation of the financial statements did not require questions about the actual useful life of goodwill and the methods for estimating it. In fact, the legal criterion determined the duration of the amortization, limiting the subjective evaluations only to the choices under a) and b).

Therefore, equation (6) was not verified, being possible that:

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$$A_p \neq T_n - T_1, \text{ and } A_p \leq 5 \quad (7)$$

The Civil Code in force from 2016 to today

Since 1991, article 2426 on goodwill has not been modified until 2016, when it was reformed by Legislative Decree 139/2015 according to the version still in force today. The current article 2426 of the Italian Civil Code provides that the amortization of goodwill must be carried out according to its useful life. Furthermore, where, in exceptional cases, the latter cannot be reliably estimated, the amortization must be completed within a period not exceeding ten years. Current legislation thus represents the definitive affirmation of the model that this study has proposed on the basis of the interpretations of Business Economics. Today, the art. 2426 of the Civil Code expressly establishes that the useful life is the main criterion of amortization, and implicitly admits that its estimation can ordinarily be performed on a reliable basis. The hypotheses in which it may prove to be unreliable are in fact limited, by legal presumption, to exceptional situations. Relation (6) is therefore fully verified, but the necessary condition changes, given that the amortization of goodwill must be completed within the maximum term of 10 years.

Equation (6) then becomes:

$$A_p = T_n - T_1, \text{ and } (T_n - T_1) \leq 10 \quad (8)$$

Overall evolution of the period 1882-2022

The results that emerged in the different phases are summarized in Table 1 which covers the entire observed period. Table 1 shows how, in the overall evolution of Italian legislation, the correspondence of amortization to the useful life of goodwill has been the main basic rule. After the exception of the period 1991-2015, it still remains the fundamental parameter today, both from a legal point of view and from a Business Economics perspective.

Table 1. Legal framework and goodwill useful life 1882-2022

Historical period	Goodwill useful life formula
Commercial Code of 1882	$A_p = T_n - T_1$, and $(T_n - T_1) \neq \infty$
Civil Code in force from 1942 to 1990	$A_p = T_n - T_1$, and $(T_n - T_1) \neq \infty$
Civil Code in force from 1991 to 2015	$A_p = T_n - T_1$, and $(T_n - T_1) \leq 5$, or $A_p \neq T_n - T_1$, and $A_p \leq 5$
Civil Code in force from 2016 to 2022	$A_p = T_n - T_1$, and $(T_n - T_1) \leq 10$

Source: elaboration of the author

Discussion

The results of the legal-economic analysis have highlighted how the problem of accounting for goodwill can find a suitable solution in linking the

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duration of the amortization to that of the period in which the company that bought it obtains the excess income. As shown by the study, this criterion combines the constraints imposed by law with the very nature of goodwill, understood as intangible capital whose usefulness is appreciated precisely in the achievement of above-average incomes.

The regulatory constraint has changed over time but the analysis of the evolution of Italian Codes has revealed that some essential elements for the evaluation of goodwill have remained unchanged. These elements are represented in particular by two essential conditions: (a) the law does not allow that the useful life of goodwill is indeterminate or infinite; (b) given that the useful life has a limited duration in time, the criterion that links amortization to this duration is consistent both with the constraint imposed by law and with the hypothesis in which the excess income is destined to run out after a certain number of years. Furthermore, the legal maximum number of years for amortization has changed over time, going from the absence of a limit (the 1882 Commercial Code) to the setting of a purely qualitative limit, dictated by accounting conservatism (the Civil Code of the period 1942-1990), to a maximum limit of 5 years (the Civil Code of the period 1991-2015), up to a limit of 10 years (the Civil Code of the period 2016-2022). This lengthening of the term appears to be in line with legislation that has progressively enhanced the concept of useful life, as opposed to accounting conservatism, according to which the amortization must be completed as quickly as possible, regardless of the duration of the excess income.

The main limitation of the proposed model lies in the confined dimension of the context on the basis of which it was elaborated. In fact, if on the one hand the study contributes to filling the research gap in the Italian legal-economic analysis of goodwill, on the other, the reference to a single country limits the possibilities of generalization to other geographical contexts. Or rather it can be extended only to countries that have legal frameworks similar to the Italian one. However, it is important to underline that beyond the specific content assumed by Italian legislation over time, the methodological scheme on which the model is based is potentially applicable to all civil-law systems, in which the analysis of financial statements cannot regardless of the regulatory provisions. Although, in fact, in these systems, the regulation of the financial statements varies from state to state, some common features still remain unchanged. In this respect, Bushman and Piotroski (2006) have underlined that civil-law systems are similar due to their low legal protection of outside investors. Bédard and Gendron (2010) also have pointed out that in the Germanic and Latin systems the shareholders predominate; however, these systems differ in the influence of banks and families. In addition, this study considered two more commonalities, which stand out in importance: the conservative accounting; the need to interpret and apply the

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rules consistently with the nature of the firm in general, and of goodwill in particular.

Conclusions

In response to the research question, which asks to identify the parameters of the economic analysis useful for determining the amortization period of goodwill, this study has highlighted the centrality of two variables: (a) the usefulness of goodwill; (b) the duration of the period in which this usefulness continues. In relation to parameter (a), the study showed how, according to the conceptual framework of the Italian Business Economics, the usefulness of goodwill is expressed by the capacity of a given capital to generate excess income. In particular, formulas (1) to (3) express the surplus income produced by the capital of two different companies, one of which has goodwill and the other does not. Formulas (4) and (5) express the surplus income produced by the capital of a given company, before and after the purchase of goodwill. As regards parameter (b), its definition is strictly dependent on (a), given that, if the utility of goodwill is represented by its ability to produce excess income, the duration of this utility will go from the moment in which the excess incomes arise to the one in which they cease. This duration defines the useful life of the goodwill and measures the duration of the amortization period. From these observations derives the formula (6) which summarizes the economic parameters implied by the research question. More specifically, formula (6) identifies the duration of the amortization of goodwill in the number of years between the moment in which the production of excess income begins (T_1) and the moment in which this production ceases (T_n).

The analysis highlighted how the model developed by this study on the basis of the principles of Italian Business Economics has shown continuous interpretative validity over time. While, in fact, during the period regulated by the Commercial Code of 1882, this model represented the only conceptual framework available for the interpretation and accounting of goodwill, in the following years the rules on the financial statements have imposed more stringent and precise constraints. However, the model has retained its methodological effectiveness, continuing to serve as a guide for estimating the useful life and the amortization period. The exception to this continuity is the period 1991-2015, during which the law was totally detached from the concept of useful life, or was implicitly based on the assumption, rather unlikely, that the useful life of goodwill could not exceed five years.

This circumstance can be explained as the consequence of a historical period in which the European accounting harmonization process (Doni, 2013; Kaduku, 2012), despite having taken a decisive start, was still strongly linked to conservatism and still openly detached from international practice, which

instead already dealt with the life of goodwill and impairment testing. It is therefore not surprising that the 2016 reform, born with the aim of opening up to international best practices, has finally recognized explicitly – i.e. in the text of the law – the criterion of the useful life.

The study carried out can provide a contribution to the literature on goodwill, especially thanks to the identification of a model that has interpreted the entire legislative evolution following Italian unification in an economic key. Today this model is applicable even more than in the past and confirms how the combination of legal and economic analysis can lead to results that are useful for theory and practice.

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