A C A D E M Y

Format of Financial Statements: a trend analysis

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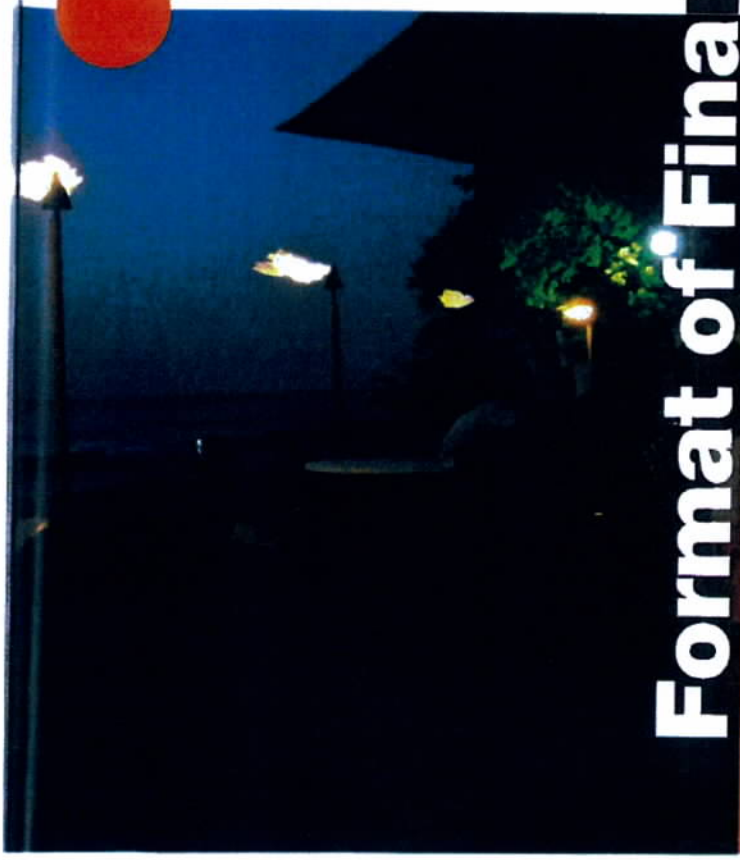
This work focuses on the format for the three main statements: the balance sheet, the income statement and the cash flow statement, with the aim of determining so far the degree of implementation of the IFRS



1. RESEARCH METHODOLOGY

Until January 1, 2005, an entity was required to prepare its balance sheet and income statement in compliance with articles 2424 and 2425 c.c., while full discretion was allowed in the preparation of the cash flow statement. The document analysis of 2003 and 2004 financial statements, therefore, allowed to draw interesting conclusions with reference to the cash flow statement only. During these years, in fact, all the tested entities prepared their balance sheets and income statements in compliance with law requirements. On the contrary, the analysis of 2005 half-year reports and of 2005 financial statements allowed to figure out the impact of IAS/IFRS regulations on the preparation of the three annual reports.

2. COMPANIES BEHAVIOUR WITH REGARDS TO BALANCE SHEET AND INCOME STATEMENT

2005 half-year reports are, as mentioned above, the first useful document to understand whether and how Italian entities applied new IFRS. Furthermore, the comparison of 2005 financial statements and 2005 half-year reports clearly shows transition to IFRS has been almost completed.

In half-year reports and despite legal requirements, 24% of the tested entities still submits a *balance sheet* compliant to law requirements, while 6% does not even include any balance sheet in the half-year report. The remaining 70% of the documents analysed, instead, is IAS/IFRS compliant. All 2005 financial statements, on the contrary, include a balance sheet that is compliant to IFRS.

Classification – According to IFRS, it is then possible to classify an entity's assets and liabilities on the basis of two alternative methods – current/non-current or liquidity/solvency – while IAS 1 explicitly encourages using the first method. The reading of 2005 half-year reports and of 2005 financial statements, excluding the formal disclosure of the aggregates in financial statements, does not allow to understand what option the entities adopted. As regards 2005 half-year reports, 66% of the entities, nominally submitting IAS/IFRS compliant balance sheet classifications, does not either provide any comment in the notes to the financial statements on the criteria adopted in the preparation of the statement, or disclose the meaning of the "current" label used in the balance sheet. The remaining 34% simply informs that IFRS have been complied with, in this case too, with hint to which of the two criteria has been used. If 2005 financial statements are to be taken into account, the level of information neatly improves. The percentage of entities reporting compliance with IAS/IFRS increases up to 62%, while the remaining 38% does not depart from its 2005 half-year report position. This lack of information may partially result from the fact that, according to the accounting standard, should the operating cycle not be clearly identifiable, a conventional period of twelve months may be considered – thus conforming the first method to the second.

Minimum content – IAS/IFRS provide for a minimum content to be included in the balance sheet. The analysis performed on 2005 half-year reports highlights that 57% of the entities submitting balance sheets duly meets IFRS requirements, providing all the required information.

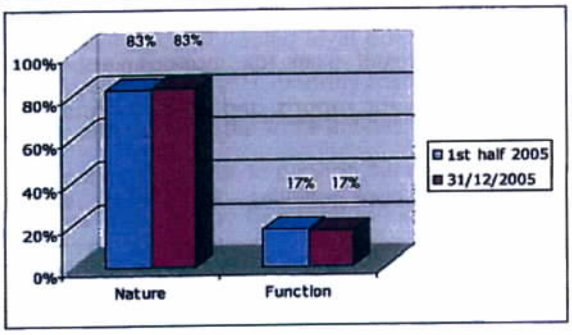
In the remaining 43% of the cases, the entities omit one or more information: admittedly, in almost all cases, the separate indication of investment property. The omission, in some cases, may simply be due to the fact that such category of asset does not exist, thus leading the entity not to report separately the investment property item, assigning it the value "zero". Anyway, also in this case, the analysis of 2005 financial statements shows a strong trend towards better alignment to IFRS. In particular, 85% of the entities meets IAS/IFRS requirements.

As it may have been expected entities opting for the new balance sheet format opted for the new format also for their *income statements*. Under the structural perspective, IAS/IFRS income statement must be prepared in a scale format (one column), with costs alternatively classified "by nature" or "by function". The IFRS does not explicitly encourage either one classification or the other. As shown by the following *Chart*, both in 2005 half-year reports

and in 2005 financial statements, a fair 83% of tested entities opted for the classification by nature. This option is certainly the consequence of the fact that this principle is widely similar to that already used in the past in the preparation of statutory statements.

Classification – It may be worth observing, *a contrariis*, that only in 17% of cases, did entities change their formats by choosing the classification by function, therefore, classifying costs by the usage of the several production factors and conditions in the different activity areas of the entity.

Income statement: classification criteria



Limitation of the figure may arise from a series of factors:

a) entities do prefer the classification by nature;

b) the choice has been put off in the future;

c) entities are not provided with the information required for the preparation of the statement as they do not avail themselves of an adequate management information system.

Minimum content – Also for the income statement, IAS/IFRS provide a minimum content. This provision is fulfilled, in 2005 financial statements, by 91% of the entities and, in 2005 half-year reports, by 77% of the entities adjusting to new provisions.

It should be highlighted, however, that, in determining such percentage, account was also given of the entities including the item "income from associated undertakings " in their income statement, with no explicit reference to the origin of the same (dividends, reversals, disposals, etc.), as well as of those entities posting finance costs net of financial income. In this regard, it should be noted that, if separate indication of the amounts connected to revaluation of investments in associated undertakings had to be regarded as essential in assessing their same value with the equity method, the percentages reported would fall, in 2005 half-year reports, down to 46% and, as regards same year financial statements, to 38%.

Likewise, had separate indication of finance costs to be regarded as fundamental, the percentage would fall to 51% in 2005 half-year reports. In 2005 financial statements, this trend is reversed and the percentage of entities indicating the result from financing management in the income statement grows up to 98%.

Under the current statutory regulations, if we do not consider IFRS, financial statements are first "classified" according to Civil Code provisions and then "re-classified" by the reader who wishes to analyse and assess the profitability of the entity according to the management format. Preparation of the statements according to the new accounting regulations, IFRS, gives than the chance

to publish most significant income statements, allowing financial statements readers a convenient and immediate understanding of the income management contribution to the results for the year. Indeed, the disclosure of the result from ordinary core activities and its separation from the result from ordinary non-core activities are fundamental.

Core & complementary activities – With regard to 2005 half-year reports, 97% of the entities under scrutiny report such result, but separate indication of the result from complementary activities is available in 57% of the cases only. Such information has been considered available when entities provide separate indication of finance revenews. This means, for example, that rent receivables on non-instrumental investment property are reported within the entity's ordinary activities rather than in a separate section of the statement. In 2005 financial statements, the result from ordinary core activities is provided by all the entities analysed, but 11% of the entities only expressly reports the result from ordinary non-core activities.

Interests payed – An innovation with respect to the past is the IFRS request for the disclosure of the amount of finance costs, thus offering immediate information to the reader on the trend of the entity's financing activities. In 2005 half-year reports, this disclosure is providedby 51% only of the entities: many entities directly report the total financial income and expenses in the statement. 2005 financial statements, instead, show an almost complete implementation of the international provision: financial expenses are disclosed in 96% of the cases.

Extraordinary items – According to IAS/IFRS, then, all the components are generated by the entity's ordinary activity, thus prohibiting separate indication of ordinary and extraordinary income items. When preparing 2005 half-year reports, 6% of the entities does not comply with this provision, while compliance is full in 2005 financial statements.

Taxes – It may be finally worth highlighting that the disclosure of taxation and, consequently, of the result from tax management is required by both IAS/IFRS and statutory statements. It is not surprising, then, to see that almost all entities disclose the result from tax management, both in 2005 half-year reports and in 2005 financial statements.

Breakdown of core activities – In half-year reports and in annual financial statements, part of the entities adopting IAS/IFRS included further breakdown of the result from ordinary core activities. In half of the cases (43% in 2005 half-year reports and 51% in 2005 annual financial statements) gross operating margin (GOM) and/or added value have been disclosed; in a more disregardable percentage (17% in 2005 half-year reports and 13% in 2005 annual financial statements) the gross industrial income has been determined and the contribution margin in a highly irrelevant percentage (6% in 2005 half-year reports and 4% in 2005 annual financial statements).

3. COMPANIES BEHAVIOUR WITH REGARD TO CASH FLOW STATEMENT

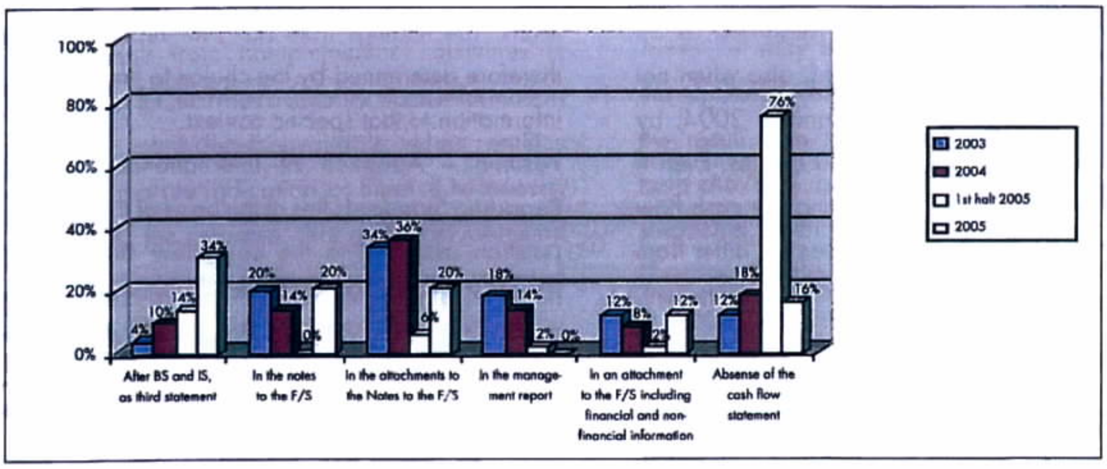
Relevance & status – The first focus point analyzed was the degree of relevance granted to the cash flow statement in the reporting period by the entities tested is considered than whether the cash flow statement could be found in both the consolidated financial statements and the Parent Company financial statements, when both were submitted. The result is extremely interesting. The cash flow statement is no doubt regarded as an important document: it is prepared, also when not required by IAS/IFRS, in 2003 and in 2004, by a significant percentage of the 50 entities. Even if the percentage of entities submitting the cash flow statement at consolidated level does not differ from that submitting Parent Company cash flow statement, often these are not the same entities. This means that some entities choose to provide the information only at one level. It may be useful to highlight that also widening the scope of the analysis to encompass all 191 entities, the result for 2003 does not change in any respect, standing at 88%, both when analysing consolidated financial statements and financial statements. In 2005 half-year reports, a substantial change emerges no doubt due to IAS/IFRS compliance becoming a law requirement. Therefore, the percentage of entities preparing cash flow statement at consolidated level grows, though not reaching the totality of the sample, while the number of entities preparing Parent Company cash flow statement falls by a fair 60%. In 2005 financial statements, cash flow statement is submitted both in the consolidated financial statements (96%) and in the Parent Company financial statements (84%). Limiting the analysis to 2005 half-year reports, a somehow perverse effect emerges: the entities, assessing and implementing the procedures required by compliance with the new and complex accounting regulations, abandon or, at least reduce, that information which is not strictly mandatory. 2005 financial statements, however, mark a u-turn taking the percentage back to previous years levels. The findings from half-year reports appear therefore determined by the choice to limit optional information to that specific context.

Position – Adoption of International Financial Reporting Standards lies at the basis of the different position assigned to the cash flow statement in financial statements as well as in consolidated financial statements. The International Accounting Standard, IAS 7, indeed provides for the cash flow statement to be included as third statement, while the national accounting principle no. 12 do require the cash flow statement to be included in financial statements, though assigning it to the notes to the financial statements. The following *Charts* show that, in 2003 and in 2004, cash flow statement was submitted in most of the cases as an attachment to the notes to the financial statements, within the notes to the financial statements themselves or within the management report. On the contrary, 2005 half-year reports and 2005 financial statements include the cash flow statement as third statement of the financial statements, after the balance sheet and the income

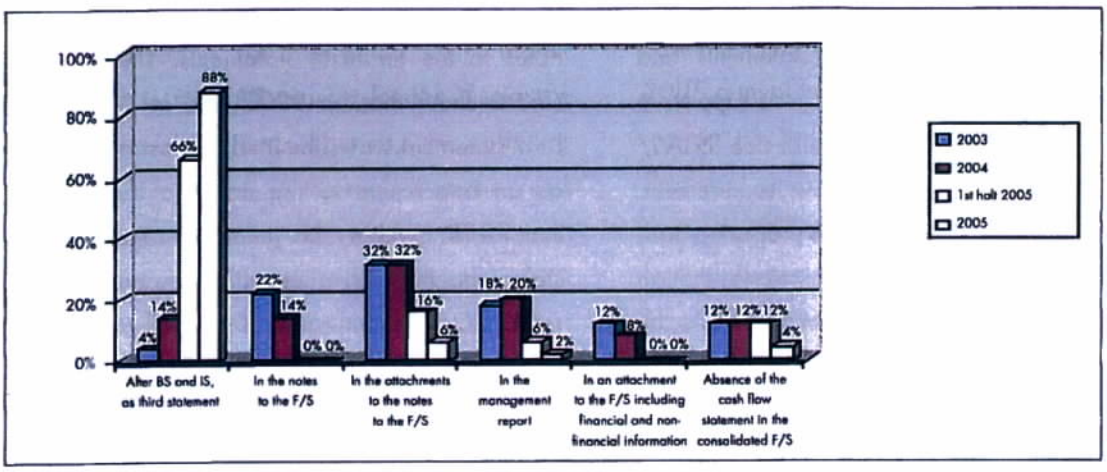
statement. This change is confirmed by the analysis of consolidated financial statements, where this option has been chosen, as regards 2005 half-year reports, by 66% of the 50 entities posting an increase by 54% from previous year and, as regards 2005 financial statements, by 88% of the entities with a further increase by 14%. A different attitude emerges when analysing Parent Company's documents: this choice has been made by 14% only of the entities in 2005 half-year reports and in 2005 financial statements by 31% of the entities.

Next part of the analysis, consistently with that reported in the previous paragraph, will make exclusive reference to consolidated financial statements.

Position of the cash flow statement in financial statements



Position of the cash flow statement in consolidated financial statements

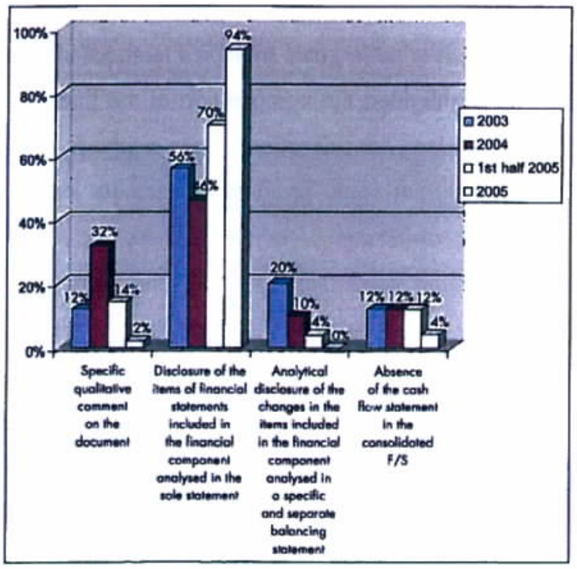


Financial flow to be investigated – As already mentioned, IAS 7 requires the preparation of the cash flow statement to be made with reference to liquidity and, more precisely, to the "cash and cash equivalents" item. Such uniformity may not be found in Italian accounting standards. Document no. 12, indeed, reads as follows: «the cash flow statement in terms of liquidity, and particularly those in terms of cash and cash equivalents, is currently granted increased financial information value than the cash flow statement in terms of working capital, the latter, though, remaining a valid instrument». Assonime, with circular no. 14 of 11 February 1986, more clearly encouraged the preparation of a «cash flow statement in terms of liquidity», highlighting the poor relevance of the changes in net working capital for the interpretation of the entity's solvency. So far the Legislator fails to give precise instructions on the matter, just like national accounting principles fail to provide consistent solutions, thus leaving room, in the past, for inconsistent treatments adopted by Italian entities. On the contrary, as arising from the results obtained the need to achieve compliance with international standards, led to achieve homogeneity in a rather short time. In 2003 financial statements, only 48% of the tested entities prepared a cash flow statement based on liquidity, percentage increasing by 14% in 2004, scoring 88% in 2005 half-year reports and 96% in 2005 financial statements. At the same time, the percentage of entities opting not to conform to IAS/IFRS provisions fell from 40% to 26%, setting almost to zero in 2005. In other words, in half-year reports and in 2005 financial statements, all the entities preparing the consolidated cash flow statement referred the analysis to cash and cash equivalents.

Breakdown of the financial flow to be investigated – Consolidated cash flow statements obtained from 2003 and 2004 financial statements have often been prepared with "free" reference to different financial aggregation of items. In particular, from the analysis, it emerges that different labels have been used for financial aggregation of items actually homogeneous in their composition. Likewise, identical labels have sometimes been used for financial aggregation of items subsequently turning out to be of very different composition. In such a context, as information were not available to the reader on the composition of the financial aggregation of items analysed, the interpretation of cash flow figures were highly difficult and comparisons could be risky. The following *Chart* shows whether, and by which method, the 50 entities highlighted the composition of the financial item taken into consideration. Three methods have been identified: some financial statements include a specific qualitative comment; others include a separate and a dedicated balancing statement; in others, the composition of the component has been disclosed within the cash flow statement itself. 2005 half-year reports show that separate qualitative comments and specific and separate balancing statements have been widely replaced by an higher complexity of the cash flow statement. The

trend is confirmed by the analysis of 2005 financial statements, where the percentage of entities opting for this solution reaches 94%. This is no doubt due to international standards which require the balancing of the cash & cash equivalents – with changes in stock values of the financial component analysed – to be included at the bottom of the cash flow statement. As already mentioned, in 2005 all the entities preparing consolidated cash flow statements opted to refer the same to liquidity as defined by IAS/IFRS: in this new context, the reconciliation, though no longer necessary for the understanding of the composition of the financial statement, as in 2003 and in 2004, preserves its centrality, as it allows to ascertain the correct implementation of the standard adopted by the entity.

Disclosure method adopted for the financial flow to be investigated



Method used for the identification of the cash flow from operating activities – An effort has been made to understand which method, among the ones suggested by IFRS, has been followed by entities when identifying their cash flow operating activities. The findings are unmistakable. Over the three years – 2003, 2004, 2005 – all the entities preparing cash flow statements used the indirect method. It is worth reminding that IAS 7 encourages presentation of cash flows from operating activities using the direct method, as this provides useful information in estimating future cash flows, information which is not made available through the indirect method. Clearly, this indication has not been followed. The reasons may lie in the greater difficulties met in preparing statements through the direct method or, perhaps, in the widespread use of the indirect method by Italian entities. In this light, it may be interesting to make reference to the analysis carried out in 2003 on all the 191 tested entities. Only 3 financial statements out of the 191 assessed (i.e. only 1.5% of the cases) showed the direct method.

Disclosure of the contribution of different operating activities by functions – The objective was to understand whether the entities analysed prepared their cash flow statements reporting cash flows from operating activities reclassified by function, indicating, thought using the indirect method, the contribution of the different activities – ordinary and complementary and/or finance and tax – to the general income trend. The findings seem interesting. While in 2003 financial statements, only 6% of the statements analysed (up to 4% when

considering all the 191 entities analysed) showed this re-organisation, in 2004 the percentage increases up to 50%, finally reaching 68% in 2005 half-year reports. 2005 final figures confirm the trend of the half-year reports, taking the percentage to 96%. IAS/IFRS influence proves once more crucial. International standards encourage separate indication of items but they mainly are tax and interests paid.

Format adopted – In Italy the label "Prospetto Fonti & Impieghi" meaning "Source & Application of funds Statement" is a label generally used to refer to the cash flow statement. Such expression refers to a disclosure of the items according to a two column format, in all respects different from the format provided by both Italian accounting principles and IFRS. The analysis performed allows to observe that this habit has been gradually abandoned over the period considered: while in 2003, 4% of the entities prepared a two column section statement, this percentage falls to 2% in 2004, then setting to zero in 2005 half-year reports and 2005 financial statements. It may be worth observing that 2003 figures, considering all the 191 entities, show that two comlumn section cash flow statements were submitted by a higher percentage of entities: 9%.

Separate indication of cash flows from material changes in equity – In Italy, where shareholding is scarcely spread and where governance of even listed entities is characterised by pivot shareholders and by a limited floating, it may be useful to understand whether the entities provided separate indication of cash flows from changes in equity in their cash flow statements. IFRS, as well as the national, do not allow this option and broadly classify as cash flows from financing activities both those from loan operations with third parties and those from operations on equity. This assumption comes from the idea that the lenders and shareholders can be considered, from a financial point of view, as "cash flow sources". The second ones – the shareholders – are not assigned any particular or different relevance in respect of the first ones – the lenders: both pay or receive money from the entity. It may be worth pointing out that, both in 2005 half-year reports and 2005 financial statements, despite precise indications provided by accounting standards, 20% of the tested Italian entities continued providing separate indication of the operations impacting on equity.

4. CONCLUSIONS

The analysis of the documents showed that much has been done by the majority of the entities under scrutiny, even though a not negligible minority – approximately a third when considering the balance sheet and the income statement – postponed adoption of the new formats to the end of 2005. The comparison between 2005 half-year reports and 2005 financial statements shows that the examined entities gradually adjusted their statements to achieve compliance with IFRS.

Focusing now on the balance sheet and the income statement, there appear to be improvement room in the information collected. It emerged that the minimum content required by IAS/IFRS is sometimes

not available, though the exceptions are often merely formal. Also where statements include all and any mandatory items, a significant omission is to be found with reference to balance sheets. There is no document expressing the classification principle adopted, as it is not clear whether the "current" label used in the statements actually refers to assets and liabilities that are receivable/due in twelve months, or to assets and liabilities falling within the operating cycle. The above omission leads the reader to assumptions that may not be effectively verified, i.e. that all the items grouped under the "current" aggregate answer to both criteria.

Finally, it comes as a surprise the fact that many entities do not avail themselves of alternative formats allowed by new regulations. This is particularly true when one considers the options allowed for the income statement and, particularly, when assessing the consistency of the statements received with the provision (paragraph 83 of IAS 1) to report additional line items, headings and subtotals aimed at offering financial statements readers an effective understanding of the entity's economic trend. The above mentioned paragraph leaves the subject preparing the financial statements completely free to choose among the well-known formats provided by national and international regulations. Only some of the tested entities report reorganisation of the result from ordinary activities. In these cases, the most used format is the added value one, no doubt the format that may be regarded as the only one consistent with the classification by nature used by the majority of the tested entities, as well as the closest, upon preparation, to the statutory income statement. Few entities measure themselves with the preparation of an income statement classified by function.

When moving on to the current status of the cash flow statement, the analysis provides more than satisfactory results. From 2005 half-year reports already, it clearly emerges that the statement has been granted an unprecedented relevance. In a significant number of cases, in fact, the statement can be found in financial statements as third document, together with the balance sheet and the income statement. Furthermore, all the entities preparing it comply with the international standard, both with regard to the format and to the financial flow to be investigated. One peculiarity only should be highlighted, i.e. the priority given by all the entities to the indirect method of income cash flow assessment, despite IAS 7 encouraging using the direct method.

In conclusion, on the basis of the investigation it may be observed that the majority of the entities required to, duly dealt with the problems connected with the preparation of the new statements. The first balance sheets, income statements and cash flow statements prepared according to the new regulations, though not perfect, appear, in comparison with past statutory statements, more concise, easier and, above all, allowing immediate analysis of the liquidity, of the soundness and the profitability of the entity. Finally it may be suggested that the most significant innovation brought in by the adoption of IFRS is precisely the increased availability of and access to information.