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IMPROVING BUSINESS REPORTING: NEW RULES, NEW OPPORTUNITIES, NEW TRENDS

a cura di
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CHAPTER 13
ADOPTION OF IAS/IFRS IN ITALY: FORMAT OF FINANCIAL STATEMENTS. A TREND ANALYSIS

PATRIZIA RIVA (*)

1. – IAS/IFRS FINANCIAL STATEMENTS: BALANCE SHEET, INCOME STATEMENT AND CASH FLOW STATEMENT

According to the International Accounting Standard, IAS 1 (*Presentation of financial statements*), financial statements prepared in compliance with International Financial Reporting Standards issued by IASB must include the following documents: balance sheet, income statement, statement of changes in net equity, notes to the financial statements and cash flow statement. Each document is a component of the financial statements prepared according to IAS/IFRS and must be submitted by the entity regardless of the company type and size. 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 both the degree of implementation of the International Financial Reporting Standards and the main effects on management, organisation and information flow.

1.1. – *Balance sheet format*

International Financial Reporting Standards do not impose a rigid and binding balance sheet format (1). This choice, consistently

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(1) For further information, reference can be made to ANDREI P., "La struttura e il contenuto del bilancio d'esercizio", in AZZALI S. (cured by), *L'informativa di bilancio secondo i principi contabili nazionali e internazionali*, Giappichelli,

adopted also with reference to other documents included in the financial statements, leads to the definition of a "minimum content" that must be provided for the classes of items at year end (2):

a) property, plant and equipment;

b) investment property;

c) intangible assets;

d) financial assets (excluding amounts shown under (e), (h) and (i));

e) investments accounted for using the equity method;

f) biological assets;

g) inventories;

h) trade and other receivables;

i) cash and cash equivalents;

j) trade and other payables;

k) provisions;

l) financial liabilities (excluding amounts shown under (j) and (k));

m) liabilities and assets for current tax;

n) deferred tax liabilities and deferred tax assets;

o) minority interest, presented within equity;

p) issued capital and reserves attributable to equity holders of the parent;

q) assets classified as "held for sale" and assets included in the disposal groups classified as "held for sale" in compliance with IFRS 5;

r) liabilities connected to the disposal groups classified as "held for sale" in compliance with IFRS 5.

Starting from the above minimum content, it must be assessed whether, and to what extent, additional line items, headings and subtotals should be added, to be able to provide financial statements users with an effective understanding of the financial position of the entity (3). Aiming to reach this same goal, items nominally pertaining to the same class of values but calculated according to different

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Torino, 2005.

(2) IASB, *IAS 1 – Presentation of Financial Statements*, paragraphs 68 and 68A.

(3) IASB, *IAS 1 – Presentation of Financial Statements*, paragraph 69.

principles shall be separately indicated in the balance sheet (4). According to IAS 1, some analytical information may be reported directly in the balance sheet or, alternatively, in the notes to the financial statements; in any case, the option to proceed with further subclassifications, as of paragraph 75 of IAS 1, must be considered depending on their size, nature and function within the specific context of the entity. This option ultimately applies to tangible assets, to receivables, to closing inventories, to provisions for risks and charges and to ideal components of the net equity. Finally, it should be noted that either the balance sheet or the notes to the financial statements must also provide analytical information for each category of shares (number, par value, number of shares issued and fully paid, and issued but not fully paid, rights, preferences and restrictions attaching to the different classes of outstanding shares, own shares held by the entity), as well as on the nature and function of the different reserves included in the net equity (5).

From a structural perspective, according to the International Financial Reporting Standards, an entity's assets and liabilities may be classified on the basis of two alternative principles:

1. *current/non-current*: this classification is based on the separation of assets and liabilities by their current and non-current quota, considered the operating cycle of the entity (time elapsed from the acquisition of production factors and monetary collection of results from sales); should the operating cycle not be easily identified, a conventional period of twelve months is assumed;

2. *liquidity/solvency*: in this case, equity assets and liabilities are classified from a financial perspective, in order to breakdown short-term and medium/long-term receivable (assets) and payable (liabilities) items.

IAS 1 neatly encourages the first classification method ("current/non-current"), also adding that the alternative method may be used in particular industries (for example, by financial institutions) or when other specific circumstances make information provided by financial principles of classification reliable and more relevant. Regardless of the principle adopted, for each category of items posted

(4) IASB, *IAS 1 – Presentation of Financial Statements*, paragraph 73.

(5) IASB, *IAS 1 – Presentation of Financial Statements*, paragraph 76.

in the balance sheet separate indication must be nonetheless provided of the receivable / payable quota due by twelve months after the balance sheet date or beyond.

Non-current assets	*Net Equity*
– Property, plant and equipment	– Share capital
– Investment property	– Share premium reserve
– Goodwill and other intangible fixed assets with undetermined useful life	– Revaluation reserve
– Other intangible fixed assets	– Other reserves
– Shareholdings	– Retained earnings (losses)
– Other non-current financial assets	– Profit (loss) for the year
– Trade receivables and other receivables	*Non-current liabilities*
– Deferred tax assets	– Outstanding bonds (non-current quota)
	– Non-current payables to banks
	– Other non-current financial liabilities
	– Provisions for risks and charges
	– Staff provisions
	– Deferred tax liabilities
Current assets	*Current liabilities*
– Trade receivables and other receivables	– Outstanding bonds (current quota)
– Inventories	– Current payables to banks
– Other assets held for sale	– Trade payables
– Works in progress	– Advances on works in progress
– Other current financial assets	– Other current financial liabilities
– Cash and cash equivalents	– Current tax payables
	– Other current payables
Total assets	*Total equity and liabilities*

Chart 1.
Balance sheet according to International Financial Reporting Standards.

In order to classify current assets and liabilities, IAS 1 identifies the following alternative principles:

1. Current assets:
   - expected to be realised in, or intended for sale or consumption in, the entity's normal operating cycle;
   - held primarily for the purpose of being traded;
   - expected to be realised within twelve months after the balance sheet date;
   - consisting in cash or cash equivalents.
2. Current liabilities:
   - expected to be settled in the entity's normal operating cycle;

- held primarily for the purpose of being traded;
- due to be settled within twelve months after the balance sheet date;
- the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date.

Considered all the above, the balance sheet prepared in compliance with IAS 1 may appear as shown in *Chart 1* (6).

1.2. - Income statement format

As previously pointed out with reference to the balance sheet format, also for the income statement International Financial Reporting Standards do not provide binding format and content, rather identifying a reporting "minimum content" (7). At least the following items must be included:

a) revenue;

b) finance costs;

c) share of the profit or loss of associates and joint ventures accounted for using the equity method;

d) profit (or loss) before taxation reported upon disposal of assets or settlement of liabilities connected to discontinued operations;

e) income taxes;

f) net profit or loss.

IAS 1 latest version requires income from extraordinary activities not to be separated from income from ordinary activities; paragraph 85, indeed, explicitly prohibits to present as "extraordinary" any income items, both with regard to the income statement, and to the notes to the financial statements. The reasons for the above resolution are provided in IAS 1, by observing that all items of income result from the entity's ordinary activities and

(6) The format has been taken, with amendments, from ORGANISMO ITALIANO DI CONTABILITÀ, *Guida operativa per la transizione ai principi contabili internazionali*, Giuffrè, Milano, 2005, p. 45, and is in line with that proposed, as an example, by IASB.

(7) For further information, reference can be made to ANDREI P., "La struttura e il contenuto del bilancio di esercizio", see above.

that, avoiding separation between ordinary and extraordinary income, the problems of subjectivity connected to such classification are thus cancelled; furthermore, the request of separate indication of income and loss from disposal of assets or from settlement of liabilities connected to discontinued operations leads, anyway, to the separate indication of some items of income generally classified as "extraordinary", even though, in this case, their classification as extraordinary in the income statement does not arise from subjective assumptions. Also for the income statement, as already mentioned for the balance sheet, IAS 1 identifies additional line items, headings and subtotals to be included, allowing financial statements users an appropriate understanding of the entity's financial performance (paragraph 83). In the same light, it has been resolved that some analytical information may be provided directly in the statement or, alternatively, in the notes to the financial statements; the following are examples of this information:

1. write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of any of such write-downs;
2. restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;
3. disposals of items of property, plant and equipment;
4. disposals of investments;
5. discontinued operations;
6. litigation settlements;
7. other reversals of provisions.

Under the structural perspective, the income statement should present an analysis of expenses using a classification based, alternatively, on "nature" or on "function". Under the first classification, equal to the one at the basis of art. 2425 c.c., expenses are aggregated according to their nature, while under the classification "by function" expenses are aggregated according to their function in the different management areas of the entity. IAS 1, under paragraphs 91 and 92, provides examples of the two different expense classifications, briefly mentioned above (*Charts 2* and *3*), also pointing out that entities classifying expenses by function shall disclose additional information on the nature of expenses, including depreciation and amortisation expense and employee benefits expense.

+	Revenue
+	Other income
+/–	Changes in inventories of finished goods and work in progress
+	Capitalised costs for self-construction
–	Raw materials and consumables used
–	Employee benefits costs
–	Depreciation and amortisation expense
–	Write-downs of tangible fixed assets
–	Other expenses
–	Interests
+	Income from associated undertakings
=	*Income before taxation*
–	Income taxes
=	*Profit*

Chart 2.

Income statement according to International Financial Reporting Standards with expenses classified "by nature"

+ Revenue
– Cost of sales (industrial costs)
= *Gross profit*
+ Other income (non industrial, complementary and secondary or equity managements)
– Distribution costs
– Administrative expenses
– Other expenses
– Interests
+ Income from associated undertakings
= *Income before taxation*
– Income taxes
= *Profit*

Chart 3.

Income statement according to International Financial Reporting Standards with expenses classified "by function"

IAS 1 does not explicitly encourage either one expense classification or the other, also adding that the choice will be made by the entity based on a series of aspects, thus achieving the most appropriate method for its specific case (nature of the activities carried out, historical, contextual and industrial factors and so on). It should finally be noted that, according to IAS 1, an entity shall disclose, either in the income statement or in the statement of changes in equity, or in the notes to the financial statements, the amount of dividends recognised as distributions to equity holders during the period, and the related amount per share.

1.3. – Cash flow statement format

The cash flow statement allows the analysis and presentation of the causes of the changes reported by certain financial and monetary items, crucial for the entity's profitability (typically, cash provisions and net working capital) over a certain period of time. In other words, preparation and analysis of the cash flow statement allows managers to get an insight (and a tools for the communication to stakeholders) of the conditions, and their origin, at the basis of the financial and monetary balance characterising the entity at the end of a given administrative period (8). It should be noted that the cash flow statement provides information not available in any other section of the financial statements. It is therefore crucial for the financial statements' capability to fully account for the economic trend of the entity (9). The cash flow statement appears as

(8) For additional information on the preparation of the cash flow statement, reference can be made to RIVA P., "La preparazione e la lettura del rendiconto finanziario per flussi di CCN e di liquidità", in PROVASOLI A. (cured by), *Amministrazione e Bilancio,* Il Sole 24 Ore/La Repubblica, Milano, 2006.

(9) «This statement provides financial elements which may not be otherwise found in the comparative balance sheet, even when accompanied by the income statement, as the balance sheet does not clearly show either the changes posted by financial and capital resources or the causes at the basis of these changes», CNDC-CNR (this body was removed and replaced by the *Organismo Italiano di Contabilità* OIC in 2001 the new rule-making body), Document no. 12 – *Composizione e schemi del bilancio di imprese mercantili, industriali e di servizi.* «A cash flow statement, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities», IASB, *IAS 7 – Cash Flow Statements.*

mandatory, as it somehow represents an "additional accounting pillar" helping financial statements meeting its aims (10).

Italian legislation does not explicitly requires an entity to prepare the cash flow statement. Italian Accounting Standards (document no. 12), instead, require the cash flow statement to be included in the financial statements: it «must be included in the notes to the financial statements» and exceptions may be accepted exclusively in case of «entities with less complex administrative structure due to their smaller size» (11).

International Financial Reporting Standards dedicate a specific document to the presentation and preparation of the cash flow statement, namely IAS 7. According to IAS 7, the cash flow statement must be submitted by all entities regardless of the nature of the entity's activities (manufacturing, trading or financing) and of whether cash can be viewed as the product of the entity (as may be the case with a financial institution). According to IASB *Framework*, IAS/IFRS financial statements aim at «providing information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions». The objective of the cash flow statement is, then, to provide information on an entity's cash flows so that financial statements users may assess the ability of the entity to generate cash and cash equivalents, as well as to determine the entity's need of cash and cash equivalents. This information «enhances comparability of operating results posted by different entities as they cancel the effects arising from the use of different accounting treatments for the same events and operations». International Financial Reporting Standards provide precise guidelines: both with regard to the choice of the financial flow to be investigated, as well as to the format.

(10) BRUNETTI G.-SOSTERO U., *Il rendiconto finanziario alla luce della nuova normativa del bilancio*, Rivista dei Dottori Commercialisti, n. 3, 1994; TEODORI C., *La costruzione e l'analisi dei flussi finanziari e monetari. Il rendiconto finanziario*, Giappichelli, Torino, 1994; DI LAZZARO F., *I fabbisogni e le fonti di finanziamento nel sistema informativo d'impresa: i principi IAS 7, 17, 20, 23*, Franco Angeli, Milano, 2003; POTITO L., *Il rendiconto finanziario delle imprese*, Giannini, Napoli, 1978.

(11) Thus the national accounting standard no. 12.

According to IAS 7, the financial flow to be investigated is cash (or cash on hand and demand deposits) and cash equivalents (or cash equivalents consisting in highly liquid investments that are readily convertible to a known amount of cash, and that are subject to an insignificant risk of changes in value) (12). It is interesting to consider the reasons provided for such resolution: it would be harder for users of business reporting to be able to understand a cash flow statement referred not to cash and cash equivalents, but to net working capital flows, as they are not provided with all necessary information. Precisely for this reason, a financial analysis performed taking net working capital as reference is considered even dangerous as potentially leading to false conclusions. International Financial Reporting Standards clearly highlight that a positive net working capital does not necessarily mirror liquidity and, vice versa, a negative net working capital does not necessarily mirror lack of liquidity. For example, an entity with problems in liquidity – i.e. unable to meet its short-term obligations by means of its cash and balances with banks – may be characterised by a cash flow statement referred to net working capital flows showing an increase in net working capital. This can happen for instance in case of an increase in short-term receivables due to an increase in the time required for their collection. The sole reference to net working capital is, therefore, considered *dangerous* for the external user as it is thus possible to hide lower cash levels behind increased receivables and inventories connected to situations of insolvency of the entity.

IAS 7 also requires the cash flow statement to classify cash flows by type or nature of the operations that generated them. Cash flows are classified in three broad classes: cash flows from operating activities, cash flows from investing activities, cash flows from financing activities. The cash flow statement must additionally include a separate section for the analytical breakdown of the components of cash and cash equivalents at the opening and at the closing of the financial year and the reconciliation of these values

(12) We would like to highlight that the same is generally confirmed also by US (FAS 95) and English (FRS 1) accounting standards. The focus on liquidity rather than net working capital (in its many forms) is also confirmed abroad.

with those posted in the balance sheet. The cash flow statement is therefore divided into areas, in scale format. (*Chart 4*):

A.	*Cash flows from operating activities*
B.	*Cash flows from investing activities*
C.	*Cash flows from financing activities*
D.	*Net cash flow from operations (A ± B ± C)*
E.	*Opening cash and equivalents*
F.	*Closing cash and equivalents (D ± E)*

Chart 4.
Cash Flow Statement according to International Financial Reporting Standards

The total cash flows arising from individual operating activities (A), investing activities (B) and financing activities (C) allow to *reconcile* cash balance at the beginning of the year (E) with year end balance (F). The classification by three main areas seems not to imply particular difficulties and results in a reorganization of the information according to the logical format provided (13): more details have now to be given on recognition criteria of cash flows to the three broad classes. Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss. Examples of cash flows from operating activities are: cash receipts from sale of goods and from rendering of services, cash receipts from *royalties*, fees, commissions and other revenues, payments to suppliers for goods and services, payments to employees, receipts and payments of an insurance entity for premiums and claims, annuities and other policy benefits. Cash flows from operating activities may be reported using two alternative methods. The *direct* method, showing major classes of gross cash receipts and gross cash payments, i.e. flows in the financial component (cash and cash equivalents) are identified by the total material revenues and costs on

(13) Reference can be made to RIVA P., "La costruzione e la lettura del rendiconto finanziario", (see above)

such component. Original figures may directly come from the general accounting system, or they may be determined taking in consideration sales revenues, cost of sales and other figures obtained from the income statement, and adjusting them by accounting for changes in operating receivables, operating payables and inventories, as well as other income and expenses not generating financial effects (14).

+	*Cash receipts from customers*
–	*Cash paid to suppliers and employees*
=	*Cash flow from operating activities*
–	*Interest paid*
–	*Income taxes paid*
=	*Net cash flow from operating activities*

Chart 5.
Cash Flow Statement according to International Financial Reporting Standards: cash flows from operating activities identified by "direct method"

The *indirect* presentation of cash flows from operating activities requires, instead, income before tax and before financial expenses to be increased by "non-monetary costs" and diminished by "non-monetary revenues". The net working capital flow from operating activity is thus identified, as generated or used during the reporting period.

The latter, usually not clearly reported in the statement, is itself immediately adjusted to account for the changes in operating working capital (15), thus determining the cash flow from operating activities (*Chart 6*).

(14) ANDREI P., "La struttura e il contenuto del bilancio di esercizio", (see above), p. 94.

(15) It is worth highlighting that, adopting an alternative accounting method – far too little used – which another indirect method, it is possible to disclose, first, material operating costs and revenues as resulting from the income statement, and, subsequently, adjusting them by observing the changes in the operating working capital (trade receivables, trade payables, inventories, accruals

± *Profit before interest and income taxes*
\+ *add back depreciation and amortisation of goodwill*
\+ *costs for staff leaving indemnity*
\+ *medium/long-term provisions*
\+ *other non-monetary costs*
– *other non-monetary revenues*

= *Operating income before changes in working capital* (16)

\+ *increase in trade payables*
\+ *increase in accruals and deferred income*
\+ *decrease in trade receivables*
\+ *decrease in inventories*
\+ *decrease in prepayments and accrued income*
– *decrease in trade payables*
\+ *decrease in accruals and deferred income*
– *increase in trade receivables*
– *increase in inventories*
– *increase in prepayments and accrued income*

= *Cash flow from operating activities*

– *Interest paid*
– *income taxes paid*

= *Net cash flow from operating activities*

Chart 6.
Cash Flow Statement according to International Financial Reporting Standards: net cash flow from operating activities identified by "indirect method"

Of the two presentations, IAS 7 encourages the *direct* method, as, quoting the standard, «it provides information which may be useful in estimating future cash flows and which is not available under the indirect method». What is actually observed, however, is that, as it

and prepayments).

(16) This sub-total is hardly ever highlighted in reality or, in some cases, is indicated with the label of "Net working capital flows from operating activities". In the first case, adjustments from identification of positive e negative income statement items not affecting liquidity and adjustments from, instead, the emerging of changes in the operating working capital, are included in the statement without any interruption.

will be observed further on, the indirect method is generally used. The prohibition to report the items of income from extraordinary activities separately from those from ordinary activities in the income statement (IAS 1) requires also the cash flow statement not to report the above separation, thus making provisions included in paragraphs 29 and 30 of IAS 7 impracticable.

Cash flows from investing activities refer to purchases or sales of tangible, intangible and financial fixed assets. These flows may arise from: acquisition of property, plant, equipment, intangibles and other long-term assets; sale of property, plant, equipment, intangibles and other long-term assets, acquisition of equity or debt instruments of other entities, sale of equity or debt instruments of other entities.

Cash flows from financing activities include receipt and repayment of financial resources as risk or loan capital. These flows may arise from: cash proceeds from issuing shares or other equity instruments, distribution of dividends to shareholders, cash payments to owners to acquire or redeem an entity's shares, cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long-term borrowings, cash repayments of amounts borrowed.

2. – DATA AND ANALYSIS.

Two complementary investigation methods have been adopted to investigate the balance sheet, income statement and cash flow statement formats in annual reports as well as the difficulties experienced by management upon adoption of new International financial reporting standards. The two methods are: documents analysis and interviews.

As far as the documents analysis is concerned, it may be useful to remind that, 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 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.

2.1. – *Balance sheet and income statement: analysis of 2005 half-year reports and 2005 financial statements*

2005 half-year reports are, as mentioned above, the first useful document to understand whether and how Italian entities applied new International Financial Reporting Standards. Furthermore, the comparison of 2005 financial statements and 2005 half-year reports clearly shows transition to International Financial Reporting Standards has been almost completed. What follows is a summary of the findings of the investigation with reference, first, to the consolidated balance sheet and, then, to the consolidated income statement.

Balance sheet

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 International Financial Reporting Standards.

According to International Financial Reporting Standards, 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 International Financial Reporting Standards 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.

In a previous paragraph, we reminded that 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 International Financial Reporting Standards 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 International Financial Reporting Standards. In particular, 85% of the entities meets IAS/IFRS requirements.

Income statement

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 International Financial Reporting Standards does not explicitly encourage either one classification or the other. As shown by *Chart 7*, 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.

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.

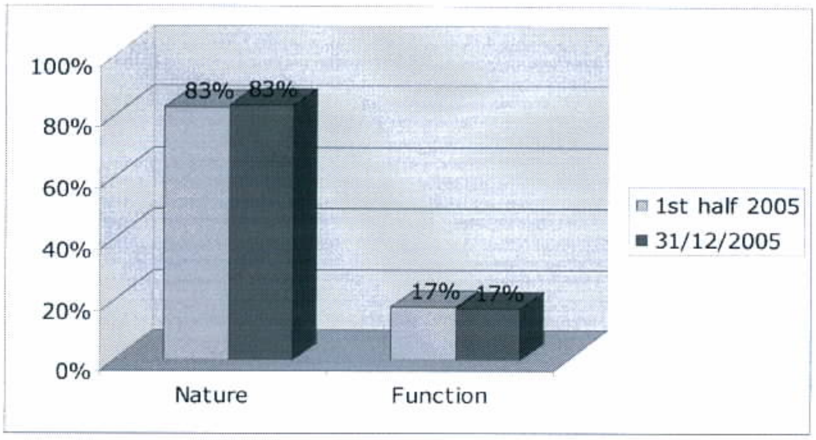

Chart 7.
Income statement: disclosures of the entity on classification criteria

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.

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.

With regard to 2005 half-year reports, 97% of the entities under scrutiny report such result (*Chart 8*), 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.

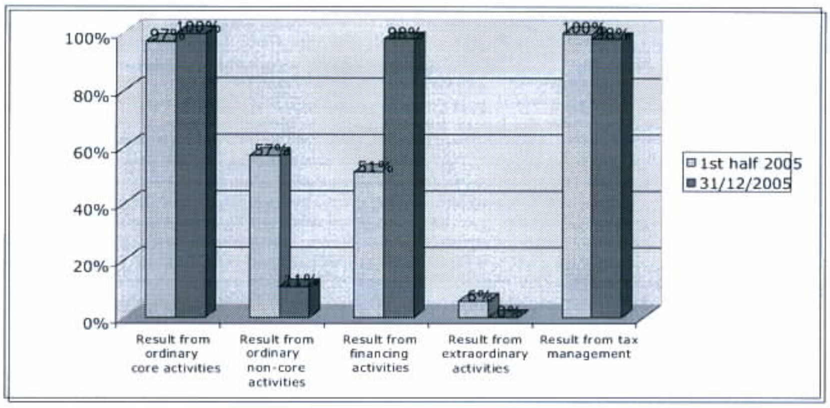

Chart 8.
Income statement: Breakdown of the contribution of the activities by functions

An innovation with respect to the past is the International Financial Reporting Standards 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 provided, as already previously mentioned, by 51% only of the entities: many entities, as a matter of fact, directly reports 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.

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 components. When preparing 2005 half-year reports, 6% of the entities does not comply with this provision, while compliance is full in 2005 financial statements.

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.

It should be noted that 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).

2.2. – Cash flow statement: analysis of 2003, 2004, 2005 financial statements and of 2005 half-year reports

In a first stage of the investigation, 2003 financial statements of 191 Italian listed entities were analysed. The second step was to go further into details with a number of 50 particularly interesting entities, choosen among these and to go on considering also their 2004 and 2005 financial statements and 2005 half-year reports. In order to achieve clear and effective disclosure of the findings, we will proceed by showing and commenting on some charts highlighting the trend over the three years analysed for these 50 entities out of the 191. Findings on 2003 total entities will be commented on only when they depart from those obtained from the 50 entities.

Materiality and preparation level

In the first place, the question was the degree of relevance granted to the cash flow statement in the reporting period by the entities tested and whether the cash flow statement could be found in both in the consolidated financial statements and in 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 at one level only of the possible two. 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 the 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, the 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, the 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 them to the notes to the financial statements. In 2003 and in 2004, the 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 of 16%. 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.

The next part of the analysis, consistently with that reported in the previous paragraph, will make exclusive reference to 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 (17).

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

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(17) Among others: *total resources* = (working capital + fixed capital); *net working capital broadly speaking* = (current assets – current liabilities), where current means all the assets receivable within twelve months and all the liabilities due within twelve months; *net working capital strictly speaking* = (current assets – current liabilities), where current meaning those assets and liabilities closely connected to the purchase-processing-sale cycle (*the operating cycle*), so that have to be considered non-current all those items classified under current assets and liabilities only on the basis of a liquidity principle (for example, mortgage instalments falling due); *net working capital strictly speaking, as referred by corporate analysts* = (current assets – current liabilities – cash and cash equivalents), the exclusion of cash and cash equivalents arises from the assumption that holding cash represents a precise alternative form of investment, thus reflecting non-operating choices; *net cash provisions* = cash and bank net of short-term liabilities due to banks; *cash provisions* = cash and bank deposits.

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. *Chart 9* 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.

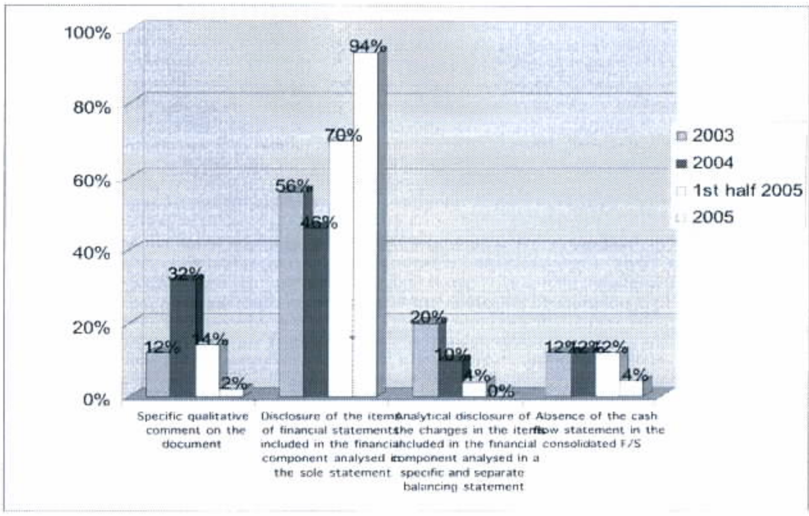

Chart 9.
Disclosure method adopted for the financial flow to be investigated

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.

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 International Financial Reporting Standards, 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.

Depuration from "extraordinary" items (capital gains, capital losses, capitalised costs etc.) of cash flows from operating activities adding them back to investment flows

IAS 1 latest version, as shown above, prohibits to keep income items from extraordinary activities separate from income from ordinary activities in the income statement. International Standards, if fully implemented, apply the same provision also to the cash flow statement. In 2003 and in 2004, almost half of the entities preparing cash flow statements made separate recordings.

This items were kept separate as they may not occur again and/or as they were connected to other activities, typically equity and investments (the classic example is the reversal of capital gains and of capital losses then added back to the value of the investment).

On the contrary, when analysing 2005 half-year reports and financial statements, every entity prepared its cash flow statement without separate indication of extraordinary items. The introduction of this IAS/IFRS requirement deeply impacted on the behaviour of the entities.

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 the contribution of the different – ordinary, complementary, financing, tax – activities to the general financial trend. The findings are interesting. While in 2003 financial statements, only 6% of the statements analysed (down 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 it is usefull point out that functions found were tax management and interest 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 International Financial Reporting Standards. 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 fell 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 are 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, more typically, corporate 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. International Financial Reporting Standards, 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, simply 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.

2.3. – Main effects on management and organisation

One of the objectives of this investigation is to understand whether the adoption of international standards had, or may potentially have, important effects also on entities' managements and organisations. The new principles introduce, in fact, a data collection method other than the one used in the past, deeply modifying administrative staff's consolidated procedures.

This assumption may sound, at an initial level of analysis, relevant when referred to the problems arising from the adoption of the new valuation criteria, while of lower significance when referred to the classifications of the statements.

Such a conclusion appears to lie on an incorrect assumption, i.e. on the view of the preparation of the statements according to one method or the other as the mere closing "formal" step in the preparation of the financial statements.

This may only be true in the case of medium-size entities, where the administrative function is either lowly developed, or demanded to third parties, or in entities opting *not* to use IAS/IFRS formats for internal purposes. In all other cases, i.e. when entities opt for consistency of internal and external communication, the ensuing changes in management systems highly impact on the accounting data collection procedure.

Recoding of all the accounts means, in fact, training and sharing of the new code at any level of the organisation.

In order to understand the impact of International Financial Reporting Standards, 50 interviews were carried out through a questionnaire preliminarily sent to those interviewed, at the administrative departments of the 50 tested entities.

The investigation confirms that a significant percentage of the entities opts for the same format for the statements destined to third parties and for those destined to the management.

Only 38% of the administrative managers interviewed replies that the entity does not use IAS/IFRS balance sheet and income statement formats for internal management. This percentage decreases down to 22% when considering the cash flow statement.

This higher degree of adoption of the international format in the case of the cash flow statement may be probably explained by the lack of previous national regulations and by the not negligible number of entities measuring themselves with the preparation of the statements for the very first time, thus following IAS 7 provisions.

2.4. – Main effects on information systems

The choices discussed in the previous paragraph required significant intervention on information systems. It appears evident that the implementation of the new IAS/IFRS code, both in the preparation of public financial statements and, potentially, in internal management, would not have been possible without substantial update of software and, very likely, without adequate training of the personnel involved. Administrative managers of the tested entities were asked whether the information system had been significantly modified or not. The question specifically referred to the cash flow statement, given the latter was previously not mandatory. The positive results reported in the following pages show that the most demanding steps were indeed taken in connection to the cash flow statement.

40% of the tested entities confirmed that actions of different nature were necessary. More in details: 55% of the 20 entities confirming significant interventions reports having changed its former classification format, 24% of the entities reports intervention in adjustments to its data collection procedure and, finally, 21% of the entities reports resetting of the information system to grant a different function and a higher centrality to the document.

3. – CONCLUSIONS AND IMPLICATIONS FOR FURTHER RESEARCH

The investigation allowed to determine the level of implementation of International Financial Reporting Standards with reference to financial statements format, as well as the influence of the process on tested entities' managements and organisations. The following are some brief remarks on the findings.

In the first place, it may be worth highlighting that 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 2005financial statements shows that the examined entities gradually adjusted their statements to achieve compliance with International Financial Reporting Standards.

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. Furthermore, almost all the entities do not comply with IAS/IFRS provisions requiring the result from financing activities to be presented separately and report, consistently with the former statutory format, the net total of financial income and expenses.

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.

The investigation by questionnaire also allowed to understand that a significant number of entities opted for the same format for both external and internal statements. In entities with well-structured administrative departments, this was an important and pervasive choice, requiring, or likely to require, administrative staff to be involved at all levels as recoding, training and sharing a new code. Such a result would have never been achieved without relevant changes in information systems. Indeed, the operators of the entities opting for the adoption of the new standards, also internally, regarded these actions as unavoidable.

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 International Financial Reporting Standards is precisely the increased availability of and access to information.

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