With the patronage of

6th Conference
EMERGING ISSUES IN INTERNATIONAL
ACCOUNTING & BUSINESS
DEPARTMENT OF ECONOMIC SCIENCES - University of Padova, Italy
CENTER FOR INTERNATIONAL ACCOUNTING EDUCATION AND RESEARCH - Niagara University, USA
Padua, 24-26 June 2004

Effects of the IFRS On Financial Communication In Italy: impact on the consolidated financial statement

Monica Veneziani

PhD in Accounting – University of Brescia – Department of Accounting
Contrada Santa Chiara, 50 – 25122 Brescia – Italy
Tel: +39 030 2988554 - Fax: +39 030 295814 Mail: venezian@eco.unibs.it

Summary – 1. The context of application of the IFRS In Italy and the structure of the study - 2. The consolidation area - 3. The Pre-Conditions for consolidation - 4. The consolidation differences - 5. Intragroup transactions - 6. Assessment of investments in subsidiaries excluded from the consolidation - 7. Conclusions

Abstract

A fundamental step for European companies towards accounting harmonisation was the issue of Regulation no. 1606 dated 19th July 2002 in which the European Union obliges listed companies to draw up their consolidated financial statements as from 2005 according to the principles of the International Accounting Standards Board (IASB).
For Italian companies in particular, introduction of the International Financial Reporting Standards (IFRS) will involve important changes as it will impose modifications on the accounting culture with consequences not only at operating but also at organisational level: efforts in terms of time and resources employed will therefore be considerable.
The topic is therefore of great relevance today and can be tackled from different aspects.
One of the areas considered most critical is understanding of the effects and changes (deriving from introduction of the IFRS) in terms of financial communication and assessment of financial performances for companies subject to the process of harmonisation.
As the main aim of the study, we have therefore chosen to analyse and focus attention on the above effects with specific reference to construction of the consolidated financial statements of listed Italian parent companies at the head of non-financial groups in particular.

1. The context of application of the IFRS In Italy and the structure of the study

A fundamental step for European companies towards accounting harmonisation (Alexander D. – Nobes C.W., 1994; Zambon S., 1996; Nobes C. – Parker R., 2002) was the issue of Regulation no. 1606 dated 19th July 2002 in which the European Union obliges listed companies to draw up their consolidated financial statements as from 2005 according to the principles of the International Accounting Standards Board (IASB).

For Italian companies in particular, introduction of the *International Financial Reporting Standards* (IFRS) will involve important changes as it will impose modifications on the accounting culture with consequences not only at operating but also at organisational level: efforts in terms of time and resources employed will therefore be considerable.

Firstly, it should be remembered that in Italy Roman law prevails, characterised by the importance of written codified law, as opposed to custom and usage, with which the community must comply. Written law takes precedence over practical concrete aspects and governs individual cases in detail. This system is also characterised by the existence of a rigid hierarchical order as regards the sources of law: analogy is permitted only in cases not explicitly provided for by the legal system. The situation is therefore more rigid than the systems of common law: the provisions of the law (Civil Code and special laws for particular sectors such as banking, finance and insurance) govern, to a more or less detailed extent, the path followed in drawing up of the financial statement in its substantive and procedural aspects. In Italy, furthermore, the accounting standards issued by a commission called Commissione dei Dottori e Ragionieri Commercialisti (in 2001 replaced by the *Organismo Italiano di Contabilità* (OIC), the new rule-making body) contribute, together with the provisions of the Civil Code, to formation of the financial statement but only in a subordinate role: these standards therefore have an integrative and interpretative function with respect to the provisions of the law. It can therefore be said that while in Italy the accounting standards play a secondary role for companies in drawing up of the financial statement, a situation which has been identified and highlighted by empirical studies and research (Marchi, 2000), in Anglo-Saxon countries these standards constitute the basis for mandatory financial communication.

Having briefly defined the general framework within which to place the IFRS (Viganò E., 1990; Onesti T., 1995; Viganò A., 1997), it should be highlighted that these standards will also involve important effects on financial communication and assessment of group financial performances since they differ, at times considerably, from the provisions of the Italian regulations.

The topic is therefore of great relevance today and can be tackled from different aspects.

One of the areas considered most critical is understanding of the effects and changes (deriving from introduction of the IFRS) in terms of financial communication and assessment of financial performances for companies subject to the process of harmonisation (Nobes C.W., 1996; Provasoli A. – Viganò A, 1995, Zambon S., 2002; Campedelli B., 2003).

As the main aim of the study, we have therefore chosen to analyse and focus attention on the above effects with specific reference to construction of the consolidated financial statements of listed Italian parent companies at the head of non-financial groups in particular.

The following structure is adopted for each paragraph:

1. summary presentation of Italian law and comparison with the provisions of the IFRS or IAS – *International Accounting Standards* (in this study the two terms will be used as synonyms)[i]. In this regard it is useful to anticipate that, in general, Italian law concerning financial statements – in particular the Legislative Decree 127/1991 (D.Lgs. 127/91) – differs from the IAS due to the presence of certain significant exceptions to the general principles.

2. analysis of the effects on financial communication and assessment of group financial performances resulting from introduction of the international accounting standards in Italy, highlighting – with reference to the aspect investigated – the positive and negative aspects of the change in progress.

In particular, in the first paragraph we tackle the problems connected with definition of the concept of control and, therefore, the consolidation area[ii]: the critical aspect of the problem lies in the fact that the inclusion or exclusion of some companies from the consolidation can modify, even significantly, the group income and equity.

The second paragraph is dedicated to analysis of the requirements of uniformity necessary to implement the consolidation. More specifically, the main operations to be performed in this phase concern the following aspects a) the accounting policies; b) the reporting date; c) structure and content of the balance sheet and income statement; d) the presentation currency.

The third paragraph deals with a specific topic relating to construction of the consolidated financial statement: determination and method of accounting of the consolidation differences.

The fourth paragraph is dedicated to intragroup transactions: they are one of the main peculiar features of group management. Here again, we shall highlight the effects of application of the IAS on group income and equity.

After examining in depth the main phases connected with construction of the consolidated financial statement, the concept of control discussed in the first paragraph is taken up again in order to conclude the study with analysis of the accounting policies and accounting practices for investments in subsidiaries excluded from the consolidation.

More specifically, the fifth paragraph is divided into two parts. The first is dedicated to study of the cases of exclusion present in Italian law and not admitted by the International Accounting Standards. The second part, on the other hand, deals with assessment of investments in subsidiaries relating to the only two cases of exclusion from the consolidation provided for by the IAS. In this regard, as these investments are assessed (according to the international accounting standards) at fair value, the most interesting aspect for further study is understanding of the changes connected with this method of assessment in the Italian financial context which has always been geared to the accounting system based on the historical cost.

The gradual analysis carried out in the five paragraphs dealing with the different phases in the consolidation process leads to the formulation of conclusions which aim to highlight, overall, the impact of application of the IFRS in Italy. More specifically, three criteria are identified, listed below, on the basis of which to formulate a judgement of the changes introduced into Italy by the IFRS as regards determination and representation of group income and equity. In particular, the criteria selected, since they are considered among the most important for assessment of the study topic, are the following:

1. best representation of the group financial situation – understood as unitary entity – for external users of the consolidated financial statement;

2. high level of uniformity of behaviour in construction of the consolidated financial statement in favour of accounting harmonisation;

3. reduction of possible opportunistic behaviour, in order to guarantee the greatest transparency of information.

2. The consolidation area

2.1. Consolidation according to Italian law: comparative analysis with the IAS 27

The purpose of the consolidated financial statement is to highlight the group financial situation (Parker R.H., 1985; Flint D., 1988; Childs W.H., 1999).

The first critical point to be tackled is definition of the extent of the subject of the study or, in other words, the consolidation area; to determine it, we must:

a) define the subjects obliged to draw up the consolidated financial statement;

b) identify the companies to be consolidated;

c) determine the companies to be excluded from the consolidation.

Subjects obliged to draw up the consolidated financial statement

In Italy art. 25 of the D.Lgs. 127/91 identifies three types of subjects obliged to draw up the consolidated financial statement:

- joint-stock companies that control at least one company;
- public bodies, with exclusive or main purpose being a commercial activity, that control at least one joint-stock company;
- co-operative societies and mutual insurance companies that control at least one joint-stock company.

An implicit exemption exists for some types of subject even if they control a joint-stock company:

- partnerships (with some exceptions);
- associations and foundations that carry out economic activity;
- individual concerns.

The main reason for exemption is due to the fact that the latter types of companies are not obliged to publish their financial statements, hence drawing up of the consolidated financial statement would have no sense juridically. However, it should be highlighted that from an accounting theory point of view, since the group exists independently of the legal status of the parent company, the consolidated financial statement would nevertheless be important.

Furthermore, Italian regulations provide for a form of explicit exemption for groups of modest size not comprising companies with financial instruments listed on the stock exchange. In

particular this occurs if for two consecutive years the parent company together with the subsidiaries do not exceed two of the following limits: total assets 12,500,000 Euro; total revenues 25,000,000 Euro; average number of employees employed in the period 250.

Lastly, art. 27 of the D.Lgs 127/91 provides for explicit exemption in the presence of sub-holdings if the following conditions occur:

- drawing up of the consolidated financial statement is not requested, at least six months beforehand, by as many shareholders as represent 5% of the shares;
- the parent company owns over 95% of its shares;
- the parent company is subject to the law of one of the European Union member states;
- the parent company has not issued shares listed on the stock exchange.

Having briefly summarised the Italian law with regard to the subject of the study, we now compare the provisions of the IAS 27. In particular, unlike the Italian situation, the IAS consolidated financial statement must be drawn up by any parent company independently of its legal status; the obligation concerns groups of any size; the only exemption provided for by the IAS 27, with the consent of the minority shareholders, is in the case of a sub-holding which is entirely or for a percentage equal to at least 90% owned by another company. In this regard, it is important to underline that the modifications to this point relating to the sub-holdings present in the Improvements of December 2003 (par. 10) come nearer to the provisions of the Italian legislator.

From this initial comparison it can be affirmed that although it is true that in relation to the listed groups application of the IAS 27 in the points analysed so far does not involve any modification for Italian companies, what it is important to underline is the different approach of the Board compared to the Italian legislator. The former, having recognised within the IAS 27 the fundamental value of the consolidated financial statement in terms of information for its users and in particular for investors, extends the discipline to all kinds of groups. This aspect, furthermore, becomes more important if we look at the international standards with an eye to the future, where the trend will be to extend them to the financial statements not only of the listed groups.

The companies to be consolidated

The second problem to be tackled concerns the application context of the consolidated financial statement. In particular, Italian law (like the IAS 27) establishes that the parent company should consolidate all subsidiaries. To establish which companies are subject to consolidation, we must turn our attention to the concept of control. In this regard the Board, by adopting a mixed criterion (legal, substantial and contractual control), admits a definition of control very similar to that of Italian law. The only different element, as it is not dealt with by the Italian legislator, concerns the *Special Purpose Entities* (Spe). In the light of this latter aspect we can affirm that the Board's concept of control, although generally speaking similar to that of art. 26 of the D.Lgs. 127/91, is actually much wider, as emerges from in-depth analysis, as it

attributes greater importance to the substantive aspect, with the possible important effect of a widening of the consolidation area.

The companies to be excluded from the consolidation

The last problem to be tackled concerns identification of the cases in which, despite existence of the formal conditions for control, it is necessary or obligatory to exclude the company from the consolidation. We shall now discuss the main differences between the provisions of Italian law and the Board.

In particular, the only cause for mandatory exclusion from the consolidation provided for by the D.Lgs. 127/91 concerns subsidiaries that carry out activity differing from the main activity of the group. Non-consolidation, moreover, is commented upon critically by some scholars (Azzali S., 2002; Pizzo M., 1996; Rinaldi L., 1999; Teodori C., 2003) and should not be interpreted too restrictively in order to avoid excluding companies which, although carrying out non-similar activities, have an important role within the group. As is well-known, the Board has always moved in the opposite direction to that of the Italian legislator and is motivated by the belief that the best information for the investor is obtained by providing a full picture of the group and, therefore, also consolidating subsidiaries that carry out dissimilar activity and presenting additional information on the different activities, according to for example the IAS 14. At the level of financial communication, application of the IAS 27, in relation to this latter aspect, certainly introduces important modifications in the financial statement results in terms of both extent of the consolidation area and different methods of accounting these financial instruments: according to Italian law they are assessed by means of the equity method whereas according to the IAS 27 they are subject to the consolidation.

Italian legislation, furthermore, treats the two causes of mandatory exclusion from the consolidation provided for by the IAS 27 – temporary control due to the acquisition of financial instruments for the *exclusive* purpose of sale in the short term and severe and long-term restrictions that *significantly* prevent the transfer of funds by the subsidiary to the parent company (this latter point is no longer provided for by the Improvements of December 2003 because the control could exist despite severe and long-term restrictions on the subsidiary) – as causes of optional exclusion. In this regard it should be highlighted that by analysing in detail the reasons underlying the exclusion, the *initial choice* of the Board (IAS 27) is the more expedient one: *in both cases*, in fact, we are *probably* dealing with situations in which there is a lack or cessation of effective exercise of control by the parent company over the subsidiary.

Lastly, among the optional causes of exclusion from the consolidation, the Italian legislator provides also for non-relevance[iii] of the subsidiary for the purposes of true and fair representation of the consolidated financial statement and the impossibility of promptly obtaining the information necessary for consolidation of the company without sustaining disproportionate costs.

In relation to the first cause, the legislator’s objective is to simplify the consolidation process and reduce costs, excluding small-sized firms. According to the contents of the paragraph, this approach is not provided for by the IAS 27 as it is not coherent with its basic rationale. The Board, in fact, considers the consolidated financial statement an important information tool for

investors as it represents the group's financial situation independently of its size and, therefore, also the size of the subsidiaries.

The IAS 27 makes no provisions for the second cause either. Moreover, it should be pointed out that in Italy this exclusion represents an exceptional and unrepeatable event connected, for example, with the acquisition of a company on a date very near the reporting date of the consolidated company. The information provided in the explanatory notes must demonstrate this to prevent the possibility of exclusion becoming an excuse for not consolidating some companies or simply being a cause of inefficiencies of the parent company or subsidiary in obtaining or providing the necessary information.

What has been said so far concerning consolidation, already points to the consolidated financial statement according to the international accounting standards involving important variations on financial communication (consolidation of companies today excluded under the law) in addition to an increase in costs for drawing up of financial communications. The aim of the following paragraph is to identify these effects and study them in further detail.

2.2. Consolidation: effects of non-uniformities on financial communication

Any modification of the consolidation area affects the financial statement of a group (Chow Y.C., 1942; Moonitz M., 1951; Zambon S., 1996). From the picture that has emerged in the previous paragraph, we should ask ourselves what changes will take place on financial communication for Italian companies obliged to apply the international accounting standards.

From analysis of the three fundamental steps for determination of the consolidation area, the following observations can be made.

1. With respect to Italian law, the approach of the Board has the immediate effect of extending the consolidation area with consequences on group performances according to the financial situations of the consolidated companies and, therefore, of providing a more complete, more articulated picture of the group reality. Extension of the consolidation area is due also to the prevalence of substance over form in identifying the companies to be consolidated.
2. Very positively, furthermore, introduction of the international accounting standards in Italy will reduce the discretionary powers of management in definition of the consolidation area, since according to the IAS 27 (and the Improvements) the cases of exemption or exclusion are limited.

Point (sub 1) in particular requires further study. Although on the one hand extension of the consolidation area provides a more complete picture of the group, on the other it should be specified that said extension requires wider information and only reference to the IAS 14 permits overall improvement of the communication process.

In this regard it should be remembered that, first of all, if the group comprises subsidiaries that perform different activities with respect to the others, what is important in assessment of the financial situation of the same is not so much the lack of uniformity in the activity but the degree of complementarity and integration of said activity within the overall managerial rationale. A

finance company in an industrial group is one of the most common situations in practice. The activity carried out by the first company is obviously different in physical-technical terms from that of the other companies, but if the finance company provides financing or leasing facilities for the customers and/or units of the group, then obviously this different activity would in practice be financially complementary to that of the other companies in the group. In this case, non-consolidation of the finance company would involve, at a first glance, an important loss of significance and information capacity of the consolidated financial statement.

More precisely, however, two main effects can be distinguished at information level: on the one hand inclusion of the company in question certainly provides a more complete picture of the financial situation of the group but on the other, representation of the financial situation may not satisfy the requirements for truthfulness and fairness – if not adequately supported in terms of information – due to the heterogeneity caused by the consolidation of profoundly different balance sheet and income statements items. The choice of the Italian legislator has been dictated by the latter motive, consequently giving management greater discretionary power and resulting in a less complete picture of the group.

The Board has avoided this conflict by remaining coherent with the basic rationale and recognising, at the same time, the existence of important differences between the company that carries out dissimilar activity and the group. In fact, the IAS 27 affirms that to offer investors the best information, companies with dissimilar activity belonging to a group must be consolidated and, to fill in the information gap generated by the consolidation of companies with profoundly different balance sheet and income statements items, the consolidated financial statement must comprise the sector information as required, for example, by the IAS 14 (*Segment Reporting*). Certainly application of the IAS 14 will require a great effort on the part of Italian companies who will have to provide detailed information per sector of activity and per geographical area. In this regard, it should be underlined that Italian law and national accounting standards require limited sectorial information, only if significant and certainly not comparable, in terms of detail and completeness, with the provisions of the IAS 14. Often, the information provided in the financial review by management and in the explanatory notes is so general that it does not add anything to the rest of the financial communication .

To conclude, it can be said that the Board's choice, i.e. that of constructing a consolidated financial statement that represents the overall reality of the group providing for a consolidation area coherent with a substantive concept of control, accompanied by the need to integrate this information with segment information, achieves the objective of providing investors with complete financial communication, certainly more so than would be obtained by excluding some companies, even strategic, from the area or including said companies not accompanied by adequate segment information.

This last aspect is of no small importance especially in the light of current trends represented by the development of highly diversified groups. We are dealing with entities that are unitary but present in very different commercial sectors in terms of problems, risks and development opportunities. To assess the group as a whole, it is therefore necessary for the financial communication (Ceccherelli A., 1970; Coda V., 1991) to take account of this development phenomenon, also presenting detailed segment information.

3. The Pre-Conditions for consolidation

3.1. The pre-conditions for consolidation according to Italian law: comparative analysis with the IAS 27

Construction of the consolidated financial statement involves integration of the financial statements of the individual companies in the group. To achieve this objective, after determining the consolidation area, the problem of uniformity of the elements to be consolidated must be tackled. In particular, the main operations to be performed in this phase concern the following aspects: a) the accounting policies; b) the reporting date; c) structure and content of the balance sheet and income statement; d) the presentation currency.

In relation to the point *sub a)* it should be highlighted that the general principle in Italian law – i.e. the application of the same accounting policies for all the companies subject to consolidation – is not very different from the provisions of the Board. What is not provided for by the IAS 27, and even less so in the Improvements of December 2003 which are even more restrictive than standard 27, is the exception governed by Italian law referring to the concept of non-relevance: a quality requirement not easy to apply in practice as it can lead to very subjective decisions.

Regarding this last point, the choice of the Board is preferable and is also the most correct from an accounting theory point of view as it is coherent with the concept of group unity. In fact, on the basis of the assumption that the group is a unitary entity, the income and equity of which are determined, the elements (relating to similar facts in similar circumstances) of the individual financial statements to be consolidated must be treated uniformly from an assessment point of view, without exception. The position of the Board, reinforced by the latest Improvements in relation to uniformity of the accounting policies, therefore fits perfectly into this basic rationale.

As regards the point *sub b*), the reference date for the consolidated financial statement must be established, performing the adjustments necessary to refer financial statements with a different reporting date to the above reference date. In this regard Italian law provides the following solutions:

1. use of the reporting date of the parent company or the reporting date of the majority of the subsidiaries or the most important companies consolidated. In this latter case it should be pointed out that the importance of a firm can be determined on the basis of dimensional parameters (for example turnover, number of employees, capital invested), according to the level of criticality of the activity carried out in the group or in relation to its contribution to the income capability of the group;
2. drawing up of an intermediate financial statement in the event of a difference between dates, even less than three months.

The following important differences exist with respect to the IAS 27.

Firstly, it can be immediately observed that there is greater rigidity on the part of the Italian legislator who provides, in the event of any deferment, for the presentation of an intermediate

financial statement at the reporting date of the consolidated company. Within the three-month limit, on the other hand, the Board admits the simplified solution of adjustments for the effects of significant transactions. This latter choice, however, conflicts with the basic rationale of construction of the consolidated financial statement. In other words, if we wish to determine the income and equity of a group, the elements to be consolidated must refer to the same periods of time, without any exceptions.

Secondly, Italian law is considered more complete as it envisages different possibilities for identification of the reporting date. In fact, the general rule which establishes that the reporting date is that of the parent (the solution admitted by the IAS 27) admits two exceptions. At first sight the difference identified could appear to be insignificant but in some circumstances it can be important, such as when the parent company is a finance company within an industrial group and the majority of the subsidiaries choose a common date according to the characteristics of the production process. This is therefore a situation in which the parent company has a different reporting date. In this particular case, the drawing up of an intermediate financial statement by the subsidiaries, i.e. a financial statement referring to a reporting date not appropriate for the characteristics of the activity performed by the companies in question, could give rise to a less significant representation of their financial situation with respect to the original one, due to the greater incidence of the estimated and assumed values representing production cycles still in progress: all this would have consequent negative effects from an information point of view on the consolidated financial statement. Furthermore, the solution put forward here would be very onerous for the group. It should be underlined, however, that the consolidation using different dates is not logically correct, therefore, vis-à-vis one single date as provided for by the IAS 27, it is very important to provide, together with the intermediate statement, adequate disclosure by management of the criteria for and methods of determining the most critical values, in order to make the financial communication as transparent as possible. This simple example is sufficient to show once again that the best solution as regards consolidation date has been formulated by the Italian legislator. In this regard it should be highlighted that the latest Improvements partly modify the position of the Board; in fact the Board affirms that the reporting date must coincide with that of the parent company *unless this solution turns out to be impossible.*

As regards the uniformity of the balance sheet and income statement (*sub c*) it should be pointed out that while this problem has been substantially eliminated in Italy via the D.Lgs. 127/91, with application of the IAS which establish minimum contents without imposing rigid structure of balance sheet and income statement (as provided for by Italian law), a problematic situation could re-occur during the consolidation phase. In our opinion, financial statement integration operations would certainly be facilitated if a shared group accounting plan (in the context of the common accounting standards) and a shared structure of balance sheet and income statement existed.

Lastly, as regards the presentation currency (*sub d*) it should be highlighted that no substantial differences emerge between the provisions of national accounting standard no. 17[iv] and the IAS 21: application of the IAS would not produce any important changes in Italian companies on financial communication . It is important to point out, however, that the Board has operated via a specific exposure draft, making numerous and important amendments to the IAS 21.

In particular, the main amendments (approved by the latest Improvements) are as follows: termination of the distinction between foreign entities and integral foreign operations; elimination of the method for integral foreign operations and application of the current exchange rate method for all types of foreign companies, establishing allocation of the exchange differences to a specific reserve of the equity, with the condition that, when the potential income is realised (for example in the case of sale of the foreign company), it is entered under the income statement.

3.2. The pre-conditions for consolidation: the effects of non-uniformities on financial communication

Application of the IAS in relation to the topic in question can generate effects at both the level of organisational choices within the group and in terms of financial communication.

More specifically, the choice of the Board, contained in the Improvements to the IAS 27, which provides for the application of uniform accounting policies eliminating any exceptions and always imposing appropriate corrections of non-uniform values will probably provide an incentive for parent companies to define common accounting standards for all the companies in the group so as to facilitate consolidation procedures.

In this regard it should be remembered that Regulation 1606/2002 imposes application of the IAS to financial statements consolidated as from 2005 and leaves each country to impose application of the IAS on the other listed and non-listed companies . In Italy, the decision has been the application of the IAS to all subsidiaries.

This operation could create a problem at the level of consolidation procedures if the subsidiaries choose not to apply the IAS. In general terms, furthermore, with European accounting harmonisation there is a problem of comparability of financial statements within Italy. There will be *at least* two types of financial statement: the first will concern the parent companies obliged to apply the IAS as from 2005 and the second will consist of all the other companies that draw up financial statements in accordance with Italian law.[v]

Above and beyond these latter considerations, the proposal of the Board to make accounting policies uniform is judged positively, since it aims to improve the information quality of the consolidated financial statement. In particular, application of the IAS will make the consolidation pre-condition phase more objective as it will eliminate the exception provided for by the Italian legislator that refers to the concept of non-relevance. The above is coherent with the concept of group understood as a unitary entity.

In relation to uniformity of the financial statement reporting dates, for Italian companies the prospect is that of a situation that will be simpler to manage: if the difference falls within the three-month limit, it will be possible to present appropriate adjustments without drawing up an intermediate statement. All this, in our opinion, facilitates consolidation operations but to the detriment of quality of the information. Even if the Board envisages intervening to adjust the values, the drawing up of an intermediate statement undoubtedly provides more complete detailed information. Furthermore, we do not agree with the choice of the IAS 27 in respect of "modest deferment" as it is not coherent with the group concept as illustrated above, but above all

because we believe that the problem of temporal uniformity of values depends not so much on the time difference between the reporting dates but on what happens in that period. In other words, given that three months is a short period, the need to simply adjust the values or draw up an intermediate statement providing more complete information should not depend on the period of time but, rather, on the importance – measured in quantity or quality terms – of company events occurring in that period. Adjustment of the values could be permitted only in cases in which no important events occur in the three-month period. At this point, however, we are faced once again with the problem illustrated previously concerning the concept of relevance: avoiding any element of subjectivity in this regard and favouring more complete information, the provisions of Italian law are therefore judged to be undoubtedly better. With application of the IAS 27 (and the Improvements), furthermore, attention will be required in cases where the reporting date of the parent company has been chosen and the date differs by more than three months from that of the subsidiaries, especially in highly diversified groups. The risk of adjustment to the reporting date of the parent company, in fact, could produce negative effects on consolidated financial communication . We reiterate, however, that with one single date, the intermediate statement accompanied by adequate disclosure by management on the criteria and methods for determining the most critical values provides significant and transparent financial communication .

Lastly, as regards translation of the financial statement into presentation currency (Andrei P., 1994), no important changes are envisaged for Italian companies even considering the latest Improvements to the IAS 21, since almost all Italian parent companies already use the current exchange rate method.

Having analysed the position of the Italian legislator and the Board with regard to consolidation and the problems involved in achieving uniform financial statements for the companies to be consolidated – highlighting the possible effects on financial communication – in the next paragraph we will tackle the problem of consolidation differences, an area in which there are many non-uniformities, both substantive and formal.

4. The consolidation differences

4.1. Determination of the consolidation differences according to Italian law: comparative analysis with the IFRS 3

During integration of the financial statements of the firms subject to consolidation, the value of the equity instrument entered in the financial statement of the parent company is replaced by the total assets and liabilities of the subsidiary (according to the integral method required by the national and international standards), in order to determine the group financial situation.

To determine these differential values it is fundamental to define the date on which to make the comparison. Unlike what is established by the IFRS 3 and recommended by the national accounting standards (no. 17, paragraph 10.1), the Italian legislator has opted for a solution that is simpler from an operating point of view but less preferable at technical level and in terms of

results produced: the reporting date does not correspond to the moment of acquisition but to that of the first consolidation[vi]. In this way preference is not given to the financial substance of the operation because, as provided for by the purchase method (IFRS 3), control by the parent company begins at the moment when it is able to govern the subsidiary, i.e. at the moment control is acquired. Therefore, to correctly identify the meaning of any consolidation differences, we must go back to the moment when the parent company actually takes control of the subsidiary. Paradoxically, due to management events that can occur between acquisition and the date of the first consolidation, and which modify the equity value of the subsidiary, a positive difference at the time of acquisition could become a negative difference at the first consolidation (and vice versa). The restrictive interpretation of the D.Lgs. 127/91 (art. 33/1) would therefore provide results that are not significant or not representative of the group reality.

In this regard and for greater clarity, there is also a formal difference between the D.Lgs. 127/91 and the IFRS 3.

More specifically, the D.Lgs. 127/91 (art. 33/1) establishes that the consolidation difference is determined by comparison of the purchase cost of the equity instrument with the book value equity share of the subsidiary. The international accounting standards, on the other hand, provide for comparison between purchase value of the equity instrument with the current value equity share (with reference only to the current values of the tangible elements) of the subsidiary; any difference corresponds to the goodwill or negative goodwill[vii].

In particular, taking as an example the existence of a positive consolidation difference[viii] that can be attributed partly to the assets and liabilities and partly to goodwill, the IFRS provides for adjustment of the assets and liabilities of the company acquired *ex ante* with respect to determination of the differential value: in this way the only resulting difference is the goodwill.

If we refer to Italian law, on the other hand, comparison between the purchase cost of the equity instrument and equity share produces a consolidation difference still to be "analysed", attributing it partly to the assets and liabilities and partly to goodwill. For greater clarity, it should be pointed out that in this study "overall consolidation difference" means the value deriving from the comparison between purchase cost of the equity instrument and book value equity share of the subsidiary.

4.2 Accounting of positive consolidation differences according to Italian law: comparative analysis with the IFRS 3

The D.Lgs 127/91 (art. 33) affirms that the overall positive consolidation differential must be attributed firstly, if the conditions exist, to the assets and liabilities of the subsidiary while any excess, unlike the provisions of the IFRS 3, can be treated in one of the following two ways:

a) the first consists in entering it under the assets, under the name *"consolidation difference"*;

b) the second involves allocation to a specific equity class called *"consolidation reserve"*, reducing it up to its total value.

In the case *sub a)*, the difference (or part of it) undergoes systematic amortisation according to the rules concerning goodwill, which provide for a period of 5 years or a longer time span, on

condition that it is within the term of the useful life that can be reasonably envisaged, providing adequate motivation in the explanatory notes. The national accounting standards, while establishing periodic control of the congruity of non-current asset values, do not define an overall assessment method such as that governed by the IAS 36.

It should be pointed out that the two options provided for by the Italian legislator must not give rise to subjective choices: therefore, the difference (or part of it) should be allocated to reduction of the consolidation reserve only if it cannot be attributed to goodwill. In the case of incorrect assessment in the case of acquisition, a literal interpretation of art. 33 of D.Lgs. 127/91 would appear to preclude attribution of the difference to the income statement, whereas this is provided for, more correctly, by the national accounting standard no. 17 (par. 10.4).

Even in a situation in which the greater value attributed to the subsidiary depends on the strategic role assigned to it within the group, the consolidation difference (or part of it) must be attributed to the specific reserve. In this case the national accounting standard, assuming a very restrictive position, does not permit assimilation of the differential with goodwill as provided for by the IFRS 3. To be precise, in our opinion, it is correct to attribute said differential value to the assets but the name is misleading: here we are not talking about goodwill but more generally about a positive consolidation differential.

Comparison between the position of the Italian legislator and that of the Board highlights the following differences:

1. in name: the positive excess[ix] is called goodwill in the IFRS 3 and "consolidation difference" in art. 33. The aim of the Italian legislator is to distinguish this differential from the goodwill already entered in the financial statement of the consolidated companies. This aspect, however, does not affect group income and equity;

2. accounting of the goodwill. Actually, the IFRS 3 prohibits the amortisation of goodwill acquired in a business combination and requires the goodwill to be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired, in accordance with the IAS 36. Therefore, this IFRS requires goodwill to be measured after initial recognition at cost less any accumulated impairment losses. The Board observed that "the useful life of acquired goodwill and the pattern in which it diminishes generally are not possible to predict, yet its amortisation depends on such predictions. As a result, the amount amortised in any given period can at best be described as an arbitrary estimate of the consumption of acquired goodwill during that period"[x]. Therefore the Board agreed that if a rigorous and operational impairment test could be devised, more useful information would be provided to users of financial statements under an approach in which goodwill is not amortised, but instead tested for impairment. As regards the different treatment of the goodwill between Italian legislation and IFRS, there will obviously be differences in terms of determination of the group income and equity, whenever the value of the amortisation differs from the one derived from the impairment test. For example if the goodwill is not impaired, there is an improvement on the return on assets and on the return on equity (with respect to what would occur with the Italian legislation). Therefore especially in the case of goodwill with relevant value, it is very important to provide the user of the financial statement with

complete information. Lastly, it should be pointed out that with application of the IFRS 3, determination of the goodwill value to be entered in the financial statement for the Italian parent companies will become much more complicated.

3. accounting allocation: more specifically, on the basis of the provisions of the IFRS 3, the positive consolidation difference always participates (except the particular case in witch the goodwill is not impaired) in determination of the group income. This does not occur under Italian law in the specific case in which the consolidation reserve is used.

4.3 - Positive consolidation differences: effects of non-uniformities on assessment of group financial performances

In our opinion, analysis of the effects on assessment of group financial performances (Brunetti G., 1990; Lai A., 1997; Marchi L. 1998) of introduction of the IAS in Italy should concentrate on the point *sub 3),* paragraph 3.2, as it represents the biggest difference between Italian legislation and the international accounting standards, with consequent effects on the group income and equity. More specifically (apart the different treatment of the goodwill, pointed out above) the main differences between the international accounting standards and Italian legislation concern two situations:

a) the positive difference (or part of it) concerns the strategic role of the subsidiary within the group. In this case, according to Italian law, the differential value is allocated to reducing the consolidation reserve producing, with respect to what would occur with the IFRS 3, effects at on the balance sheet – via reduction of both the group equity and the assets – and *probably* on the income statement – due to non-influence of the goodwill (*subject to impairment test*) on determination of the group net income;

b) the positive difference (or part of it) is related to incorrect assessment in the acquisition phase. If the D.Lgs. 127/91 is applied, effects would be produced at the balance sheet level, via reduction of the group equity and income statement, due to non-influence of the difference on determination of the group income.

More specifically, from the above, it can be seen that with the application of Italian law (in relation to modification of the consolidation reserve values) we always have – compared to what would occur by applying the IFRS – an increase in return on equity (Foster G., 1998), understood as ratio between net income and equity net of the income. Furthermore, with particular reference to the case *sub a)*, the increase in the return on the capital invested due to a lower invested capital should also be highlighted; the differences will be accounted, all other conditions being equal, over the entire duration of the goodwill. These effects are all the more evident the greater the consolidation difference in question.

Having considered the positive effects on income deriving from allocation of the positive difference to the consolidation reserve, adoption of the IFRS (which, as is well-known, do not provide for this solution, and rightly so) will involve, and this is very positive, the elimination of possible opportunistic behaviour – which could occur particularly in groups characterised by

unsatisfactory financial performances – in favour of a more significant representation of the group reality.

Lastly, application of the IFRS, in our opinion, should give greater expression to the method of determination and representation of the group income and equity. In our opinion it is correct for the positive consolidation difference to participate in formation of the group income: independently of the cause, effects are always produced on the consolidated income statement which, therefore, must be accounted. In other words, the differential value or part of it can give rise to two types of situation: either it can be demonstrated, as for all the assets, that it results in financial benefits for the group (in this case it is equated with goodwill subject to impairment), if it does not satisfy this condition, it must be considered a loss and as such it must negatively affect the group result.

4.4 Accounting of negative consolidation differences according to Italian law: comparative analysis with the IFRS 3

If the purchase value of the equity instrument is lower than the equity fraction, we have a negative overall consolidation difference. As in sub-paragraph 3.3, here again we must trace back the cause.

In particular, after attributing the consolidation difference to the assets and liabilities of the subsidiary (if the conditions exist), the D.Lgs. 127/91 (art. 33/3) establishes that any negative excess, when due to forecasts of unfavourable financial results, be allocated to a specific item called *Consolidation fund for future risks and charges* (entered in the liability section of the balance sheet) to be used – on the basis of forecasts founded on reliable assessments – in the subsequent years in the event of losses (or lower income) in the subsidiary. In all other cases, the negative excess must be allocated to the consolidation reserve, thereby increasing it.

From comparison between Italian legislation and the international accounting standards, the following observations can be made:

1. firstly, there is a difference in names: the negative excess[xi] is called negative goodwill in the IFRS 3 and "consolidation difference" in art. 33;

2. accounting of the negative goodwill. Actually, the Board affirmed that the most appropriate treatment for any excess remaining after the acquirer performs the necessary reassessments is immediate recognition in the income statement and the acquirer should be required to disclose the amount and a description of the nature of any such excess. More specifically, the Board agreed that most business combinations are exchange transactions in which each party receives and sacrifices equal value. In others words, the Board disagreed with the view that expectations of future losses and expenses could give rise to an excess. Although expectations of future losses and expenses have the effect of depressing the price that an acquirer is prepared to pay for the acquiree, the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities will be similarly affected. The Board reaffirmed that an excess should rarely remain if the valuations inherent in the accounting for a business combination are properly performed. However,

when such an excess exists, the acquirer should first reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the business combination. Any excess remaining after the reassessment could comprise one or more of the following components: 1) a bargain purchase, 2) errors, 3) differences due to a valuation method which differs from fair value. As regards point *sub 1)* the Board agreed that the most representationally faithful treatment of that part of an excess is immediate recognition in the income statement, and affirmed that separately identifying the amount of an excess that is due to errors or others causes is not feasible. So, the Board finally concluded that the most appropriate treatment for any excess remaining is immediate recognition in the income statement[xii];

3. for the Board, as in the case of the positive consolidation difference, the negative differential always affects the group income, regardless of the cause.

4.5 Negative consolidation differences: effects of the non-uniformities on assessment of group financial performances

As previously with regard to the positive difference, in order to analyse the effects of application of the IFRS in Italy, attention is concentrated on point *sub 2*), paragraph 3.4, as it represents the biggest difference between Italian legislation and the international accounting standards, with consequent effects on the group income and equity.

In the event of a negative consolidation difference being due to future losses in the subsidiary, according to the Board's valuations, a correct assessment of the business combination should not involve any difference between application of the Italian law and the IFRS: in this case the value of excess (or negative goodwill) and therefore of *Consolidation fund for future risks and charges* is zero. However in the event of excess, the most important effects due to the application of IFRS 3 will be: in the first year, an increase of return on equity and the opposite situation in the next years in which losses in the subsidiary will occur.

In the event of the difference (or part of it) being due to causes other than future losses in the subsidiary the D.Lgs. 127/91 establishes that the differential value (or part of it) is allocated to increasing the consolidation reserve. This latter choice produces effects at the balance sheet level – via increase in the group equity – and at income statement level due to non-participation of any capital gain in increasing the consolidated gains.

More specifically, in this latter case, the IFRS 3 (with respect to application of art. 33 of the D.Lgs 127/91) determines: a decidedly higher return on equity in the consolidation year due above all to inclusion of the residual negative differential in the gains, which produces a lower group equity (profit excluded), as the consolidation reserve values are not modified.

In conclusion, if the negative goodwill were attributed to the income statement (again according to the IFRS 3), effects would be felt at the level of return on equity. In particular, all conditions being the same, the latter would be very high only in the consolidation year (obviously depending on the extent of the difference). In this regard it should be underlined that distorted application of the IFRS 3 could, at a first glance, result in opportunistic behaviour: registration of

the entire difference under the gains in order to obtain a high return on equity. We believe that this attitude is not expedient for firms, however, as the positive effect on income would occur only in the first year and the opportunistic decision would be identified in the short term with consequent loss of trust and credibility on the part of the investors. Furthermore, we are of the opinion that the solution envisaged by the Italian legislator is clearly dictated by interpretation of the principle of prudence which is particularly restrictive in Italy; the choices of the Board, on the other hand, are more geared to substantive representation of financial events. Once again, therefore, we agree with the Board's decision to include the negative difference, independently of the cause, in formation of the group income. In other words, the differential can give rise to two types of situation: it either derives from future losses in the subsidiary (in this case the differential affects the value of assets and liabilities and participates in formation of the income via a possible excess) or, if it does not depend on this cause, it must be considered only as a gain resulting from the operation and, as such, it must positively affect the group result.

5. Intragroup transactions

5.1. Intragroup transactions according to Italian law: comparative analysis with the IAS 27

The aim of the consolidated financial statement is to represent the income and equity of a group, resulting from the set of transactions it has carried out with third parties. In order to respect the aims of the financial statement, intragroup transactions must therefore be identified and eliminated.

The D.Lgs. 127/91 (art. 31/3) establishes the general principle according to which any type of value resulting from exchanges between companies in the group must be eliminated, with the exception of intragroup profits/losses connected with construction contracts to third party order, which occur in the case of subcontract between two firms in the group: this choice is coherent with the accounting policy on the basis of the stage of completion, specifically applied to construction contracts. The general principle of elimination permits two exceptions, however. The first refers to the concept of relevance, so that if the values deriving from mutual exchanges are not particularly significant, they can be maintained; the second permits intragroup income to be maintained, even if considerable, subject to the joint occurrence of specific conditions: they must derive from current company transactions; the transactions must be concluded under normal market conditions; elimination of the income in question involves disproportionate costs.

As is well-known, on the other hand, the IAS 27 (paragraphs 17 and 18) establishes *elimination in full of all types of values (intragroup balances, intragroup transactions and resulting unrealised profits) resulting from exchanges between companies in the group.* The only situation that does not come under this general rule is non-elimination of unrealised losses[xiii].

From summary comparison between the provisions of art. 31 and the IAS 27, the following observations can be made.

a) The choice of the Board relating to maintenance of intragroup losses in the event of unrealised losses is undoubtedly a good choice. If this were not so, elimination would not be correct as an unjustified positive effect would be produced on the group income and equity as the "unrealised loss" has already occurred even though the transaction has not involved third parties. The choice of the Italian legislator, on the other hand, not to explicitly provide for maintenance of unrealised losses, may be puzzling in some respects. In this regard it must, however, be underlined that the national accounting standard 17 (paragraph 11.2.d) establishes that the asset values cannot under any circumstances be revalued following elimination of intragroup losses beyond the limit of the realisable value.

b) We do not agree with the choice of the Italian legislator to allow maintenance of the values resulting from intragroup transactions if non-relevant, for two main reasons: on the one hand, they nevertheless affect consolidated financial performances making them not completely correct; on the other, exercise of the option in any case involves the effort of determining whether the amounts are truly non-relevant and therefore it is difficult to see why they should not, more simply, be eliminated. In this regard the choice of the Board is undoubtedly more appropriate as it is perfectly coherent with the construction rationale and information purposes of the consolidated financial statement.

c) The same judgement applies to an even greater extent with regard to the other exemption granted by art. 31/3 which operates also in the case of significant intragroup incomes upon occurrence of the three conditions established. What we do not agree with, in particular, is the "permissive approach" of the Italian legislator. We believe that independently of the existence or otherwise of particular conditions, intragroup incomes must always be eliminated: they are profits/losses relating to resources simply transferred *within* the group and, therefore, of no external relevance. Here again, therefore, the choice of the Board is considered more correct, as it is coherent with the information purposes of the consolidated financial statement.

d) The only aspect of the IAS 27 we do not agree with concerns elimination of the intragroup profits/losses if they concern construction contracts to third party order. The precision introduced by the Italian legislator is, in fact, coherent with the specific accounting policy, i.e. with the stage of completion method, considered by the national and international accounting principles to be the most suitable for the assessment of construction contracts.

5.2. Intragroup operations: effects of the non-uniformities on assessment of group financial performances

After analysing the provisions of the Italian legislator and the Board concerning intragroup transactions, the aim is now to focus attention on the effects, in terms of formation of group income and equity, of application of the IAS 27 (and the Improvements), compared to art. 31, with reference to two main situations:

1. the existence of intragroup unrealised losses;
2. the presence of intragroup profits resulting from current transactions, concluded under normal market conditions, the elimination of which involves disproportionate costs.

In the first case, it can be observed that elimination of the unrealised intragroup loss relating, for example, to exchanges of finished products (with reference to the first accounting period in which the situation in question occurs) positively affects both profitability and solvency as it involves an increase in assets and equity at balance sheet level, while in terms of income statement it implies greater operating income (EBIT) and a higher group net income. The overall picture of the group is therefore better than the one that would be obtained by applying the IAS. Elimination of the loss, however, is not correct and neither is it coherent with the rationale behind construction of the financial statement, as it produces an unjustified positive effect on the group income and equity, since the “unrealised loss” has substantially already occurred even though the operation has not involved third parties. The greater the extent of the loss in question, the more distorted the group financial situation. Given the positive effects deriving from non-elimination of the intragroup loss in question, it can be affirmed that the narrow interpretation of the provisions of the Italian legislator could favour opportunistic behaviour in groups with greater difficulty. Moreover, it should be remembered that art. 31 must be interpreted in the context of the fundamental principle of true and fair representation of the group’s financial situation and basic principles of the financial statement: in our opinion, therefore, the loss in question should not be eliminated if it conflicts with the above general principles.

A similar positive effect on the group financial situation is obtained by applying Italian law in the context of the second situation if the option of maintaining the intragroup profits is exercised, due to occurrence of the three conditions illustrated above. In this regard it should be underlined that, in our opinion, occurrence of the conditions provided for by the Italian legislator does not fully justify non-elimination of the intragroup income. More specifically, we do not agree with the condition of disproportionate cost since, in drawing up the financial statement, what matters is best representation of the group income and equity: this is illustrated, for example, by the case of important intragroup profits that produce significant effects on solvency and profitability. Furthermore, the second condition, i.e. the fact that the operation must form part of the current activity, takes on too wide a meaning since, especially in a non-financial group, commercial exchanges can be practically all traced back to the current activity. In short, the only condition that could actually tip the balance in favour of non-elimination of the profits in question is the one concerning the exchange that must take place under normal market conditions. In this regard, however, there is the problem of demonstrating that this has actually happened: the situation is highly unlikely in groups in which there are intense relations between the different entities. This problem is nevertheless solved by the information that must be provided in the explanatory notes whenever the option is exercised. Up to now only the intragroup profits have been considered, but we should not neglect the fact that the option granted by the Italian legislator concerns intragroup incomes in general and therefore also the losses. Given the effects that elimination of the loss produces at the financial situation level, it is nevertheless obvious that for the sake of convenience the option will be exercised only in the presence of profits.

To conclude, the following observations can be made:

a) application of the IAS, in our opinion, will improve representation of the group financial situation. The regulations established by the Board are certainly more restrictive than the Italian ones, imposing the elimination of any value resulting from intragroup operations without exception, barring the specific case of unrealised losses;

b) the approach of the Board will also favour greater uniformity of behaviour among managers in drawing up the consolidated financial statement;

c) on the basis of the assumption that the group represents one unitary entity, the approach of the IAS is more coherent with the aims of the consolidated financial statement and, in some cases, more geared to the principle of prudence than the provisions of art. 31/3;

d) the lack of exceptions, furthermore, avoids possible opportunistic behaviour on the part of the groups, which could exercise the options provided for by the D.Lgs. 127/91 in order to convey a better image than that of their actual financial situation.

6. Assessment of investments in subsidiaries excluded from the consolidation

6.1. Assessment of investments in subsidiaries excluded from the consolidation according to Italian law

At this stage, to complete assessment of all the subsidiaries, we must analyse those which, although subsidiaries, are not included in the consolidation area for various reasons.

More specifically, as highlighted in the first paragraph, while under the IAS 27 (and the Improvements) there are at most two cases of exclusion of the subsidiaries from the consolidation, the Italian legislator provides for a number of options.

The objective is therefore to understand the effects in terms of group income and equity for Italian parent companies which from 2005 will be subject to the international accounting standards, with reference to investments in subsidiaries for which, under Italian law, there is the option or obligation to perform assessment according to the equity or cost method, whereas the IAS 27 provides for consolidation.

In particular, looking briefly at the D.Lgs. 127/91, the following cases can be highlighted:

a) *assessment of investments in subsidiaries that perform activity different from that exercised by the majority of the consolidated companies*. Exclusion from the consolidation represents the only mandatory cause provided for by Italian law (art. 28/1). Art. 36 first paragraph establishes that these investments must be assessed with the equity method, with the option of applying the cost method if the financial investment is non-relevant;

b) *assessment of investments in subsidiaries excluded from the consolidation due to lack of the necessary information.* In this circumstance we are talking about an option: if

it is exercised, the specific assessment method does not emerge from art. 28/2. Although application of the *equity method* is possible, for operating purposes, given the similarity of the information necessary with respect to the information required for consolidation, this investment will frequently be assessed at cost;

c) *assessment of investments in subsidiaries excluded from the consolidation because they are non-relevant.* Also in this situation (art. 28/2) we are talking about an option: if exercised, the cost method is used.

6.2. Assessment of investments in subsidiaries excluded from the consolidation under Italian law: the effects of non-uniformities on financial communication

The most evident effects of the different treatment provided for by the IAS 27, in relation to investments in subsidiaries excluded from consolidation under Italian law, are the following:

a) introduction of the IAS will favour greater uniformity in management behaviour and more complete group financial communication. In fact, application of art. 28 of D.Lgs. 127/91 could allow the parent company not to draw up the consolidated financial statement. In other words, with reference to the same reality, the IAS provides investors with information on the group; under application of Italian law, on the other hand, the consolidated financial statement could be replaced by the financial statement of the parent company with consequent totally different *information flow* to the external users. Using a deliberately "forced" example, let's take the case of an Italian parent company with two subsidiaries: one carries out a different activity while for the other it is difficult and onerous to obtain the information necessary for consolidation. In particular, it is assumed that the former is badly indebted and the latter has a negative income: if the first subsidiary is not consolidated (assessing it via the equity method), the solvency ratios of the group improve, whereas if the subsidiary with the negative financial performance is not included in the consolidation (assessing it at cost), a considerable improvement in group profitability is obtained. The observations formulated clearly highlight the possible problems connected with the approach of the Italian legislator: in particular, the granting of options on the one hand favours medium-small groups, simplifying the consolidation process, but on the other could lead to an opportunistic type application of the law;

b) the IAS will involve important changes, in terms of interpretation of the financial situation, in groups in which there are companies that carry out different activity, especially if these companies are badly indebted as could be, for example, the case of a finance company in an industrial group. In particular, the main and immediate result will be a considerable worsening in the perceived solvency of the group.

6.3. Assessment of investments in subsidiaries excluded from the consolidation according to the IAS 27

In these last sub-paragraphs we will conclude assessment of investments in subsidiaries in the context of the consolidated financial statement. More specifically, we shall look in greater depth at the only two situations of mandatory exclusion from the consolidation provided for by the IAS 27.

Going back partly to what we said in the first paragraph, the following cases are identified:

a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future;

b) the subsidiary operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent (this latter point is no longer provided for by the Improvements of December 2003, because the control could exist despite severe and long-term restrictions on the subsidiary).

The IAS 27 affirms that in cases in which a subsidiary is excluded from the consolidation, the investment must be assessed and accounted in the consolidated financial statement in accordance with the provisions of the IAS 39 (in this study we refer to the December 2003 version).

More specifically, in the case of exclusion of the subsidiary from the consolidation due to temporary control for sale of the investments in the short term, the same can be placed among the current assets in the balance sheet and comes under the “financial assets held for trading” category. The Board establishes that said investments are assessed at fair value (with accounting of any unrealised profits or losses directly in the income statement), while the Italian legislator establishes that the assessment is performed at whichever value is lower, cost or realisation value. Applying the two different methodological approaches, the same result is obtained only if the cost is higher than the realisation value; under Italian law, this evidently involves depreciation of the equity instrument in the income statement.

If, on the other hand, the cause of exclusion of the subsidiary is due to severe long-term restrictions due to which control over the subsidiary is lost, in our opinion one of two situations can occur. The parent company decides to make the equity instrument available for sale and therefore does not consider it a non-current asset, or the parent company decides (despite the lack of substantial control) to retain the equity instrument for a medium-long period. In the first case the IAS 39 will be applied, placing the equity instruments in the “financial assets available for sale” category: assessment according to the IAS is still at fair value (but with the accounting of any unrealised profits or losses directly under equity), while for the Italian legislator, assessment is always performed at whichever value is lower, the cost or realisation value (with possible depreciation of the equity instrument in the income statement). In the second case, in the absence of specific information, the equity instruments are valued at cost. In the latter circumstance, i.e. if the equity instruments in question are considered non-current assets, there are no differences with respect to the provisions of Italian legislator.

To sum up, in relation to the provisions of the IAS 39 in the cases studied, the main aspects differing from Italian law concern the equity instruments classified among current assets assessed at fair value.

6.4. The introduction of fair value in Italy

Looking briefly at the problems linked with the assessment criteria, application of the IAS entails important consequences for Italian parent companies.

In our opinion, the main change that Italian companies subject to the international accounting standards as from 2005 will have to face will consist in application of the assessment and accounting rationale associated with fair value, abandoning, for some items, the basic cost criterion (Ijiri Y., 1970; MacNeal K., 1970; Canziani A., 1991). It is fundamental to take into account the fact that assessment at fair value (Edwards E.O., 1975; Rutherford B.A., 1985; Alexander D., 1996; Ordelheide D., 1996) will produce effects on the method of income determination (Edwards E.O., 1965; Sterling R.R, 1979; Parker R.H., 1986) and, therefore, on financial communication. The change is therefore very important as it will require modifications in Italian accounting and financial practice with consequences not only at operating but also at organisational level.

In particular, with introduction of the IAS, the main users of the financial communication will change (from the creditors to the investors) and, consequently, the information objective: the primary aim of the fair value assessment is to provide information on company performances, on invested capital and on capital structure corresponding to each accounting period. The principle of realisation of income and an approach geared mainly to the past will be abandoned. Investors will be provided with operating results that are more representative of the company reality, albeit potential, especially in cases in which realisation is possible in the short term. On the other hand, assessment at fair value, due to accounting of profits potentially realised, can generate volatility in the income: it will therefore be of fundamental importance to accompany this assessment criterion with adequate disclosure.

The main reason for these changes depends on the fact that there are profound differences between the concept of historical cost (which has always formed the basis of Italian accounting practice) and fair value: since the first accounting entry is made at cost, the differences, as is well-known, are particularly evident during assessments subsequent to purchase.

"Income type" is closely connected with the characteristics of the historical cost and fair value (Lee T., 1985). In this regard the following observations can be made:

- the accounting system at historical costs, due both to the concept of cost as maximum assessment limit and to the emphasis placed on the principle of prudence so that the presumed losses but not the unrealised profits are accounted in the financial statement, leads to configuration of the "income produced" which consists in recognising an income only when complete realisation of it has been ascertained;
- the fair value, due to use of the fair value during assessment which leads to determination of the income by juxtaposition of the positive and negative income components accrued at the time of the reporting date, independently of whether they have been realised, leads to configuration of the "potentially produced income".

The immediate consequence of these different income types is different financial communication (Pizzo M., 2000): with the historical cost, users of the financial statement are

provided mainly, but not exclusively, with information geared to the past whereas assessment at fair value provides information on company performances at the time of the reporting date with, at the same time, a perspective on the financial situation of the company.

6.5. Assessment of investments according to the IAS 39 and the effects on financial communication: concluding remarks

The aim is to highlight the main effects in terms of financial communication for Italian companies subject to the international accounting standards, in relation to investments in subsidiaries excluded from consolidation according to the IAS 27.

In particular, the following observations can be made:

a) considerable effort will be required of Italian groups in terms of resources employed and time dedicated both to determination of the fair value (certainly more complex than determination of the cost) and the detailed information to be provided in the financial statement;

b) with application of the IAS 39 the cost method becomes residual. It may be particularly difficult to assess equity instruments that do not have a quoted market price in an active market for which the cost method can still be applied only after ascertaining unsuitability of the fair value to achieve reliable values;

c) the Board adopts the same accounting method independently of the sign of the differential deriving from subsequent assessments at fair value. In particular, in the case of financial assets held for trading, the main difference with respect to the provisions of Italian law is accounting of unrealised profits in the income statement, involving greater net income and capital invested. In the case of financial assets available for sale, on the other hand, there are important differences in the presence of both unrealised profits and losses due to the fact that they are entered (according to the IAS 39) directly under equity. In particular, if profits are present – with the same net income – the invested capital and equity are greater; if losses are present, application of the IAS – with the same invested capital and equity – results in a higher income, due to non-accounting of the loss in the income statement, as required by Italian law.

Lastly, it should be underlined that assessment at fair value leads to determination of the “potentially produced income” type in relation to which it is fundamental to distinguish between realised and realisable income to avoid, above all, depauperation of equity.

Recently the Board proposed a new income statement scheme which is currently still at the project stage. The distinguishing feature of the project in progress is the concept of income understood as “comprehensive income”, obtainable from assessment of the assets and liabilities at fair value. In particular, the new income statement is characterised by a structure that enables the reader to understand the positive and negative income components in relation to their level of realisation.

7. Conclusions

After completing our gradual analysis of the main changes and related effects resulting from introduction of the IAS in Italy and going back to the criteria (indicated at the beginning of the study)[xiv] on the basis of which observations have been formulated at the end of each of the five paragraphs, we now wish to express our overall judgement on the ability of the IAS to give greater significance to determination and representation of group income and equity for the Italian companies in question.

From the study performed so far, the following observations can be made:

a) application of the IAS, in our opinion, will lead to the drawing up of a financial statement that is more representative of the complex group reality, due above all to the definition of a wider consolidation area with respect to the provisions of the D.Lgs. 127/91. This will involve, on the one hand, considerable effort in terms of change, especially for Italian groups that exercise the options granted by the legislator in order to simplify the consolidation process or, in some cases, to obtain a benefit deriving from opportunistic behaviour; on the other, however, the presence (according to the international standards) of only two exceptions to the general rule of consolidating all the subsidiaries will have the immediate effect of greater uniformity of behaviour thus making it easier to compare financial statements;

b) participation of the consolidation differences in formation of the income should - as a whole - improve the methods of determination and representation of group income and equity;

c) the existence of fewer options in the IAS, in relation to the intragroup transaction in particular and more generally the entire consolidation process, is on the one hand coherent with the accounting theory concept of group understood as one unitary entity and, on the other, permits reduction of possible opportunistic behaviour in favour of a more significant and clearer representation of the overall financial situation of the group;

d) the assessment rationale of the fair value leads to configuration of the "potentially produced income" which in the Board's income statement project corresponds to the "comprehensive income". This income configuration permits better representation of the group financial situation and performances, also with an eye to the future, especially in cases in which the financial assets owned for trading represent an important part of the capital invested (Chambers R.J., 1974; Chambers R.J., 1986). It is true that with the fair value assessment the income determined is characterised by a certain volatility associated with uncertainty concerning realisation of the profits accounted. It should be highlighted, however, that the fair value represents the amount of which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction: therefore, in the specific case of financial instruments that conform to this assumption or are about to be exchanged, although there is no total certainty of realisation, a very significant income value is nevertheless achieved even if only potentially produced;

e) in this regard, it should be underlined that the information value of the comprehensive income depends to a large extent on the information available, both quantitative and qualitative, relating to its determination and measurement by the companies involved in the innovative process.

From the analysis performed, it can therefore be affirmed that as a whole – i.e. excluding the treatment of intragroup transactions in the case of construction contracts for third parties – introduction of the international accounting standards should improve financial communication in relation to the consolidated financial statement in Italy and will certainly require a new approach to and interpretation of it.

REFERENCES

AA.VV. (a cura di Marchi L., Zavani M.), *"Economia dei gruppi e bilancio consolidato"*, Giappichelli, Torino, 1998.
Alexander D., Nobes C., *"A European Introduction to Financial Accounting"*, Prentice Hall International, UK, 1994.
Alexander D., *"Truer and Fairer. Uninvited comments on invited comments"*, in The European Accounting Review, 1996.
Andrei P., *"Gruppi aziendali e politiche dei prezzi di trasferimento"*, in AA.VV., *Le aggregazioni di impresa*, Giuffrè, Milano, 1999.
Azzali S., *"Il sistema delle informazioni di bilancio delle aziende di produzione. Il modello dell'I.A.S.C."*, Giuffré, Milano, 1996.
Azzali S., *"Il bilancio consolidato secondo i principi contabili internazionali"*, Il Sole 24 Ore, Milano, 2002.
Brunetti G., *"L'analisi economico-finanziaria mediante bilancio consolidato di gruppo"*, in Brunetti G. – Coda V. – Favotto F., *Analisi, previsioni, simulazioni, economico-finanziarie d'impresa*, Etas Libri, Milano, 1990.
Campedelli B. (a cura di), *"L'internazionalizzazione della comunicazione economico-finanziaria d'impresa"*, Obiettivo 2005, Franco Angeli, Milano, 2003.
Canziani A., *"Critica della True and Fair View"*, in AA.VV. *Studi in onore di Ubaldo di Dominicis*, Lint, Trieste, 1991.
Chambers R.J., *"Accounting, Evaluation and Economic Behaviour"*, Scholars Book Co., 1974.
Childs W.H., *"Consolidated Financial Statements. Principles and Procedures"*, Cornell University Press, New York, 1999.
Chow Y.C., *"The Doctrine of Proprietorship"*, in The Accounting Review, Vol. XVII, n. 2, aprile, 1942.
Coda V., "*Comunicazione ed immagine nella strategia dell'impresa"*, Giappichelli, Torino, 1991.
Edwards E.O. – Bell P.W., *"The Theory and Measurement of Business Income"*, University of California Press, 1965.
Edwards E. O., *"The State of Current Value Accounting"*, in The Accounting Review, 1975.
Flint D., *"A True and Fair View in Consolidated Accounts"*, in Gray S.J. – Coenenberg A.G. (Eds), *International Group Accounting*, Croom Helm, London, 1988.
Foster G., *"Financial Statement Analysis"*, Prentice Hall, Englewood Cliffs, 1998.
Ijiri Y., *"A Defence of Historical Cost Accounting"*, in Sterling R.R. (ed.) *Asset Valuation and Income Determination*, Scholars Book Co, 1970.
Lai A., *"Le situazioni di equilibrio economico-finanziario di gruppo"*, Franco Angeli, Milano, 1997.
Lee T. *"Income and value measurement"*, Van Nostrand Reinhold, UK, 1985.
MacNeal K., *"Truth in Accounting"*, Scholars Book Co., 1970.
Marchi. L. (a cura di), *"L'applicazione dei principi contabili nei bilanci delle imprese"*, Il Sole 24 Ore, Milano, 2000.
Moonitz M, *"The Entity Theory of Consolidated Statements"* The Foundation Press, Brooklyn, 1951.

Nobes C.W., *"Some Practical and Theoretical Problems of Group Accounting"*, Haskins and Sells, Deloitte, London, 1986.
Nobes C. – Parker R., *"Comparative International Accounting"*, Prentice Hall International, UK, 2002.
Onesti T., *"Fattori ambientali e comportamenti contabili, Analisi comparata dei sistemi contabili di alcuni Paesi industrializzati",* Giappichelli, Torino, 1995.
Ordelheide D., *"True and Fair View"*, in The European Accounting Review, 1996.
Parker R.H., *"Consolidation Accounting"*, in Nobes C.W. – Parker R.H. (*eds*), *Comparative International Accounting*, Oxford/New York, Philip Allan/St. Martin's Press, II ed., 1985.
Parker R.H. – Harcourt C.G. – Whittington G. (Eds), *"Readings in the concept and Measurement of income"*, Philip Allan, Oxford, 1986.
Pizzo M. *"L'area di consolidamento nei bilanci di gruppo"*, Cedam, Padova, 1989.
Pizzo M., *"Il fair value nel bilancio di esercizio"*, Cedam, Padova, 2000.
Poselli M., *"Il linguaggio internazionale dei bilanci nello scenario europeo"*, Giappichelli, Torino, 2000.
Prakash P. – Sounder S., *"The Case against Separation of Current Operating Profit and Holding Gain"*, in Accounting Review, gennaio, 1979.
Provasoli A. – Viganò A. (a cura di), *"Processi di formazione dei principi contabili in alcuni Paesi europei, Italia, Francia, Regno Unito, Germania"*, Edizioni Scientifiche Italiane, Napoli, 1995.
Rinaldi L., *"L'analisi del bilancio consolidato"*, Giuffré, Milano, 1999.
Rutherford B.A., *"The true and Fair Doctrine: A Search for Explication"*, in Journal of Business Finance and Accounting, 1985.
Sterling R.R., *"Theory of the Measurement of Enterprise Income"*, Scholars Book Co., 1979.
Teodori C., *"Il bilancio consolidato. La metodologia di costruzione e il profilo informativo",* Giuffrè, Milano, 2003.
Viganò A. *"Elementi di ragioneria internazionale"*, Egea, Milano, 1997.
Viganò E., *"L'impresa e il bilancio europeo, Saggi di ragioneria internazionale"*, Cedam, Padova, 1990.
Zambon S., *"Entità e proprietà nei bilanci di esercizio"*, Cedam, Padova, 1996.
Zambon S., *"Profili di ragioneria internazionale e comparata, Un approccio per aree tematiche"*, Cedam, Padova, 1996.
Zambon S., (a cura di) *"Informazione societaria e nuovi processi di armonizzazione internazionale. Alle soglie del cambiamento"*, Il Mulino, Bologna, 2002.
Zambon S., *"Locating accounting in its national context: the case of Italy"*, Franco Angeli, Milano, 2002.

---

[i] In this paper we consider the 2003 published version of the IAS (International Accounting Standards Committee Foundation, "International Accounting Standards", London, 2003) and the Improvements approved in December 2003, except the IAS 22 (today IFRS 3) and the IAS 39 (version December 2003).
[ii] By consolidation area we mean the set of subsidiaries subject to the consolidation process.
[iii] In this regard it should be pointed out that the national accounting standard no. 17 establishes that the relevance of one or more companies must be assessed considering them not individually but globally; this applies above all if the group consists of several small companies. Lastly, judgement as to whether a company is relevant should not be based only upon quantity aspects but also upon quality aspects, i.e. by verifying the strategic importance of the small firm in the group as a whole.
[iv] It should be pointed out that in this case only the national accounting standard 17 is referred to because the D.Lgs. 127/91 makes no provisions in this regard.
[v] The expression *at least* should be underlined since the harmonisation project also comprises, in the long term, the creation of a system of simplified IAS for small-medium sized firms. The trend is therefore to achieve, step by step, common harmonisation for all companies.
[vi] Considering Italian legislation, the two dates could also be in different years.
[vii] The same approach is present in the national accounting standard no. 17.
[viii] The same rationale, however, applies in the case of negative difference.
[ix] By positive excess we mean the part of the consolidation difference not attributed to the assets and liabilities.
[x] IFRS 3, Basis for Conclusions BC 140.

[xi] By negative excess we mean the part of the consolidation difference not attributed to the assets and liabilities.
[xii] IFRS 3, Basis for Conclusions BC 143-156.
[xiii] The same approach, in our opinion, is present in the Improvements to IAS 27, par. 25, December 2003.
[xiv] In particular, the concluding judgement will be formed on the basis of the following selected criteria:

a) *best representation of the group financial situation – understood as unitary entity – for the external users of the consolidated financial statement;*
b) *high level of uniformity of behaviour in construction of the consolidated financial statement in favour of accounting harmonisation;*
c) reduction of possible opportunistic behaviour, in order to guarantee the greatest transparency of information.