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# CHAPTER 1

## THE IMPACTS OF IFRS ON EUROPEAN BANKS: AN ANALYSIS FRAMEWORK

### 1.1 THE INTRODUCTION OF IFRS IN THE EUROPEAN UNION

The International Financial Reporting Standards (IFRS, formerly International Accounting Standards IAS) are the accounting standards issued by the International Accounting Standards Board (IASB, formerly International Accounting Standard Committee IASC). The attention towards these standards and the operating of IASB is enormously increased in the last few years, in particular after the decision of European Union to introduce them for listed companies.

The decision of EU of introducing IFRS is part of a broader project that has as final goal the complete integration of European Union's capital markets<sup>1</sup>. The procedure by which IFRS has been adopted by EU is very complicated and involved, other than European Union's institutions, many other technical committees (some of them specifically created for the purpose) with a regulatory or consultative function (table 1.1). Besides, for each Member State, the representatives of accounting professional body and the representatives of the principal categories interested by the introductions of IFRS (banks, industrial firms and national security regulators bodies) have been solicited to express their opinion.

The process began in 2000 and took more than three years to be completed. The major legislative steps were the followings:

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<sup>1</sup> In June 1999 the European Council endorsed a plan - Financial Service Action Plan - in which were indicated the actions that had to be taken to achieve the major goal of the integration of European Union's capital markets. The introduction of common accounting standards for firms listed on EU's capital markets was one of the priorities identified in the plan.

1. On the 13<sup>th</sup> of the June 2000 the EU Commission (EC) issued a Communication<sup>2</sup> to the Council and the European Parliament on the future European financial reporting strategy. In it the Commission recommended the introduction of IFRS for listed companies.
2. On July 19<sup>th</sup> 2002<sup>3</sup>, Following a EC proposal, the European Parliament and Council adopted regulation n° 1606/2002. In compliance with this Regulation, for each year starting on or after January 1<sup>st</sup> 2005, companies governed by the law of Member State shall prepare their consolidated financial statements in conformity with the International Accounting Standards adopted at the European level (endorsed IAS or endorsed IFRS<sup>4</sup>) if, at their balance sheet date, their securities are admitted to trading on a regulated market of any Member State (article 4)<sup>5</sup>. Approximately 7000 European Listed companies and indirectly many more subsidiaries will be affected by these regulation;
3. In June 2002 EFRAG<sup>6</sup> recommended the adoption of IFRS and related interpretations "en bloc";
4. in July 2003 the Accounting Regulatory Committee<sup>7</sup> recommended that the European Commission endorse all IFRS and Interpretations existing as of 14 September 2002, except IAS 32 and IAS 39 and the related interpretations on financial instruments;

<sup>2</sup> Communication from the Commission to the Council and the European Parliament, EU Financial Reporting Strategy: the way forward, COM (2000) 359, Brussels, 13<sup>th</sup> June 2000.

<sup>3</sup> Published in the Official Journal on September 11<sup>th</sup> 2002.

<sup>4</sup> International Financial Reporting Standards (IFRS) being the new name of IAS issued since May 2002. From now I refers to IAS/IFRS using the acronym IFRS.

<sup>5</sup>The article 9 of the Regulation n° 1606/2002 provides that "By way of derogation of article 4, Member State may provide that the requirements of Article 4 shall only apply for each financial year starting on or after January 1<sup>st</sup> 2007 to those companies:

- a) Whose debt securities only are admitted on a regulated market of any Member State with the meaning of article 1 (13) of Directive 93/22/EEC; or
- b) Whose securities are admitted to public trading in a non- member state and which, for that purpose, have been using internationally accepted standards since a financial year that started prior the publication of this regulation in the Official Journal of the European Communities.

<sup>6</sup> EFRAG is the acronym of European Financial Reporting Advisory Group, an organization established in 2001 by a broad group of organizations representing the European Accounting profession, prepares, users and national standard setters. For a description of the role of this organization see the next paragraph of this chapter.

5. on 29<sup>th</sup> September 2003 European Commission completed the process adopting a regulation (regulation n° 1725/2003) endorsing all existing IFRS and related Interpretations, with the exception of IAS 32 and IAS 39 and related interpretations;
6. on April 2004 European Commission adopted a regulation (regulation 07/2004) endorsing revised IFRS 1 and related interpretations;
7. On December 2004 European Commission adopted Regulations 2086/2004 and 2237/2004 endorsing, respectively, IAS 39 and IAS 32 and related interpretations.

**Table 1.1 – The introduction of IFRS in Europe**

| DATE          | ISSUE   | REFERENCE  |
|---------------|---|--|
| June 1999     | Established a plan for a complete integration of European Union's financial markets             | Financial Services Action Plan COM (1999) 232  |
| June 2000     | EC recommendations on IAS submitted to European Council and Parliament                          | EU Financial Reporting Strategy: the way forward. COM (2000) 359   |
| February 2001 | EC proposal to require IAS for listed companies   | Proposal for a Regulation of the European Parliament and of the Council on the Application of International Accounting Standards. Proposal COM (2001) 80 |
| May 2001      | Amendments to the 4 <sup>th</sup> and 7 <sup>th</sup> Directives to allow fair value accounting | Directive 2001/65/EC   |
| June 2001     | Two securities market committees created: ESC and CESR  | C (2001) 1493 and C (2001) 1501  |
| June 2001     | EFRAG Established and technical expert group created.   | EFRAG press release, 26 June 2001  |
| July 2001     | ESC endorsed the Proposal COM (2001) 80   | EU Economic and Social Committee Report to Ec Council  |
| May 2002      | EC Proposed revised accounting directives   | Proposal COM (2002) 259  |
| June 2002     | EFRAG recommended adoption of IAS and SIC "en bloc"   | EFRAG letter to Mr. Mogg   |
| July 2002     | Adoption of the regulation requiring listed companies to use International Accounting Standards | Adoption of certain International Accounting Standards. Regulation (EC) 1606/2002  |
| October 2002  | CESR issued a paper on enforcement of accounting standards in Europe                            | Proposed Statement of Principles of Enforcement of Accounting Standards in Europe, CESR Consultation Paper.  |
| March 2003    | EU securities regulators adopted accounting enforcement standard                                | Standard no. 1 on Financial Information – Enforcement of Standards on Financial Information in Europe- CESR/ 03-073                                      |
| May 2003      | EU approved amended   | Directive 2003/51/EC   |

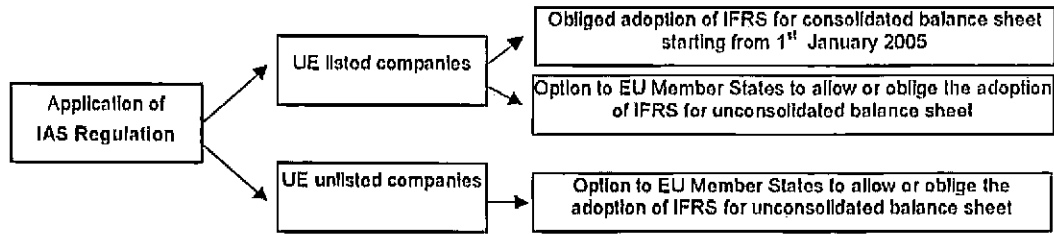
<sup>7</sup> As defined in article six of the regulation.

|                | accounting directives  |  |
|----------------|--|--|
| July 2003      | ECOFIN suggested that IAS 32 and IAS 39 might not be adopted immediately in Europe | 2520 <sup>th</sup> Council meeting – Economic and Financial Affairs – Brussels, 15 July 2003. 11180/03 (press 201)                                       |
| July 2003      | ARC endorsed all IFRS' other than IAS 32 and IAS 39 and relating SIC               | Meeting of the Accounting Regulatory Committee of 16 July 2003. Summary record   |
| August 2003    | IASB issued an Exposure Draft on macro hedging                                     | IASB, ED Fair Value Hedge for a Portfolio hedge of Interest Rate Risk  |
| September 2003 | European endorsement of IFRS was completed   | Adoption of certain International Accounting Standards in accordance with Regulation (EC) 1606/2002 (text with EEA relevance). Regulation (EC) 1725/2003 |
| October 2003   | CESR issued proposals on IFRS disclosure and enforcement                           | Draft recommendation for additional guidance regarding the transition to IFRS. CESR consultation paper, CESR/03-323b                                     |
| October 2003   | Endorsed IFRS published in all official languages                                  | Official Journal of European Union, volume 46, October 2003  |
| March 2004     | IASB issued IFRS 3 replacing IAS 22  | IFRS 3 published on March 2004   |
| April 2004     | European endorsement of revised IFRS 1 and related interpretations                 | EC Regulation 707/2004 (text with EEA relevance)   |
| December 2004  | European endorsement of IAS39 and IAS 32   | EC Regulations 2086/2004 and 2237/2004   |

The choice of the Commission to use the instrument of regulation instead of Directive marks a big change of strategy by EU in the field of financial reporting harmonization. European Regulations, differently from Directives, after their adoption by the Commission, are immediately effective in each member state without any legislative intervention of reception by the single states is needed. Thus this choice shows the clear willingness of European institutions to achieve the objectives fixed in the FSAP in a short term.

National Governments have only to express their preferences, by legislative interventions, about the different options, in terms of application' extension of IFRS, foreseen by the Regulation 1606/2002. In particular, each member state can decide if extend or not, as mandatory or facultative the adoption of IFRS other than for the preparation of consolidated financial statements by listed firms. In this sense the options left opened by Regulation 1606/2002 are resumed in figure 1.1.

**Figure 1.1**



In Italy a final decision about these options has not been taken. On December 2003 Italian Parliament adopted law 306/2003 that delegates the Government to issue a decree by which exercising the options foreseen by IAS Regulation. Until now (January 2005) the Government has not yet exercised this Delegation. As well as this, a draft of the decree discussed by the Cabinet has also been circulated. According to this document:

1. all Italian companies, starting from 1<sup>st</sup> January 2005, can prepare their consolidated and unconsolidated balance sheet adopting IFRS;
2. all banks insurance companies and other financial intermediaries, starting from 1<sup>st</sup> January 2005, must prepare their consolidated balance sheet adopting IFRS;
3. all banks insurance companies and other financial intermediaries, starting from 1<sup>st</sup> January 2005, can prepare their unconsolidated balance sheet adopting IFRS;
4. all the companies that prepare their consolidated balance sheet according to IFRS, starting from 1<sup>st</sup> January 2006, must prepare their unconsolidated balance sheet adopting IFRS.

The endorsement of this decree is expected in the next months.

## **1.2 THE IMPACTS OF IFRS ON THE ACCOUNTS AND THE OPERATIONS OF EUROPEAN BANKS: A SUMMARY VISION**

From 1st January 2005 banks must draw up their consolidated accounts according to international accounting principles (IFRS). This is clearly an important innovation which will have several effects on the operations of our

European credit intermediaries. IFRS are in fact very different from the domestic accounting principles which have been used until now in many European countries. In particular, IFRS will also bring to all Europe the Anglo-Saxon principle of the "*Usefulness Approach*",<sup>8</sup> according to which the primary objective of the accounts is to supply information which is useful in taking investment decisions. From this point of view the accounts are directed mainly at equity holders and the measures of income and shareholders' equity shown by the accounts must respectively reflect a measure of *performance* and one of economic capital. From an operational point of view this translates into an accounting system in which the accruals principle prevails over that of prudence and substance prevails over form. As a natural consequence of this basic requirement, IFRS are characterised by a greater use of *fair value* as an accounting substitute or as an alternative to cost, by a greater number of economic events being collected and shown in the accounts and by a greater detail of information being provided in the notes, with greater *disclosure* which will make the firm's activity more transparent.

The accounts therefore become a potentially richer source of information, but at the same time they are more complex to draw up and read. In this sense the introduction of IFRS is destined on the one hand to change the relationship between the firm and its *stakeholders* – impacts of the "external" type – and on the other hand to bring about important changes in the procedures and internal organisational structure of the firms who adopt the new principles – "internal" impacts.

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<sup>8</sup> A definition of this approach is provided by W.R.Scott (2003) "... *The information perspective on decision usefulness is an approach to financial reporting that recognizes individual responsibility for predicting future firm performance and that concentrates on providing useful information for this purpose. The approach assumes that the market will react to useful information from any source, including financial statements*".



**Figure 1.2 – The effects of the introduction of IFRS**

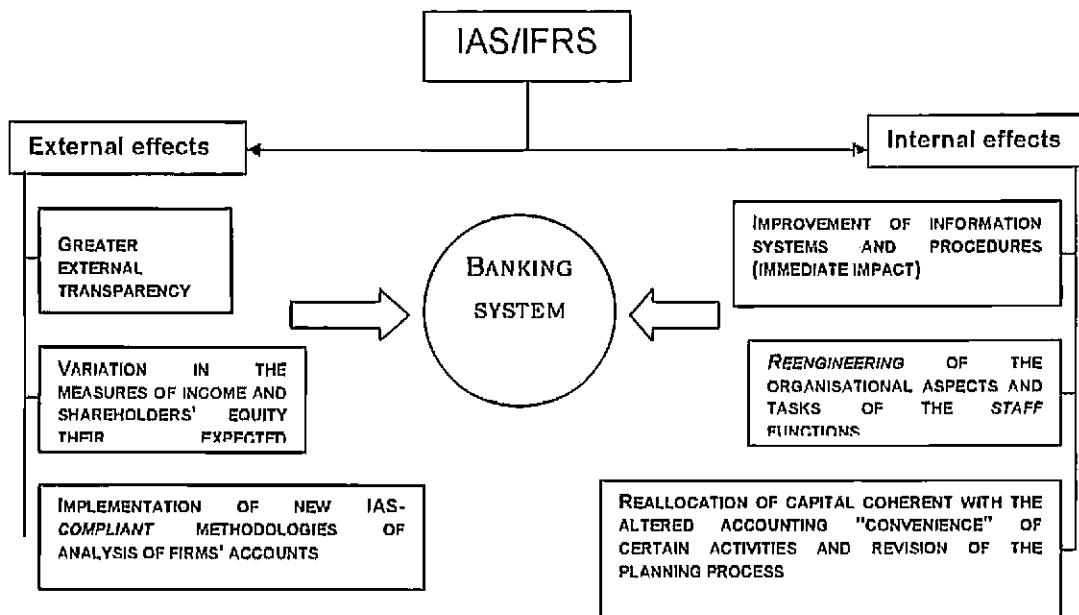


Figure 1.2 proposes an analytical scheme based on the previously mentioned distinction between “external” and “internal” effects, where the former means the impacts which IFRS will produce on the relationships between the bank and other economic operators such as *stakeholders*, the financial community and client firms, while the latter refers to the repercussions the new rules will have on the internal structure of the banks in terms of organisational aspects, structure of the information systems and strategic choices. It is clear that “external” and “internal” effects are interdependent. Indeed on the one hand the “internal effects” are none other than the responses of the bank in order to govern the “external” effects and on the other hand the ability to exploit the new rules in order to improve the relationships which the institution has with other economic players depends on the coherence and adequacy of these responses.

In this context, the most critical IFRS for banks (Table 1.2) appear to be: IAS 39 and IAS 32, which deal with the accounting treatment of financial instruments, IAS 14 which deals with *segment reporting* and IAS 22, 36 and 38, which together define the rules which should be

applied for the accounting treatment of acquisitions and the *goodwill* which arises from them.

**Table 1.2 – The most critical IFRS for banks**

| IFRS   | Impact of an external type  | Impact on systems and procedures   | Impact of a strategic-operational nature   | Impact of an organisational type  |
|--|---|--|--|---|
| IAS 39: accounting treatment of financial instruments          | <b>High:</b> Extension of the use of the criteria of <i>fair value</i> with a consequent increase in the expected volatility of the measures of income and Shareholders' Equity   | <b>High:</b> Implementation of new systems for classifying instruments. Introduction of new metrics to estimate <i>fair value</i>  | <b>High:</b> The convenience of undertaking certain operations changes, for example, securitisation, the need to revisit <i>hedging</i> techniques | <b>High:</b> Need to encourage the exchange of information and skills between the accounting function, <i>risk management</i> unit and the finance area |
| IAS 32: representation and disclosure of financial instruments | <b>High:</b> Specific rules for the representation in the accounts of financial instruments. A greater <i>disclosure</i> of operations using financial instruments and of the strategies for managing the risk taken on by the firm are foreseen. | <b>High:</b> It is necessary to adopt procedures to calculate the <i>fair value</i> of all financial instruments in a reliable manner conforming with the new principles | <b>Medium:</b> Greater knowledge sharing by all the organs of the bank concerning the strategies to manage risks taken on will be necessary        | <b>High:</b> The effects are as for IAS 39  |
| IAS 27: consolidated accounts                                  | <b>High:</b> The area of consolidation will become larger. In particular, it will be necessary to consolidate controlling stakes in insurance firms and SPVs, which are currently excluded from consolidation.                                    | <b>Low:</b> The information procedures and systems should be revisited in the light of the changed scope of consolidation  | <b>High:</b> The convenience of pursuing the model of the insurer bank as has hitherto been happening could dramatically reduce                    | <b>Low:</b> Any impact of an organisational nature should not be important  |

|  |   |  |  |  |
|--|---|--|--|--|
| <p><b>IAS 14:</b><br/><i>segment reporting</i></p>                         | <p><b>High:</b><br/>Cost accounting information which is not currently communicated externally will be supplied in a note to the accounts and will notably increase the transparency of the firm's activities</p>     | <p><b>High:</b><br/>Information procedures and systems will be introduced which, in line with cost accounting, will allow the firm to produce trustworthy information coherent with the plans and budgets used for internal managerial ends</p>  | <p><b>High:</b><br/>The process of strategic planning will be reconsidered so that the plans and budgets made for internal aims will be coherent with the communications made to analysts during the periodical meetings with the financial community (<i>roadshows</i>) and with the information inserted in the accounts</p> | <p><b>High:</b><br/>We are talking about designing organisational solutions which encourage the exchange of information and skills between the general accounting function, the control function and the bodies which deal with planning</p>   |
| <p><b>IAS 36 and IAS 38:</b><br/><i>goodwill and intangible assets</i></p> | <p><b>High:</b><br/>The proposed new accounting treatment of <i>goodwill</i> (no amortisation, but an annual <i>impairment</i> test) will have a strong impact on the measures of income and Shareholders' Equity</p> | <p><b>High:</b><br/>It will be necessary to design procedures which allow the trustworthy identification, coherent with IAS 36, of the units which generate financial flows. Furthermore, it will be necessary to adopt information systems which allow important information to be produced at the level of the single unit which generates financial flows</p> | <p><b>High:</b><br/>The convenience of undertaking certain activities will change, for example, <i>merchant banking</i></p>  | <p><b>High:</b><br/>Probably the <i>impairment</i> test will be entrusted to external professionals and consultants, however it will be necessary to supply them with the information relevant to the indirect calculation of the <i>goodwill</i> value. An important contribution by the organisational functions dealing with the preparation of the accounts and control will therefore be necessary.</p> |
| <p><b>IAS 22 and IFRS 3:</b><br/><i>business combinations</i></p>          | <p><b>High:</b><br/>All the acquisitions will be accounted for using the <i>purchased</i> method,</p>   | <p><b>Low:</b><br/>We are talking about extending the accounting procedures adopted in the case of</p>   | <p><b>Low:</b><br/>It should not change the convenience of undertaking acquisitions apart from the</p>   | <p><b>Medium:</b><br/>In the light of the new treatment of acquisitions, it will be necessary to increase the exchange of</p>  |

|  |  |                                 |  |  |
|--|--|---------------------------------|--|--|
|  | therefore the ways of accounting for mergers will change, with important effects on the measures of Shareholders' Equity at a consolidated level | acquisitions to mergers as well | treatment of <i>Goodwill</i> (IAS 36 and IAS 38) | skills and information between the administration and control functions and the finance area |
|--|--|---------------------------------|--|--|

### 1.3 THE "EXTERNAL" IMPACTS OF IFRS

From the point of view of "external" impacts, there will first of all be strong qualitative and quantitative repercussions on how various items are shown in the accounts and therefore on the summary measures of income and shareholders' equity, both in terms of absolute size<sup>9</sup> and above all in terms of their volatility, which will inevitably increase. In this context we should remember that according to the theory of banking technique the shareholders' equity represents the strategic parameter with which we should compare the different types of risk taken on by the intermediary. This logical requirement is imposed by the regulatory authorities who define the rules of healthy and prudent management. The expected increase in the volatility of the shareholders' equity in the accounts is therefore a critical element which should be monitored and managed through an effective control by the managerial bodies on the drawing up of the accounts as well as through appropriate operational choices which must take account of the new accounting rules.

<sup>9</sup> Table 1.3 shows what could happen to European banks with the introduction of IFRS. In it are reported the reconciliation of Net Income and Shareholders' Equity to US GAAP for some European banks listed on NYSE. The impact of the adoption of different standards on banks' accounts is enormous.

**Table 1.3 – Recociliation to US GAAP (2002, US Dollars Mil.)**

|  | San Paolo<br>IMI<br>S.p.A. | Banco<br>Bilbao<br>Vizcaya<br>Argenteria<br>Group | Santander<br>Central<br>Hispano<br>Group | Bank of<br>Ireland<br>Group | BES<br>Group   | Banco<br>Totia | ABN Amro<br>Holding NV | Ing<br>Group<br>NV | Banco<br>Comercial<br>Portugues |
|--|----------------------------|---|--|-----------------------------|----------------|----------------|------------------------|--------------------|---------------------------------|
| Net Income<br>under home<br>GAAP                   | 889                        | 1.719   | 2.247                                    | 826                         | 222            | 205            | 2.207                  | 4.500              | 272                             |
| Goodwill and<br>business<br>combinations           | -1.488<br>(167%)           | -122<br>(7%)                                      | 542<br>24%                               | 6<br>1%                     | -30<br>(-14%)  | -70<br>(-34%)  | 1.000<br>(45%)         | -13.030<br>(-289%) | -878<br>(-323%)                 |
| Impairment of loans                                | 0<br>(0%)                  | 221<br>13%  | -126<br>(0%)                             | 0<br>(0%)                   | -35<br>(16%)   | -20<br>(10%)   | 0<br>(0%)              | 0<br>(0%)          | 0<br>(0%)                       |
| Investment<br>securities                           | -90<br>(10%)               | 415<br>24%  | -38<br>(2%)                              | 0<br>0%                     | -326<br>(147%) | 95<br>47%      | 1.187<br>54%           | -407<br>(9%)       | -441<br>(162%)                  |
| Derivatives  | 75<br>8%                   | -126<br>(7%)                                      | 226<br>10%                               | 75<br>9%                    | 45<br>20%      | 0,5<br>0%      | 802<br>36%             | -470<br>(10%)      | 217<br>80%                      |
| Early retirements                                  | -74<br>8%                  | -514<br>(30%)                                     | -839<br>(37%)                            | -44<br>(5%)                 | -100<br>(45%)  | -20<br>(10%)   | 6<br>0%                | -56<br>(1%)        | 0<br>0%                         |
| Compensations<br>plans                             | -24<br>(3%)                | 0<br>0%   | 0<br>0%                                  | -3<br>0%                    | -23<br>(10%)   | 0<br>0%        | 82<br>4%               | 0<br>0%            | -23<br>(9%)                     |
| Deferred tax                                       | 75<br>8%                   | -14<br>(1%)                                       | -97<br>(4%)                              | 3<br>0%                     | 143<br>64%     | 10<br>5%       | -420<br>(19%)          | -99<br>(2%)        | 106<br>39%                      |
| General banking<br>risks                           | -364<br>(42%)              | 0<br>0%   | 0<br>0%                                  | 0<br>0%                     | 0<br>0%        | 0<br>0%        | 0<br>0%                | -172<br>(4%)       | 0<br>0%                         |
| Others adjustments                                 | -119<br>(13%)              | 266<br>15%  | 371<br>17%                               | -96<br>(12%)                | -57<br>(26%)   | -32,5<br>(16%) | -754<br>(34%)          | 77<br>2%           | 9<br>3%                         |
| Net Income US<br>GAAP                              | -1.120<br>(126%)           | 1.845<br>107%                                     | 2.286<br>102%                            | 767<br>93%                  | -161<br>(73%)  | 168<br>82%     | 2.110<br>96%           | -9.627<br>(-214%)  | -738<br>(-271%)                 |
| -----  |                            |   |  |                             |                |                |                        |                    |                                 |
| Equity under<br>home GAAP                          | 10.537                     | 12.602  | 18.242                                   | 4.195                       | 2.001          | 1.358          | 10.781                 | 18.254             | 2.188                           |
| Goodwill and<br>business<br>combinations           | 6.475<br>63%               | 5.425<br>48%                                      | 2.925<br>16%                             | 422<br>10%                  | 203<br>10%     | 178<br>13%     | 6.399<br>59%           | 4.611<br>25%       | 3.570<br>164%                   |
| Debt restructuring<br>and impairment of<br>loans   | -87<br>(0,8%)              | 675<br>6%   | 473<br>2,5%                              | 0<br>0%                     | 9<br>0%        | 0<br>0%        | -49<br>(0,4%)          | 187<br>1%          | 0<br>0%                         |
| Investment<br>securities                           | 76<br>(0,7%)               | 1.077<br>9%                                       | 2.274<br>12%                             | 113<br>2,8%                 | -390<br>(19%)  | 23<br>2%       | 2.049<br>27%           | 9.300<br>52%       | -738<br>(-30%)                  |
| Derivatives  | -20<br>(0,2%)              | 15<br>0%  | 31<br>0%                                 | 2<br>0%                     | -10<br>(0,4%)  | 47<br>3%       | 686<br>6%              | -763<br>(-4%)      | 164<br>7%                       |
| Pension plans and<br>Employee<br>termination costs | 245<br>2,3%                | 183<br>(1,2%)                                     | -784<br>(4%)                             | -12<br>(0,3%)               | 170<br>8%      | -238<br>(18%)  | 133<br>1%              | -2.698<br>(-12%)   | 165<br>7%                       |
| Deferred tax and<br>income tax<br>adjustment       | -1780<br>16%               | -327<br>(2,5%)                                    | -483<br>(2,6%)                           | 30<br>0%                    | 150<br>7%      | 206<br>15%     | -1.558<br>(14%)        | -624<br>(3%)       | 469<br>21%                      |
| Dividends  | 0<br>(0%)                  | 0<br>0%   | 0<br>0%                                  | 238<br>6%                   | 0<br>0%        | 0<br>0%        | 346<br>3%              | 0<br>0%            | 0<br>0%                         |
| Others adjustments                                 | -532<br>(5%)               | -743<br>(6%)                                      | 436<br>2,3%                              | -799<br>(19%)               | -204<br>(10%)  | 279<br>20%     | 12<br>0%               | -381<br>(-2%)      | -383<br>(-17%)                  |
| Shareholders'<br>equity under<br>US GAAP           | 14.934<br>141%             | 18.907<br>150%                                    | 23.114<br>126%                           | 4189<br>99%                 | 1.939<br>97%   | 1.441<br>106%  | 19.013<br>176%         | 25.060<br>137%     | 5.395<br>246%                   |

A second effect of the “external” type of the introduction of IFRS can be seen in the greater level of transparency with regard to the market, which the new principles should guarantee thanks to the enrichment of the information which must be inserted in the accounts (for examples, the *segment reporting* imposed by IAS 14). In this context the activity of *investors relations*, in which the publication and presentation of the accounts is an essential part will become more important than in the past. In particular, it will be necessary to reconsider the bank’s entire external communication activities, in order to ensure that it is coherent with and complements the accounting documents. Given the complexity of the latter, they should probably be “explained” in order to improve the ability of the final users to exploit them to the full.

Finally, the introduction of IFRS will have an impact on the bank as a user of others’ accounts. In particular, all the company valuation processes in which the analysis of the accounts plays an important role will have to be reviewed.

#### **1.4 THE “INTERNAL” IMPACTS OF IFRS**

The concepts mentioned above lead us to consider as a consequence the “internal” effects which IFRS will have on banks’ organisations. The implementation of international accounting principles in fact on the one hand obliges banks to adopt in the near future informational aids and systems able to satisfy the new legal requirements and on the other hand, given the widespread effect of the innovations which will be introduced, will change in the medium term the internal structure of institutions and many of the current operational procedures.

In reference to the first aspect, it is evident that a complete rethink of the information structure of the bank is required so that the information necessary to draw up the IFRS accounts, but which is not currently available or which is scattered throughout the institution and stored in such a way that it cannot be used in the accounts, can be gathered<sup>10</sup>. Furthermore, it is

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<sup>10</sup> For an analysis of the impact that the introduction of the IAS/IFRS has on bank information systems, see Larosa M. and Pandozy P., “The impact of IFRS on the bank information system I” and Caruso G. “The impact of IFRS on the bank information system II” in FITD “IAS-IFRS: their application to banks”, Bancaria Editrice, Rome 2004.

necessary to revisit the process of summarising and processing information, in order to allow a correct drawing up of the accounts. In this context, the introduction of IFRS in banks, even more than in industrial firms, will bring into the sphere of general accounting and the accounts a series of information and procedures which will be gathered and drawn up respectively within other firm functions which are involved in control (*risk management*, control, strategic planning). In other words, the bank's systems of external communication (accounts and regulatory instructions) and internal communication (industrial accounting, measures of risk and accounting according to a *Value Based Management* approach), will be drawn closer to each other, and in many ways overlap, especially in the light of the forthcoming introduction of the new Basel accord.

In this context, the approach adopted by banks to respond to the challenges mentioned above was naturally of a *top-down* nature, giving priority in the initial phase, through the use of external consultants, to more focused planning, aiming above all at the *reengineering* of the information platforms and the valuation of the "external" impacts deriving from the initial application of the new principles. Furthermore, procedures were adopted in order to be able to comply with legal requirements.

As mentioned above, therefore, these actions represent only the first necessary response to the introduction of the IFRS which is destined to change deeply as well the internal structure of the banks. In this context, we expect strong effects in strategic planning and the organisational structure of the *staff*<sup>11</sup> functions.

With reference to the first outline mentioned, the following aspects are important:

- The altered convenience of undertaking certain operations/activities where the accounting innovations will have a potentially explosive

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<sup>11</sup> This refers to those organisational units within a company structure which are normally directly dependant on managing bodies - Director General, Vice Director General and/or Managing Director and which are or will be directly or indirectly involved in the process of drafting the balance sheet. Therefore for banks, reference should be made to the Accounting and Balance Sheet function (Administration), the Planning and Control function, Risk Management and to a certain extent Finance/Treasury Management and to Holdings Management. Section 3 examines the organisational structure of staff functions in Italian banks in greater depth.

impact, for example securitisation operations and *merchant banking* activities;

- The need to reallocate the available shareholders' equity between the various areas of the firm taking account of the impact which the new rules will have on its volatility;
- The need to revisit the processes through which forecasts are made, making these processes coherent and compatible with the new legal body and the increasing *disclosure* obligations which it requires.

The aforementioned impact of a strategic nature can be effectively managed only when there is an organisational restructuring of the administrative functions which allows the management bodies of the bank to be able to take knowledgeable decisions which simultaneously take account of all the relevant variables. In this context the role of the general accounting function should evolve and above all be integrated with other functions of the firm, *risk management* and control, which are currently only marginally involved in the process of drawing up the accounts. In particular, it will be necessary to devise and realise organisational solutions which favour the exchange of information and skills in both directions. In fact, on the one hand accounting skills will be indispensable from an *ex ante* perspective in order to be able to make the most correct operational choices (the case of the hedging operations is a case in point). On the other hand, with regard to drawing up the accounts, the organisational unit dedicated to this must take ownership of and check values which have been calculated according to metrics set out by other functions of the firm, which will therefore contribute, even if in an indirect way, to the preparation of the accounts. The organisational solutions adopted must, however, provide a clear subdivision of tasks and responsibilities in order to give the managerial bodies of the bank effective control and governance. In this context we should not exclude the possibility of setting up new organisational bodies which will undertake the aforementioned co-ordination role and which will have responsibility for the internal process. In particular, it is possible that the bank will introduce the role of *Chief Financial Officer*, which is already present in industrial firms but which would undertake particular tasks within financial institutions, to undertake which varied and complex skills are required. Moreover, there are many possible organisational solutions in order to deal with these changes,



each of which has advantages and disadvantages. It will therefore be the task of each institution to choose the solution which best fits its needs.

# **CHAPTER 2**

## **THE ASSUMPTIONS UNDERLYING IFRS AND THEIR ADOPTION IN EUROPE: THE RELATION BETWEEN INSTITUTIONAL FACTORS AND OPTIMAL ACCOUNTING POLICY**

### **2.1 THE OBJECTIVES PURSUED WITH THE INTRODUCTION OF IFRS IN THE EUROPEAN UNION: THE USEFULNESS APPROACH TO FINANCIAL REPORTING**

On July 19<sup>th</sup> 2002<sup>12</sup> the European Parliament and Council adopted regulation n° 1606/2002. In compliance with this Regulation, for each year starting on or after January 1<sup>st</sup> 2005, companies governed by the law of Member State shall prepare their consolidated financial statements in conformity with the International Accounting Standards (IASs) adopted at the European level (endorsed IASs or endorsed IFRS<sup>13</sup>) if, at their balance sheet date, their securities are admitted to trading on a regulated market of any Member State (article 4). Approximately 7000 European Listed companies and indirectly many more subsidiaries will be affected by these regulation. For many of these companies the adoption of IFRS will represent a big change because the home GAAP they have been using until now differs substantially from IFRS. The consequences of this change will affect a broad range of

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<sup>12</sup> Published in the Official Journal on September 11<sup>th</sup> 2002.

<sup>13</sup> International Financial Reporting Standards (IFRS) being the new name of IFRSs since May 2002.

aspects with a magnitude that will differ across the companies in function of several elements (nationality, business, dimension, organization etc.).

In any case, two are the major objectives pursued by European Union with this innovation:

- 1) the harmonization of accounting practices across Europe for listed companies, considered a fundamental step towards the final goal of complete integration of European capital markets;
- 2) the improvement of the average quality of accounting information provided by European listed firms to capital markets. In particular a specific objective pursued by IASB is to generate accounting information that current and potential investors can use in making rational investment decisions, i.e. financial information that is useful in estimating the intrinsic value of securities issued by a listed firm (International Accounting Standards Committee [IASC], 1997).

In this sense it is not surprising that the IFRS issued by the IASB present a great level of similarity with the home GAAP of Anglo-Saxon countries (USA, UK, Canada and Australia), where the typical approach to financial reporting is exactly the Usefulness Approach, according to which the major goal of financial statement is to help investors to take investment decision. This approach assigns to financial reporting a role that is at least partially different from that traditionally it covers in the Continental countries (Italy, Germany and France). In these countries politicization typically leads to a "stakeholder" governance model, involving agents for major groups contracting with the firm. Conversely, because these groups' agents are represented in corporate governance insider communication solves the information asymmetry between managers and stakeholders. So accounting practices are more influenced by the pay out preferences of agents for labor, capital and government and less by the demand for public disclosure, coherently to this context the current-period accounting income tends to be viewed as the pie to be divided among groups, as dividends to shareholders, taxes to governments and bonuses to managers and perhaps also employees.

In the Anglo-Saxon countries, instead, is predominant the "shareholders" governance model in which shareholders alone elect members of the governing board, pay outs are less closely linked to current-period accounting income, and public disclosure is a more likely solution for the information asymmetry problem. In comparison with more political process in the Continental countries, the most desirable properties of financial reporting are determined primarily in the disclosure market and thus its key role is to provide useful information to investors.

According to this view of the key role of financial reporting, financial accounting theory and research, to predict and measure the usefulness of accounting information has operationalized the concept of usefulness equating it with the concept of information content of accounting information. The information content has been measured by researchers as market response to accounting information and as level of association between accounting numbers and prices of securities (returns). This approach is called the information perspective on decision usefulness of financial reporting and has dominated Anglo-Saxon financial accounting theory and research since the pioneering work of Ball and Brown (1968).

A definition of this approach is provided by W. R. Scott (2003) "... The information perspective on decision usefulness is an approach to financial reporting that recognizes individual responsibility for predicting future firm performance and that concentrates on providing useful information for this purpose. The approach assumes that the market will react to useful information from any source, including financial statements".

According to this approach the criteria by which evaluate the quality of financial reporting information is that of "value relevance" of accounting information, where the concept of value relevance is strictly related to the study of association between accounting amount and equity market values, Barth et al. (2001) provides the following definition : "... an accounting amount is value relevant if it has a predicted association with equity market values." .

From the pioneer study of Ball and Brown (Ball and Brown 1968) the relation between accounting numbers and stock market values (or changes in values) has been investigated by researchers in a huge number of studies using different empirical specifications (e.g. Harris and Mueller 1999).

Holthausen and Watts (2001) classify these studies in three categories: i) relative association studies; ii) incremental association studies and iii) marginal information studies.

i) Relative association studies compare the association between stock market values (or changes in values) and alternative bottom-line measures. For example, a study might examine whether the association of an earnings number, calculated under a proposed standard, is more highly associated with stock market values or returns than earnings calculated under existing GAAP (e.g., Dhaliwal et al., 1999). Other studies compare the value relevance of accounting numbers in different countries (e.g. Alford et al., 1993).

ii) Incremental association studies investigate whether the accounting number of interest is helpful in explaining value or returns given other specified variables (e.g., Vekatachalam, 1996). That is accounting number is typically deemed to be value relevant if its estimated regression coefficient is significantly different from zero.

iii) Marginal information content studies investigate whether a particular accounting number adds to the information set available to investors. They typically use event studies (short window return studies) to determine if the release of an accounting number (conditional other information released) is associated with value changes. Price reactions are considered evidence of value relevance.

In the Anglo-Saxon countries, because of the role attributed to accounting information, the value relevance literature as whole, providing helpful information to judge the validity of accounting measures adopted and to identify eventual improvement's necessities, represents an important support to the work of standard setters (Barth, Beaver, Landsman, 2001)<sup>14</sup>.

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<sup>14</sup> Holthausen and Watts (2001) criticize the utility of value relevance studies for standard setting purposes. They move essentially two main critics: i) an high association between accounting numbers and stock market values is not the only and more important objective pursued by standard setters when they issue a standard, so no operational decision could be taken on the basis of the evidence provided by value relevance literature; ii) The valuation models used by value relevance researcher to develop their tests are not well specified. In particular they are built on the hypothesis of market efficiency, this hypothesis makes accounting unhelpful. Both these critics are well addressed by Barth et al. (2001).

## **2.2 WHICH FACTORS DRIVE THE QUALITY OF ACCOUNTING NUMBERS? THE FINDINGS OF PREVIOUS LITERATURE**

In the traditional international accounting debate much of the discussion has focused on accounting standards per se, which have been viewed as the primary input for high quality accounting. Many researchers performed international studies with the objective to identify the standards of higher quality, where the concept of quality has been defined along different dimensions (value relevance, timeliness and conservatism), almost related to the capability of financial statements to convey useful information to the investors.

One of the first and most important studies of this type is that of Alford, Jones, Leftvich and Zmijevski (1993) (hereafter AJLZ). They compare the information content and timeliness of accounting earnings in 16 countries using US as benchmark. They perform two types of analysis. The first examines an investment strategy based on the rank of unexpected earnings, similar to the approach in Ball and Brown (1968). The second estimates a regression model of 15-month returns on the contemporaneous level and change in earnings. AJLZ found that in Anglo-Saxon countries, generally, earnings are more value relevant than in continental countries (a relevant exception is represented by France). Although they cite as possible explanations of their findings, the differences in corporate governance and corporate disclosure, they identify differences in accounting standards as main source of international variation in the value relevance of accounting earnings.

This type of research has dominated the international accounting debate during the '90s – Amir et al. (1993), Banyopadhyay et al. (1994), Harris et al. (1994), Joos and Lang (1994); Barth and Clinch (1996), Joos (1997), Lewitt (1998) and Pope and Walker (1999) – providing an empirical justification to the harmonization of accounting practices world-wide; as Pope (1993) pointed out, “when the results of these studies reflect different information content of accounting data under different GAAP, this helps to justify the process of harmonization”. As said before, this way of thinking identifies in the accounting standards the main source of accounting quality and assesses a

small role to others institutional factors that are seen only as disturbance elements. According with this view, nowadays the harmonization process of accounting standards is boosting worldwide, in particular in the recent years several countries have adopted or plan to adopt International Financial Reporting Standards (IFRS) in an attempt to improve accounting quality. The problem is that, as often happens, regulatory intervention lags findings of academic research. More specifically, recently, the role played by institutional factors as determinants of accounting quality is being reevaluated by researchers that are issuing many doubts on the efficacy of accounting harmonization measures recently adopted or announced. This new mainstream of research, often called institutional accounting, is built on the line of research that during the last two decades attempted to classify the different accounting systems developed worldwide and to identify their determinants.

This previous line of research identifies many institutional variables influencing the development of national accounting systems and by which classify them. Choi and Mueller (1992) pointed out that relevant characteristics are the source of accounting standards (private/public standard setters), the compliance between accounting and taxation rules, the political system, the financial system (market/bank oriented), the enforcement system and the efficiency of the market. Similar variables and classifications are used by other researchers - for a classification survey, see Nobes and Parker (1992) - . The lack of this stream of research is that how these variables affect important properties of accounting information internationally is largely untested. International accounting texts in which these classifications are presented, typically list variables to justify the classifications, without correlating them with the national accounting standards, let alone with properties of the financial statements actually prepared under those standards.

The institutional accounting tries to overcome this lack identifying empirically the nature of these relations; the major and more recent studies in this field focus on the role of institutional factors as determinants of national accounting systems and accounting practices. As Ball (2001) noted, the global debate focuses too much on the standards and too little on the role of institutional factors and market forces in shaping firms' incentives to report

informative earnings. Accounting standards generally grant substantial flexibility to firms. Measurements are often based on private information and the application of standards involves judgment. Corporate insiders can use the resulting discretion when it is in their best interest. For this reason, reporting incentives are likely to play an integral role in determining the informativeness of reported accounting numbers. While this insight is not new (e.g. Watts and Zimmerman, 1986), it is overlooked in the traditional international standard setting.

The first study that tries explicitly to examine, by empirical tests, the association between value relevance of accounting numbers and country-specific factors related to financial reporting is that of Ali and Hwang (AH hereafter) (2000). They use data from manufacturing firms from 16 countries (the same of AJLZ) and explore relations between measures of the value relevance of financial accounting data and four country-specific factors (financial system orientation, sources of GAAP, financial-tax alignment, spending on auditing services). Value relevance is specified primarily in terms of explanatory power of accounting variables (earnings and book value of equity) for security returns, relative to explanatory power for comparable US firms. Their findings are the followings: i) the value relevance is higher for countries with market oriented (as opposed to market oriented) financial systems; ii) value relevance is lower for countries where private-sector bodies are not involved in the standard setting process; iii) value relevance is lower for Continental model countries than for British-American model countries; iv) value relevance is lower when tax rules significantly influence financial reporting measurements; v) value relevance is higher more is spent on external accounting services. The four factors considered are strongly interrelated and principal analysis, performed by AH, shows that only one underlying construct manifests itself in the five country-factors considered. They are not able, however, to label the construct.

Another important paper for the development of institutional accounting is that of Ball, Kothari and Robin (2000) (BKR hereafter). They study the association between the "transparency" of financial statement and the extent of political influence on accounting in 8 countries. More precisely, as proxy for transparency they consider two properties of accounting income: timeliness and conservatism. Timeliness is defined as the extent to which current-period



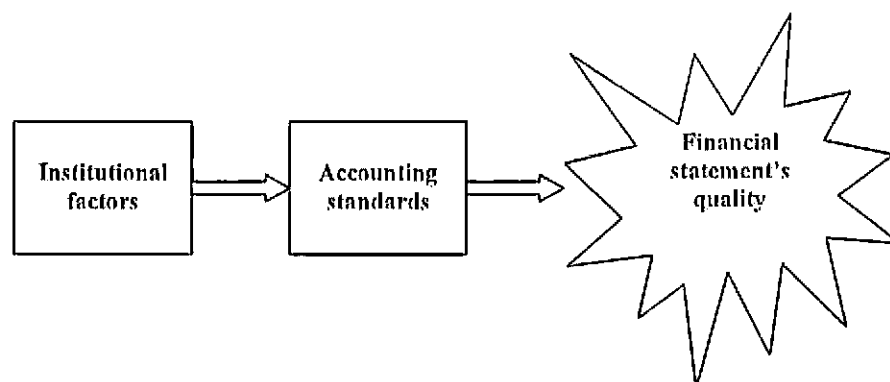
accounting income incorporates current-period economic income, their proxy for which is change in market value of stockholders' equity. Conservatism is defined in the BASU (1997) sense as the extent to which current-period accounting income asymmetrically incorporates economic losses, relative to economic gains.

The proxy they use for political influence is a dichotomous classification of countries into code law systems with high political influence versus common law systems in which accounting practices are determined in the private sector.

The central result of BKR's study is that accounting income in common-law countries is significantly more timely than in code law countries due entirely to quicker incorporation of economic losses. BKR explain these findings arguing that information asymmetry more likely is resolved in code-law countries by institutional features other than timely and conservative public financial statements, notably by closer relations with major stakeholders.

The seminal studies of AH and BKR for the first time test empirically the relations between some institutional factors and some properties of accounting numbers. These studies enrich the traditional literature in international accounting, but they do not contrast explicitly the idea that financial reporting quality depends almost on standards; what these works implicitly suggest is that countries-specific factors influence demand for high quality financial reporting and by this the kind of standards implemented in each country.

**Figure 2.1**



This view has been showed to be incomplete and potentially misleading by the fundamental paper of Ball, Robin and Wu (2003) (BRW hereafter) that clearly shows that reporting quality ultimately is determined by the underlying economic and political factors influencing managers' and auditors' incentives, and not by accounting standards *per se*. BRW analyze financial reporting quality in 4 East Asian countries – Hong Kong, Malaysia, Singapore and Thailand – that provide a useful setting for testing the importance of preparer incentives. These countries have accounting standards that are generally viewed as high-quality but they have institutional structures that give preparers incentives to issue low-quality reports. BRW operationalize the concept of financial reporting quality using the same approach of BKR (2000) while the institutional environment in each country is described in very detail using a qualitative approach. In particular, they argue that the 4 countries analyzed present an institutional environment more similar to code-law model than common-law model. According to this evidence, the results of the study show that in the 4 countries analyzed accounting earnings present properties – in terms of timeliness and conservatism – more similar to that of code-law countries (BKR 2000) than common-law countries. These findings suggest that institutional factors are more relevant than accounting standards *per se* in determining properties of accounting numbers. The way by which institutional factors affects financial reporting quality is double: i) Influencing the kind of standards implemented; ii) determining preparer incentives to follow high-quality reporting practices and so to reduce earnings management activity. The second effect predominates the first one.

Recently the relation between incentives and accounting practices has been investigated in more detail, with particular attention to the earnings' management activity. Leuz, Nanda and Wysocki (2003) (LNW hereafter) examine systematic differences in earnings management across 31 countries.

They propose an explanation for these differences based on the notion that insiders, in an attempt to protect their private control benefits, use earnings management to conceal firm performance from outsiders. Thus, earnings management is expected to decrease in investor protection because strong protection limits insiders' ability to acquire private control benefits, which reduces their incentives to mask firm performance. Their findings are

consistent with this prediction and suggest an endogenous link between corporate governance and the quality of reported earnings. More precisely they perform a descriptive country cluster analysis, which groups countries with similar legal and institutional characteristics. Three distinct country clusters are identified: (1) outsider economies with large stock markets, dispersed ownership, strong investor rights, and strong legal enforcement (e.g., United Kingdom and United States); (2) insider economies with less-developed stock markets, concentrated ownership, weak investor rights, but strong legal enforcement (e.g. Germany and Sweden); and, (3) insider economies with weak legal enforcement (e.g., Italy and India).

These clusters closely parallel simple code-law and common-law as well as regional characterizations used in prior work (e.g., La Porta et al. 1997; Ball et al. 2000 ). LNW find significant differences in earnings management across these three institutional clusters. Outsider economies with strong enforcement display the lowest level of earnings management and insider economies with weak enforcement the highest level of earnings management. That is, earnings management appears to be lower in economies with large stock markets, dispersed ownership, strong investor rights, and strong legal enforcement. These results remain significant after they control for cross-country differences in accounting rules.

**Table 2.1 – Institutional accounting literature**

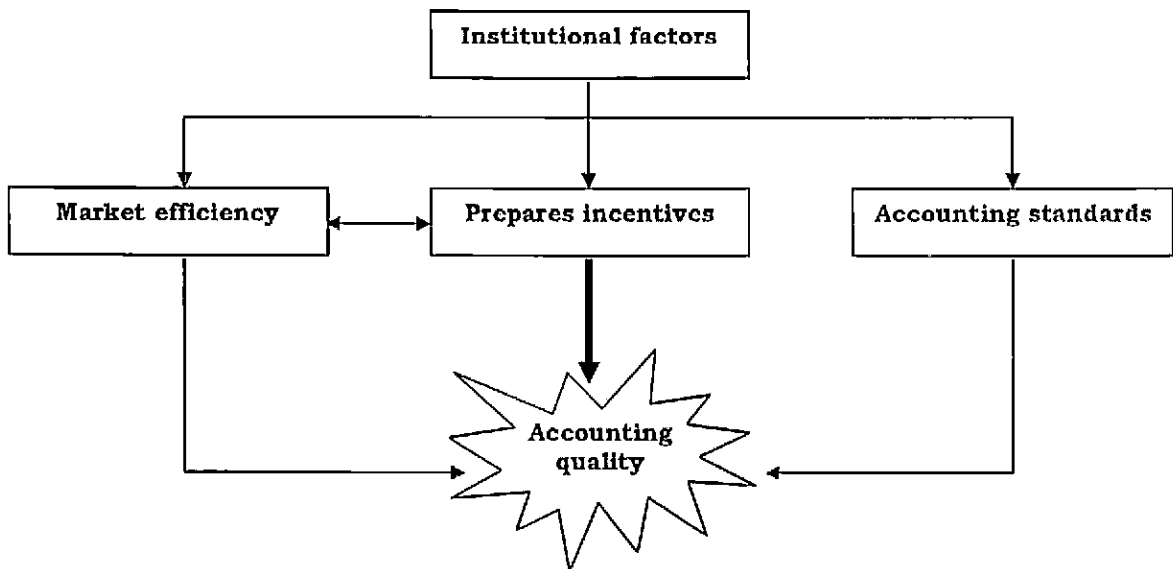
| Study  | Institutional factors  | Earnings management   | Financial reporting quality  |
|--|--|---|--|
| Ali, A.; Hwang, L., "Country-specific factors related to financial reporting and the value relevance of accounting data" <i>Journal of Accounting Research</i> 2000, pp. 1-23        | i) financial system orientation; ii) sources of GAAP; iii) financial-tax alignment; iv) spending on auditing services.   |   | the value relevance is higher for countries i) with market oriented (as opposed to bank oriented) financial systems; ii) where private-sector bodies are involved in the standard setting process; iii) where British-American model is adopted; iv) where tax rules do not significantly influence financial reporting measurements; v) in which is spent more on external accounting services. |
| Ball, R.; Kothari, S.; Robin, A., "The effect of international institutional factors on properties of accounting earnings" <i>Journal of Accounting and Economics</i> 2000, pp. 1-52 | i) political influence: code law systems with high political influence versus common law systems in which accounting practices are determined in the private sector. |   | i) accounting income in common-law countries is significantly more timely than in code law countries due entirely to quicker incorporation of economic losses.   |
| Ball, R.; Robin, A.; Wu, J.; "Incentives versus standards: properties of accounting income in four East Asian countries" <i>Journal of Accounting and Economics</i> 2003, pp.235-270 | ii) accounting standards; iii) political influence: code law systems versus common law systems.  |   | i) institutional factors are more relevant than accounting standards <i>per se</i> in determining properties of accounting numbers.  |
| Leuz, C.; Nanda, D.; Wysocky, P; "Earnings management and investor protection: an international comparison" , <i>Journal of Financial Economics</i> 2003, pp. 505-527                | i) financial system orientation; ii) level of investors' protection; iii) level of legal enforcement.  | Earnings management appears to be lower in economies with i) large stock markets and dispersed ownership; ii) strong investor rights; iii) and strong legal enforcement.                |  |
| Burgsthaler D., Luzi H. and Leuz C. " The Importance of Reporting Incentives: Earnings Management in European Private and Public Firms" <i>Unpublished Working Paper</i> 2004        | i) public versus private firms; ii) alignment between tax and accounting rules; iii) level of legal enforcement;   | earnings management is more pervasive i) in private than in public firms; ii) in countries with weak level of legal enforcement; iii) and strong alignment of tax and accounting rules. |  |

Burgsthaler, Luzi and Leuz (2004) enrich the previous literature showing that earnings management is more pervasive in private firms than in public firms and both public and private firms exhibit more earnings management in

countries with weak legal enforcement and a high extent of alignment between tax and accounting rules.

Another element that is important in determining the value relevance of accounting numbers is the efficiency of capital markets. Although until now there are not empirical studies that consider explicitly the effect of this variable, it is commonly recognized that it could play a key role influencing the usefulness of financial statements prepared according to certain standards. In this sense figure 2 sensitize in a proper way all the variables and the relations between them influencing financial reporting quality in a certain country.

**Figure 2.2**



### **2.3 THE CONCEPT OF MARKET EFFICIENCY AND ITS RELATION WITH STANDARD SETTING POLICY**

The efficient markets hypothesis (EMH) has been the central proposition of finance for nearly thirty years. In his classic statements of this hypothesis, Fama (1970) defined an efficient financial market as one in which security prices always fully reflect the available information.

The EMH then states that the real-world financial markets are actually efficient according to this definition. The power of this statement is dazzling. Perhaps most radically, the EMH “rules out the possibility of trading systems based only on currently available information that have expected profit or return in excess of equilibrium expected profit or return” (Fama 1970). In plain English, an average investor – whether an individual, pension fund or mutual fund – cannot hope to consistently beat the market, and the vast resources that such investors dedicate to analyzing, picking and trading securities are wasted. Better to passively hold the market portfolio, and to forget active money management altogether. If the EMH holds, the market truly knows the best.

The basic theoretical case for the EMH rests on three arguments which rely on progressively weaker assumptions. First, investors are assumed to be rational and hence to value securities rationally. Second, to the extent that some investors are not rational, their trades are random and therefore cancel each other out without affecting prices. Third, to the extent investors are irrational in similar ways, they are met in the market by rational arbitrageurs who eliminate their influence on prices<sup>15</sup>. This last case (Milton Friedman [1953] and Fama [1970]) it is one of the most intuitively appealing and plausible arguments in all economics and represents the most solid theoretical foundation of EMH.

In the first decade after its conception in the 1960s, the EMH turned into an enormous theoretical and empirical success. Academics developed powerful theoretical reasons why hypothesis should hold. More impressively, a vast array of empirical findings quickly emerged – nearly all of them supporting the hypothesis. Indeed, the field of academic finance in general, and security analysis in particular, was created on the basis of the EMH and its applications. The University of Chicago, where EMH was invented, justly became the world’s center of academic finance. In 1978, Michael Jensen – a Chicago graduate and one of the creators of the EMH – declared that “there is no other proposition in economics which has more solid empirical evidence supporting it than Efficient Markets Hypothesis” (Jensen 1978, p. 95).

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<sup>15</sup> A textbook definition (Sharpe and Alexander 1990) defines arbitrage “as the simultaneous purchase and sale of the same, or essentially similar, security in two different markets at advantageously different prices”.

Beaver (1973) provided the first examination of the reporting implications of efficient securities markets. According to Beaver, the major implication is that accounting policies do not affect security prices, as long as these policies have no differential cash flow effects, the particular policies used are disclosed, and sufficient information is given so that the reader can convert across different policies. Thus, the efficient market argument is that as long as firms disclose their selected policy, and any additional information needed to convert from one method to another, investors are able to make the necessary calculations to see through to the resulting differences in reported net income. That is, the market can see through to the ultimate cash flow and dividend implications regardless of which accounting policy is actually used for reporting. Thus, the efficient market is not "fooled" by differing accounting policies when comparing different firm's securities. This suggests that standard setters should not impose a particular accounting policy, the only important thing is to impose the disclosing of all information needed to understand the effect of the specific accounting policy chosen by each firm. Thus, if efficient market hypothesis holds (EMH), the best accounting policy is **full disclosure**, because all information, independently from the form in which is disclosed, is instantaneously incorporated in market prices. More precisely, the reasons for this statement are twofold. First, market efficiency implies that investors will use all available, relevant information as they strive to improve their predictions of future returns, so that additional information will not be "wasted". Second the more information a firm publishes about itself, the more information is publicly available about that firm. Consequently, investors' confidence in the securities market is enhanced.

Moreover market efficiency implies that standard setters and firms should not be overly concerned about the naive investor – that is financial statement information need not be presented in a manner so simple that every one can understand it. The reason is that if enough investors understand the disclosed information, this is sufficient to ensure that the market price of a firm's shares is the same as it would be if all investors understood it. This is referred to as investors being price protected by the efficient market. The mechanism by which the information is incorporated in the prices is that of arbitrage.

In the last twenty years, both the theoretical foundations of the EMH and the empirical evidence purporting to support it have been challenged. The key forces by which market are supposed to attain efficiency, such as arbitrage, are likely to be much weaker and more limited than the efficient markets theorists have supposed. In particular Grossman and Stiglitz (1980) showed that if information is costly, EMH can't hold in the pure form (Fama 1970). Markets can only near to the concept of efficiency formulated by Fama that is price is **fully informative**. Since information acquisition is costly, and investors could not expect to beat the market when the market price already reflects all publicly known information, investors would simply stop gathering information and rely on market price at the best indicator of future security returns. The **logical inconsistency** then, is that if prices fully reflect available information, there is no motivation for investors to acquire information; hence prices will not fully reflect available information. Technically speaking, the problem here is that stable equilibrium prices do not exist. So as suggested by Grossman and Stiglitz in their model: "..... In equilibrium must there be a certain degree of disequilibrium: prices reflect the information of informed individuals (arbitrageurs) but only partially, so that those who expend resources to obtain information do receive compensation".

More recently, behavioral finance theorists, supported by numerous empirical studies, pointed out that in real world EMH does not hold because<sup>16</sup>: **i)** many investors - noise traders - have erroneous beliefs about the future distribution of returns on a risky asset; **ii)** there is a correlation - sentiment - in the way these investors form their erroneous beliefs; and **iii)** arbitrage strategies are risky and therefore limited. The last hypothesis is the more interesting and the more innovative and in a certain sense it represents the principal milestone of this new line of research. Behavioral finance theorists identified three main sources of risk potentially affecting arbitrage strategies in real world:

- 1) the incompleteness of capital markets;
- 2) the existence of a "noise trader risk" (De Long *et al.*1990);

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<sup>16</sup> For a review of behavioral finance literature see Shleifer A. "Inefficient markets: an introduction to behavioral finance" Clarendon Lectures in Economics, Oxford University Press, 2002.



- 3) the existence of an agency problem between arbitrageurs and their financiers; that producing a budget constrain on arbitrageurs can reduce the effectiveness of their actions.

The effectiveness of arbitrage relies crucially on availability of close substitutes for securities whose price is potentially affected by noise trading. The problem is that in many instances, securities do not have obvious substitutes. Thus arbitrage does not help to pin down price levels of, say stocks and bonds as whole (Figlewsky 1979, Campbell and Kyle 1993). These broad classes of securities do not have substitute portfolio, and therefore if for some reasons they are mis-priced, there is no risk-less hedge for the arbitrageur. An arbitrageur who thinks that stocks as whole are overpriced cannot sell short stocks and buy a substitute portfolio, since such portfolio does not exist. The arbitrageur can simply sell or reduce exposure to stocks in the hope of an above-market return, but this arbitrage is no longer even approximately risk-less, especially since the average expected return on stocks is high and positive (Siegel 1998). If the arbitrageur is risk-averse, his interest in such arbitrage will be limited. With a finite risk-bearing capacity of arbitrageurs as a group, their aggregate ability to bring prices of broad groups of securities into line is limited as well<sup>17</sup>.

There is a further source of risk for an arbitrageur, which he faces even when securities have perfect substitutes. The risk comes from the unpredictability of the future resale price or, put differently, from the possibility that mispricing becomes worse before it disappears. Even when two securities those are fundamentally identical, the expensive securities may become even more expensive and the cheap security may become even cheaper. Even if the prices ultimately converge with probability one, one trade may lead to temporary losses for an arbitrageur can maintain his position through such losses, he can still count on positive return from his trade. But, sometimes he cannot maintain his position through the losses. In the case arbitrageurs need to worry about financing and maintaining their position when price divergence can become worse before it gets better, arbitrage is again limited. This type of risk that De Long *et al.* dubbed "noise trader risk",

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<sup>17</sup> This problem holds not only for broad classes of securities but for individual stocks too because in the market does not exist perfect substitutes even for individual stocks.

shows that even an arbitrage that looks nearly perfect from the outside is in reality quite risky and therefore quite to be limited (Shleifer and Vishny 1997). As consequence, the arbitrage based theoretical case for efficient markets is limited as well – even for securities that have fundamentally close substitutes.

Shleifer and Vishny (1997) shows that an another important source of risk for arbitrageurs comes from the fact that their capability to recover funds by investors depends on their past performance. Poor past performance can depend on incapability of the arbitrageur or on the manifestation of the “noise trader risk”. In the second case the arbitrageur can become more constrained exactly when he has the best opportunities, i.e., when the mispricing he has bet against widens. As a consequence, when arbitrage requires outside capital, the fear of such scenario would make arbitrageurs more cautious when they put on their initial trade, and hence less aggressive in betting against the mispricing.

The arguments resumed above and the huge number of recent empirical studies supporting them, suggest that EMH cannot hold in the pure form, more realistically capital markets are affected from a certain level of inefficiency that differs across different markets according to some institutional characteristics.

In particular according to previous research it is possible to formulate some conjecture about the institutional factors affecting market efficiency:

- 1) the more investors who are informed and rational (professional investors – arbitrageurs), the more informative is the price system, thus higher will be the degree of market efficiency;
- 2) The more effective and efficient are the regulation and the supervisory Institutions in reducing the agency problems between individuals and professional investors, the more effective will be the role played by arbitrageurs, thus higher will be the degree of market efficiency;
- 3) the higher the cost of information, the smaller will be the equilibrium percentage of investors who are informed, thus lower will be the degree of market efficiency;
- 4) the higher is the quality of information – in terms of width and completeness – the more price system will be informative, thus higher will be the degree of market efficiency;

- 5) The more effective are regulation, litigation law and procedures and supervisory institutions in reducing the information asymmetry between issuers and investors and in protecting them from fraud behavior of the issuers, the higher will be the quality of information provided to the market, thus higher will be the degree of market efficiency.

In this context the best accounting policy is not simply full disclosure, the things are more complicated because standard setters doing their job have to consider many factors such as the cost of information, the completeness of information, the preparers' institutional incentives to follow properly accounting standards and the degree of market efficiency; obviously all these factors are interrelated one each other and often, because of these interactions, trade-off arise complicating the job of regulators that have solve them.

#### **2.4 THE HYPOTHESIS UNDERLYING THE INTRODUCTION OF IFRS IN EUROPE: A CONCEPTUAL FRAMEWORK**

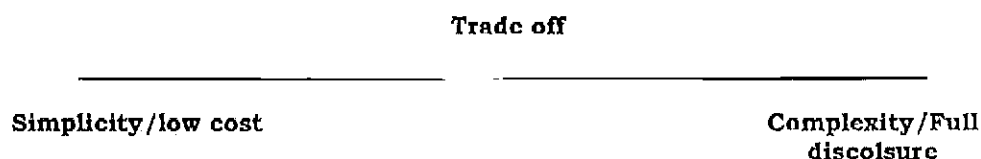
The major objective pursued by European Union with the introduction of IFRS is, as already said before, the improvement of the usefulness, measured in terms of value relevance, of accounting information provided by the issuers to the investors in the European capital markets.

According to the framework previous presented (Figure 2.2) the value relevance of accounting information depends essentially on three elements: 1) the accounting standards; 2) the market efficiency; and 3) the preparers incentives to produce high quality information.

These factors are interrelated and the comprehension of these interrelations is fundamental to understand the choices adopted by standard setters and to predict their effects on the usefulness of accounting information. Obviously, the only variable under control by standard setters is represented by standards themselves, so it is necessary to try understand in which situations a certain set of standards is desirable given a certain institutional environment, i.e., it is necessary understand which is the relation between institutional factors (in terms of market efficiency and

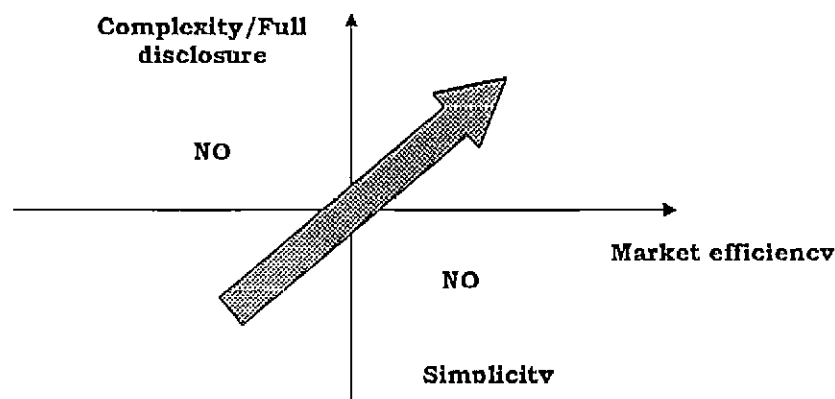
prepares incentives) and best accounting policy. Beaver (1973) showed that if EMH holds in the pure form the standards setter's job is quite easy: the best accounting policy is simply to impose the full disclosure. But, as said before, in real world EMH does not hold in the pure form, in this context a crucial role is played by the cost of production and treatment of the information. If the market is not so efficient, because the number of institutional investors investing in that market is small and/or their knowledge is limited, it is important to provide to investors an information easy to understand and interpret. In other words the best accounting policy is not always **full disclosure**; It is not sure that increasing the completeness of accounting information will increase its usefulness: often, higher is the completeness of information higher is its complexity, thus higher is the cost of that information for the users. Standard setters should define accounting standards in such way to solve this trade-off.

**Figure 2.3**



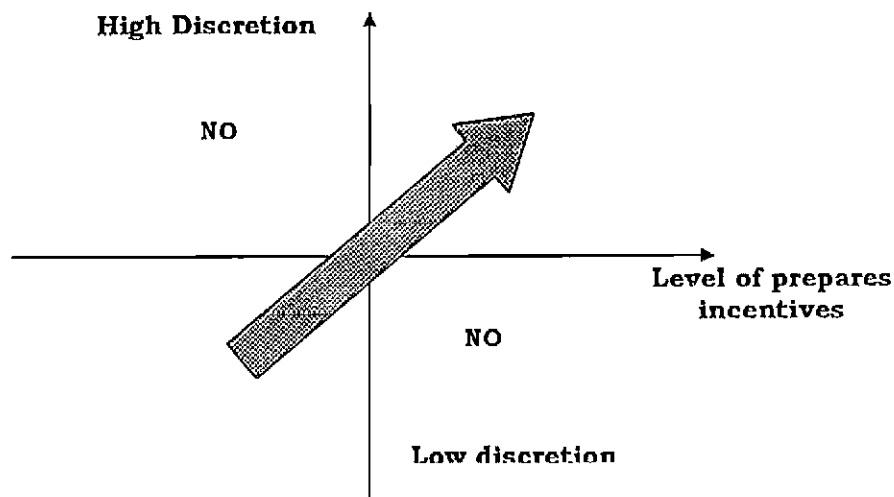
In particular, higher is the degree of market efficiency more important is the completeness (complexity) of accounting information. On the other hand, if the degree of market efficiency is low, the understandability (simplicity) of financial statements becomes relatively more important.

**Figure 2.4**



The second institutional factors that standard setters has to consider is represented by the prepares incentives to follow high-quality reporting practices. This element is crucial, because if the market discipline and the legal system are not severe to punish window dressing activity than standard setters should issue binding standards that leave few discretion to the prepares. On the other hand where the incentives are strong it is probably better allow prepares an higher level of flexibility that can bring to the production of accounting information of higher quality.

**Figure 2.5**



According to the framework presented, it is possible to say that, even if the only objective of standard setters was to increase the usefulness of accounting information, an absolute best accounting policy does not exist: the validity of a set of standards depends on the characteristics – i.e. market efficiency and prepares incentives – of the market in which the standards are applied.

At this stage, considering the characteristics of standards that are going to be introduced in Europe for listed companies, it is possible to extract the implicit hypotheses that European Union and IASB (standard setters) are doing.

The IFRS are very close to US GAAP, they are standards very complete (full disclosure) and complex (high cost) that leave a great level of discretion to the

prepares in the production of accounting information, therefore it is possible to say that European Union and IASB are assuming that:

- 1) European capital markets are reasonably equally efficient one each other and prepares incentives to follow high-quality reporting practices are essentially the same in all the countries member of the European Union;
- 2) European capital markets, as whole, work in the same way and as well as US capital markets;
- 3) European capital markets work quiet well, thus the level of market efficiency is high and prepares incentives are strong. In this sense, on average, the home GAAP actually in force in the European countries are simpler and more binding than IFRS.

# CHAPTER 3

## THE IMPACT OF THE INTRODUCTION OF IFRS ON THE EUROPEAN BANKS' ACCOUNTS FROM A VALUE RELEVANCE PERSPECTIVE: WHAT CAN WE LEARN FROM THE US? AN EMPIRICAL INVESTIGATION

### 3.1 INTRODUCTION

The research question to which this chapter would like to answer is the following: will the introduction of IFRS improve the value relevance of accounting numbers for European listed banks?

In the extant literature, as discussed in chapter two, the concept of value relevance is strictly related to the study of association between accounting amount and equity market values, Barth et al. (2001) provides the following definition : "... an accounting amount is value relevant if it has a predicted association with equity market values".

Adopting this notion of value relevance, the exact question to which the study would like to answer is: following the introduction of IFRSs will the association of earnings and book values with equity market values for European listed banks change?

The question is relevant from both: a standard setting perspective and a valuation perspective. For standard setting purposes the improvement of value relevance of accounting numbers is one of the goals pursued by standard setters (International Accounting Standards Committee [IASC] 1997; Financial Accounting Standards Board). So, the assessment of the effect of new standards on the value-relevance of accounting numbers provides to standard setters helpful information to judge the validity of these new standards and to identify eventual improvement's necessities (Barth, Beaver, Landsman, 2001). From a valuation point of view the relation between accounting numbers and value is a crucial element. In particular, it is

important to identify which is the strength of this relation and to identify the valuation model that performs better from an empirical point of view (Kothari 2001).

After the recent revisions (accounting for derivatives, business combinations, impairment of intangible assets), US GAAP are very similar to IFRSs that are going to be adopted in Europe, so the financial statements prepared by American banks in the last few years represent a good reference point to understand which will be the impact of new standards for European listed banks<sup>18</sup>. So, to answer to the research question, I perform an international relative association study in which I compare the association of earnings and book values with stock prices and returns for European (Italian, French and German banks) and American listed banks for the period 2001-2003.

I extract a set of American listed banks comparable to European listed banks of each countries selected (I'm extracting three different subset of US banks) and I analyze the different properties of banks' accounting numbers in these countries. More precisely, the research design and the organization of the analyses are based on four accounting themes related to the value relevance of earnings and book value: the differences in value relevance of accounting information across Europe (countries selected) and US, the relative importance of book value and earnings for valuation, the incremental value relevance of accounting numbers and the different properties of accounting earnings in terms of timeliness and conservatism (Basu 1997).

The objective is to answer the following four questions: (1) Are banks' accounting numbers more value relevant in US than in European Continental countries? (2) Are there systematic differences in value relevance between banks' earnings and book value across the different European and US accounting systems? (3) Do banks' book value and earnings convey different information to stock valuation? (4) Do banks accounting earnings present different properties in US and Continental Europe?

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<sup>18</sup> Previous literature, as discussed in chapter two, demonstrate that accounting standards are not the only determinant of accounting numbers' value relevance, in fact institutional factors are also important. So my study is an as if - *ceteribus paribus* - study. In this sense, the results have to be interpreted with caution, it is not certain that adopting Anglo-Saxon accounting standards in continental countries will produce the same accounting numbers with exactly the same properties they have in US or UK.



The results of the analysis realized are: 1) the value relevance of banks' accounting numbers is essentially the same in US, France and Italy, while it is lower in Germany; 2) in US and surprisingly in Germany banks' earnings are more value relevant than book value, while in France it is true the opposite; 3) in Italy both earnings and book value have incremental explanatory power; 4) earnings are more conservative in Italy and Germany than in France and US.

These results are quite different from those reported in previous studies analyzing value relevance of accounting numbers in an international context (Alford et al. 1993, Joos 1997, Mora et al. 2000, Ball et al. 2003). The differences can be explained by the fact that previous research concentrated only on industrial firms. In this sense my study suggests that internationally banks' accounting numbers present different properties respect to those of industrial firms.

The interpretation of results on the light of the next introduction of IFRS suggests that the new standards will change valuation properties of banks' accounting numbers in Europe. In particular, earnings would become less conservative and more relevant than book values. Obviously these are only preliminary considerations on the field, in fact to have a more precise measure of the effect of the introduction of IFRS will be necessary repeat this kind of analysis after their effective introduction in Europe.

### 3.2 METHODOLOGY AND RESEARCH DESIGN

#### *The difference in value relevance of accounting numbers across Europe and US*

The first question I address is related to the cross-country differences in value relevance: are accounting numbers more value relevant in US than in European Continental countries? Following previous evidence (Joos 1997; King and Langli1998) I analyze this problem studying the relation between financial statement variables and stock prices. In particular I use the following EBO model (Ohlson 1995):

$$P_{it} = a_0 + a_1BV_{it} + a_2NI_{it} + e_{1it} \quad (1)$$

where  $P_{it}$  is the share price of company (i) at balance sheet date (t), BV is the book value, and NI the accounting earnings in a per share basis<sup>19</sup>.

In this case, I have to consider that I'm comparing  $R^2$  between different samples. Brown et al. (1999) show that the use of  $R^2$  to measure value relevance could be inappropriate when I make comparisons between different samples using levels regressions like model (1). This is due to the existence of scale effects that increase  $R^2$ , and these effects increase the scale factor's coefficient of variation. Although the comparison of  $R^2$ 's is appropriate when there are no significant differences in the scale factor's coefficient of variation across samples, a previous analysis of the data shows large differences across the countries under study.

Following Brown et al. (1999) I solve this problem deflating each variable in model (1) by a proxy for the unobservable scale factor. I use the share price at the beginning of the period to proxy for the scale factor. Then model (1) and subsequent models are estimated deflating by  $P_{it-1}$ . Further more, to control for possibly exogenous market-wide effect on independent variable, I deduct from it the sample mean ratio  $P_{1j}/P_{0j}$  in fiscal year  $t$  for the firm's reporting country  $j$ . Controlling for market-wide effect creates an independent variable that sums zero for each country-year sample and hence is risk-free in the context of a domestic CAPM.

*The relative importance of book value versus earnings for valuation.*

In order to test the relative importance of banks' book value versus banks' earnings for valuation, I decompose model (1) into two models that consider the individual value relevance of book value and earnings. The models considered are derived from model (1):

$$P_{it} = a_0 + a_1 BV_{it} + e_{2it} \quad (2)$$

$$P_{it} = a_0 + a_2 NI_{it} + e_{3it} \quad (3)$$

The value relevance of the book value and earnings is measured with the  $R^2$  in models (2) and (3). Then to compute the incremental  $R^2$  of both earnings

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<sup>19</sup> I use per share values to mitigate the effect of heteroscedasticity (Barth and Kallapur, 1996), even though I estimate the t-statistics using the White (1980) heteroscedasticity consistent standard errors.

and book value and test the statistical significance of both measures I use a two-step regression and *t*-test. The "two-step *t*-test" indicates if book value (earnings) conveys different information than earnings (book value).

In particular, it is possible to distinguish if earnings and book value convey different information to explain market values by decomposing the  $R^2$  of model (1) as (Theil 1974):

$$R_{(1)}^2 = R_{\Delta M}^2 + R_{\Delta BV}^2 + R_c^2$$

where  $R_{\Delta BV}^2$  is the incremental book value  $R^2$  on earnings,  $R_{\Delta M}^2$  is the incremental earnings  $R^2$  on book value and  $R_c^2$  is the common  $R^2$  to book value and earnings. The incremental  $R^2$  of book value (earnings) on earnings (book value) is computed as the difference between the  $R^2$  of model 1 and the  $R^2$  of model 2 (model 3):

$$R_{\Delta BV}^2 = R_{(1)}^2 - R_{(3)}^2$$

$$R_{\Delta M}^2 = R_{(1)}^2 - R_{(2)}^2$$

The explanatory power common to book value and earnings is the total explanatory power of book value and earnings less the incremental explanatory power of book value and the incremental explanatory power of earnings.

$$R_c^2 = R_{(1)}^2 - R_{\Delta BV}^2 - R_{\Delta M}^2$$

This Methodology is carried out in many international accounting papers such as Joos (1997) and King and Langli (1998).

*The timeliness and the conservatism of banks' earnings*

The research design infers timeliness and conservatism from the way banks' accounting incomes incorporate their economic incomes over time. I therefore specify accounting income as the dependent variable. I measure firms' economic incomes as fiscal-year changes in market values of equity, adjusted for dividends and capital contributions (Hicks, 1946).

"Clean surplus" accounting (Ohlson, 1988) implies two relevant identities for all firms. First, accounting income equals fiscal-year change in book value of equity, adjusted for dividends and capital contributions. Second, a firm's accounting and economic incomes summed over its lifetime are identical. I investigate the temporal process of the incorporation of economic income in accounting income, i.e., the accounting model of income determination. This research design allows for two fundamental features of the accounting model of income determination: accounting recognition principles that generally reduce the timeliness of accounting income by smoothing its incorporation of economic income over time and accounting income-statement conservatism.

The most fundamental feature of accounting determining the incorporation of economic income in accounting income over time are the accounting recognition principles, including the Revenue Realization and Expense Matching principles. Whereas economic income immediately incorporates changes in expectations of the present values of future cash flows, the recognition principles incorporate such changes in accounting income gradually over time, generally at points close to when the actual cash flow realizations occur. Hence, accounting income systematically lags economic income (Ball and Brown, 1968) and the lag extends over multiple periods (Beaver et al., 1980; Easton et al., 1992; Kothari and Sloan, 1992). The recognition principles therefore cause economic income to be incorporated in accounting income in a lagged and smoothed fashion over time. This feature of accounting income arises because there is demand for an income variable with properties additional to timeliness. While timeliness per se is desirable, information asymmetry between managers and users creates a demand for an income variable that is observable independently of managers. Accounting income thus incorporates only the subset of available value-relevant information that is independently observable, whereas economic income incorporates information that is not independent of managers, such as plans and forecasts. In other words, accounting income does not attempt to

anticipate future cash flows to the same extent as economic income. The first-order effect of the recognition principles thus is to make accounting income a complex moving average of past economic incomes:

$$NI_{it} = f(\Delta P_{it}, \Delta P_{it-1}, \Delta P_{it-2}, \dots) \quad (4)$$

where  $NI$  and  $\Delta P$ , respectively, denote accounting and economic income. Economic income,  $\Delta P$ , is fiscal-year change in the market capitalization of equity plus dividends and minus capital contributions during the year (Hicks, 1946). I hypothesize that the accounting model is applied differently across countries, and assume the model's parameters hold for all banks  $i$  that report under the accounting systems of country  $j$ . Assuming that  $\Delta P$  is independent over time, this simplifies to

$$NI_{it} = g_j(\Delta P_{it}, n_{it}) \quad (5)$$

The disturbance  $n_{it}$  incorporates lagged changes in market values ( $\Delta P_{it}, \Delta P_{it-1}, \Delta P_{it-2}, \dots$ ). This disturbance term affects the  $R^2$  of regression (5), which is used as a proxy for the timeliness property of accounting income. After scaling by opening market value,  $P_{it-1}$ , the dependent and independent variables are annual rate of return ( $R_{it} = P_{it}/P_{it-1} - 1$ ) and earnings yield ( $NI_{it}/P_{it-1}$ ), and a linear specification gives

$$NI_{it} / P_{it-1} = \hat{\delta}_{0j} + \hat{\delta}_{1j} R_{it} + e_{it} \quad (6)$$

The second fundamental feature of the accounting income model I study is conservatism. A longstanding example of income conservatism is the "lower cost principle" that obliges to recognize unrealized loss but does not permit to recognize unrealized gains.

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<sup>20</sup> As in the previous equations, to control for possibly exogenous market-wide effect on independent variable, I deduct the sample mean return  $R$  in fiscal year  $t$  for the banks' reporting country  $j$ . Controlling for market-wide effect creates an independent variable that sums zero for each country-year sample and hence is risk-free in the context of a domestic CAPM.

Following Basu (1997), I incorporate conservative asymmetry in accounting income timeliness by modifying (3) for asymmetric incorporation of negative economic income:

$$NI_{it} = a_{0j} + b_{1j}RD_{it} + c_{2j}R_{it} + d_{3j}R_{it}RD_{it} + e_{it} \quad (7)$$

The dummy variable  $RD_{it}$  assumes its value based on the sign of stock return, not earnings: one if return  $R_{it}$  is negative, and zero otherwise.  $c_{2j}$  and  $(c_{2j} + d_{3j})$  capture the incorporation in current-year accounting income of positive and negative income respectively, in country  $j$ .

This specification has several attractive features. One advantage of specifying accounting income as the dependent variable is avoiding the need for a noisy earnings expectations model. Here, the independent variable (annual stock return) is relatively free of short-term microstructure, liquidity or mispricing effects. An additional advantage of the specification is that it incorporates the fundamental tenets of accounting income recognition. In particular, it incorporates lags that arise from the demand for an independent income measure, and piecewise linearity allows us to study international differences in asymmetric timeliness, or conservatism.

I estimate separate individual-country relations for each country  $j$ , pooling all banks  $i$  reporting under the country's accounting standards and all years  $t$ . International differences in income timeliness, for positive and negative income combined, are reflected in the  $R^2$ 's of individual-country regression (7).

### 3.3 DATA SELECTION AND SAMPLE DESCRIPTION

The sample, per each European Country, is represented by the banks listed on the primary home stock exchange in the period 2001-2003. Data on these banks are collected from DATASTREAM. I exclude the two extreme percentiles of each variable ( $NI/P_0$ ,  $P_1/P_0$ ,  $BV/P_0$  and  $R$ ). Next I exclude each firm/year with a missing value for any variable, giving the same observation set for the various variables and models estimated.

To select US banks and to collect data on them I use Compustat Bank file and Compustat PDE file. Compustat bank file contains information on 773 banks. As starting point I consider only banks having FYE in December and that in December 31 2003 were listed in one of the principal US capital markets (NYSE, NASDAQ and AMEX) (591 banks). According to previous research (Alford et al.; Pope 1999), to ensure a better comparability between Europeans and Us banks I select three subset of the 565 Us banks previous identified matching them with the three sample of European banks in terms of size measured as market capitalization at December 31-2003. The selection strategy I follow for the Italian case is this: on December 31-2003 32 Italian banks were listed on Italian Stock exchange. I divide these banks in quartile according their market capitalization at 31/12/2003. Then I identify the US banks falling in each quartile previous identified and defined by market value range. The 3rd quartile is that which the smaller number of US banks (29) fall in. So, to replicate in the US sample the same size distribution of Italian sample, I select 29 US banks for each quartile. To select these banks I use a simple and neutral rule: per each quartile I select the 29 banks identified in Compustat file by the smaller GVKEI code number. I use this sample for all the three years considered. As for European countries I exclude the two extreme percentiles of each variable ( $NI/P_0$ ,  $P_1/P_0$ ,  $BV/P_0$  and  $R$ ). Next I exclude each firm/year with a missing value for any variable, giving the same observation set for the various variables and models estimated. I replicate this sorting strategy to select matching samples for French and German samples.

All the samples (for all countries) are formed for the majority by commercial banks as identified by the international classification provided by Bankscope, furthermore the financial analyst coverage for banks included in the samples selected, on average, is quite similar. Table 3.1 provides some descriptive statistics.

**Table 3.1 – descriptive statistics**

|                   | <i>Mean.</i> | <i>Median.</i> | <i>Max.</i> | <i>Min.</i> | <i>Std. Dev.</i> | <i>N</i> |
|-------------------|--------------|----------------|-------------|-------------|------------------|----------|
| <b>Italy</b>      |              |                |             |             |                  |          |
| <i>P1</i>         | 10,92        | 6,51           | 171,10      | 0,22        | 20,30            | 90       |
| <i>NI</i>         | 0,46         | 0,28           | 7,58        | -5,27       | 1,39             | 90       |
| <i>BV</i>         | 10,91        | 3,96           | 173,65      | 0,35        | 25,43            | 90       |
| <i>NI/PO</i>      | 0,05         | 0,06           | 0,16        | -0,41       | 0,07             | 90       |
| <i>BV/PO</i>      | 1,09         | 0,87           | 11,59       | 0,07        | 1,27             | 90       |
| <i>P1/BV</i>      | 1,57         | 1,28           | 7,75        | 0,10        | 1,23             | 90       |
| <i>P1/NI</i>      | 22,86        | 17,04          | 110,33      | 4,66        | 17,45            | 90       |
| <i>R</i>          | 0,12         | 0,13           | 1,35        | -0,75       | 0,43             | 90       |
| <b>US Matched</b> |              |                |             |             |                  |          |
| <i>P1</i>         | 28,32        | 26,07          | 97,75       | 3,55        | 13,85            | 327      |
| <i>NI</i>         | 2,08         | 1,89           | 8,85        | -1,99       | 14,33            | 327      |
| <i>BV</i>         | 13,78        | 11,92          | 84,43       | 3,97        | 13,68            | 327      |
| <i>NI/PO</i>      | 0,08         | 0,08           | 0,49        | -0,32       | 0,06             | 327      |
| <i>BV/PO</i>      | 0,58         | 0,49           | 3,67        | 0,12        | 0,36             | 327      |
| <i>P1/BV</i>      | 2,22         | 2,06           | 5,71        | 0,50        | 0,88             | 327      |
| <i>P1/NI</i>      | 14,29        | 13,23          | 57,13       | -3,68       | 6,10             | 327      |
| <i>R</i>          | 0,08         | 0,06           | 0,87        | -0,94       | 0,23             | 327      |
| <b>France</b>     |              |                |             |             |                  |          |
| <i>P1</i>         | 79,27        | 75,39          | 303,11      | 2,71        | 55,15            | 108      |
| <i>NI</i>         | 6,50         | 4,26           | 37,08       | 0,43        | 6,43             | 108      |
| <i>BV</i>         | 64,60        | 47,03          | 252,62      | 2,25        | 47,98            | 108      |
| <i>NI/PO</i>      | 0,18         | 0,09           | 1,13        | 0,02        | 0,22             | 108      |
| <i>BV/PO</i>      | 1,01         | 0,90           | 2,82        | 0,23        | 0,54             | 108      |
| <i>P1/BV</i>      | 1,49         | 1,26           | 4,85        | 0,34        | 0,91             | 108      |
| <i>P1/NI</i>      | 17,63        | 12,96          | 63,65       | 2,22        | 13,48            | 108      |
| <i>R</i>          | 0,17         | 0,11           | 2,68        | -0,70       | 0,40             | 108      |
| <b>US Matched</b> |              |                |             |             |                  |          |
| <i>P1</i>         | 27,64        | 25,27          | 96,95       | 2,75        | 13,05            | 430      |
| <i>NI</i>         | 1,93         | 1,81           | 8,77        | -2,07       | 14,25            | 430      |
| <i>BV</i>         | 13,97        | 11,91          | 84,42       | 3,97        | 13,67            | 430      |
| <i>NI/PO</i>      | 0,07         | 0,08           | 0,49        | -0,32       | 0,06             | 430      |
| <i>BV/PO</i>      | 0,63         | 0,47           | 3,64        | 0,10        | 0,34             | 430      |
| <i>P1/BV</i>      | 1,98         | 1,97           | 5,62        | 0,41        | 0,79             | 430      |
| <i>P1/NI</i>      | 14,32        | 12,85          | 56,75       | -4,06       | 5,72             | 430      |
| <i>R</i>          | 0,07         | 0,05           | 0,85        | -0,95       | 0,22             | 430      |



|                   | <i>Mean</i> | <i>Median</i> | <i>Max.</i> | <i>Min.</i> | <i>Std. Dev.</i> | <i>N</i> |
|-------------------|-------------|---------------|-------------|-------------|------------------|----------|
| <b>Germany</b>    |             |               |             |             |                  |          |
| <i>P1</i>         | 39,81       | 16,23         | 359,94      | 0,90        | 62,62            | 64       |
| <i>NI</i>         | 2,63        | 0,67          | 61,11       | -15,64      | 10,04            | 64       |
| <i>BV</i>         | 42,81       | 19,39         | 438,51      | 0,55        | 80,98            | 64       |
| <i>NI/PO</i>      | -0,04       | 0,03          | 0,73        | -1,82       | 0,36             | 64       |
| <i>BV/PO</i>      | 1,28        | 0,91          | 10,57       | 0,07        | 1,49             | 64       |
| <i>P1/BV</i>      | 1,25        | 0,90          | 4,36        | 0,13        | 0,95             | 64       |
| <i>P1/NI</i>      | 25,79       | 19,67         | 68,72       | 1,81        | 19,15            | 64       |
| <i>R</i>          | 0,04        | -0,04         | 2,15        | -0,95       | 0,59             | 64       |
| <b>US Matched</b> |             |               |             |             |                  |          |
| <i>P1</i>         | 29,01       | 26,67         | 98,35       | 4,15        | 14,45            | 397      |
| <i>NI</i>         | 2,03        | 1,95          | 8,91        | -1,93       | 14,39            | 397      |
| <i>BV</i>         | 14,10       | 11,93         | 84,43       | 3,98        | 13,69            | 397      |
| <i>NI/PO</i>      | 0,08        | 0,08          | 0,49        | -0,32       | 0,06             | 397      |
| <i>BV/PO</i>      | 0,60        | 0,51          | 3,69        | 0,14        | 0,38             | 397      |
| <i>P1/BV</i>      | 2,06        | 2,12          | 5,78        | 0,57        | 0,95             | 397      |
| <i>P1/NI</i>      | 14,29       | 13,51         | 57,42       | -3,40       | 6,39             | 397      |
| <i>R</i>          | 0,08        | 0,08          | 0,88        | -0,93       | 0,25             | 397      |

### 3.4 EMPIRICAL RESULTS

The first question I address concerns differences in the value relevance of banks' accounting numbers across Italy, France, Germany and US. Table 3.2 presents the  $R^2$  obtained performing models (1), (2) and (3). First of all, data show that banks' earnings and book values, together, in Italy and France are as value relevant as in US. In particular in all these three countries the  $R^2$  is about 10%, while in Germany it assumes the lowest value (4,2%). This evidence differs from that presented by Alford et. al. (1993), while, at least for France Italy and Germany, confirms results presented by Arce and Mora (2002). Both these studies consider only industrial firms.

Looking to valuation properties of banks' accounting numbers across countries considered, table 3.3 shows that in US and surprisingly in Germany earnings dominates book value, while the opposite happens in France. In Italy both earnings and book value have statistically significant incremental explanatory power, suggesting that in Italy Economic Value Added models probably are the most performing valuation models for banks.

**Table 3.2 - Estimated regressions of models (1), (2) and (3)**

|                   | <i>Intercept</i> | <i>NI/PO</i> | <i>BV/PO</i> | <i>Adj. R-Sq.</i> |
|-------------------|------------------|--------------|--------------|-------------------|
| <b>Italy</b>      | -0,11            | 0,79         | 0,06         | 0,108             |
|                   | (0,010)          | (0,050)      | (0,004)      |                   |
|                   | -0,05            | 0,90         | --           | 0,034             |
|                   | (0,226)          | (0,044)      | --           |                   |
| <b>US Matched</b> | -0,07            | --           | 0,07         | 0,083             |
|                   | (0,050)          | --           | (0,003)      |                   |
|                   | -0,12            | 0,97         | 0,08         | 0,104             |
|                   | (0,000)          | (0,002)      | (0,121)      |                   |
| <b>France</b>     | -0,10            | 1,24         | --           | 0,098             |
|                   | (0,000)          | (0,000)      | --           |                   |
|                   | -0,09            | --           | 0,17         | 0,067             |
|                   | (0,000)          | --           | (0,000)      |                   |
| <b>France</b>     | -0,21            | 0,11         | 0,19         | 0,108             |
|                   | (0,001)          | (0,483)      | (0,000)      |                   |
|                   | -0,04            | 0,24         | --           | 0,013             |
|                   | (0,331)          | (0,120)      | --           |                   |
| <b>US Matched</b> | -0,21            | --           | 0,19         | 0,111             |
|                   | (0,001)          | --           | (0,000)      |                   |
|                   | -0,10            | 1,01         | 0,07         | 0,123             |
|                   | (0,000)          | (0,000)      | (0,143)      |                   |
| <b>US Matched</b> | -0,10            | 1,18         | --           | 0,109             |
|                   | (0,000)          | (0,000)      | --           |                   |
|                   | -0,08            | --           | 0,20         | 0,079             |
|                   | (0,000)          | --           | (0,000)      |                   |
| <b>Germany</b>    | 0,00             | 0,25         | 0,01         | 0,027             |
|                   | (0,985)          | (0,050)      | (0,800)      |                   |
|                   | 0,01             | 0,26         | --           | 0,042             |
|                   | (0,835)          | (0,050)      | --           |                   |
| <b>US Matched</b> | -0,03            | --           | 0,022        | 0,000             |
|                   | (0,636)          | --           | (0,4939)     |                   |
|                   | -0,13            | 0,99         | 0,09         | 0,132             |
|                   | (0,000)          | (0,000)      | (0,111)      |                   |
| <b>US Matched</b> | -0,09            | 1,17         | --           | 0,100             |
|                   | (0,000)          | (0,000)      | --           |                   |
|                   | -0,09            | --           | 0,20         | 0,64              |
|                   | (0,000)          | --           | (0,000)      |                   |

**Table 3.3 – R<sup>2</sup> decomposition model (1) and two step regression t-test**

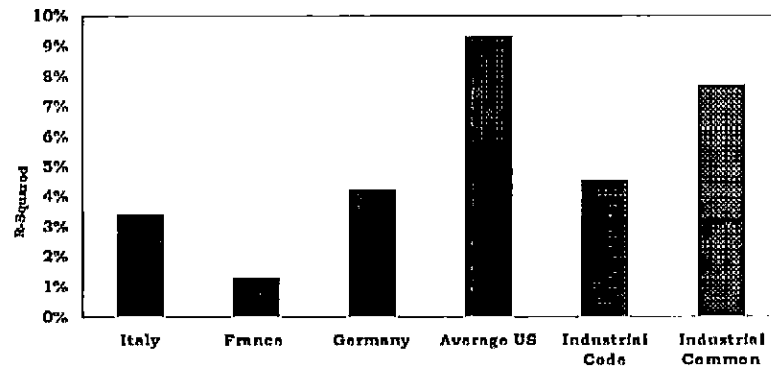
|  | <i>R-Sq.</i> | <i>Sig.</i> |
|--|--------------|-------------|
| <b>Italy</b>                               |              |             |
| <i>Incremental R-Sq. of NI/P0 on BV/P0</i> | 0,035        | 0,000       |
| <i>Incremental R-Sq. of BV/P0 on E/P0</i>  | 0,084        | 0,000       |
| <i>Common R-sq.</i>                        | 0,009        | 0,130       |
| <i>Total</i>                               | 0,128        | 0,000       |
| <b>US Matched</b>                          |              |             |
| <i>Incremental R-Sq. of NI/P0 on BV/P0</i> | 0,042        | 0,000       |
| <i>Incremental R-Sq. of BV/P0 on E/P0</i>  | 0,011        | 0,090       |
| <i>Common R-sq.</i>                        | 0,06         | 0,001       |
| <i>Total</i>                               | 0,113        | 0,000       |
| <b>France</b>                              |              |             |
| <i>Incremental R-Sq. of NI/P0 on BV/P0</i> | 0,006        | 0,231       |
| <i>Incremental R-Sq. of BV/P0 on E/P0</i>  | 0,103        | 0,000       |
| <i>Common R-sq.</i>                        | 0,016        | 0,080       |
| <i>Total</i>                               | 0,125        | 0,000       |
| <b>US Matched</b>                          |              |             |
| <i>Incremental R-Sq. of NI/P0 on BV/P0</i> | 0,056        | 0,000       |
| <i>Incremental R-Sq. of BV/P0 on E/P0</i>  | 0,015        | 0,060       |
| <i>Common R-sq.</i>                        | 0,070        | 0,000       |
| <i>Total</i>                               | 0,141        | 0,000       |
| <b>Germany</b>                             |              |             |
| <i>Incremental R-Sq. of NI/P0 on BV/P0</i> | 0,051        | 0,000       |
| <i>Incremental R-Sq. of BV/P0 on E/P0</i>  | 0,001        | 0,440       |
| <i>Common R-sq.</i>                        | 0,006        | 0,310       |
| <i>Total</i>                               | 0,058        | 0,000       |
| <b>US Matched</b>                          |              |             |
| <i>Incremental R-Sq. of NI/P0 on BV/P0</i> | 0,060        | 0,000       |
| <i>Incremental R-Sq. of BV/P0 on E/P0</i>  | 0,016        | 0,047       |
| <i>Common R-sq.</i>                        | 0,068        | 0,000       |
| <i>Total</i>                               | 0,144        | 0,000       |

The last question I address concerns the differences of banks' earnings properties across countries analyzed. In particular, I study timeliness and

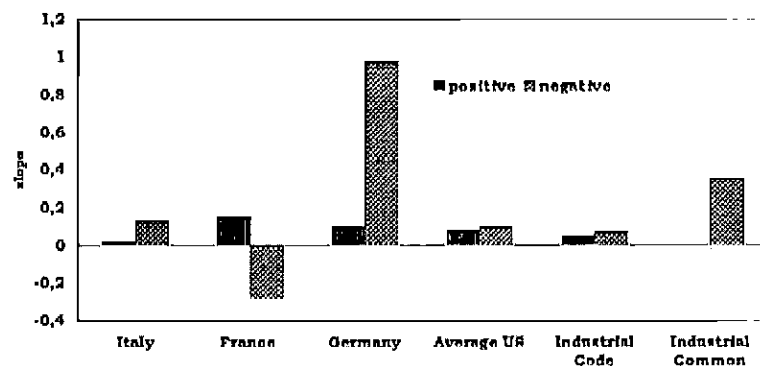
conservatism of earnings as defined by Basu (1997). The presence of these properties is interpreted by researchers as signal of quality of earnings.

Previous studies shows that, referring to industrial firms, accounting earnings are more timely and conservative in Common law (i.e US) countries than in Code law countries (Ball et al. 2000; Ball et al. 2003). I argue that this is not true for banks, because US GAAP recently revised (SFAS 133; SFAS 121; SFAS 144) reduce earnings conservatism allowing to recognize unrealized gains. The empirical results obtained performing models (6) and (7) support my thesis. US banks' earnings are very timely (Figures 3.1 and 3.2) but not conservative (Table 3.4). In Italy and Germany accounting earnings are more conservative than in US.

**Figure 3.1- timeliness of banks' earnings:  $R^2$  of model (6)**



**Figure 3.2 - conservatism of earnings- slope coefficients of model (7)**



**Table 3.4 - Estimated regressions of models (6) and (7)**

| <i>Panel A:</i> $NI=a+b*RD+c*R+d*R*RD+e$ |          |             |          |             |                   |          |
|--|----------|-------------|----------|-------------|-------------------|----------|
|  | <i>c</i> | <i>p(c)</i> | <i>d</i> | <i>p(d)</i> | <i>Adj. R-Sq.</i> | <i>N</i> |
| <b>Italy</b>                             | 0,02     | 0,459       | 0,11     | 0,050       | 0,047             | 90       |
| <b>US. Matched</b>                       | 0,08     | 0,004       | 0,02     | 0,717       | 0,089             | 327      |
| <b>France</b>                            | 0,15     | 0,023       | -0,42    | 0,120       | 0,037             | 108      |
| <b>US Matched</b>                        | 0,09     | 0,001       | 0,03     | 0,601       | 0,094             | 430      |
| <b>Germany</b>                           | 0,10     | 0,625       | 0,87     | 0,050       | 0,081             | 64       |
| <b>US Matched</b>                        | 0,07     | 0,001       | 0,02     | 0,780       | 0,097             | 397      |

| <i>Panel B:</i> $NI=a+b*R+e (R>0)$ |          |                  |          | $NI=a+b*R+e (R<0)$ |                   |          |
|------------------------------------|----------|------------------|----------|--------------------|-------------------|----------|
|                                    | <i>b</i> | <i>Adj. R-Sq</i> | <i>N</i> | <i>b</i>           | <i>Adj. R-Sq.</i> | <i>N</i> |
| <b>Italy</b>                       | 0,04     | -0,013           | 44       | 0,12               | 0,063             | 46       |
| <b>US. Matched</b>                 | 0,10     | 0,078            | 165      | 0,11               | 0,081             | 162      |
| <b>France</b>                      | 0,01     | 0,051            | 50       | -0,07              | 0,014             | 58       |
| <b>US Matched</b>                  | 0,13     | 0,087            | 215      | 0,09               | 0,079             | 215      |
| <b>Germany</b>                     | 0,02     | 0,003            | 33       | 0,09               | 0,071             | 31       |
| <b>US Matched</b>                  | 0,14     | 0,092            | 197      | 0,10               | 0,088             | 200      |

| <i>Panel C:</i> $R=a+b*NI+e$ |          |             |                   |          |
|------------------------------|----------|-------------|-------------------|----------|
|                              | <i>b</i> | <i>p(b)</i> | <i>Adj. R-Sq.</i> | <i>N</i> |
| <b>Italy</b>                 | 0,9      | 0,04        | 0,034             | 90       |
| <b>US. Matched</b>           | 1,24     | 0,000       | 0,098             | 327      |
| <b>France</b>                | 0,24     | 0,122       | 0,013             | 108      |
| <b>US Matched</b>            | 1,10     | 0,000       | 0,090             | 430      |
| <b>Germany</b>               | 0,26     | 0,050       | 0,042             | 64       |
| <b>US Matched</b>            | 1,18     | 0,010       | 0,092             | 397      |

# CHAPTER 4

## THE IMPACT OF IFRS ON THE ORGANISATIONAL STRUCTURE OF THE ADMINISTRATIVE AND CONTROL FUNCTIONS IN ITALIAN BANKS

### 4.1 INTRODUCTION

This chapter focuses on the analysis of the “internal” impacts of IFRS on banks. In particular it is centered on the analysis of the effects which the IAS/IFRS might have on the adequacy of the organisational structure of *staff* functions in Italian banks.

The study is divided into three sections. The first section goes on to provide a brief examination of the fundamental characteristics of the present organisational structure of the staff functions within the leading companies of the main Italian banking groups. In particular, the position typically adopted in the company flowchart by the function put before the drawing up of the consolidated balance sheet, as well as the relation it has to other central directions. The current process of drawing up balance sheets is also outlined.

In the second section, the IAS/IFRS which will have a greater impact on the organisational structure of Italian banks are identified. Particular attention is given to the aspects of the new legislation which are considered to have a decisive role in modifying the organisational structure of the staff functions and the process of drawing up the balance sheet, as previously described.

Finally, the last section sets out some possible solutions to the organisational problems outlined.

## 4.2 THE ORGANISATIONAL ASPECTS OF STAFF FUNCTIONS WITHIN ITALIAN BANKING GROUPS<sup>5</sup>

### *Framework of analysis*

The analysis of the organisational structure of banking institutions is complex and extremely broad and should be examined from several angles. Therefore, for the purposes of this study, it will be done by using a practical approach, with the specific objective of identifying the position typically adopted by the organisational body responsible for drawing up the consolidated balance in an organisational structure of the Head Office in a banking group. As well as this, the relations it has with the other central functions and with the managing bodies of the bank will also be identified.

This analytical approach is consistent with the objectives of this study which aims to identify on the one hand any weaknesses in the present process of drawing up the balance sheet in preparation for the introduction of the IAS/IFRS and on the other, the possible organisational solutions which could be adopted to overcome these weaknesses

The decision to focus the analysis only on the Head Office of a banking group can be considered acceptable since many of the consequences of the impact of the IAS/IFRS on the organisational structure of their central functions vary according to the individual banks belonging to the group. They also vary, though in different ways, for the smaller independent banks which typically have an elementary-functional organisational structure and which do not directly interface with the capitals market.

### *The organisational aspects of the staff functions and the process of preparing the accounts within Italian banking groups*

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<sup>5</sup> The information regarding the organisational structure of staff functions and the process of drawing up the consolidated balance has been gathered using a variety of sources as: balance sheets, company websites, interviews with Administration managers of some banks and with professionals from consultancy companies, called upon to help banks implement the IAS project. The large number of people interviewed makes it impossible to mention them personally, but they all have my sincere thanks for their help. The help, however, was purely informative and any conclusions drawn from it and expressed either directly or indirectly in the following pages are the responsibility of the author.

The organisational structures of the Head Office of banking groups can not be easily placed within a single model since their development processes, organisational philosophies and competitive choices are very different. Nevertheless, they share common characteristics which, for the purposes of this analysis, can be used collectively to consider the impact of the new accounting principles on the organisational structure of the functions which are and will be involved in the process of drawing up the balance sheet.

It is therefore possible to state, with inevitable simplification, that by tracing the organisational development of the main Italian banking groups, there has been a change from a functional-elementary type of organisational structure (consistent with the limited dimensions and restricted productive diversification of Italian groups in the 1980's) to a complex functional organisational structure (M-Form), consistent with a process of growth and diversification which began in the 1990's<sup>6</sup> and which in the last few years has been transformed into a divisional type of organisational structure (in terms of market segments), and which is typical of the structure of today's main Italian banking groups.<sup>7</sup>

In particular, the process of client segment division (corporate, retail, private), though representing a systematic trend, has affected several credit institutions in this country to varying degrees; as a result, divisionalised structures (the most obvious example being that of the Unicredito group) exist alongside those in which the group's activity has a mixture of approaches, connected partly to productive specialisation and partly to the policy of client segmentation (for example the San Paolo-IMI group). Either way, the Head Office, either a pure holding company or a mixed one, has a duty to guarantee the co-ordination of the work carried out by the various components of the group and therefore to define strategy through efficient planning and control. This co-ordination can consist of different characteristics depending on the level of integration of the various components of the group, the prevailing organisational philosophy (centralised/decentralised) and the degree of cost

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<sup>6</sup> For an analysis of the organisational structures of Italian banking groups following the process of service diversification see Mottura P., Previati D., Schwitzer P., Borsato R. e Saita, F. "Diversification and Organisation of Credit Groups" EGEA, Milan, 1996

<sup>7</sup> For an analysis of the divisionalisation process undertaken by Italian banking groups see Baravelli M. "Strategy and Organisation in banks", EGEA Milan, 2003

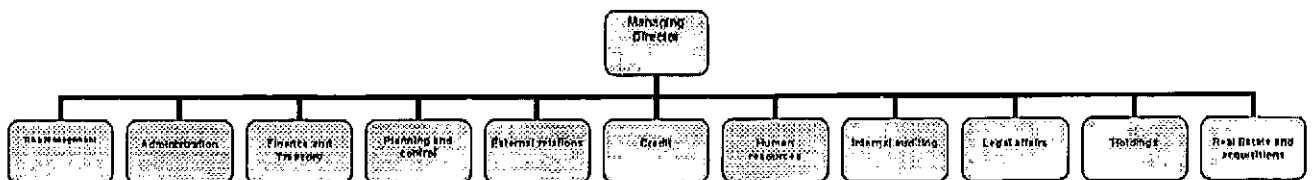


control pursued through the creation of centralised organisational units. The Head Office remains responsible, however, for the following work:<sup>8</sup>

- strategy definition;
- the process of planning and control;
- management of the participative portfolio;
- risk control and the definition of the risk policy at group level;
- fulfilling the supervisory obligations at group level;
- producing the consolidated balance;
- investor relations work.

In terms of the operational aspects, this work is carried out through the setting up of a series of central organisational units, directly dependant on General Management (staff functions – Administration, Planning and Control, Risk Management, Holdings, Treasury etc.) and in terms of the strategic aspects it is done through the establishment of governing bodies, or committees, whose job it is to define the courses of action which the staff must follow when carrying out their work. The number of organisational units mentioned may vary, as can the specific duties of each one. By way of example, the flowchart below illustrates the central functions of Banca Intesa S.p.a., the leading company in the Intesa group, with its considerable diversification, which can serve as a reference for a brief description of the roles of various central bodies into which the organisational structure of the leading company can be divided.

**Figure 4.1 – Banca Intesa S.p.a flowchart**



**Source – group's internal information**

<sup>8</sup> Risk and Treasury management are often centralised activities in leading companies.

In this example, there are as many as eleven central functions; in particular Administration, which is required to produce the consolidated balance, appears to be quite self-governing with regard to: i) Planning and Control (responsible for drawing up company plans, budget and periodic accounting for the purposes of the bank's managing bodies); ii) Risk Management (whose job it is to assess the group's overall exposure to financial risk and to provide support to the bank's managing bodies in their decisions concerning the allocation of capital); iii) the Finance division (responsible, along with Risk Management, and within the limits set by the group's managing bodies, for the management of risks;) and iv) External Relations (responsible for the relations between the group and the market).

As with the other functions mentioned, Administration depends directly on the Managing Director, who is responsible for his own actions and therefore for the production of the consolidated balance.

Not all banking groups, however, have such a clear, or even formal, division between the organisational units mentioned; in particular, the following solutions may occur:

- the Administration and Planning and Control divisions are united in a single Management, whose head answers to the managing bodies (e.g. Banca Toscana);
- with a view to Value based Management, Risk Management is placed within the unit responsible for the planning and production of the internal reports (the San Paolo and Unicredito groups);
- all three functions mentioned have a single person responsible for them, and who is also the point of contact for General Management (MPS group).

#### *Drafting the balance sheet<sup>9</sup>*

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<sup>9</sup> The following considerations, though not based on thorough analysis, are backed up by numerous interviews held with people involved to varying degrees in the implementation of the IAS project in several banks.

In spite of the specific position adopted by the organisational unit in its place in the company flowchart, the process of drafting the consolidated balance has until now been characterised by certain typical elements, which, while of varying intensity, seem to be shared by numerous banking institutions. More specifically, drafting the balance sheet has usually been assigned to a team of professionals who have highly specialised accounting skills. Moreover, specialised knowledge in accounting is not normally accompanied by qualified skills in other areas, such as risk management and finance. As well as this, the teams responsible for the drafting of the balance sheet have so far often worked in a relatively independent way compared to the rest of the banking areas.<sup>10</sup> barely connected to procedures followed in management, can be considered completely inadequate within the new legislative framework. Given the innovative and multidisciplinary nature of the IAS/IFRS, an integrated approach is required for drafting the balance sheet, including the active participation of several company functions. From this point of view it is clear that the process of drafting the balance sheet and the organisational structures of the central functions involved in the process must be reviewed. In other words, the work of the unit given the task of drafting the balance sheet seems to be highly specialised yet poorly integrated with the other central functions. This organisational solution, while seeming consistent with the nature of the country's accounting principles, which are based on a system of metrics founded on cost criteria and, it is unhelpful in the new normative context. In fact with IFRS a interdisciplinary approach to the the preparation of balance sheet is needed.

#### **4.3 IAS/IFRS ARE DESTINED TO HAVE A GREATER IMPACT ON THE ORGANISATIONAL STRUCTURE OF A BANK**

If it is true that the entire body of international accounting principles is destined to have strong repercussions on the operations of credit intermediaries, it is without doubt that some principles will have a decidedly greater innovative effect and which, therefore, will have stronger

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<sup>10</sup> The relationship between Administration and the other company areas are normally secondary and rather than aiming to share knowledge and skills, they simply aim to obtain raw

repercussions. A complete examination of the contents of the IAS/IFRS falls outside the objectives of this work, but it would be useful to outline the essential themes of the most critical IAS/IFRS for banks from the point of view of internal impacts. In particular, the specific objective of this analysis is to identify those aspects of the new regulations which will have strong repercussions on the adequacy of the organisational aspects of the *staff* functions within banks. In this context, the most critical IAS/IFRS appear to be IAS 39 and IAS 32, which deal with the accounting treatment of financial instruments, IAS 14 which deals with *segment reporting* and IAS 22, 36 and 38, which together define the rules which should be applied for the accounting treatment of acquisitions and the *goodwill* which arises from them.

*The accounting treatment of financial instruments: IAS 39 and IAS 32<sup>11</sup>*

IAS 39 and IAS 32 revolutionise the rules regarding the representation, *disclosure* and accounting treatment of financial instruments. These two principles, therefore, are those which will have a greater impact on banking organisations, whose *core business* is operations in financial instruments.

In particular, the innovations in question will produce important effects both of an "external" and an "internal" type. In this context, we will dwell here only on those aspects of the new regulations which will have strong repercussions on the organisational aspects of the *staff* functions of banks. We will therefore leave aside a complete examination of the contents of the two principles, which falls outside the objectives of this work.

In outline, the new rules concerning the accounting treatment of financial instruments are characterised by:

- Including in the accounts of some postings which have hitherto been absent because they have been considered *off-balance sheet* (derivatives);
- A greater use of the criteria of *fair value* in the accounting treatment of financial instruments;

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data which is then processed internally for the purposes of drafting the balance sheet.

- A different and more complex approach to evaluating hedging operations (*hedge accounting*);
- An increase in the information to be provided in the notes to the accounts about the financial position of the firm and the strategies and techniques to manage the risks adopted.

More specifically, IAS 39 introduces a new classification of financial instruments, according to which it is possible to subdivide financial assets into four categories (trading assets, long-term hold, own capital and available for sale) and financial liabilities into two categories (trading and other financial liabilities). Different valuation criteria and representation in the accounts will be applied to the different classes of financial instruments. In this context, it is important to underline that due to the extension of the scope of application of the criteria of *fair value*, many financial instruments will be valued in the accounts at their fair value (trading assets and liabilities, assets available for sale, assets for which the firm exercises the *fair value option* and financial instruments used in hedging), independently of whether an active market exists for them and therefore whether a reliable and easily determined price quotation can be obtained. In other words, with IAS 39 values will be put into the accounts which are estimated according to financial valuation techniques which have hitherto been used only for control purposes. The organisational unit responsible for the preparation of the accounts will therefore find itself in the situation of having to validate and to some degree certify values constructed according to algorithms and techniques which, have typically been developed within the *risk management* unit and finance area, with which a high level of subjectivity will often be associated, with the purpose of entering them into the accounts. It is clear that in this regard, a greater interaction between the organisational units in question will be necessary, over and above the updating the information systems. In fact, how would it otherwise be possible to define in a knowledgeable way the class into which the various instruments initially observed should be inserted? And furthermore, how could the administrative function effectively govern the process of preparing the accounts and take

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<sup>11</sup> For a complete examination of the contents of IAS 39 and 32 see Palombini E. . "Ias 32 Financial Instruments: Disclosure and Presentation" and "Ias 39 Financial Instruments: recognition and Measurement" in FITD, Op. Cit

responsibility for it without having first understood and shared the algorithms which are the basis for the *fair value* estimates?

The need for greater co-ordination between the organisational units mentioned is even more evident if we take into consideration the arrangements foreseen by IAS 39 for the accounting treatment of hedging operations and those foreseen by IAS 32 with regard to *disclosure*.

In this context, the elements of the new requirements which are relevant for the purpose of an analysis of the organisational impacts can be summarised as follows:

- Accounting for hedging operations at *fair value* (the criteria used for the hedging instrument prevails over that used for the instrument being hedged);
- The need to respect the very stringent requirements which must be fulfilled in order to use *hedge accounting*, in particular the introduction of an effectiveness test is foreseen;
- Very stringent rules, which partly conflict with operational practices, regarding the accounting treatment of operations hedging a portfolio of financial instruments with respect to interest rate risk (*macrohedging*);
- The obligation to describe in the notes to the accounts the objectives and guidelines for *risk management* activities, with particular regard to hedging strategies undertaken, including the main types of transactions foreseen, the level of risk concentration and the use of instruments to reduce risk;
- The need to provide specific and detailed information with regard to the exposure of the firm to various categories of financial risks;
- The obligation to show the *fair value* of all the financial instruments of the firm independently of their classification in the accounts;
- The obligation to show the methodologies and hypotheses used to calculate the *fair value* of individual instruments, as well as the effects resulting from the use of alternative hypotheses.

The innovative character of these requirements will constrain the banks to make their risk management activities more transparent to the outside world and to review the operational ways in which they carry out *hedging*, in order to avoid the risk that they are represented in the accounts as speculative

operations instead of ones used to hedge. In particular, the following actions are necessary:

- The transfer of *knowledge* of an accounting nature to the organisational units responsible for the realisation of hedging operations (*risk management* and the finance/treasury area);
- The transfer of *knowledge* of a financial nature to the organisational units dealing with the preparation of the accounts;
- The definition of a firm protocol in which the lines of action to be followed in *hedging* operations are indicated. This will form the basis for the description of *risk management* strategies which will be provided in the accounts;
- The availability of procedures and forms to use for the preparation of the documentation necessary to respect the requirements for the use of *hedge accounting*;
- The definition of methodologies with which to test the effectiveness of the hedging.

It is clear that these actions can be carried out only with a determined effort from the bank's *staff* functions. In this case as well it will therefore be necessary to consider suitable mechanisms for the transfer of information and skills between the various organisational units involved, as well as a clear division of tasks and responsibilities.

#### *IAS 14: segment reporting*<sup>12</sup>

The new requirements with regard to *segment reporting* introduced by IAS 14 foresee the inclusion in the accounts of information, typically of a cost accounting or managerial nature, which aims to represent the economic and financial progress of the firm, divided into industrial or geographical sectors. The presentation of this information is compulsory for quoted firms, whilst it is only advised for other firms which adopt IAS/IFRS.

In particular, based on IAS 14 a firm must:

- Choose the primary scheme for representation (industrial sectors or geographical sectors) which will be the basis for the sector information;

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<sup>12</sup> For further details see "International accounting principles" II Sole 24 Ore, Milan, 2003

- Proceed to the identification of the sectors for both the primary and the secondary scheme;
- Produce the information to be inserted in the accounts for the purposes of *segment reporting*.

It is important to underline here that there is a very close link between the sector information which is provided in the accounts and the internal information which is produced, typically by the financial planning and control function, for senior management *reporting*. In this regard, IAS 14 leaves no room for doubts, in fact paragraph 28 of the *standard* states: "..... The organisational and managerial structure and its internal accounting system are normally the best evidence of the principal sources of risks and benefits in regard to sector information. Therefore, with rare exceptions, a firm will provide sector information in the accounts in the manner used for internal reports used by administrators. The principal source of risks and benefits becomes the primary information scheme for sectors. The secondary source of risks and benefits becomes the secondary information scheme for sectors."

Due to the requirements summarised above, it is clear that strong co-ordination between the accounting and planning and control functions is necessary. More specifically, we are talking about redesigning the internal accounting procedures, taking account of the fact that their *output* will be inserted into the accounts. Furthermore, the sector accounting will be carried out in a manner coherent with IAS/IFRS.

#### *The accounting treatment of business combinations<sup>13</sup>*

IAS 22, IAS 36 and IAS 38 together define the rules to be applied for the accounting treatment of firm aggregations (*business combinations*). In this context, the main innovations introduced by the new requirements can be summarised as follows:

- All firm aggregation operations (including mergers) must be accounted for using *purchased method*;
- The goodwill, in as much as it is an intangible asset with no fixed life, must not be amortised, but subject to an annual *impairment* test which

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<sup>13</sup> For further details see "International accounting principles" Il Sole 24 Ore, Milan, 2003



will allow its value to be checked and will prepare for eventual devaluations;

- The value of goodwill must be estimated using an indirect valuation process which foresees:
  - The identification within the firm/group structure of a series of units generating financial flows (IAS 36) to which, as an initial step, the goodwill can be allocated;
  - The annual estimate of the value of these units generating financial flows according to the DCF method (*assets side variation*);
  - The devaluation of the goodwill registered in the accounts when conditions require.

The picture summarised above allows us to usefully reflect on the analysis of the impact of the new regulations on the organisational aspects of the *staff* functions within banks. In this context, the problems connected with the definition of the units generating financial flows appear to be particularly critical. IAS 36 defines a unit generating financial flows as "...The smallest identifiable group of assets which generates financial inflows resulting from the continued use of assets and which are fully independent of the financial inflows generated by other assets or groups of assets ...." (par. 5). The definition, as much as it is generic and in some ways obscure, gives those who prepare the accounts full discretion, which will be fully exploited in order to reduce to the minimum the risk of an excessive volatility in the measures of profit and Shareholders' Equity, caused by unexpected and significant *write-offs* of the goodwill. In this context, the correct identification of the units generating financial flows and the allocation of *goodwill*, since they are choices which will produce lasting effects on the representation of the economic-financial situation of the firm, take on a strategic importance. In order to assure that informed choices are made by the bank's top management, the process of defining the limits of the units generating financial flows must therefore necessarily involve various people, not only those within the accounting function. In particular, the planning and control function and equity management will certainly be involved. Furthermore, in many cases it could be useful to turn to external professionals, who will bring specific skills. Such an integrated approach to the problem appears to be indispensable also to ensure the coherence of all the information produced by

the bank for external parties. It is clear, in fact, that the information provided with regard to the units generating financial flows must be coherent with that concerning the sectors identified for the purposes of *segment reporting* and more generally with the overall structure of the consolidated accounts. This coherence must furthermore be assured in terms of the correspondence between the plans presented to the market and the contents of the accounts. The planning processes must therefore be reviewed in order to ensure effective management by the directors of the relationships between the bank and its *stakeholders* and the market.

#### 4.4 POSSIBLE SOLUTIONS TO THE ORGANISATIONAL CHALLENGES IMPOSED BY THE INTRODUCTION OF IAS/IFRS

*The need to review the organisational structures of banks' staff functions: the transitoriness of the IAS/IFRS*

The analysis contained in the previous section has shed light on the need to introduce appropriate co-ordination techniques within the various functions of the staff involved in the process of drafting the balance sheet, as a result of the IAS/IFRS coming into force. This need has begun to be seen through the way in which banks have been forced to set up a transition process to IAS/IFRS (IAS project). As expected, the organisation of the IAS project, consistent with the multidisciplinary nature of the new principles, has involved several functions: Administration, Planning and Control, Risk Management, Finance, Credit etc.<sup>14</sup>

Moreover, the collaboration of these organisational units, though viewed as "extraordinary", has still not produced permanent changes in the banks' organisational structures. In other words, for the moment, it is considered "temporary" and serves only to ensure that the work complies with the requirements for initial application of the IAS/IFRS.

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<sup>14</sup> In an aim to create the IAS project, collaboration between various staff functions has become evident through the creation of committees, made up of professional from all the managerial areas involved, whose job it is to deal with the procedural and operational problems connected with adopting some of the most innovative IAS for banks. For further details see Dabbene F. "The introduction of IFRS - the experience of Banca Intesa", Costantini A. "The introduction of IFRS - the experience of Banca delle Marche" in FITD, Op. cit.

If this experience can be considered a starting point for structuring more long-lasting courses of action which will normally allow effective control of the process of drafting the balance sheet, it is clear that in the near future the organisational rearrangement of staff functions will represent one of the main challenges which Italian banks will have to face.

For this reason, it seems appropriate to add one further consideration to the comments made in the previous sections, to illustrate the urgency of this challenge. Particular reference should be made to the "transitory" nature of the IAS/IFRS. These principles are subject to continuous revision and modification, and therefore the "IAS project" can never be considered entirely completed. As a result, the types of collaboration adopted for the transition to the new principles will have to be formally placed within the organisational structures of the banks. In other words, the "natural" instability of the legislative framework in the accounting context represents a further stimulus to quickly adopt an efficient organisational readjustment of staff functions within banking.

#### *Two possible solutions to the organisational challenges imposed by the IAS/IFRS*

There are various organisational solutions which can be adopted to meet the challenge set by the IAS/IFRS, not all of which are easily identifiable.

There are certainly no miracle cures, especially since the effectiveness of the specific solution which the individual institution adopts will depend on numerous factors such as: the size, <sup>15</sup> the level of service/product diversification, the state of the listed or unlisted bank, the prevailing organisational culture etc. For this reason, the following two options set out have no prescriptive value and are certainly not the only ones possible.

Previous analysis has highlighted the need to introduce appropriate co-ordination techniques within the various functions of the main staff involved in the process of drafting the balance sheet. In particular, the organisational

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<sup>15</sup> Smaller banks, characterised by an elementary functional structure, and usually unlisted, will probably have less difficulty in meeting the needs of greater co-ordination of the staff function work following the introduction of the IAS/IFRS. Given the extreme simplicity of the company structure, co-ordination in these banks can be easily achieved in informal ways

units in question are: Administration (Accounts and Balance sheet), Planning and Control, Risk Management, Holdings, Finance/Treasury, and Investor Relations.

The first possible way in which this co-ordination could be ensured is through the establishment of a Steering Committee, consisting of heads of all the areas involved and presided over by the Managing Director. The Committee should be given the following tasks and responsibilities:

- definition of the methods with which knowledge can be shared between the various functions;
- a clear and explicit definition of the role and responsibilities which will be assigned to the various functions with a view to drafting the balance sheet;
- drawing up and updating a company policy about the courses of action to be followed in carrying out hedging and effectiveness tests;
- validating the evaluation models used for estimating fair value;
- identifying the units which generate financial flow and, for unions between companies, the allocation of goodwill which it produces;
- defining a framework for internal reports;
- co-ordination and control of all the work carried out by the organisational units involved;
- responsibility for consistency in the bank's/group's internal and external communication systems.

This solution should be able to guarantee a satisfactory level of co-ordination between the various organisational units involved while at the same time maintaining the status quo. For this reason the main advantage of this option lies in its "acceptability" to the heads of the functions involved, who would not consider their roles under threat in the company hierarchy. Moreover, offset against this "political" advantage, the introduction of a Steering Committee brings with it some weaknesses. In particular, because of the governing body, it would be more difficult to settle any conflicts, causing a loss in efficiency of the co-ordination mechanism. As well as this, this solution

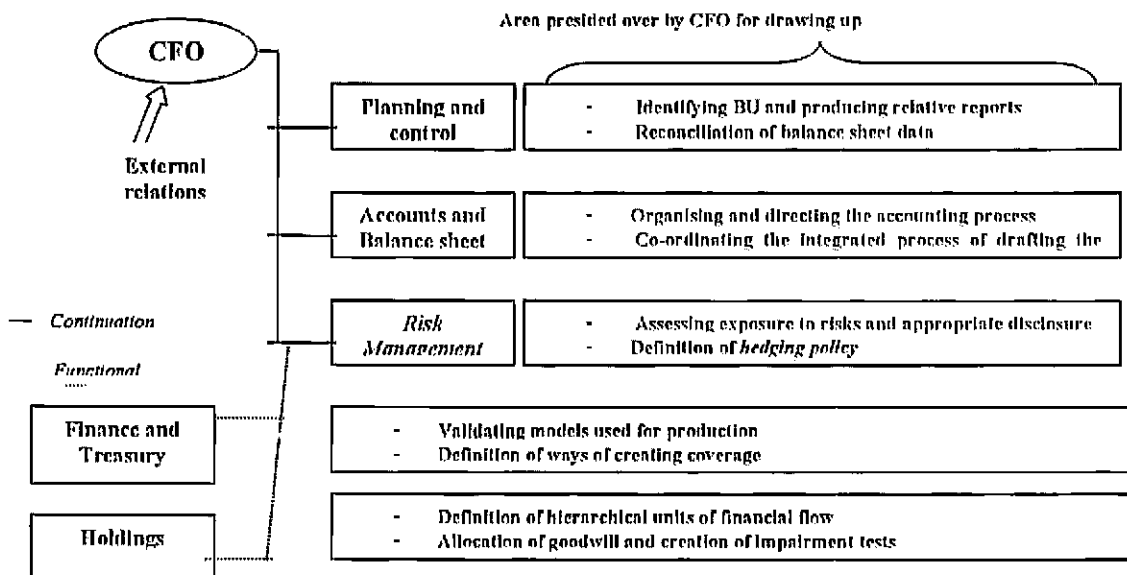
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without having to alter the organisational structure. For this reason, the comments made in this section do not apply to these banks.

does not give stakeholders the opportunity to have an individual in charge of providing them with information from the bank to the outside world. This weak point is particularly important for those institutions which, as listed companies, have daily contact with the financial community. In fact, given the increased disclosure obligations resulting from the IAS/IFRS and from the third mainstay of the Basel agreement governing the market, it would seem particularly appropriate to centralise the group's external relations and make one person responsible for this task. This person, through his role within the bank, would be given thorough knowledge of the company in terms of its economic-financial position and its exposure to the various risks.

The inconvenient aspects of the establishment of a Committee such as the one outlined above, could be overcome by introducing a new element into the company structure: the Chief Financial Officer (CFO). The CFO would be head of an organisational unit placed higher in the hierarchy than the following functions: Administration, Planning and Control and Risk Management and linked by functional relationships with the following Management areas: Finance, Holdings and Credit. As well as having the duties previously outlined for the Steering Committee, the CFO should also be given the direct responsibility for carrying out the work of Investor Relations.

Figure 4.2 – The Chief Financial Officer



The position of CFO already exists in industrial companies and in numerous foreign financial institutions<sup>16</sup>, but its introduction into Italian banks would be a great innovation and, if effectively implemented, could guarantee the bank's governing bodies actual control of the whole process of drafting the balance sheet, with the CFO being the only point of reference. Moreover, this organisational solution would allow the quality of the relationship with the market to be improved. Meeting this target is subject to the bank's ability to identify a professional with the necessary skills and who is able to convince all the people involved to accept the change. For this reason, depending on the individual company, it is possible to envisage a two-stage process beginning with the introduction of moderate forms of co-ordination, such as the Steering Committee, followed by the introduction of more structured solutions, such as that of the CFO. It is clear, however, that the two solutions outlined are mere examples of directions which can be chosen to meet the organisational challenges of the IAS/IFRS. The solutions which will actually be adopted will have to be gauged on the specific characteristics of each individual institution.

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<sup>16</sup> According to research carried out by Accenture, the presence of a CFO is extremely widespread in Spanish and British banks. Accenture "The organisational structure of European banks", 2004

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