

ITALIAN SMALL AND MEDIUM-SIZED ENTERPRISES AND HARMONIZATION OF EUROPEAN ACCOUNTANCY: CONTEXTS AND IMPACTS

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1. Introduction

There is no doubt that the process towards accountancy harmonization in the European Union has been fundamentally helped by the approval of directive 2001/65/EC dealing with the introduction of the valuation criterion of fair value and of regulation (EC) 1606/2002 regarding the application of I.A.S. – I.F.R.S. on the part of quoted companies.

These two legislative acts in fact entailed modifications in how consolidated and annual accounts are perceived and compiled that were so profound as to be defined as epochal. That is, in the light of the Fourth directive 78/660/EEC concerning annual accounts of whatsoever type of company and the Seventh directive 83/349/EEC on consolidated accounts having allowed the survival of particular local accounting habits, insufficiencies progressively came to light with respect to the need for guaranteeing the comparability, in terms of form, content and valuation criteria, of accounting documents in the context of an environment which was ever more open and dynamic.

However, at the same time the fact cannot be overlooked that the last innovative intervention in Community accounting law activated in the wake of the previous two – that is, directive 2003/51/EC – represents a moment resolving continuity with respect to precedent norms and practices and, as such, is liable to being configured not only as being as important as its two predecessors but even as being more important and incisive than them. This is both because of the undoubted relevance in terms of number and contents of the changes that, as we shall see, it brings to the heart of Community accounting law – that is, directive IV – and then, in a flood, to its specific consequence and outcome – that is, directive VII, directive 86/635/EEC relating to banks and other financial institutions and directive 91/674/EEC relating to insurance companies and because of the range of subjects that it potentially involves and attracts in its field of operation

– that is, Community companies which, not being involved in the immediate application of regulation (EC) 1606/2002 from the financial year 2005, will continue to compile their own annual and consolidated accounts observing (only) accounting directives¹.

In light of these first propositions, the objective with which we are faced in the current work is first of all to examine the salient aspects of directive 2003/51/EC itself. Once this legal foundation has been outlined, an attempt will be made to verify its potential impact on legislation currently in force and on today's generally accepted practices in Italy, taking into account therefore how national legislation has already received and put into effect at the time of writing² directive 2001/65/EC and regulation (EC) 1606/2002 respectively.

2. Directive 2003/51/EC. Salient aspects

With this in mind, our point of departure is therefore constituted by the European Commission's presentation, on 28 May 2002, of the directive proposal (European Commission, 2002), aimed firstly at emending the contents of directive IV, already only just modified by directive 2001/65/EC itself, with the general objective of making its substantial principles entirely in line with the new international vocation of Community accounting legislation: in other words, to make it definitively fully compatible and coherent with the I.A.S. – I.F.R.S. system, both in the current version in force on 1 May 2002 which at the time was taken as a point of reference and in any version it may assume in the future.

In particular, the aims that the European Commission explicitly declare that they wish to be reached through this legislative act are essentially three:

"1) to eliminate all conflicts existing between accounting directives and the I.A.S.;

2) make sure that accounting options currently allowed by the I.A.S. can be used by EU companies which will continue to observe accounting

¹In fact, this is the majority of Community businesses.

On the subject, it is relevant to consider that in Italy, according to the official data of Unioncamere of February 2006 (Unioncamere, 2006), at the end of 2005 there existed 6 073 024 businesses, of which 3 504 631 were individually run, 1 248 342 were partnerships and 1 123 694 were joint-stock companies. Of those which were joint-stock, only 60 339 were juridically joint-stock, and only 282 of these were listed on the Italian Stock Exchange, as follows: 88 *Blue Chip*, 72 *Star*, 104 *Standard* and 18 *Mercato Expandi* (Borsa Italiana, 2006).

²31 December 2006.

rules based upon accounting directives (that is, companies which will not prepare their annual or consolidated accounts in conformity with the I.A.S. adopted in compliance with I.A.S. regulation) and

3) to update the fundamental structure of accounting directives in such a way that they offer a view of financial information which will be both in line with modern practices and sufficiently flexible to adapt itself to future developments of the I.A.S.”.

All of the above implies that the European Commission, moving from the unquestionable ground that the accounting directives – notably the IV - and the principle of the ‘true and fair view’ which inspires and informs them at the deepest level, however represent the absolute and undisputed base of all Community accounting law, had come to realize that the adoption of I.A.S – I.F.R.S. for quoted companies, were it not accompanied by an analogous provision at the national level for companies not quoted, could have had a detrimental effect on the informative quality of the face of the financial statements prepared by this section of companies which, furthermore, cannot currently be considered as a residual quantity. This, obviously, would have had a profoundly negative effect on financial statements transparency and comparability, which are however necessary for the efficiency and integration of the European capital market.

In other words, the European Commission realized that the framework of directive IV, like that of those directives which it has in turn produced, had to be innovatively revisited, given that, although still largely adequate with respect to the known evolution of accounting doctrine and practices, it was suffering under the weight of the many years passed since its first adoption. The directive, in fact, in its original formulation, reflected in some aspects accounting behaviour which was the child of the time in which it was written up and which had become obsolete and therefore no longer cutting edge with respect to the new dynamic international context inspired by and acknowledging the I.A.S. – I.F.R.S.

It therefore not only became necessary to proceed to the elimination of situations where there was a lack of homogeneity, however marginal, between the system of the complex of accounting directives and the system of the I.A.S. – I.F.R.S. in force, but also essential to intervene in their structure so as to give them the flexibility needed for them then to be able to adequately conform in the future, following their presumed and hoped-for evolution.

Furthermore, in such a context the opportunity could not be overlooked to delineate a reference legislative context for financial statements destined to the capital market which would be common for most European companies whether or not they were quoted on a regulated market – that is, whether subject or not to the provisions of regulation (EC) 1606/2002. Transparency, comparability and account information quality were (and

are) attributes which could not and should not (and cannot and must not) be reserved solely for the companies, presumably large, which operated (and operate) in organized markets, but had to (and have to) be able to count for all other businesses, even those of small or medium dimensions. Only thus is it in fact possible to create a common platform preventing the presence in the same socio-economic environment of two accounting models, one national and one international, in other words conditions which should allow access to accounting information evolved and harmonized on the Community base and which, at the same time, should give incentives and stimulation to smaller companies to open towards direct operability on capital markets.

If therefore the guideline assumed by the European Commission is the comparability of accounting language extended to all companies with legal status, we shall now see how this has been as it were delineated in the relevant dispositions found in directive 2003/51/EC. Notwithstanding the fact that, for the reasons given above, we shall only stop to look at the modifications it brings to the dispositions of directive IV, it is most interesting to highlight first of all that these essentially contain those options left to member states to allow them to authorize or to allow them to oblige, companies falling under the relative operative headings to adopt determined accounting behaviour. Furthermore, such interventions present a character which we may as it were call 'incremental' insofar as, if observed with the original regulations in mind, they always appear as prescriptions added to these latter, which therefore themselves retain almost unaltered their full initial force.

This, under one aspect, indubitably conforms to the necessity of providing member states with the flexibility to intervene in the respective national regulations whilst meeting the need not to impose on them modifications not considered opportune or fitting with respect to their accounting practices. This situation may be seen without difficulty above all in those countries where the practice of the annual account has a strong connection with fiscal regulation³. For this reason, through this system of options the European Commission does not intend to interfere in an excessive – or incongruous at least – manner in national accounting customs but rather wants to act in such a way that the changes are carried out by the individual legislators only if and when (and only in the necessary degree) they are considered opportune and in such a way as to guarantee their being gradual in terms of time and proportionate in terms of content. All of the

³ Insofar as Italy in particular is concerned, such a connection has effectively witnessed a slowing-down in recent times thanks to a double legislative modification: one in accounting and one in taxation.

above evidently has the aim of making the respective internal discipline, as far as statementing goes, as coherent as possible with regards to the chief needs and characteristics of the business communities themselves, in the implicit knowledge that the change sanctioned by the advent of I.A.S. – I.F.R.S. is already in itself the potential cause of profound mutations in the field of accounting, both at the theoretical and operative levels, to which neither those who read nor those who draw up financial statements, nor the entire array of those connected with business, are accustomed; nor, perhaps, are they fully ready.

However, from another point of view, at the same time it cannot be denied that this system of first-level options in member states' favour, above which there is a further system of second-level options reserved for those companies with a legal status and for those who draw up their respective accounts, can only further perpetuate something that has represented one of the main reasons for the partial lack of success of directive IV, as with the other accounting directives, with respect to the aim of Community accounting harmonization.

Just as this directive, from when it was first adopted, has demonstrated that it is not fully able to give an adequate impetus to the homogenization of accounting languages in European Union businesses, so this regime, highly optional as it is, readies once again the field for particular national choices inspired by internal traditions and local customs which are a long way from the aim of verifiability, comparability and transparency of financial information in the Community context. Indeed, although it is undoubtedly to be hoped that member states unanimously put into action a spontaneous and accelerated process of adaptation to the new options offered them, the risk of producing instead in the immediate future a situation, albeit transitory, worsening transnational accounting data comparability should not be undervalued.

However, it is most interesting to examine the substantial content of the legislative initiative in question. Indeed, given that its aim is to make small- and medium-sized businesses draw nearer to the I.A.S – I.F.R.S. - influenced accounting system, what is new in it is certainly both of great importance and great relevance.

In particular, although a full and detailed examination of these innovations lies outside the scope of the present article, the most salient can nonetheless be summarized as follows, at least insofar as they refer (as is confirmed) to directive IV:

- member states are authorized to consent to or forbid the inclusion in the financial statements of 'supplementary documents', which is first of all to say cash flow statements, but also, secondly, a statement showing changes in equity;

- member states, in order to render a 'true and fair view' of the company's situation, are authorized to permit or require that the collocation of entries in the profit and loss account and in the balance sheet take into account the substance of the operation or contract that is the subject of accounting, that is, that the principle of substance over form be respected;
- member states are authorized to allow the drawing up of a scheme of the balance sheet based on the distinction between current and non-current assets/liabilities, on the condition, however, that information content of such a presentation structure be substantially equivalent to that of the schemes originally foreseen by directive IV;
- member states are authorized to allow or require the drawing up of a statement of performances in place of profit and loss account, on the condition that the information contained therein be equivalent to that of the schemes originally foreseen by directive IV⁴;
- member states must proceed in such a way that, in the name of respecting the principle of the 'true and fair view' and, after that, of accrual basis, the provisions reflect contingents effectively existing in the reference data of the financial statements;
- member states may authorize or require, in well-defined conditions, not only tangible and financial assets, but also intangible assets, instead of being listed at cost, to be revalued at the end in order to express thereby the relative fair value;
- member states may allow or require other categories of activity than financial instruments, including derived contracts, held for trading and available for sale to be available for valuing at determined amounts making reference to their fair value, as long as within the limits of a generally accepted and recognized international frame of reference, and in these cases the variation in value deriving must be registered in the income statements, in derogation of prudence;
- finally, member states must proceed in such a way that, in order to allow the situation and development of the company to be understood, as well as the trend of its business, the annual report contains a description of the chief risks and uncertainties it faces, and in this case the information

⁴ This modification is directly linked with the possibility of using the fair value measurement criterion in drawing up the annual account, as we shall see below. This implies that unrealized profits may also be counted, which, besides being incompatible with prudence, determines a lesser substantial coincidence of produced and distributable income.

Therefore, to continue to keep the two different configurations of produced and realized income evident inside the income statement, the drawing-up of a statement of performances is foreseen, that is, an income statement containing both components of realized income and components of unrealized income, both in the income statements and in equity, but separately highlighted. Only the former, although the latter are relevant to the determination of income produced, are distributable.

provided must not be limited to the financial aspects of the activity, but also those which are not financial, therein included above all issues relating to the environment and employees.

If the above is taken into consideration, one cannot but observe that directive 2003/51/CE gives a dynamic impetus to a body of legislation, that of directive IV, the keystone of Community accounting law, which has for too long remained static in its original set-up that, although undoubtedly an expression of the time, historically and politically, that formed it, had since shown itself in less than three decades to be no longer fully in line with the needs of the new international and globalized economy.

3. Directive 2003/51/EC. Reception in Italy: first considerations

In such a context, the Italian legislators too find themselves faced by a task that, although fruit and reflection of European Union strategy, is certainly none the less important for that.

Indeed, in the process of putting into effect in Italy directive 2003/51/EC, it must be duly taken into account that it refers to small- and medium-sized enterprises, that is to say, those 'closed' realities that do not operate on the internal capital market, let alone the international, but which nonetheless constitute the essential basis of the national economic and entrepreneurial environment, being in fact a typical and characteristic factor thereof.

However, at the moment of writing, Italian legislators have not yet enacted regulations proceeding from the directive in question⁵, so as to be able to investigate the potential impact on the legislation in force and the practices currently generally accepted in Italy; it therefore would appear useful to examine how internal legislation has already received and put into effect those Community legislative acts preceding it both chronologically and substantially, that is, directive 2001/65/EC and regulation (EC) 1606/2002 respectively.

Above all, from the choices already made by Italian legislators regarding the latter, it is to be hoped that it will be possible to be able take some indications as to the legal scenario which may reasonably be foreseen from the point of view of the reception of one of the most disruptive and innovative of the provisions of directive 2003/51/EC with respect to the legal framework already existing, which is to say, that which offers member

⁵ Regarding this, it should be highlighted that article 1, l. 62/2005, attributes to the Italian government the task of issuing before 12 November 2006 the legislative decrees necessary for actuating, amongst innumerable others, the directives in question.

states the option of allowing or requiring other categories of activity than financial instruments to be valued at fair value with the imputation of the consequent value variations to the income statements, to be however considered along with those inherent in the economic revaluation of all the typologies of assets in order to express thereby the relative fair value.

These are provisions that are in their turn evidently connected to that whereby member states are permitted to allow or forbid the drawing-up of a statement of performance in place of income statements, the eventual reception whereof could represent a further change, equally complex if not more so, for Italian accounting law, insofar as it would go towards undermining the very concept of income⁶.

Indeed, all of those countries based upon the principles of civil law, amongst which is Italy, adopting prudence, tend to identify a business's economic performance with a concept of income produced that is also at the same time distributable, in the sense that it is the fruit of an overall process of valuing financial items tending to favour the conservation of financial integrity. In the configuration of income in Italy, then, unrecoverable profit is not taken into account.

In countries based on common law principles, however, a business's economic performance is individuated in a concept of potential income expressing the economic set-up from a viewpoint of dynamic evolution that, privileging an accrual basis, also includes unrecoverable income items.

Furthermore, taking into account the aforementioned objectives of directive 2003/51/EC, it may be hoped that it will possible to individuate those precepts that, having already influenced that part of the overall process of putting internal accounting law in line with the international scenario already put into effect, may reasonably be considered suitable for also guiding its reception in Italy and, in particular, the extension of the application of fair value for measurement purposes and thus the consequent accounting of unrecoverable profit.

Bearing this in mind, let us pass on to examining directive 2001/65/EC.

4. Directive 2001/65/EC. Reception in Italy

Directive 2001/65/EC was received into Italy by legislative decree 394/2003 with effect from 1 January 2005, that is, for financial statements relating to financial years beginning 1 January 2005.

⁶ We shall not deal below specifically with the face of the financial statements in question, also known as *statement of earnings and comprehensive income*, as there has yet to be formed a unanimous and official consensus internationally.

Subjects involved in the application of the new regulations are those business typologies that, in the light of regulatory evolution, will continue to use the complex of regulations of the civil code for drawing up their annual accounts, including in particular those companies that can draw up their accounts in an abridged form as per article 2435-bis, c.c. The application of these regulations does not therefore concern those companies which, as we shall see in more detail below, must adopt in their entirety the I.A.S. – I.F.R.S. international accounting principles for drawing up their consolidated accounts and, optionally, their annual accounts from the financial year 2005 onwards, as per legislative decree 38/2005.

Therefore, it may be seen that legislative decree 394/2003 affects the majority of Italian companies.

This last detail is undoubtedly important in terms of the present discussion, if one considers that also insofar as those businesses defined as ‘minor’ by directive 2003/38/EC⁷ are concerned, by raising the quantitative parameters foreseen by directive IV, the passing of which allow small-⁸ and medium-sized businesses to make use of various types of simplification in the drawing-up, revision and publication of financial statements, it in prospective brings a notable (further) extension of the array of businesses satisfying the requisites so as to be so considered.

In terms of the content of the dispositions of legislative decree 394/2003, although bearing in mind that an exhaustive examination thereof lies outside the scope of this work, it is important to underline that the reception of the original community discipline did not come about in a full and complete way but rather only partially, both in terms of face of the financial statements in question and the object.

Indeed, there has been no introduction of regulations aimed at making provisions for financial instrument fair value accounting, as is in fact requested by the text of the directive, but only the introduction of regulations making provisions for the insertion of specific information on the fair value of financial instruments in the notes on the accounts (article 2427-bis, civil code) and in the annual report (article 2428, civil code, 6-bis).

⁷ In particular, this directive, in order to reflect the economic and monetary evolution of the European Union in the five years prior to its adoption, raises (by 16.8%) the dimensional parameters constituted by balance sheet total and net turnover, leaving unchanged the parameter of average number of employees.

With this directive too the Italian government has the task, with article 1, l. 62/2005, of issuing the necessary legislative decrees to actuate it before 12 November 2006.

⁸ Bearing in mind that Italy has only internalized in its legislation only those simplifications that directive IV reserves for companies, the dimensional parameters of which allow them to be defined as ‘small’, creating thereby, with article 2435-bis, civil code, the discipline of the abridged annual account, let us limit ourselves to observing how the dimensional parameters in question have been raised: the balance sheet total has gone from 3 125 000 euros to 3 650 000 euros and the net turnover from 6 250 000 euros to 7 300 000 euros.

In particular, the disclosure called for in the notes on the accounts only regards certain typologies of financial instruments: derivatives (except for those companies allowed to draw up an abridged annual account as per article 2435-bis, civil code) and financial assets, excluding investments in joint venture, affiliated and controlled companies.

However, the disclosure called for in the annual report has the function of supplying a complete representation of the potential impact of financial instruments on the financial situation, the business's results, as well as on the expected cash flow.

With the choice made, that is, not to make provisions for the insertion of fair value as a measurement criterion alternative to the historical cost for given typologies of financial instrument, Italian legislators have demonstrated that they are fully aware of the fact that the objective of fair value inside the whole system of statements is not that of guaranteeing the integrity and efficacy of equity in favour of the interests of creditors and partners; an objective which is in fact linked at a fundamental level to historical cost and prudence. No, the objective is that of supplying a transparent representation of the overall outcome of the management, and the financial situation in particular, that, without favouring anyone, acts to the benefit of all categories of stakeholder, notwithstanding the fact that it tends to orientate itself, however, prevalently in favour of investors.

Italian legislators, then, preferring so to speak a 'soft' introduction of fair value to the legislative set-up concerning annual (and consolidated) accounts, have demonstrated that they respect its set-up that traditionally assumes important connotations of guarantee. The use of fair value for measurement ends would in fact have entailed entrying economic components both negative and positive that, being merely the expression of oscillations undergone over the time of fair value, cannot really be said to be truly recoverable, thereby causing a definitive break with prudence and recoverability.

It can therefore be seen that the caution with which Italian legislators have acted obviously shows that their intention was to try and fully preserve the principle inspiring the body of company law, of which the regulations governing annual and consolidated accounts are part: the care of third parties' credit worthiness through the protection of their credit rights with the company in question.

However, from all of the above there emerges, as we see it, a legal framework which would appear in a certain sense difficult to interpret, if not contradictory.

On one hand, on the objective level, legislative decree 394/2003, acting as it does solely on qualitative documents composing and accompanying the annual account, does not at all sanction that continuity solution with respect to measurement criteria that, present in the intentions and dispositions

of Community legislators, would have led to prudence and historical cost being, if only partially, abandoned. From that point of view, therefore, what potentially looked to be a genuine change in national accounting practice and regulation has instead shown itself to be only an 'incomplete reform'.

On the other hand, on the subjective level, to the circumstance that the category of subjects included in the operative field of legislative decree 394/2003 is made up of majority of national companies, that is, those not held to the direct application of I.A.S. – I.F.R.S. international accounting principles, it should be borne in mind that a potentially increasing significant number of these satisfy the parameters of dimension that allow them to be classed as being allowed to draw up abridged annual accounts, and are thus exonerated both from the predisposition of the annual report and the consequent information now required by the new section no. 6-bis) of article 2428, civil code, and the presentation of part of the information as per article 2427-bis, civil code. From this point of view, therefore, the real impact of the information communicated by these businesses to the plethora of their respective interested parties would appear to be, when all is said and done, modest.

To this it should be added that in the Italian accounting system the already limited operation of fair value for financial instruments must take into account the limited extension of official markets destined for their exchange and the relatively small volume of transactions performed there. In such a sense some perplexities must be raised by the fact that the effective adoption of fair value may be limited practically in the lack of a market value for the specific financial instrument that, being the expression of an active and liquid market, is suitable to express that trustworthy, transparent and verifiable public quotation that the concrete identification of its fair value requires, prefiguring thereby the need to look at the application of historical cost.

It should be remembered on this subject that, in general terms, the fair value of an equity element from the conceptual point of view is not identified with its market value, from which it is indeed logically autonomous, although it represents a fundamental parameter for its determination. In other words, fair value presupposes the existence of a market characterized by an adequate dynamism in terms of frequency and materiality of transactions, so as to supply the quotations given with objectivity, neutrality and verifiability, and therefore informative relevance.

Thus, on one hand, the market value of the equity element considered can be transformed into its own fair value only through the execution of a series of rectifications. On the other hand, whenever the market value is lacking or not sufficiently relevant, the individuation of fair value requires the assumption of a formally and substantially analogous equity element on the market or the application of one of the alternative methods of calculation (financial or stochastic, for example). Such techniques refer above all to recent transactions concluded under normal market conditions, to current

market values of other substantially identical elements, to specific values calculated through discounting cash flow or to option measurement models.

The overall considerations formulated hitherto on the reception of directive 2001/65/EC, and in particular those inherent in the cautious conduct leading to prudence and the criterion of historical cost being maintained in every effect, take on particular and interesting relevance insofar as the present investigation is concerned if one bears in mind the provisions of directive 2003/51/EC for extending fair value measurement to other categories than financial instruments and for allowing the fair value economic revaluation of assets.

It is indeed evident that this conduct of guaranteeing and protecting third parties' credit rights and holdings rights that has prevailed in the putting into effect of the first of the two directives in question should with the second necessarily be able to add the market need for receiving from companies account information of quality, that is, comparable and intelligible.

Italian legislators, then, in putting into effect the revision of those civil regulations governing both annual and consolidated accounts should tend towards achieving an adequate compromise, a satisfactory point of balance between information transparency and public trust: values which together constitute the keystone of the existence and function of the market, and specifically the capital market.

It is thus the case that it is in the dispositions drawn up to put regulation (EC) 1606/2002 in force in Italian law that those guide lines may be traced that, preserving the integrity of owner's equity and allowing the hoped-for general improvement of the intelligibility, transparency and comparability of account documents to be achieved, may be considered authoritative 'precedents' suitable for application for accounting regulations for smaller businesses, giving adequate space thereby to the respective needs.

5. Regulation (EC) 1606/2002. Enforcement in Italy

Moving on to examine regulation (EC) 1606/2002, the detail should first of all be taken into account that it, in providing for quoted European Union companies to be obliged to apply I.A.S. – I.F.R.S. international accounting principles ratified following the apposite techno-political procedure of endorsement in drawing up consolidated and annual accounts from 1 January 2005, has at the same time given member states the faculty of requiring or authorizing the adoption of the same principles for quoted companies with regards to annual accounts and for all other companies with regards to both consolidated and annual accounts.

This faculty found its realization in Italy with legislative decree 38/2005.

This decree firstly lists those subjects who, in Italy, are obliged or authorized to apply said international accounting principles in the preparation of annual and consolidated accounts from the financial year 2005 onwards, which fact implies that, from the first financial year of their adoption onwards, said subjects are legally obliged to observe solely ratified international accounting principles, and are therefore obliged to ignore, as it were, internal accounting regulations⁹.

The decree then lists, for the above subjects, the obligations and faculties in relation to the application of international accounting principles for consolidated and annual accounts and, finally, gives the dispositions of adaptation of internal fiscal and civil regulations aimed at disciplining the effects of the adoption of international accounting principles.

In particular, notwithstanding the fact that a complete and exhaustive examination of all the regulations contained in the legislation in question lies outside the scope of the present work and that therefore we limit ourselves to examining only their essential details where these bear on matters discussed here, it is important to point out that the subjects, in relation to the adoption of international accounting principles, are listed as follows:

a) quoted companies, that is, those companies issuing financial instruments admitted for negotiation on regulated markets in whatsoever European Union member state, other than insurance companies;

b) companies with publicly-diffused financial instruments, other than insurance companies;

c) Italian banks and other supervised financial intermediaries;

d) insurance companies;

e) controlled companies, that is, companies included in the consolidated accounts of the preceding companies (a-d), other than those that can draw up abridged annual accounts *ex* article 2435-bis, civil code, and other than those listed above (a-d);

f) companies drawing up a consolidated account, other than those listed above (a-e) and other than those that can draw up abridged annual accounts *ex* article 2435-bis, civil code;

g) companies remaining, other than those listed above (a-f) and other than those that can draw up abridged annual accounts *ex* article 2435-bis, civil code.

Insofar as the application of I.A.S. – I.F.R.S. international accounting principles for drawing up annual and consolidated accounts is concerned,

⁹ Essentially constituted, as is known, by the articles from 2423 to 2435-bis, civil code, and by the national accounting principles drawn up by the Commissione per la Statuizione dei Principi Contabili del Consiglio Nazionale dei Dottori Commercialisti e del Consiglio Nazionale dei Ragionieri e Periti Commerciali and, now, by the Organismo Italiano di Contabilità.

the obligations and eventual faculties for the subjects listed above are established in the following modality:

- a) quoted companies;
- b) companies with publicly-diffused financial instruments;
- c) banks and other supervised financial intermediaries;
- d) insurance companies;

are obliged to draw up their consolidated accounts following international accounting principles as from the financial year finished or in progress as of 31 December 2005.

Whereas,

e) controlled companies, that is, companies included in the consolidated accounts of the preceding companies (a-d), other than those that can draw up abridged annual accounts *ex* article 2435-bis, civil code, and other than those listed above (a-d);

f) companies drawing up a consolidated account, other than those listed above (a-e) and other than those that can draw up abridged annual accounts *ex* article 2435-bis, civil code¹⁰;

have the option of drawing up their consolidated account according to international accounting principles as from the financial year finished or in progress as of 31 December 2005.

Insofar as the annual account is concerned, the subjects that are obliged to draw it up according to international I.A.S. – I.F.R.S. accounting principles are:

- a) quoted companies;
- b) companies with publicly-diffused financial instruments;
- c) banks and other supervised financial intermediaries;
- d) insurance companies, but only if quoted and not drawing up a consolidated account;

with reference to the financial year finished or in progress as of 31 December 2006, without prejudice to the fact that the first three typologies of company are permitted to avail themselves of this faculty as from the financial year finished or in progress as of 31 December 2005.

The subjects that have the option of drawing up their annual account according to international accounting principles as from the financial year finished or in progress as of 31 December 2005 are:

- e) controlled companies, that is, companies included in the consolidated

¹⁰ These are normally companies of medium to large dimensions that draw up consolidated accounts but are not quoted. These companies' faculty to draw up their consolidated accounts according to international accounting principles from the end of the financial year closed or in process as of 31 December 2005 is motivated by the fact that thereby Italian legislators wanted to avoid creating a regulatory inequality in favour of unquoted companies over quoted companies, with the consequent lack of incentive for becoming.

accounts of the preceding companies (a-d), other than those that can draw up abridged annual accounts *ex* article 2435-bis, civil code, and other than those listed above (a-d);

f) companies drawing up a consolidated account, other than those listed above (a-e) and other than those that can draw up abridged annual accounts *ex* article 2435-bis, civil code, but only if contextually exercising the faculty of drawing up their consolidated account according to the same principles from 2005;

g) companies remaining, other than those listed above (a-f) and other than those that can draw up abridged annual accounts *ex* article 2435-bis, civil code, if included in the consolidated accounts drawn up by subjects (f) above.

Insofar as regards companies other than those listed above and other than those that may draw up abridged annual accounts, the faculty is foreseen of drawing up their annual accounts following the I.A.S. – I.F.R.S. international accounting principles as from the individuated financial year with the necessary decree from the Minister for Economy and Finance and the Minister for Justice.

In this ultimate category there is obviously included the majority of Italian businesses, including those small- or medium-sized, for whom Italian legislators have preferred, for motives of prudence, to ask the competent ministers to fix a financial year whereafter such a faculty may be exercised. Indeed, in consideration of the experience of those larger businesses that will have applied international accounting principles from 2005 onwards, this will allow the evaluation of eventual problematic aspects and eventual difficulties in applying it, both at the theoretical and operative level.

From the above there emerges that the direct application of international accounting principles firstly involves, for consolidated accounts as much as annual, essentially (only) those large companies working in particular sectors – banking, financial and insurance – which represent a scarce minority of Italian businesses.

The remaining companies, then, by no means numerically unimportant, but rather a majority, and in particular those companies that may draw up abridged annual accounts, those companies not exercising the faculty of applying the I.A.S. – I.F.R.S. as established by legislative decree 38/2005, although foreseeing the faculty of their being applied, subordinates their start to the aforementioned interministerial decree¹¹, continue to apply internal accounting regulations.

¹¹ For such companies, not controlled by the company that draw up the consolidated accounts, other than those that draw up abridged annual accounts *ex* article 2435-bis, civil code, the faculty of applying international accounting principles is still not yet operative, as of today 31 December 2006, the ministers have yet to issue the decree fixing its onset.

However relevant may be the above to the present discussion, it is elsewhere in the dispositions of legislative decree 38/2005 that we find constituted a precious point of reference for the individuation of accounting and legal solutions put into place to preserve the integrity of owner's equity linking it with the increasing of the quality of information in account documents.

Here we are referring to those regulations which deal with the definition of a system of protection and which those companies drawing up their annual accounts following international accounting principles as per the above must respect in terms of the distribution of annual profit and reserves, so as not to damage the effectiveness, the existence and the integrity of the owner's equity, and to thereby protect the credit worthiness of third parties in general, and in particular of creditors and the needs of their own legitimate funds.

In particular, what results from the regulations in question is that limits are set to the possibility of distributing profit and reserves deriving from the adoption of fair value for measurement purposes, and therefore from unrealised profit, that this causes to be included with the income statements or directly on the equity.

In substance, this sort of juridical-accounting 'sterilization' of appreciation deriving from fair value makes it obvious that the circumstance of fair value's being admitted as a measurement criterion, which is nonetheless alongside historical cost, is subordinate to the necessity of preserving the function of guaranteeing that the owner's equity subsists in the view of the general body of the business's stakeholders and of its various financiers in particular.

There exists, however, appreciation deriving from fair value inscribed in the income statements for which, although not effectively realized, such distributive limitations do not come into play, as they can be assimilated to profits genuinely attained: this is the case of those relating to the financial instruments of dealing, change and coverage.

For completeness' sake, it should be added that the system of unavailability in question is also extended, quite coherently, to equity variations found in the opening balance sheet of the first annual account drawn up following the beginning of the application of the I.A.S. – I.F.R.S. international accounting principles.

6. Directive 2003/51/EC. Reception in Italy: contexts and impacts

If these are the dispositions governing both the first phase of transition to I.A.S. – I.F.R.S. international accounting principles and their full systematic use, the question may legitimately be asked if and to what degree

they may be considered extendable to the cases in point that could come to pass in the near future as an effect of the current reception of directive 2003/51/EC from the point of view of the (wide) array of companies that will continue to apply internal Italian regulations.

From such a perspective, it is thus evident that the relative application, total or partial, of the modifications that could be brought about by the putting into place of directive 2003/51/EC in Italian law depends on whether, and, if so, how, Italian legislators use the two faculties of extending the use of fair value to other categories of activity than financial instruments and revaluing assets at the relative fair value.

This depends, however, on whether and, if so, how, Italian legislators decide to modify it in turn, as already happened with the case of legislative decree 394/2003, towards also providing for the including in accounts of fair value, and not merely obligations of a purely informative nature, unifying thereby Italian law with what directive 2001/65/EC requires.

It is for this reason that it is so important to individuate those situations that, in the current state of affairs, may give rise to appreciation deriving from the measurement of fair value included in income statements or directly affecting equity, in order to be able to verify to what degree they may repeated with respect to smaller companies governed by the civil code and national accounting principles.

Insofar as appreciation included in income statements is concerned, the origin and nature of which lead them not to be considered distributable, they may essentially come from fair value measurement for predisposition of the annual accounts of types of activity other than financial instruments (that is, from property bought as speculative investment, as provided for by I.A.S. 40, *Investments property*, as well as biological activities, as per I.A.S. 41, *Agriculture*).

Moving on to equity reserves constituted by and transacted in direct counterpart of fair value measurement, these may come from the following, at least in those cases in point held to be most relevant:

- from fair value measurement of available for sale financial instruments, governed by I.A.S. 39, *Financial instruments: recognition and measurement*;
- from the fair value revaluation of tangible and intangible assets, for which see I.A.S. 16, *Property, plant and equipment*, and I.A.S. 38, *Intangible assets*.

In all of the above cases the necessity arises of introducing cautionary limits to the distribution of effectively unrealized profits and equity reserves constituted by and transacted with unrealized profits. This is because the annual account has the legal function of safeguarding the owner's equity in the interest of partners and creditors, unlike the consolidated account,

which instead has a role that is principally, or rather, exclusively, only informative in favour of a far wider array of subjects than loaned capital or owner's equity bearers.

7. Conclusions

To near our conclusion, the comparative examination of the dispositions of legislative decree 38/2005 and directive 2003/51/EC has made it abundantly clear, as we see it, that Italian legislators have already been able to proceed, with the former, to individuating legal and accounting solutions that, faced with the advent of the fair value measurement criterion, are able prudentially to preserve owner's equity integrity from the point of view of larger businesses. These solutions are obviously also extendable to unrealized profits that could in the short term be included in internal accounting regulations applicable for smaller businesses as a consequence of the reception of the latter.

However, our opinion is that it is exactly this potential extension of the fair value measurement criterion to small- and medium-sized Italian businesses that should make the Italian legislators assume a critical attitude, and consider all the implications.

First of all, it should duly be borne in mind that the application of fair value as a measurement criterion for drawing up annual and consolidated accounts determines the 'volatility', the relativity in time of the size of equity items, which is totally foreign to traditional measurement logic based upon historical cost. As such, the dynamism of the values introduced at a temporal level with respect to elements of assets and liabilities measured according to fair value produces disruptive elements not only on the behaviour of compilers of financial statements, but also on their recipients, habituated as they hitherto have been to practices giving 'absolute' historical values. It is no coincidence that it has been the banks that have so far expressed the greatest perplexity regarding the possible consequences produced by the volatility in time of equity value and of economic results in terms of trust and risk perceived.

Secondly, the applicatory difficulties introduced should not be undervalued.

The determination of fair value presupposes the availability of high-level professional skills, possibly also including outsourced skills, and access to multidimensional information sources that are not always readily and profitably feasible on the part of Italian small- and medium-sized businesses, which traditionally badly served administratively. In other words, whereas the application of historical cost (obviously when less than realizable amount) is relatively simple, in the sense that past values derive directly from recognition, the use of fair value is instead relatively complex,

requiring recourse to information support outside of accounting, including estimation processes, which in turn can lead to an increase in administrative costs.

It is in fact quite evident that on one hand the necessity of using surveys drawn up by professionally-qualified independent experts in order to identify market value, and on the other possibility of also approximating fair value with measurement models and techniques where the market value is lacking (a detail that allows the break with absolute identity between the former and market value, making it thereby ever more discretionary) inevitably make the technical and administrative process necessary for arriving at its quantification more difficult, both in terms of measurement and information. In turn, this problem weighs more heavily the less expert the specific professional skills available both inside smaller companies and above all outside of them.

At the same time, to emphasize (or even to exacerbate) the search for transparency, intelligibility and comparability of financial statements could in the end show itself to be excessive with respect to the characteristics of the business in question, that is, with respect to the limited array of respective external interlocutors, possibly thereby ending by giving rise to phenomena of information redundancy that are damaging as well as useless and contrary to principles of materiality and relevance.

It should not in fact be forgotten that fair value's original purpose as a substitute for historical cost comes about from circumstances in which financial statements are prevalently – or exclusively – orientated to the market, in the sense that it is aimed primarily at satisfying the principal knowledge-based needs of current and potential investors, and in general of the various capital market operators, who have to make conscious economic and financial decisions on the basis of the representation of the effective economic and financial dynamics of businesses. Fair value, therefore, comes out of an overall vision of annual accounts that is prevalently in an evolutionary perspective, insofar as it must allow investors to assess the business's capacity to generate future profits as well as risks connected with investing in it.

Fair value, therefore, constitutes an elaborated practical and theoretical response to the difficulty that 'traditional' annual accounts have in achieving the necessary information load for interlocutors – or rather, investors – of businesses operating on the capital market, the equity accounting value of which differs, sometimes consistently, from the market value, also due to the presence of intangible elements that are not adequately represented by traditional historical cost accounting.

As we see it, it is exactly because of this that its use for measurement purposes in 'closed' companies should be limited and circumscribed only to those situations in which it is able to allow an effective improvement in

account information, including in terms of verifiability and credibility of the values arising from it.

With this in mind, it is to be hoped, at least in our opinion, that Italian legislators, in changing the body of accounting legislation in compliance with directive 2003/51/EC discussed herein, seize the occasion to elaborate accounting solutions that, although inspired by I.A.S. – I.F.R.S., are modelled respecting the external communication needs of small- and medium-sized businesses themselves. For these, figures typical of an economic model based on family capitalism, as is the case of Italy, and therefore often far from those phenomena of ‘financialization’ of owner’s equity motivating substantially the recourse to fair value, the information needs to be met are, perhaps, still those of information on the guarantee function of the capital to the benefit of creditor partners and third parties in general.

The stakeholder category of ‘creditor partners’ is to be understood in a fairly broad sense: not just partners – financiers with owner’s equity or loan capital – but all those with legitimate claims on the business, that is, employees and human resources in general, firstly, and then clients/consumers/users and the State (and its local manifestations) in its particular guise as the taxation body.

In other words, Italian legislators, although faced with the consolidated, shared and broad international mobilization which considers the I.A.S. – I.F.R.S. system the cornerstone for constructing the harmonization and modernization of accounting language not only on a Community scale but on a global one¹², should not forget that there is now a general shared international recognition of the inefficiency of the accounting reference framework for large businesses to meet the needs of smaller ones. It is acknowledged, therefore, that there is a need for adopting accounting rules aimed instead

¹² It should be remembered on this matter that on 22 April 2005 an agreement was signed between the European Commission and the American *Securities & Exchange Commission* (S.E.C.) whereby a concrete promise was made to promote a stricter alignment between I.A.S. – I.F.R.S. and the U.S. G.A.P.P. to bring about the elimination of the necessity for businesses that adopt the I.A.S. – I.F.R.S. international accounting principles to reconcile the face of their financial statements with respect to the U.S. G.A.P.P. before 2007 and no later than 2009. This agreement, also according to what the European Commission has announced officially, is an important step towards the creation of a single system of accounting principles of high technical quality that, exactly because of its worldwide acceptance, could lead to a hoped-for improvement of transnational capital market efficiency and, above all, restore investor faith. It should furthermore be recalled that on 7 September 2005 an agreement was reached between the I.A.S.B. and the accounting regulators of Japan, China and Korea which foresees the creation of an international technical committee to study the route to be followed towards a common accounting convergence and that very recently, 27 February 2006, there was signed between the I.A.S.B. and the American F.A.S.B. a *Memorandum of Understanding* wherein they promise to speed up the amalgamation process of the respective accounting principles, I.A.S. – I.F.R.S. and U.S. G.A.P.P., through overcoming differences of greater import, too.

at disciplining specifically those cases arising typically in the management of small- and medium-sized businesses and adapted to allowing them to be efficiently run, to have easy access to financial resources and to easily put fiscal planning into action.

In so doing, Italian legislators would also follow the opinion already expressed by the European Commission (Commission Of The European Communities, 1993), insofar as they would be favouring the development of small- and medium-sized businesses by eliminating the legal, fiscal and administrative barriers to their growth, bearing in mind their role as the fundamental underlying element of the entire European Union¹³.

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¹³ The cautious attitude that the European Commission has always had with regards to small- and medium-sized businesses as far as accounting is concerned was as it were 'consecrated' by the fact that on 27 June 2002 the I.A.S.B. started its research project, *Accounting by Small and Medium Entities and in Emerging Economies*, aimed at defining the relevant characteristics that the accounting system for small- and medium-sized businesses must possess.

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Riassunto

Il percorso verso l'armonizzazione contabile nell'Unione Europea ha compiuto passi fondamentali grazie all'approvazione della direttiva 2001/65/CE inerente all'introduzione del criterio valutativo del *fair value* e del regolamento (CE) 1606/2002 riguardante l'applicazione degli I.A.S. – I.F.R.S. da parte delle società quotate.

Tali due provvedimenti hanno poi rappresentato il presupposto per l'ulteriore prosecuzione di questo cammino di avvicinamento delle legislazioni e delle prassi contabili dei Paesi dell'Unione Europea in vista della creazione al suo interno di un linguaggio contabile comune: l'adozione della direttiva 2003/51/CE.

Tale direttiva interviene sulla IV direttiva, ossia sul cuore del diritto contabile comunitario e poi su ciò che ne è specifica conseguenza, ovvero la VII direttiva, la direttiva 86/635/CEE relativa alle banche ed agli altri istituti finanziari e la direttiva 91/674/CEE relativa alle imprese di assicurazione e, nelle intenzioni della Commissione Europea, si propone di accompagnare le società, affatto minoritarie in termini numerici, non tenute all'applicazione diretta degli I.A.S. – I.F.R.S. in virtù del regolamento (CE) 1606/2002 verso la predisposizione di bilanci di esercizio i cui criteri di esposizione e di valutazione sono accettati a livello internazionale e in grado di garantire un'informativa trasparente nei confronti del mercato degli investitori.

L'obiettivo che quindi ci si prefigge è, una volta individuati gli aspetti salienti della direttiva 2003/51/CE, di verificarne il potenziale impatto sulla legislazione vigente ad oggi nella realtà italiana, tenendo conto a tale fine di come la legislazione nazionale ha già recepito ed attuato la direttiva 2001/65/CE ed il regolamento (CE) 1606/2002.

La prospettiva a questo ultimo fine assunta sarà quella delle imprese di medie e di piccole dimensioni, ossia gli attori tipici di un modello economico fondato sul capitalismo di famiglia che sono assai spesso lontani dal mercato finanziario del capitale proprio.

Abstract

The process towards accountancy harmonization in the European Union has made crucial steps after the approval of directive 2001/65/EC, concerning the introduction of the fair value evaluation criterion, and of regulation (EC) 1606/2002, concerning the application of I.A.S. – I.F.R.S. by the listed companies.

Furthermore, these two measures have been the premise for promoting a progressive common approach for the accountancy laws and procedures of the EU countries, with the aim of creating a shared accountancy language: the adoption of directive 2003/51/EC.

This directive affects the IV directive, namely the core of EU Accountancy Law and therefore, as its specific consequence and emanation, the VII directive, directive 86/635/EEC on banks and other financial institutions and directive 91/674/EEC concerning insurance companies. Furthermore, the European Commission intends to support those companies – not a minority share – which are not required to apply the I.A.S. – I.F.R.S. directly, in compliance with regulation (EC) 1606/2002, in producing annual accounts with internationally accepted criteria, characterized by a transparent information system in relation to investors and creditors.

Once the prominent aspects of directive 2003/51/EC have been specified, the purpose of the work is to assess their potential impact on the laws in force and on the practice generally accepted in Italy in the present day, whilst considering how the national legislation has so far received and implemented directive 2001/65/EC and regulation (EC) 1606/2002.

Notably, the perspective we will apply to this purpose relates to small- and medium-sized enterprises, namely the typical characters of an economic model rooted on family capitalism; as such, these characters are frequently distant from the capital financial market.