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Dear Readers!

The recent issue of the journal is devoted exclusively to corporate governance in Italy. We try to keep our hand on the pulse of the situation around the corporate governance development in many countries. Italy is one of these countries. We decided to start with Italy. There are some reasons of our choice.

First of all, Italy is a very unique country from the point of view of corporate governance regulation. Corporate governance legislation allows Italian firms applying one of three models of the board of directors, i. e. a one-tier board, a two-tier board and the unique national board model with the board of directors and board of auditors. How does this “corporate regulation democracy” influence corporate governance performance?

For the second, Italy is a country with a quite concentrated and not transparent ownership structures. Pyramidal ownership structures are still popular in Italy. Do these structures influence corporate governance development or act as a barrier on the way to the best corporate governance practices?

For the third, a Parmalat scandal lightened many problems in corporate governance in Italy, i. e. a weak ownership transparency, manipulation with financial reporting, etc. Is this scandal a typical for Italy?

For the fourth, during a four year editorial and publishing activity we observed the market for the corporate governance research in Italy. We concluded that the degree of academic activity in researching of corporate governance issues in Italy increased remarkably. The variety of topics covered by Italian experts is respectful and includes corporate board practices, financial reporting, corporate social responsibility, family and managerial ownership, market for corporate control, internal control mechanisms, voting rights, initial public offerings and stock market, etc.

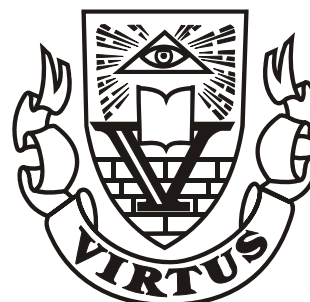
Therefore, we would like to support activity of our Italian colleagues and meet numerous requests of the world academic community for corporate governance research in Italy. We hope that our efforts will be supported by you and many other countries will be exclusively researched by us in the future.

CORPORATE OWNERSHIP & CONTROL

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Corporate Governance in Italy

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Since ownership structures characterized by the presence of multiple large shareholders are extremely common around the world, the effects of having such a controlling structure are receiving increasing attention in literature. More than one third of Italian listed companies are controlled by

coalitions of shareholders bound together by agreements called “voting trusts” which represent an interesting opportunity to study the consequences of having multiple large shareholders who share the control of firms. We perform an event-study on voting trust announcements (2004-2006), showing significant abnormal returns in both the event day and the following day. The sign of this cumulative reaction is negative for announcements of new/renewed trusts and positive in the cases of trust terminations. These findings are consistent with the “entrenchment effect” hypothesis linking the ownership structure and the firm value. As a general result, the presence of multiple large shareholders tied within a voting trust, by curbing the company’s contestability is reflected in a lower valuation of the firm.

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The greatest distinctions between corporate governance practices around the world appear to result from differences in law and not from differences in recommendations that emanate from the types of codes adopted. With the evolution of the concept of Corporate Governance the area of connections with the concept of Corporate Social Responsibility has become more and more wide. The possible way to separate ownership and control, so the corporate governance in the private sector of Italian economic system, has not been based on a unique model but on a set of different models for the different kind of enterprises involved. This paper analyses the connection between corporate governance and corporate social responsibility focusing on the Italian case where, since the system of corporate governance has never been clearly defined, the current outcome shows a unique system that well incorporates both concepts.

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In this paper we verify the degree of reliability of brokerage analysts’ recommendations, with reference to Italian IPOs and measure their long-term performance, distinguishing among affiliated and non-affiliated analysts, to test the conflict of interests hypothesis against an alternative ‘superior information hypothesis’. The empirical evidence shows that IPOs recommended by affiliated analysts have a long-run performance that is worse than firms recommended by unaffiliated ones by a relevant amount. This result supports the conflict of interest hypothesis, while it seems to be inconsistent with the hypothesis that underwriter analysts have superior information.

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Financial analysts' research activity seems to be important for investors in their investment decisions. Understanding if financial analysts' reports can influence the market and the degree of reliability of their forecasts has been a theme lively debated in the academic literature but also in the press, mainly because of recent financial scandals. The main objective of the paper is to calculate the investment value of financial analysts' recommendations on companies listed in the Italian Stock Exchange and to verify the possibility of profiting from relying on the average consensus of recommendations. We have enclosed in the analysis all the 16,634 reports issued between the 1st January 1999 and the 23rd July 2004 and available on the website of the Italian Stock Exchange, constructing a unique database for Italy. After classifying companies by quarter, five portfolios are formed based on analysts' average consensus to calculate the excess returns of each portfolio in each quarter. Our results suggest that analysts' recommendations have indeed investment value, even if investors should carefully consider neutral recommendations that can be considered as negative ones. These results, furthermore, give some interesting regulatory suggestions for a policy maker that wants to ensure transparency in the markets.

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Antonio Nicita, Riccardo Vannini

In this paper we investigate the emergence and the co-evolution of institutional complementarities between debt and equity as alternative financial instruments in the case of Italy. We focus on the evolution of Italian firms (related to the benchmark years from 1952 to 1991). Through the data collected we observed the collaterals that firms were able to transfer to loan institutes. We also examined the factors which made difficult to switch to equity financing, comparing the rate of profitability of Italian firms with alternative investments. The results show a financial structure for Italian firms that rely exclusively on debt, independently of the public or private nature of firms' property and of the economic sector. This anomaly seems to be the consequence of path-dependencies between "political origins" and firm's governance structure in Italy

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CAN AGENCY THEORY RECOMMENDATIONS AFFECT
PERFORMANCE OF FAMILY FIRMS? EVIDENCE FROM THE ITALIAN
MARKET

*Stefano Caselli**, *Stefano Gatti***

Abstract

Using data on all family owned firms listed on the Italian Stock Exchange for the entire period between 2001 and 2005, it is shown that agency theory prescriptions and monitoring activities differentially impact the market value and profitability of family owned firms. Specifically, non-founder family firms benefit from a low level of board and insider stock ownership and a high level of stockholder and foreign investor ownership, because these firms necessarily face high agency costs. Conversely, founder family firms benefit from a high level of board and insider ownership, and a low level of stockholder and foreign investor ownership, owing to their lower agency costs.

Keywords: corporate governance, family firm, ownership structure, performance

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1. Introduction

Romano et al. (2001) argue that all firms must attract external financing in order to achieve the full profit potential of the business. Unique structural features of family firms place the need for financing in a quite different context owing to family ownership and control objectives, specifically the desire for continuity of family involvement, that characterize family firm capital structure decision-making.

The Italian family business context is very specific, since, as De Laurentis (2005) and Caselli (2005) noted, firms are often owned, controlled and managed by founding families. This situation is evident in both large companies and SMEs. Moreover, this control is very strong and frequently management of the firm is shaped by family

objectives. Nevertheless, as Chami (2001) demonstrated using an international sample that included Italian firms, Italian family businesses do not suffer the consequences of agency cost since the whole organization is aligned with the interests of the owners (Trento and Giacomelli (2004); Giannetti (2003)), even though they must often overcome delicate situations relating to successional and “dynastic” issues (Caselli and Gennaioli (2003)).

When Caselli and Gatti (2006) examine the performance of Italian IPOs categorized by whether they were family or non-family businesses, they find an odd situation. Even though they show a strong and generalized IPO underperformance by family firms, and a positive impact on long-run stock market performance of strong family involvement, firm age is, counter intuitively, a negative influence.

These differences could be due to divergences in corporate governance and ownership structure or to different agency cost frameworks, in accordance with the findings of Berle and Means (1932) insofar as ownership structure should enable corporate management to realize the full potential of corporate assets. Clearly for Italy, the relationship between corporate governance and performance in family firms is poorly understood, and above all, has thus far been characterized in a limited manner, probably owing to the difficulties in applying and evaluating agency costs correctly.

In line with recent work (Randoy and Goel (2003), Mishra, Randoy and Jenssen (2001), and Steier (2003)), this study suggests that firms with founder family leadership exhibit a unique governance system whereby the problem of agency cost takes second place to the priority of access to resources. As a result, all governance structures that aim to reduce agency costs are irrelevant in the context of family control; in fact, the presence of such large shareholders does not involve cost reductions, so leads to lower performance. On the other hand, this high level of inside ownership can lead to strategic benefits and thus to superior economic performance.

The empirical evidence calls for a deeper analysis, an acceptance of the challenge put forth by Jayaraman, Khorana, Nelling and Covin (2000) that calls for empirical research concerning the predictive power of “types of organization and corporate governance systems used by family firms (with or without the founder)” on long run performance.

2. Literature review

2.1. Founder family control effects on corporate governance and long run performance

Pieper (2003) reviews the state of research on family business governance, citing many empirical studies concerning the link between performance and family firm governance. Nevertheless, as he does not focus on financing for family firms, his conclusions cannot guide or inform our research.

James (1999), Danco (1975), and Poza (1989) affirm that the reduction in agency costs in family firms is greater than in other firms and, furthermore, increases continuously, owing to the atmosphere of love and commitment created by the founder's leadership. Mishra et al. (2001), McConaughy, Matthews and Fialko (2001), and Kang (1998) study the characteristics of corporate governance systems in founder family managed firms (i.e., firms where the original founder is still the CEO or the chair). They find an outperformance that disappears when the founder or the founder family sells its ownership or otherwise stops working at the firm.

Anderson and Reeb (2003) show that it is impossible to support the hypothesis that continued

founder family majority ownership in public firms leads to minority-shareholder wealth expropriation. So, they conclude that families do not use their firms to maximize personal interests.

Lee (2004), quoting the findings of Anderson and Reeb (2003), sheds light on the profit and loss dimension of family firms and shows that family ownership and management yields greater efficiency and productivity, particularly in founder family firms. Carney (2005) concludes that the competitive advantage of family controlled firms arises from their system of corporate governance.

Klein, Shapiro and Young (2005) analyze the relationship between performance and corporate governance in Canada and find that the presence of independent directors on founder family firm boards of directors generates poorer economic and financial results. Filatotchev, Lien and Piesse (2005) perform the same analysis for Taiwan and discover that family control does not correlate with conventional performance measures such as accounting ratios, sales per issued capital, earnings per share and market-to-book value, but, contrary to Klein, Shapiro and Young (2005), they conclude that board independence from the founder family and board members' own financial interests have a positive impact on performance.

Oreland (2005) shows that the level of product market competition moderates the relationship between founder family leadership and firm performance such that firms led by the founder family perform poorly (are least profitable and show lower firm value) in highly competitive industries.

Anderson, Mansi and Reeb (2003) investigate the impact of founder family ownership structure on the agency cost of debt. They find that founder family ownership is common in large, publicly traded firms and is related, both statistically and economically, to a lower cost of debt financing. Their results are consistent with the idea that founder family firms have incentive structures that result in fewer agency conflicts between equity holders and debt claimants. This suggests that bond holders view founder family ownership as an organizational structure that better protects their interests. These findings are in accord with the studies of Johnson, Magee, Nagarajan and Newman (1985), Morck, Shleifer and Vishny (1988), and Gomez-Mejia, Nunez-Nickel and Gutierrez (2001) that suggest that founder CEOs are associated with strong performance early in their careers, poorer performance in later years, and that family member CEOs are more entrenched in their positions.

Finally, as Randoy and Goele (2003) emphasize, “there is evidence from studies that indicate that entrepreneurs and founder family are more exposed to managerial entrenchment and therefore potentially associated with weaker performance (Thomsen and Pedersen (2000)) [...] but there are other studies that reveal inconsistent results (Begley (1995); Dalton and Daily (1992)).”

2.2. The relationship between ownership structure and performance

A number of theories of board behavior have been developed over time. A brief review of these is given by Stiles and Taylor (2001). One of the most important is agency theory, which focuses on the agent-principal relationship to further understanding of the governing board. The agency relationship (or agent-principal framework) is a contract under which one or more persons, the principals, engage another person, the agent, to perform some services on their behalf. This involves delegating authority to the agent. Agency theory incorporates important assumptions about managerial behavior being self interested, such as moral hazard, and evincing bounded rationality. According to Gompers, Ishii, and Metrick (2003), agency theory regards the board of directors as an instrument of control.

Another interesting approach is stewardship theory, which proposes that there is no conflict of interest between managers and owners and that to be successful, the organization requires the structure that best facilitates coordination between managers and owners. Muth and Donaldson (1998) found that stewardship theory — in contrast to the agency theory — recognizes a range of non-financial motives of managers described in the occupational psychology literature. Examples include need for advancement and recognition, intrinsic job satisfaction, respect for authority, and work ethic.

To test the above-mentioned theories, several studies examine the relationship between board composition and company performance, either by country or by specific firm type, such as publicly-owned, fast-growing, venture-backed, or family-owned (i.e., La Porta, De Silanes, and Shleifer (1999)). Villalonga and Amit (2004) deepened the focus on family owned firms, testing relationships among performance, rules of governance, and board composition. In particular, they find that the effect of blockholders is significantly more negative for non-family firms than it is for family firms. This finding suggests that families play a moderating role in the agency conflict between other large shareholders and minority shareholders.

Faccio and Lang (2002) examine corporate governance rules with specific attention to the effects of institutional investors sitting on boards; but they do not specifically focus on family firms.

Hansell and Hill (1991), and Kroll, Wright, Toombs and Leavell (1997) investigate the specific role of ownership structure on firm performance and show that blockholder ownership in non-founder firms allows for greater outside monitoring of corporate governance. Moreover, as shown by Kang (2000), institutional investors intervene to improve firm performance, exploiting their “political influence” (the same activity engaged in by private equity operators in their participated firms, as Caselli

and Gatti (forthcoming) report in their literature review).

Smith and Amoako-Adu (1999) say that firms with multiple family members occupying senior management positions and that lack outside blockholders are more likely to appoint a family member as successor and do not apply measures of corporate governance in order to improve firm management.

Schulze and Dino (1999), as Wright, Ferris, Sarin and Awasthi (1996) had already noted, affirm that agency theory cannot be applied to firms with highly concentrated ownership and that the agency position of each family board member is likely to diverge when ownership becomes more diffuse. As a result, blockholders in family firms maintain harmony, accord and strategic agreement among themselves.

Fernandez and Nieto (2006) examine the relationship between the internationalization strategies of SMEs and types of ownership. They observe a negative correlation between family ownership and export intensity, confirming the conclusions of Kets de Vries (1996) and Poza (2004). Moreover, they support the conclusions of Schulze, Lubatkin and Dino (2003), and show that when ownership is concentrated or when ownership and control are in the same hands, firms tend to show poor performance owing to the need to satisfy both family and business interests simultaneously. Nevertheless, this limitation does not seem to present itself in family firms that have an outside corporate investor.

Oreland (2005) obtains new findings from examining the Swedish market; family control, per se, leads to slightly worse firm performance than a dispersed ownership structure with a professional manager in control. In particular, founder family firms and highly concentrated ownership family firms have lower performances.

Tiscini and Di Donato (2006) analyze how investors perceive risk in family firms and find a negative relationship between family ownership and agency risk, whatever the level of family participation.

Miller and Le Breton-Miller (2006) analyze both the agency and the stewardship theories and conclude that the picture for family firms is multifaceted. Their findings suggest that family controlled firms do best when they take advantage of the potential for lower agency cost and work to elicit attitudes of stewardship among leaders and majority owners. This is most apt to occur when voting control requires significant family ownership, when there is a strong family CEO without complete voting control and who is accountable to independent directors, when multiple family members serve as managers, and when the family intends to keep the business for generations. Often, these conditions are found in an established family business still operated by its founder.

Bekaert and Harvey (2000) or Stulz (1999) distinguish between family firms by participation or non-participation by foreign owners and they conclude that the involvement of foreign investors improves firm performance, whatever the family equity contribution or the presence of the founder.

3. Testable hypotheses

As the empirical evidence is unable to explain the relationship between corporate governance and firm performance in founder and non-founder family firms in a clear manner, a foundational idea is required to develop testable hypotheses. In our empirical evidence, the same suggestions and hypotheses developed by Randoy and Goel (2003) are tested, even if the focus is not on the world of SMEs, but on that of Italian family firms.

Randoy and Goel (2003) argue that founder leadership is a substitute corporate governance mechanism that can replace other monitoring mechanisms such as direct surveillance by owners. These authors show that founder family firms operating under a governance structure that is best suited for firms with relatively high agency costs incur cost redundancies. Consequently, a lower performance should be found in founder family firms with conventional corporate governance mechanisms.

A high level of board and insider ownership creates favorable conditions for managerial entrenchment and self-aggrandizing behavior and, at the same time, reduces the owner's ability to monitor and control the management. This phenomenon is very problematic in non-founder family firms because of the lack of the founder's creative leadership. Thus, a lower performance should be prevalent in non-founder family firms.

The effect of the presence of blockholders creates a very different effect. Blockholders have the ability to reduce agency costs in non-founder firms through a high level of active monitoring and a high degree of involvement in a company's decision making processes. Conversely, founder family firms have less need for outside screening, since the family has control of the developed business concept. Moreover, blockholders may have a more conservative view of entrepreneurial prospects than a founder family. For these reasons, superior performance should characterize non-founder family firms that have a significant presence of blockholders.

The same conclusions hold for foreign ownership. Foreign owners usually engage in stronger monitoring of managers and reduce agency costs. Nevertheless, it should be noted that foreign owners may be less familiar with the local entrepreneurial opportunities that are available and known to founder family firms. Such ignorance, combined with their requests for additional reporting, both in terms of content and frequency,

may add costs without corresponding benefit. So, foreign ownership in founder family firms may yield no advantage and could generate poorer performance.

Accordingly, the following hypotheses are tested:

H1-a. A high level of ownership control by board members has a negative influence on firm value in firms lacking a founder family CEO or chair.

H1-b. A high level of ownership control by board members has a negative influence on firm profitability in firms lacking a founder family CEO or chair.

H2-a. A high level of blockholder ownership has a positive influence on firm value in firms without a founder family CEO or chair.

H2-b. A high level of blockholder ownership has a positive influence on firm profitability in firms without a founder family CEO or chair.

H3-a. A high-level of foreign ownership has a positive influence on firm value in firms lacking a founder family CEO or chair.

H3-b. A high level of blockholder ownership has a positive influence on firm profitability in firms lacking a founder family CEO or chair.

4. Data and methodology

Borsa Italiana SpA (the Italian Stock Exchange (ISE)) and AIdAF (the Italian Family Firms Association) made available the data required to develop this empirical research. The subject sample is comprised of all family firms listed on the ISE for the entire period between 2001 and 2005, and consists of 128 firms.

To test the hypotheses, the sample universe has been divided into two sub-samples: founder family firms (76) and non-founder family firms (52). Founder family firms are those in which the founder is still the leader of the firm; that is, he is the CEO and/or the chair.

ISE provided data concerning the following parameters: the yearly average market capitalization for each firm, the composition of the board and insider participation, blockholder participation (name and commitment of each participant), foreign participation (name and commitment of each participant). AIdAF provided financial data (book value of assets, ROA, plant value, sales, financial debts, etc.) using firms' annual reports, and other information concerning the firms (age, sector, etc.) gathered through direct interviews.

For each firm, some measures are estimated in order to facilitate development of a statistical model:

– Firm value. Firm value is the ratio between the market value of a firm and the book value of total assets. Market value of a firm is the sum of the market value of equity and the book value of total liabilities. This measure, as Perfect and Wiles

(1994), and Chung and Pruitt (1994) suggest, can be taken as a correct approximation of Tobin's Q. Firm value is calculated for each year in the period 2001-2005;

– ROA. Nickell (1996) suggests that ROA, which is an accounting-based measure, cannot detect the effects of ownership structure directly; so he proposes to use a 1-year lagged ROA. In our empirical evidence, ROA is the ratio calculated using the previous year's EBIT (the numerator) and the book value of assets (the denominator);

– Founder / non-founder firm. This is a dummy variable that takes the value 1 if the CEO and/or the chair are the founder, and 0 otherwise. This measure is used to create interaction variables in order to understand differences between founder family firms and non-founder family firms;

– Board insider ownership. Percentage of all shares owned or controlled by board members and the CEO/chair;

– Blockholder ownership. Percentage of ownership of all shares by the three largest shareholders;

– Foreign ownership. Percentage of total equity held by foreign citizens or foreign institutions.

As past research indicates that results in this field of investigation could be affected by firm-

specific items, some control variables are calculated in order to avoid biases:

– Asset tangibility. This is the ratio of net property, net plant and net equipment over total assets at the end of the year;

– Debt ratio. This is the ratio of debt to total assets at the end of the year;

– Firm size. This is a logarithm of total revenues (in millions €) for each year;

– Firm age. This is a logarithm of the number of years between the observation year and the firm's founding year.

A cross-sectional OLS regression model is used to test the hypotheses. The dependent variables are firm value and ROA, while founder / non founder firm, board inside ownership, blockholder ownership, foreign ownership, asset tangibility, debt ratio, firm size, and firm age are the independent or control variables. As this approach is susceptible to heteroscedasticity and multicollinearity problems, a check of all variables is made before the OLS regression, but the analysis does not indicate any harms.

Table 1 enumerates descriptive statistics from the analyzed sample.

Table 1. Descriptive statistics

Variables	Full sample (N=128)		Non-founder firms (N=52)	Founder firms (N=76)
	Mean	Standard deviation	Mean	Mean
<i>Dependent variables</i>				
Firm value	4.68	3.15	4.04	5.11
ROA (%)	13.38	19.24	12.11	14.25
<i>Independent variables</i>				
Board and inside ownership (%)	9.17	33.15	10.21	8.45
Blockholder ownership (%)	61.10	21.56	55.14	65.18
Foreign ownership (%)	8.75	6.25	9.56	8.19
Asset tangibility (%)	48.64	31.41	52.1	46.28
Debt ratio (%)	59.99	12.36	65.42	56.28
Firm size	3.81	1.11	3.85	3.78
Firm age	4.12	1.33	4.27	4.02
<i>Other data - not in the model</i>				
Founding year	1961		1959	1962
Founder and family ownership (%)	49.20		40.36	55.25

5. Empirical findings

Table 2 summarizes the main findings and the interaction effects of the multivariate regression model applied to Italian listed family firms. The statistical model and the employed variables are valid as the adjusted R^2 is 0.351 when firm value is the dependent variable and 0.428 when the dependent variable is ROA. Interaction effects can explain the hypotheses directly as they assume value only when the item "Founder / Non founder" is equal to 1, that is when the founder is still CEO or chair.

Hypotheses 1-a and 1-b are supported completely, so it can be stated that board and insider ownership improve the performance of founder family firms and they provide no tangible contribution to non-founder family firms. The

remaining hypotheses are more difficult to support and to comment on because, on the one hand, propositions 2-a and 3-b are confirmed, but, on the other hand, propositions 2-b and 3-a are not shown to be statistically significant, even if the direction of the relationship is confirmed (there is a negative relationship for both blockholder and foreign ownership). In other words, a high level of foreign ownership has a positive influence on firm value in firms without a founder family CEO or chair, but has no consequence on the firm's economic performance; and a high level of blockholder ownership has a positive influence on firm profitability in firms without founder family CEO or chair but does not affect firm value.

Table 2. Interaction effects in multivariate analysis

Variables	Dependent variable: firm value		Dependent variable: ROA	
	Beta value	t-value	Beta value	t-value
<i>Independent variables</i>				
Founder / Non founder	0.325	(1.115)	-0.075	(-0.385)
Board and inside ownership (%)	-0.101	(-0.874)	-0.519	(-2.851)**
Blockholder ownership (%)	0.118	(1.365)	0.381	(2.514)*
Foreign ownership (%)	0.421	(4.236)***	0.058	(1.067)
<i>Control variables</i>				
Asset tangibility (%)	-0.021	(-0.687)	0.308	(2.651)*
Debt ratio (%)	0.103	(0.275)	-0.614	(-2.008)*
Firm size	-0.229	(-2.945)**	0.421	(6.284)***
Firm age	-0.001	(-1.211)	-0.236	(-1.914) ^o
<i>Interaction variables</i>				
Founder * Board and inside ownership	0.961	(2.128)*	0.746	(5.252)***
Founder * Blockholder ownership	-0.456	(-1.248) ^o	-0.412	(1.465)
Founder * Foreign ownership	-0.314	(-1.596)	-0.331	(-4.197)***
Adjusted R2	0.351		0.428	
F-statistics	5.891***		8.410***	
t-test: two-tailed				
°; *, **, ***: significance at 10%; 5%; 1%; 0.1%, respectively				

To contrast these results, a second regression was performed, in which founder family firms and non founder family firms are taken into consideration. Table 3 summarizes those results.

Even applying this regression model, hypotheses 1-a and 1-b are supported, so insider holding stimulates performance in founder-owned firms but reduces it in non-founder family firms. As far as hypotheses 2-a and 2-b or 3-a and 3-b are concerned, our findings

provide only partial support since not all results are statistically significant, even if the predicted sign is correct in all cases.

In summary, non-founder family firms derive advantages from greater monitoring by large blockholders and/or foreign investors, which consent to distinguish entrepreneurial activity from strategies implemented by managers in order to maximize their own personal objectives. So, a self-aggrandizing board and insider ownership lead to negative performance, because of the lack of control and the high agency costs due to hired managers. For

founder family firms, the situation is completely different because a high level of insider ownership has a positive impact on firm performance, while the monitoring provided by large blockholders and foreign investors has a negative effect. This is because the governance context faced by founder led family firms provides relatively little incentive for self-dealing, so the additional monitoring by large blockholders and foreign ownership is not useful in exploiting and to financing entrepreneurial opportunities.

Table 3. Ownership structure and family firm performance

Variables	Non founder firms		Founder firms	
	Firm value Beta value (<i>t</i> -value)	ROA Beta value (<i>t</i> -value)	Firm value Beta value (<i>t</i> -value)	ROA Beta value (<i>t</i> -value)
<i>Independent variables</i>				
Board and insider ownership (%)	-0.442 (-1.895) ^o	-1.215 (-3.332) ^{***}	1.459 (1.928) ^o	1.035 (3.164) ^{**}
Blockholder ownership (%)	0.238 (1.268)	0.523 (2.794) ^{**}	-0.603 (-1.895) ^o	-0.321 (-0.764)
Foreign ownership (%)	0.625 (6.631) ^{***}	0.006 (1.031)	-0.016 (-0.325)	-0.577 (3.130) ^{**}
<i>Control variables</i>				
Asset tangibility (%)	0.02 (0.725)	0.608 (2.852) ^{**}	-0.495 (-2.999) ^{**}	-0.01 (-0.167)
Debt ratio (%)	-0.115 (-1.987) [*]	-1.249 (-2.733) ^{**}	-0.028 (-0.023)	-0.152 (1.067)
Firm size	-0.695 (-1.932) ^o	0.271 (2.219) [*]	-0.729 (-1.302)	0.625 (3.942) ^{**} *
Firm age	-0.756 (-1.412)	-0.724 (1.316)	-0.003 (-0.164)	-0.308 (2.258) [*]
Adjusted R2	0.428	0.253	0.375	0.621
<i>F</i> -statistics	8.264 ^{***}	3.335 ^{***}	3.385 ^{***}	7.619 ^{***}

t-test: two-tailed

^o; ^{*}; ^{**}; ^{***}: significance at 10%; 5%; 1%; 0.1%, respectively

6. Conclusions and further research

The basic premise of this study is that agency theory prescriptions are relevant in non-founder family firms but are redundant in family firms with founder leadership. Employing the whole universe of family

firms listed on the ISE for the entire period between 2001 and 2005, the impact on firm performance of various corporate governance mechanisms is tested. In particular, performance can be modeled as lagged ROA (that is, the previous year's ROA) or as firm value (approximated by a simplified version of

Tobin's Q), while the types of governance considered are: ownership of boards, blockholders, and foreign investors.

Even if our results are not statistically significant, they always confirm the predicted direction of the relationship and they prove that the agency context for founder and non-founder family firms is quite different. Founder family firms operate in a low agency cost environment, so the monitoring activities of blockholders and foreign investors can be a drag on firm value and profitability, as they are not free of cost and they do not provide any incremental benefit. In such a firm, benefits come from board and insider ownership, because the presence of the founder limits the self-dealing of management and overall firm strategies are better implemented.

For non-founder family firms, whose management is exercised by persons outside the family, performance is positively affected by the monitoring activities of blockholders and foreign investors; they reduce managerial entrenchment and the divergence of interests between ownership and management. So, in these cases, board and insider ownership generate poorer performance and are not the ideal solution for corporate governance.

Our findings suggest that different agency contexts exist, and that the traditional separation between ownership and management should be more deeply examined. In fact, this separation does not always lead to high agency cost. For this reason, corporate governance mechanisms must be evaluated from both the cost and benefit perspectives since they could determine a firm's final performance.

There are practical implications for firm financing as well. Founder family firms seem to have more difficulty finding funding, even from private equity investors. This is because these actors usually rely on corporate governance and board ownership as mechanisms to mitigate agency costs. Non-founder family firms, on the other hand, should exploit any ownership structure that facilitates better monitoring and new shareholder participation.

Family firms with transition and succession problems might see the findings of this study as extremely useful. Founder family firms in which families intend to reduce their involvement should strengthen alternative corporate mechanisms aimed at limiting the value destruction that an abrupt exit without any governance safeguards can generate.

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THE NON-LINEAR RELATIONSHIP BETWEEN MANAGERIAL OWNERSHIP AND FIRM PERFORMANCE

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Abstract

We investigate the relationship between operating performance and ownership structure using a sample of Italian IPO-firms in the period 1995-1999. Overall, we find that their performance declines after the IPO. We find evidence of a non-linear relationship between ownership and performance using different measures of operating performance and managerial ownership. This result supports the hypothesis of a combined effect of ownership on firm performance, with a positive effect at low and high levels of managerial ownership (alignment of interest hypothesis) and a negative effect at intermediate levels (entrenchment hypothesis).

Keywords: ownership structure, performance, corporate governance, initial public offerings

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1. Introduction

The present study concentrates on the relation between ownership structure and performance. Such connection has been the subject of an important and ongoing debate in the corporate finance literature. The debate goes back to the work of Berle and Means (1932), which suggests that an inverse correlation should be observed between the diffuseness of shareholdings and firm performance. More generally, the nature of the relation between ownership structure and firm's performance, have been the core issue in the corporate governance literature. Several studies have indeed examined the relationship between ownership structure and firm performance. The early analysis of the relation between the performance of firms and ownership was linear in form (see, for example, Downes and Heinkel, 1982); corporate performance was assumed to be an increasing function of managerial ownership in an incentive-alignment or in a signalling framework. On the other hand, and primarily on the base of the entrenchment hypothesis, the later analysis of managerial ownership has considered non-linear forms (see Morck et al., 1988; McConnell and Servaes, 1990). Finally, some researchers believe that there should not be a relation between ownership and corporate performance since ownership structure of a corporation should be thought as an endogenous outcome of decisions that reflect the influence of shareholders and of trading on the market for shares (see Demsetz, 1983). Nevertheless, the empirical literature is largely

inconclusive on the effects of ownership on corporate performance. The empirical studies about the relation between these variables seem indeed to have yielded conflicting results. Such studies, viewed in totality, do not give strong evidence by which to reject or not the hypothesis that firm performance and ownership are unrelated. Furthermore, differences abound across these studies, in measurements and sample used, in estimating technique applied, in whether and how they account for the endogeneity of ownership structure, and in results obtained.

In this paper, we investigate the relationship between ownership structure and operating performance for a sample of 66 companies that went public on the Italian stock exchange in the period 1995-1999. Coherently with previous studies on other markets (such as Jain and Kini, 1994; Kim et al., 2004; Wang, 2005) we document a sharp decline in post issue operating performance of Italian IPOs, as measured by return on assets (ROA), return on equity (ROE) and cash flows from operating activities over total assets (CFROA); this occurs in spite of high growth in total assets and capital expenditures.

Investigating the effect of equity retention of substantial shareholders and board members at the IPO, we find weak evidence of the theoretical prediction of Signalling and Agency Cost Theory. In other words, the IPOs characterised by higher equity retention do not seem to perform substantially better than firms with lower levels of equity retention. This last finding is similar to that of Mikkelsen et al.

(1997) and raises doubts about the existence of a linear relationship between managerial ownership and performance. Therefore, according to the Combined Theory (Morck et al., 1988), we test the hypothesis of a non-linear relationship where alignment and entrenchment coexist at different levels of managerial ownership. Through a multiple regression analysis, we find a non-linear relationship between ownership and performance, with a positive effect at low levels of managerial ownership and a negative effect at high levels.

Moreover, consistent with the earlier findings about the conclusions of the Combined Theory (Short and Keasey, 1999; Kim et al., 2004; Wang, 2005), we find also an evidence of three-level relationship (of alignment, entrenchment, alignment) between firm performance and managerial ownership. Indeed, we find a positive effect of managerial ownership both at low and high levels of ownership and a negative effect at intermediate levels. Finally, we test the hypothesis of endogeneity between ownership structure and firm performance (Demsetz and Villalonga, 2001) and find no clear-cut evidence supporting such hypothesis.

The remainder of this paper is arranged as follows. Section 2 presents the literature review and develops the theoretical hypothesis. Section 3 describes the sample and defines the variables. In Section 4 we describe the operating performance and the ownership structure of the sample at the IPO and the evolution in the post-issue period. Section 5 analyses the relationship between ownership changes at the IPO and post-issue operating performance testing the hypothesis of a non-linear relationship between managerial ownership and performance. Section 6 summarizes and concludes.

2. Literature review and research questions

The studies about the relationship between ownership and performance of listed companies around their public offerings are characterised by an empirical approach and focus on the effect of ownership (and ownership changes) on post-issue performance.

Nevertheless, the theoretical bases of this empirical investigation are connected to an important and ongoing debate in the corporate finance literature that goes back to the Berle and Means (1932) thesis. They suggest that an inverse correlation should be observed between the diffuseness of shareholdings and firm performance. Afterwards, Jensen and Meckling (1976) analyze the conflict of interest between managers and owners when the latter cannot costlessly monitor the performance of the managers. Their model implies that when managerial ownership is high, the monitoring role of the board is decreased. In contrast, if managerial ownership is low, companies can set strong boards to monitor the management

(Fama and Jensen, 1983; Jensen, 1993). Accordingly, the reduction in management ownership that occurs at the IPO may increase the agency problems. From a different perspective but with similar predictions, Leland e Pyle (1977) develop a model in which these original shareholders seek financing for projects whose true value is known only to them. By retaining a significant ownership stake in the firm, entrepreneurs can signal projects' quality since false representation can be costly (signalling hypothesis). Both the incentive alignment and the signalling hypothesis lead to the prediction that a larger level of managerial ownership should be related to a better firm performance.

H₁: Corporate performance is an increasing function of managerial ownership

Contrary to the incentive alignment and to the signalling hypothesis, Fama and Jensen (1983) point to the problem of managerial entrenchment, suggesting that both positive and negative effects arise from managerial ownership in companies (entrenchment hypothesis). Indeed, in a high information asymmetry environment, managers may indulge preferences for non-value-maximizing behaviour.

The entrenchment hypothesis predicts a negative relation between operating performance and managerial ownership. More equity ownership by the manager may decrease financial performance because managers with large ownership stakes may be so powerful that they do not have to consider other stakeholders interest. At certain levels of equity ownership, for instance, managers' consumption of perquisites or an attractive salary may outweigh the loss they suffer from a reduced value of the firm (Fama and Jensen, 1983).

More recent research accounts for both the incentive alignment and the entrenchment hypotheses by considering a non-linear relationship between managerial ownership and firm performance. Morck, Shleifer and Vishny (1988) argue that the performance effect of the incentive alignment argument dominates the performance effect of the entrenchment argument for low levels of managerial ownership.

The alignment hypothesis effects appear to be dominant within the 0 percent to 5 percent range of managerial ownership. The entrenchment effect is dominant within the 5 percent to 25 percent ownership range; and for still higher levels the picture is reversed back once again. These ownership turning points, however, must be arbitrarily pre-specified before their piece-wise regressions are executed. However, the hypothesis in the paper by Morck et al. (1988) is not based on a formal model. As pointed out by Morck et al. (1988), the theoretical arguments alone cannot predict the relationship between ownership and performance, especially with

regard to determining the ownership turning points where managerial incentives will switch from alignment to entrenchment, and back again to alignment.

Morck et al. argument does not predict a 'clean' bell-shaped relation between performance and ownership since performance starts to increase again with a sufficiently high level of ownership concentration. The reason for this prediction is that it fits the empirical findings of their paper. Morck et al.'s interpretation of their findings is that the entrenchment effect will dominate the incentive effect only for medium concentrated levels of management ownership. This is so because for low levels of managerial ownership it might not be reasonable to think that the manager is entrenched at all since his ownership stake is too small to give him any control whatsoever.

Furthermore, for very high levels of managerial ownership it seems reasonable that the manager may be 100% entrenched since he will be 100% in control for all very high levels of ownership. As a result, the entrenchment effect will only have an impact on performance for changes in the medium-concentration levels of ownership.

Hp 2. Corporate performance is a non-monotonous function of management ownership

Finally, a different standpoint is taken from the theories of ownership structure endogeneity. These suggest that any kind of ownership structure is determined by financial performance in the sense that corporations with inefficient ownership structures will fail to survive in the long run. Demsetz (1983), Demsetz and Lehn (1985) and Kole and Lehn (1997) have argued for this kind of ownership structure endogeneity. In particular, Demsetz (1983) argues that the ownership structure of a corporation should be thought as an endogenous outcome of decisions that reflect the influence of shareholders and of trading on the market for shares.

When owners of a privately held company decide to sell shares, and when shareholders of a publicly held corporation agree to a new secondary distribution, they are, in effect, deciding to alter the ownership structure of their firms and, with high probability, to make that structure more diffuse. Subsequent trading of shares will reflect the desire of potential and existing owners to change their ownership stakes in the firm. In case of a corporate takeover, those who would be owners have a direct and dominating influence on the firm's ownership structure. In these ways, a firm's ownership structure reflects decisions made by those who own or who would own shares. The ownership structure that emerges, whether concentrated or diffuse, ought to be influenced by the profit-maximizing interests of shareholders, so that, as a result, there should be no

systematic relation between variations in ownership structure and variations in firm performance.

Hp 3: No effects of ownership structure on corporate performance (endogeneity)

The empirical studies for established firms about the relation between ownership and performance seem to have yielded conflicting results. The early analysis of the relation between the performance of firms and ownership was linear in form (for example, Demsetz and Lehn, 1985), while the later analysis of managerial ownership has considered non-linear forms (Morck et al., 1988; McConnell and Servaes, 1990, 1995; Kole, 1995; Cho, 1998; Short and Keasy, 1999). The non-linear analysis follows from the two possible effects which influence the relation between a firm's performance and managerial ownership: alignment and entrenchment. McConnell and Servaes (1990) propose a quadratic model in which the coefficient on managerial ownership is expected to be positive while the coefficient on managerial ownership squared is expected to be negative. However, they cannot support Morck et al. (1988) entrenchment findings at the intermediate ownership level. Subsequently, Short and Keasey (1999) argue that a cubic model better describes the transition between alignment affects to entrenchment affects and back again to alignment. Here, the coefficients on ownership and ownership-cubed are expected to be positive, while the coefficient on ownership-squared is expected to be negative. Their evidence supports the cubic model of ownership structure to describe firm performance in established firms.

The study of the relationship between ownership and performance is of particular interest even for not established firms, and the typical companies going public. A change in ownership structure is indeed one of the major changes that take place when a firm goes public. In particular, the IPO literature assumes that if a cross-sectional relationship exists between ownership and performance, then a change in ownership should be similarly correlated with a change in performance: if managerial ownership is positively related to firm performance, then increases in managerial ownership should lead to increases in firm performance. Accordingly, Jain and Kini (1994) find a positive linear relationship between ownership and the change in firm performance. The more shares the original owners retain, the better the firm performance. Their evidence supports the alignment hypothesis.

However, Mikkelsen et al. (1997) reject this hypothesis while also using US data. Further, Mikkelsen et al. explicitly consider a non-linear relationship between the change in performance and insider-ownership by including the squared level of ownership stake (quadratic form) as an explanatory variable for the change in performance, but this variable is also not significant. More recent analysis

on the effect of ownership changes on post IPO performance accounts for both the alignment and entrenchment hypothesis and find a non-linear relationship between managerial ownership and performance, according to the Combined Theory (Keloharju and Kulp, 1996; Kim et al., 2004; Wang, 2005; Enqvist, 2005). In this paper, we provide further evidence on this issue by investigating the relation between ownership and performance for a sample of Italian IPOs in the period 1995-1999.

3. Sample and variable definition

Sample description

We study the companies that went public on the Italian stock exchange in the period 1995-1999. During this period, the stock market experienced a significant evolution with the privatization of the Exchange, the reform of listing requirements and the establishment of new markets and segments. Thanks also to the favourable momentum of the stock market indexes, culminated in 1999 and in the first months of 2000, Borsa Italiana experienced a sensible increase in the number of IPOs culminated with the burst of the new economy bubble. The period between 1995 and 1997 has been characterised by many small and medium size industrial firms going public, taking the opportunity of a positive market momentum and tax benefit granted by the “legge Tremonti”.

Ошибка! Источник ссылки не найден. documents the IPO activity in Italy during the period under investigation. Like previous studies, we exclude from the sample financial companies, introductions (listings not accompanied by the sale of securities) and re-admissions¹. The final sample is made of 66 IPO-firms. Most of them are general industrial or cyclical consumer goods companies. Information technology companies show the lowest fraction of secondary shares offered (existing shares sold by pre-IPO owners divided by newly issued shares). This evidence may be interpreted as a possible signal of companies going public with a low capitalization that use the IPO to raise new equity to finance the growth. On the other side, utilities seem to go public mainly to provide a divestment opportunity to existing shareholders, as their offer is made only of secondary shares. [See appendices, Table 1].

Variables of Performance

The tendency of newly public companies is to underperform in the long run. Beginning with Ritter (1991) and Loughran and Ritter (1995), the focus of the empirical literature on the long run performance

¹ Our unique dataset is collected combining data from offering prospectuses and annual reports for the years following the IPO.

of IPO companies has almost always been on stock prices, with a few exceptions (for a review of the literature on this issue, see Ritter and Welch, 2002). In the US Jain and Kini (1994) and Mikkelsen et al. (1997) first compare the level of companies' profitability prior and after the IPO. They document that the accounting performance of the newly listed companies becomes worse after going public. More recently, this stream of literature has been enriched with similar studies on other markets (see, for instance, Cai and Wei, 1997; Kutsuna, Okamura and Cowling, 2002; Khurshed, Paleari and Vismara, 2003; Kim, Kitsabunnarat and Nofsinger, 2004; Wang, 2005) and this paper provide evidence for the Italian market. The literature proposes several theoretical explanations for the post-issue underperformance.

Among these, the most popular are the theory of “windows of opportunity” by Loughran and Ritter (1995), the window-dressing hypothesis by Teoh et al. (1998), as well as theory related to the change in ownership occurring at the IPO, as presented in the literature review in Section 2.

We measure the operating performance of the IPO firms using several measures.

ROA - Return On Assets – is defined scaling operating income by the book-value of assets. In this way, we measure the firm's efficiency in using assets to generate income to all providers of capital. This ratio is expected to decrease in particular at the year of the IPO, as a consequence of the capital inflow arising from the offer.

ROE – Return On Equity - measures the profitability of the firm from a shareholders' perspective by estimating the after-tax net income divided by book value of equity. ROE is particularly exposed the phenomenon of earnings management at the base of the window-dressing hypothesis.

CFROA – Cash Flow Return On Assets - evaluates the profitability in terms of cash flow on assets: cash flows from operating activities over total assets. This figure is less vulnerable to accounting manipulation and in particular it is subject to lesser artificial earnings inflations in the years prior to the IPO when discretionary accruals adjustments are often used, as shown by Teoh et al. (1998).

Ownership variables

A change in ownership structure is one of the major changes that take place when a firm goes public. In this paper, we provide evidence on ownership of equity prior going public and immediately after the IPO. Based on information in the offering prospectus, we document ownership of the substantial shareholders as well as of member of the board. Substantial shareholders (variable OWN_SUBST) are identified as existing shareholders entitled of at least 3 percent of the firm's equity. Managerial ownership (variable OWN_BOARD) is measured as the percentage of

equity shares owned by directors. This measure includes ownership by directors via corporate vehicles (e.g. where directors' are majority shareholders in other firms which have direct ownership stakes in the particular firm under consideration). This definition of managerial ownership is consistent with that of Morck et al. (1988) who define managerial ownership as ownership by members of the board of directors².

Control variables

The Industrial Organization literature indicates that market imperfections (such as natural monopoly and collusion) and any kind of market power which prevents entry or pushes exits, are strongly correlated to firm's size and age (Agarwal and Gort, 2002; Audretsch and Lehmann, 2004). With reference to the IPO literature, Mikkelsen et al. (1997) find that size and age of their sample firms are related to operating performance. Whereas small and young companies underperform industry-matched firms in the few years after going public, larger and more established firms perform as well as industry-matched corporations. Hensler et al. (1997) find that the issuer's size and age at the time of the IPO are significantly positively related to the probability of survival. Audretsch and Lehmann (2004) find that only size is positively related to the likelihood of firm survival. Thus, firm size and age seem to be key factors when investigating the post-IPO firms' performance from several standpoints. To this extent, we consider as control variable the value of total assets for the year preceding the IPO as a measure for the firm size (SIZE), while the age (AGE) of a firm is measured in years since incorporation to the IPO.

Other influencing variables refer to the investment and financing policy of the firms going public. At the moment of the issue of new shares, firms decrease their leverage as a consequence of equity capital inflow raised through the issue of new shares. Indeed, *ceteris paribus*, the more the percentage of equity issued at the offering and the higher the proportion of primary over secondary shares is, the more the firms' leverage decreases. We take into account the leverage effect through the variable LEVE, defined as book value of short plus long term debt over total assets. Moreover, one of the reasons to go public is to overcome financial constraints and use the proceedings of the IPO to improve their capital investments (Kim and Weisbach, 2005). To this extent, firms may view the

IPO as a mean for implementing valuable new investments. We take into account this variable measuring the capital expenditures (CAPEX).

4. Operating performance and ownership structure at the IPO

Operating performance

In this section, we investigate the evolution of the operating performance and of the ownership structure around the IPO. We analyse the effect of the IPO on the operating performance and report the median level of performance from the year preceding the IPO (-1) to three years after. As in Jain and Kini (1994), we calculate the change in operating performance during the year before the IPO to the year of the IPO and each of the three years after. Significance levels are tested using the Wilcoxon signed rank test.

The variable LEVE investigates the impact of the IPO on the level of indebtedness. We find a sensible decline in the year of the IPO and then a monotonic increase towards a level closed to the pre-IPO period (Table 2). This result is similar to those of Mikkelsen et al. (1997) that find that the debt ratio of US IPOs falls considerably from year -1 to year +1 (64% to 40%), but then rises afterwards. The evolution of the size of terms is measured in terms of total assets (SIZE). The median levels of total assets are each year higher and the growth rates relative to year -1 are highly positive. Also the capital expenditures (CAPEX) show a sensible increase after the IPO, from a median level of 4.68 €m in the year before the IPO, to a maximum level of 16.5 €m in the second year after the IPO and then decline to 9.3 €m in the third year after the IPO. These evidences (decrease in debt ratio, increase in total assets and capital expenditures) may point to a motivation in the decision to go public related to overcome financial constraints and use the proceedings of the IPO to improve capital investments.

The operating performance is measured using three features: ROA, ROE and CFROA. ROA show a significant decrease after the IPO. The median ROA declines indeed from 15.6% in the year preceding the IPO to 10.6% three years after. The median changes in ROA relative to the year preceding the IPO are all statistically negative. Operating performance measured by operating cash flows divided by total assets (CFROA) also shows a decline in post IPO period. The firms are less profitable also from a shareholders' perspective: ROE declines from a level of 13.0% in the year -1, to 6.0% in the year +3.

In summary, coherently with the previous studies on other market, we find evidence that IPO firms in Italy exhibit inferior post-IPO operating performance relative to the year prior going public. This occurs in spite of high growth in total assets and

² In contrast to the case of external shareholders, members of the board of directors must disclose the total holdings of their shares, regardless of the size of their shareholdings. Hence in the case of directors' shareholdings, there is no cut-off ownership level at which ownership is reported.

capital expenditures. Investment activity may be one of the causes of the decline in operating performance, but this variable does not fully explain the post-IPO operating performance. [See appendices, Table 2].

Ownership structure

In our sample, companies are generally closely held by the controlling shareholders both before and after the IPO (the median value of OWN_SUBST is still over 50% after the IPO). As reported in Table 3, substantial shareholders own 96.27% of equity capital before the IPO (86% on average) and 58% after the IPO (56% on average). The median change of the stakes of substantial shareholders at the IPO is 32%. Managerial ownership, measured as the percentage of equity shares owned by directors (OWN_BOARD), shifts from 58% before the IPO (49% on average) to 41% after the IPO (35% on average), with a median change of 25%. [See appendices, Table 3].

5. Relationship between ownership and performance

In this section, we investigate the relationship between ownership structure and operating performance. The first type of analysis focuses on the relationship between ownership structure changes and post IPO changes in operating performance. We test the existence of a linear relationship between ownership variables and operating performance (Hypothesis 1). Then, according to the Combined Theory, we test Hypothesis 2, investigating the presence of a non-linear relationship between ownership structure (OWN_SUBST and OWN_BOARD) and operating performance (ROA, ROE, CFROA).

Both the Agency Cost Theory hypothesis (Jensen and Meckling, 1976) and the Signalling hypothesis (Leland and Pyle, 1977) suggest a superior level of operating performance for firms with higher ownership retained by substantial shareholders. To test this hypothesis, as to Jain and Kini (1994), we split our sample into two groups based on the median value of the change in ownership at the IPO by substantial shareholders (OWN_SUBST: 32.19% as reported in Table 3) and by the board (OWN_BOARD: 24.52%). The change in operating performance for the post-IPO period for the two groups is reported in Table 4 where are reported, for the two sub-samples, the changes in operating performance between the year preceding the IPO and years after the IPO. In Panel A the sample is divided using the value of OWN_SUBST median change at the IPO, while in Panel B the ownership variable used to split the sample is OWN_BOARD median change.

Panel A shows a statistically significant difference between operating performance changes,

only for CFROA from -1 to +2. In particular, the CFROA change for IPO with higher equity retention (OWN_SUBST change at the IPO <32.19%) by substantial shareholders is -36%, in comparison to -84% for the low-retention sub-sample. Panel B shows a statistically significant difference between ROA changes (with the exception of the change to year +1). Similar results are obtained using ROE. In particular, the high retention group does not show a ROE decline from -1 to 0 in comparison to a decline of -14% for that year of the low retention group. We do not find instead any significant difference between the two sub-sample using CFROA and Capex/Total Assets (in Panel B). In summary, this analysis find weak evidence of the theoretical predictions of Signalling and Agency Cost Theory, but the results obtained are not as clear as those reported by Jain and Kini (1994). We investigate if the relationship between operating performance and changes in ownership structure is not linear. [See appendices, Table 4].

We use a regression model to take into account both the alignment and entrenchment hypothesis, in a way similar to Short and Keasey (1999). We test various forms of functional relationship between managerial ownership and operating performance. Specifically, we first consider a linear relationship (Hypothesis 1) between ownership structure (alternatively OWN_SUBST or OWN_BOARD) and operating performance after IPO (year +1, +2, +3). Then, we test two non-linear relationships (Hypothesis 2) using a quadratic (cubic) form, where the variable of ownership structure considered is squared (cubed). These models allow for three levels of ownership variable to have an effect on firm performance:

$$\text{PERF} = \alpha + \beta_1 \text{OWN} + \gamma_1 \text{LEVE} + \gamma_2 \text{SIZE} + \gamma_3 \text{CAPEX} + \gamma_4 \text{AGE} + \varepsilon \quad (1)$$

$$\text{PERF} = \alpha + \beta_1 \text{OWN} + \beta_2 \text{OWN}^2 + \gamma_1 \text{LEVE} + \gamma_2 \text{SIZE} + \gamma_3 \text{CAPEX} + \gamma_4 \text{AGE} + \varepsilon \quad (2)$$

$$\text{PERF} = \alpha + \beta_1 \text{OWN} + \beta_2 \text{OWN}^2 + \beta_3 \text{OWN}^3 + \gamma_1 \text{LEVE} + \gamma_2 \text{SIZE} + \gamma_3 \text{CAPEX} + \gamma_4 \text{AGE} + \varepsilon \quad (3)$$

Where, PERF can be equal to ROA, ROE and CFROA, while OWN represents the ownership stake (in percent) and refer to ownership by substantial shareholders or by the board of directors. OWN² and OWN³ represent the quadratic and cubic forms, respectively. We control for firm debt ratio (LEVE), firm Size (SIZE), capital expenditures (CAPEX) and firm age (AGE).

We control for firm debt ratio, defined as book value of short plus long term debt over total assets, as suggested by Rajan (1992) and Pagano et al. (1998). We use firm age (calculated as the difference between the establishment year and the IPO year) and firm assets (calculated as total assets) as Mikkelsen et al. (1997) suggest, firm age and firm size can explain post-IPO operating performance. Indeed, they find that older and larger firms tend to have better performance. We also include capital expenditures, as previous research (such as Mork et al., 1988, McConnell and Servaes, 1990 and Kim et

al., 2004) to test the role played by investments on firm performance.

The results of the regressions using OWN_SUBST as ownership structure variable are reported in Table 5³. In Panel A the dependent variable is ROA, in Panel B the dependent variable is ROE and in Panel C the dependent variable is CFROA. In Model 1, where we consider a linear relationship between ownership and performance according to Hypothesis 1, we find that OWN is not significant using the different measures of operating performance. Instead, firms with a lower debt ratio experiment higher operating performances. This finding is consistent with the argument of Rajan (1992) and Pagano et al. (1998): the negative relationship between LEVE and post-IPO operating performance demonstrates that firms using less debt will experience a better transition, with regard to performance, as the firm goes public. One explanation for this finding may be that firms that move away from bank financing are becoming less conservative (Anderson and Makhija, 1999). Consistent with Kim et al. (2004) and Mikkelsen et al. (1997) we do not find evidence that older firms tend to have better performance relative to younger firms, and firm size also does not seem to play an important role either. These conclusions about control variables are confirmed in Model 2 and Model 3.

In Model 2, we include the quadratic form OWN^2 to test a non-linear relationship between ownership and performance (Hypothesis 2). We find that the coefficient of OWN and OWN^2 are statistically significant and of the expected signs for the different variables of performance. In particular the effect of OWN on performance is positive (alignment of interest hypothesis) for low levels of OWN and then the effect becomes negative (entrenchment hypothesis). The turning points obtained using ROA, ROE and CFROA are 56%, 60.6% and 56.6% respectively.

Entrenchment can occur at high levels of insider ownership, but at very high ownership levels, the agency costs may be lower because management is essentially the owner and external shareholders hold only a marginal stake of equity. We therefore test for three levels of OWN with a positive effect for low and high levels of ownership and a negative effect for intermediate levels of ownership (Model 3). The results confirm the theoretical prediction of a non-linear relationship (of alignment, entrenchment, alignment) between firm performance and managerial ownership (Hypothesis 2). [See appendices, Table 5].

The estimated coefficients on all the ownership variables are statistically significant using CFROA as dependent variable. The results suggest that the

turning point from alignment to entrenchment for substantial shareholders equity stake is 48%, while the turning point back to alignment is 74%. In our sample a fraction of 31% is in the low ownership category ($OWN < 48%$) and a fraction of 24% is in the high ownership category ($OWN > 74%$). Model 3 introduces additional information relative to Model 2 about firms with a very high ownership concentration, where agency costs seem to be lower (Yang and Sheu, 2006).

The three regression models are tested also using OWN_BOARD as ownership structure variable. The results, reported in Table 6, are consistent with the conclusions obtained using OWN_SUBST. In Model 1, we find that OWN is not significant using the different measures of operating performance. Instead firms with a lower debt ratio experiment higher operating performances. We also find weak evidence that firms with a higher level of CAPEX tend to have lower operating performance (CFROA) while firm size seems to be positively correlated to CFROA (Panel C).

In Model 2, we include the quadratic form OWN^2 to test a non-linear relationship between ownership and performance and we find that the coefficient of OWN and OWN^2 are statistically significant and of the expected signs for the different variables of performance. In detail, the effect of OWN on performance is positive (alignment of interest hypothesis) for low levels of OWN and then the effect becomes negative (entrenchment hypothesis). The turning points obtained using ROA, ROE and CFROA are 35.2%, 33.3% and 32.8% respectively. McConnell and Servaes (1995) using the same measure of managerial ownership found similar results. In Model 3 we test the possibility of a reduction of agency costs at very high levels of managerial ownership, when there is a near-perfect alignment between the manager and owner. Estimated coefficients on all the ownership variables are statistically significant using CFROA as dependent variable (Panel C of Table 6). The results suggest that the turning point from alignment to entrenchment for managerial ownership is 24%, while the turning point back to alignment is 71%. In our sample a fraction of 39% is in the low managerial ownership category and a fraction of 15% is in the high managerial ownership category.

In summary, according to hypothesis 2, we find evidence of a non-linear relationship between ownership and performance, with evidence of a positive effect at low levels of managerial ownership and a negative effect at high levels according to McConnell and Servaes (1990-1995). Using CFROA as dependent variable we find evidence of a positive effect of managerial ownership at low and high levels of ownership and a negative effect at intermediate levels, consistent with the earlier general findings about the conclusions of the Combined Theory (Short and Keasey, 1999; Kim et al., 2004; Wang, 2005). [See appendices, Table 6].

³ Performance levels refer to the first year after the IPO. The regressions are tested also for year +2 and +3, but the results are qualitatively similar to the reported results.

As argued by Demsetz (1983) and shown by Demsetz and Lehn (1985) and more recently by Demsetz and Villalonga (2001), ownership structure may be endogenous. To test this hypothesis (Hypothesis 3), we regress ownership variables (alternatively OWN_SUBST or OWN_BOARD) on operating performance (ROA) and on a series of control variables (LEVE, AGE, SIZE and CAPEX). We do not find evidence supporting the hypothesis of an endogenous ownership structure: neither the coefficient of ROA nor the coefficients of control variables are statistically significant⁴. Therefore, firm performance does not seem to significantly affect the ownership structure of the companies considered in this study.

6. Conclusions

Our study investigates the relationship between ownership structure and operating performance for a sample of 66 Italian IPOs. In particular, we test three hypotheses. According to the theoretical predictions of the Agency Cost Theory and the Signalling hypothesis, we test if corporate performance is an increasing function of managerial ownership (Hp 1: linear relationship). Then, according to the conclusions of the Combined Theory, we test the hypothesis of a non-monotonous function linking managerial ownership to operating performance (Hp 2: non-linear relationship). Finally, we verify if the relationship between ownership structure and firm performance is endogenous. In other words, the market responds to forces that create suitable ownership structures for firms, and this removes any predictable relation between empirically observed ownership structure and firm rates of return (Hp 3: endogeneity, no relationship).

We consider two measures of managerial ownership, the fraction of shares owned by the substantial shareholders and the fraction of shares owned by board members. We also consider different measures of operating performance. Overall, we document a sharp decline in post issue operating performance. The theoretical prediction of the Signalling and Agency Cost Theories are weakly supported: the IPOs characterised by higher equity retention do not seem to perform substantially better than firms with lower levels of equity retention. The endogeneity hypothesis (Hypothesis 3) is also not clearly supported by our findings. Instead, we find evidence of a non-linear relationship between managerial ownership and performance, consistent with our Hypothesis 2. Managerial ownership seems therefore to have a positive effect on corporate performance at low levels and a negative effect at high levels. The story could anyway be more complicated and the entrenchment hypothesis can be mitigated by the incentive alignment for very high

levels of managerial ownership. We find indeed evidence of a positive effect of managerial ownership at both low and high levels of ownership and a negative effect at intermediate levels. This is consistent with the general predictions from the Combined Theory (Short and Keasey, 1999; Kim et al., 2004; Wang, 2005) of a three-level relationship between ownership and firm performance. For low levels of managerial ownership, the effect of the incentive alignment hypothesis is prevailing, while entrenchment hypothesis is dominant at intermediate levels. The evidence is instead mixed at very high levels of managerial ownership, where the entrenchment and alignment effects seem to coexist.

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⁴ For purposes of brevity, we do not report these results, but they are available upon request from the authors.

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Appendices

Table 1. Descriptive statistics of the IPO sample: 1995-1999. Panel A: IPOs by year and issue type. Panel B: offering characteristic by business sector. Secondary shares (%) is the ratio of secondary shares as a proportion of the total number of shares sold in the offering; Equity issued (%) is the percentage of equity issued at the offering (number of shares offered over number of shares after the IPO).

Panel A: Sample								
Year	Admissions to the Italian Stock Exchange		Initial Public Offerings		Sample: IPOs by operating companies			
1995	14		11		9			
1996	14		12		10			
1997	14		10		10			
1998	25		15		14			
1999	37		27		23			
Total	104		75		66			
Panel B: IPOs characteristics by business sector								
FTSE Industrial sector	No obs.		Market Cap (€m)		Capital Raised (€m)		Secondary shares (%)	Equity issued (%)
Resources	2	3.0%	22,185	24.1%	2,838	11.8%	53.7	19.1
Basic Industries	5	7.6%	963	1.0%	281	1.2%	26.2	29.3
General Industrials	17	25.8%	2,148	2.3%	782	3.2%	38.1	40.1
Cyclical Consumer Goods	15	22.7%	2,492	2.7%	892	3.7%	50.9	37.3
Non-Cyc. Consumer Goods	7	10.6%	1,013	1.1%	397	1.6%	41.1	39.0
Cyclical Services	10	15.2%	6381	6.9%	1287	5.3%	43.1	35.4
Utilities	5	7.6%	55,888	60.6%	17,280	71.7%	100.0	37.9
Information Technologies	5	7.6%	1168	1.3%	340	1.4%	17.0	38.2
New Market	6	9.1%	950	1.0%	266	1.1%	17.7	41.3

Table 2. Median levels of operating performance and median change between the operating performance during the year before the IPO (t = -1) to the IPO year (t = 0), and each of the 3 years after the IPO (t = +1, +2, +3).

Year relative to the IPO	-1	0	1	2	3
No. obs.	65	66	66	66	66
<i>LEVE (%)</i>					
Median	64.5	47.3 ***	49.6	57.2 ***	60.4 *
Median change relative to year -1 (%)		-20.6 ***	-18.2 ***	-11.6 **	-7.9 *
<i>SIZE (€m)</i>					
Median	79.44	133.7 ***	1601.0 ***	188.6 ***	209.5 ***
Median change relative to year -1 (%)		35.7 ***	47.1 ***	65.4 ***	90.6 ***
<i>CAPEX (€m)</i>					
Median	4.68	10.5 ***	11.8 ***	16.5 ***	9.3 ***
Median change relative to year -1 (%)		68.5 ***	96.9 ***	80.2 ***	85.5 ***
<i>ROA (%)</i>					
Median	15.6	13.7	13.3 **	10.7 ***	10.6 ***
% positive obs.	95.4	93.9	90.9	93.9	92.4
Median change relative to year -1 (%)		-10.1 **	-17.7 **	-26.6 ***	-26.5 ***
<i>ROE (%)</i>					
Median	13.0	8.9 ***	7.9 **	8.1	6.0 **
% positive obs.	92.3	92.4	81.8	83.3	74.2
Median change relative to year -1 (%)		-30.1 ***	-42.1 ***	-52.0 ***	-55.0 ***
<i>CFROA (%)</i>					
Median	3.98	2.29	2.76**	3.59*	3.12
Median change relative to year -1 (%)		-40.38***	-50.83**	-44.1**	-49.02**

Significance levels are tested using the Wilcoxon signed rank test.

* Statistically significant at the 10% level;

** statistically significant at the 5% level;

*** statistically significant at the 1% level.

Table 3. Median and average levels of substantial shareholders stake and managerial ownership stake. In the last column is reported the median change at the IPO

	Pre IPO	Post IPO	Change
<i>Panel A: Substantial shareholders (OWN_SUBST)</i>			
Median (%)	96.27	57.97	32.19
Average (%)	86.40	56.42	35.49
<i>Panel B: Managerial ownership (OWN_BOARD)</i>			
Median (%)	57.57	40.55	24.52
Average (%)	49.05	34.64	23.42

Table 4. Median changes of operating performance between the year preceding the IPO and the years +1, +2 and +3 after the IPO. The sample is divided into two groups based on the median value of ownership change of substantial shareholders (Panel A) and board members (Panel B).

	From -1 to 0			From -1 to +1			From -1 to +2			From -1 to +3		
<i>Panel A: Substantial shareholders (OWN_SUBST)</i>												
	<	>	W.	<	>	W.	<	>	W.	<	>	W.
ROA	-19.0	-3.6	—	-21.2	-16.4	—	-28.0	-26.1	—	-35.0	-17.3	—
ROE	-12.9	-2.0	—	-11.6	-4.1	—	-8.2	-3.2	—	-9.1	-6.5	—
CFROA	-24.2	-59.7	—	-48.4	-57.5	—	-36.1	-84.0	**	-57.3	-54.2	—
CAPEX / Total Assets	18.2	34.9	—	25.1	25.5	—	6.9	28.0	—	-6.4	-16.2	—
<i>Panel B: Managerial ownership (OWN_BOARD)</i>												
	<	>	W.	<	>	W.	<	>	W.	<	>	W.
ROA	-1.0	-20.0	**	-14.6	-22.6	—	-24.0	-30.7	**	-8.2	-35.0	**
ROE	0.0	-13.8	***	-2.2	-6.8	—	-1.7	-6.5	—	0.4	-11.9	**
CFROA	-42.5	-24.2	—	-41.1	-52.9	—	-53.1	-55.4	—	-49.0	-62.4	—
CAPEX / Total Assets	18.3	35.5	—	25.1	28.7	—	12.8	28.0	—	-6.1	-15.5	—

Significance levels are tested using the Wilcoxon signed rank test. * Statistically significant at the 10% level; ** statistically significant at the 5% level; *** statistically significant at the 1% level.

Table 5. Ordinary-least-squares regression coefficient estimates

The dependent variable is operating performance (alternatively ROA, ROE or CFROA) in year +1 where year 0 is the year of the IPO. OWN represents the equity stake (in percent) of substantial shareholders after the IPO. OWN² and OWN³ represent the quadratic and cubic form respectively. LEVE is firm debt ratio, defined as book value of short plus long term debt over total assets. SIZE is firm Total Asset. CAPEX is defined as firm capital expenditures. AGE is the difference between the establishment year and the IPO year. Significance levels are reported in parenthesis. * Statistically significant at the 10% level; ** statistically significant at the 5% level; *** statistically significant at the 1% level.

<i>Substantial shareholders (OWN SUBST)</i>			
	Model 1	Model 2	Model 3
PERF = ROA			
Const	0.18 (0.013)**	-0.29 (0.093)*	-0.85 (0.211)
OWN	0.13 (0.14)	2.04 (0.002)***	5.50 (0.186)
OWN ²	—	-1.82 (0.004)***	-8.59 (0.285)
OWN ³	—	—	4.22 (0.398)
LEVE	-0.27 (0.002)***	-0.25 (0.002)***	-0.25 (0.002)***
SIZE	0.01 (0.364)	0.03 (0.910)	0.05 (0.867)
CAPEX	0.01 (0.514)	0.04 (0.786)	0.02 (0.892)
AGE	0.09 (0.774)	0.08 (0.787)	0.01 (0.951)
Obs	59	59	59
Adj R ² (%)	18.43	29.86	29.47
F	3.49 (0.009)***	4.90(0.001)***	4.28(0.001)***
PERF = ROE			
Const	0.11 (0.371)	-0.34 (0.263)	-0.86 (0.362)
OWN	0.22 (0.157)	1.94 (0.073)*	5.03 (0.352)
OWN ²	—	-1.60 (0.10)*	-7.36 (0.458)
OWN ³	—	—	3.42 (0.559)
LEVE	-0.32 (0.035)**	-0.30 (0.040)**	-0.31 (0.040)**
SIZE	-0.00 (0.719)	-0.00 (0.806)	-0.00 (0.725)
CAPEX	0.00 (0.721)	0.00 (0.765)	0.00 (0.698)
AGE	-0.00 (0.242)	-0.00 (0.340)	-0.00 (0.329)
Obs	54	54	54
Adj R ² (%)	6.80	10.01	8.74
F	1.77 (0.136)	2.21 (0.070)*	1.73 (0.127)
PERF = CFROA			
Const	0.09 (0.323)	0.28 (0.187)	-1.43 (0.032)**
OWN	0.10 (0.391)	1.54 (0.043)**	8.41 (0.029)**
OWN ²	—	-1.36 (0.050)**	-14.25 (0.045)**
OWN ³	—	—	7.70 (0.061)*
LEVE	-0.21 (0.061)*	-0.19 (0.083)*	-0.19 (0.073)*
SIZE	0.00 (0.930)	-0.00 (0.881)	-0.00 (0.729)
CAPEX	-0.00 (0.950)	0.00 (0.796)	0.00 (0.702)
AGE	0.00 (0.885)	0.00 (0.713)	0.00 (0.821)
Obs	58	58	58
Adj R ² (%)	3.81	8.65	22.24
F	1.23 (0.307)	2.08 (0.084)*	4.05 (0.002)***

Table 6. Ordinary-least-squares regression coefficient estimates

The dependent variable is operating performance (alternatively ROA, ROE or CFROA) in year +1 where year 0 is the year of the IPO. OWN represents the equity stake (in percent) of board members after the IPO. OWN² and OWN³ represent the quadratic and cubic form respectively. LEVE is firm debt ratio, defined as book value of short plus long term debt over total assets. SIZE is firm Total Asset. CAPEX is defined as firm capital expenditures. AGE is the difference between the establishment year and the IPO year. Significance levels are reported in parenthesis. * Statistically significant at the 10% level; ** statistically significant at the 5% level; *** statistically significant at the 1% level.

<i>Managerial ownership (OWN_BOARD)</i>			
	Model 1	Model 2	Model 3
PERF = ROA			
Const	0.18 (0.001)***	0.17 (0.002)***	0.16 (0.003)***
OWN	0.025 (0.589)	0.43 (0.034)**	0.55 (0.289)
OWN ²	—	-0.61(0.040)**	-1.03 (0.554)
OWN ³	—	—	0.38 (0.805)
LEVE	-0.18 (0.019)**	-0.22(0.006)***	-0.22(0.006)***
SIZE	0.00 (0.354)	0.00 (0.260)	0.00 (0.253)
CAPEX	-0.00 (0.702)	-0.00 (0.823)	-0.00 (0.809)
AGE	0.00 (0.829)	0.00 (0.658)	0.00 (0.645)
Obs	57	57	57
Adj R ² (%)	6.63	12.57	10.09
F	1.80 (0.130)	2.34 (0.045)**	1.98 (0.077)*
PERF = ROE			
Const	0.25 (0.000)***	0.24(0.000)***	0.24 (0.000)***
OWN	0.02 (0.695)	0.42(0.057)*	0.11 (0.840)
OWN ²	—	-0.63 (0.062)*	-0.51 (0.786)
OWN ³	—	—	-1.01 (0.551)
LEVE	-0.29 (0.001)***	-0.32 (0.001)***	-0.32 (0.001)***
SIZE	0.00 (0.593)	0.00 (0.802)	0.00 (0.821)
CAPEX	-0.00 (0.668)	0.00 (0.917)	-0.00 (0.927)
AGE	0.00 (0.517)	0.00 (0.355)	0.00 (0.405)
Obs	60	60	60
Adj R ² (%)	16.08	19.94	18.97
F	3.26 (0.012)**	3.45 (0.006)***	2.97 (0.011)**
PERF = CFROA			
Const	0.78 (0.000)***	0.69 (0.001)***	0.64(0.002)***
OWN	-0.03 (0.865)	1.69 (0.013)**	4.08 (0.017)**
OWN ²	—	-2.57 (0.009)***	-11.28 (0.050)**
OWN ³	—	—	7.93 (0.067)*
LEVE	0.31 (0.298)	0.26 (0.361)	0.22 (0.444)
SIZE	0.00 (0.029)**	0.00 (0.077)*	0.00 (0.054)*
CAPEX	-0.00 (0.018)**	-0.00 (0.059)*	-0.00 (0.042)**
AGE	-0.00 (0.540)	-0.00 (0.862)	0.00 (0.981)
Obs	60	60	60
Adj R ² (%)	10.58	21.31	23.24
F	2.40 (0.049)**	3.44 (0.006)***	4.02 (0.005)***

SHAREHOLDERS' COALITIONS AND CONTROL CONTESTABILITY: THE CASE OF ITALIAN VOTING TRUST AGREEMENTS

Gianfranco Gianfrate*, Laura Zanetti**

Abstract

Since ownership structures characterized by the presence of multiple large shareholders are extremely common around the world, the effects of having such a controlling structure are receiving increasing attention in literature. More than one third of Italian listed companies are controlled by coalitions of shareholders bound together by agreements called "voting trusts" which represent an interesting opportunity to study the consequences of having multiple large shareholders who share the control of firms. We perform an event-study on voting trust announcements (2004-2006), showing significant abnormal returns in both the event day and the following day. The sign of this cumulative reaction is negative for announcements of new/renewed trusts and positive in the cases of trust terminations. These findings are consistent with the "entrenchment effect" hypothesis linking the ownership structure and the firm value. As a general result, the presence of multiple large shareholders tied within a voting trust, by curbing the company's contestability is reflected in a lower valuation of the firm.

Keywords: ownership structure, multiple large shareholders, voting trust agreements, firm value

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1. Introduction

The effects of ownership structures on the value of firms have been a central item in the scholars' agenda since the Seventies, when Jensen and Meckling (1976) identified large shareholders who have both strong incentives and power to discipline the management, as a medium to increase firm value. While the positive incentive effects of large ownership (mainly of managers) have been researched extensively, much less work has been done on the costs – in terms of lower firm valuation – associated with the presence of large investors. Fama and Jensen (1983), DeAngelo and DeAngelo (1985), and Barclay and Holderness (1989) argue that increased insider ownership concentration permits managerial consumption of perquisites and "entrenchment" of incumbent management by reducing the probability of bidding by outside agents, thus reducing firm value.

Stulz (1988) develops a theoretical model, formalising the costs of large shareholders and entrenchment, which predicts a concave relationship between managerial ownership and firm value. In this model, as managerial ownership and control increase, the negative effect on firm value associated with the entrenchment of manager-owners starts to exceed the incentive benefits of managerial

ownership. As a consequence, the entrenchment costs of managerial ownership, in terms of a lower firm value, relate to managers' ability to block value-enhancing takeover or to make them more costly to the bidder.

Empirically, the contribution by Mork et al. (1986) and McConnell and Servaes (1990) support the Stulz's theoretical model, finding an inverse U-shaped relationship between managerial equity ownership and firm valuation for a sample of US firms.

Slovin and Sushka (1993) adopt a different methodological approach in order to ascertain the existence of entrenchment effects due to insiders' ownership. In the "most macabre" event study ever performed within the finance literature, they analyse the market reaction to announcements of deaths of insiders who own at least 5 percent of firm shares. They find significant positive abnormal returns to the announcements of insider block-holders' deaths. Moreover, they show that for a large portion of firms in the sample, the disposition of the deceased's shareholdings leads to a reduction in the control group block and to subsequent corporate control bids. That article is broadly consistent with the Stulz's (1988) propositions, supporting the hypothesis that the firm value is positively related with its openness to the market for corporate control

while, on the contrary, is negatively affected by ownership structures in which a substantial portion of shares is held by insiders.

Substantial empirical work has shown that ownership around the world is typically concentrated in hands of a small number of large shareholders (e.g., La Porta et al., 1999; Barca and Becht, 2001). As a consequence, the research focus has shifted from the traditional conflict of interest between managers and dispersed shareholders towards an agency conflict (especially in terms of downright expropriation, self-dealing or collusion with management) between large controlling shareholders and minority shareholders. This conflict is exacerbated when in addition there is substantial separation between voting rights and cash-flow rights, as is common in both continental Europe (Faccio and Lang, 2002; Laeven and Levine, 2006) and Asia (Claessens et al., 2002). Many authors have argued that such an arrangement is particular vulnerable to self-dealing by the controlling shareholder (Zingales, 1994; Burkart et al., 1997; La Porta et al., 1998; Wolfenzon, 1998; Bebchuk et al., 2000).

The theoretical literature on multiple large shareholders is well developed. Zwiebel (1995) assumes that blocks can confer to their holders partial benefits of control, and, as a consequence, on one hand holders of small blocks will join together and form coalitions, while on the other large investors will "create their own space", i.e. by taking a large stake in a firm and thereby deterring other big blockholders; Pagano and Roell (1998) suggest that in concentrated ownership settings, the presence of other large shareholders help mitigate agency costs by monitoring the controlling shareholder; Bennedsen and Wolfenzon (2000) point out that the coalition formation improves firm performance since no individual shareholder is able to take any action without the consent of other shareholders; Gomes and Novaes (2005) show that bargaining problems among multiple controlling shareholders may prevent inefficient investment decisions that harm minority shareholders, but, at the same time, those bargaining problems may block efficient investment decisions.

Still, empirical evidence, to date, on the effect of ownership structures with multiple large shareholders on firm performance has been relatively limited. Lehman and Weigand (2000) report that the presence of a strong second largest shareholder enhances profitability in German listed companies. Faccio et al. (2001) test the effect of multiple large shareholders' structures on dividends. They find that the presence of multiple large shareholders dampens expropriation in Europe (due to monitoring), but exacerbates it in Asia (due to collusion). For Italy, Volpin (2002) provides evidence that valuation is higher when control is to some extent contestable as in the case in which a voting syndicate controls the firm. Finally, Maury and Pajuste (2005) using a

sample of Finnish listed firms show that a more equal distribution of the votes among large blockholders has a positive effect on firm value. This result is particularly strong in family-controlled firms suggesting that families are more prone to private benefit extraction if they are not monitored by another strong blockholder.

Laeven and Levine (2006), studying a sample of European publicly listed companies, find that multiple large shareholders (defined as those having at least 10% of the shares) are relatively common (34% of the sample); moreover, the market value of companies with limited "dispersion" of shareholders (measured as the distance between the first and the second largest shareholder) is higher, signalling a positive effect of either more contestable power or of monitoring by the second largest shareholder, but this effect is weakened with better shareholder protection increased if shareholders' types differ.

This paper extends the findings of Gianfrate (2007) by investigating the existence of entrenchment effects in Italian companies controlled through a voting trust. In particular, we follow, on the one hand, the reasoning line proposed by Stulz (1998) about the relation between insider ownership and market for corporate control, and, on the other hand, the insights emerging from the literature about the separation between ownership and control (Bebchuk et al., 2000). We therefore attempt to merge these reasoning lines in order to assess how the voting trusts' functioning, which implies a certain degree of closeness to the market for corporate control, actually affects firm value.

2. Italian Voting Trusts

According to Bianchi and Bianco (2006), almost 34.5% of Italian listed companies (meaning 47% of total Italian stock-market capitalization) in 2005 were controlled by coalitions of shareholders. These shareholders are usually kept together by explicit agreements to vote together, which are called voting trusts or voting syndicates ("*patti di sindacato*"). These agreements are publicly announced on national newspapers, must be communicated to CONSOB (the Italian Security and Exchange Authority), last for a fixed number of years (usually three) and can be renewed.

The members of a typical Italian voting trust just bind themselves to vote in a certain way within shareholders' meetings and/or within corporate board's meetings. Hence, the content of this kind of trusts varies widely ranging from agreements on voting together on a single specific issue to more complex agreements where the members statue the decisional criteria (i.e. *per capita*, unanimously, super-majority) to be adopted in order to determine how the members of the trust should vote on relevant corporate issues.

Moreover, Italian voting trusts are generally complemented by explicit constraints related to the

possibility of selling the shares owned by trust's members. The content of such covenants can be declined in various ways ranging from the simple prohibition of the selling to the articulation of *pre-emption-rights* among the trust's members. Thus, the content of such agreements could vary significantly but they usually contain the following articles:

- *Pre-emption rights* that confer precedence to the parties in buying other members' stakes at "fair" value in case syndicated shareholders should wish to exit the trust;

- *Provisions of control* which consist in the explicit designation of the rights and duties of the trust's members in the management of the company, and requirements of prior unanimous or majority consent (in the case of "*patti di consultazione*" a simple consultation among trust's members is required) for relevant decisions such as the declaration of any dividend, the approval of business plans or M&A transactions, the disposal of corporate assets, the issuance of shares, etc.;

- *Restrictions on the transfer of shares* when the shareholders commit not to sell, pledge, or charge their shares except with the prior written consent of all other trust's members;

- *Right of first refusal*: a shareholder offered to sell her shares to an outside investor at some price is required to offer his shares to the other shareholders at the same price. If the other shareholders decline, the first shareholder is free to sell her shares to the outside investor;

- *Election of directors and/or members of the board of statutory auditors*: explicit agreement on the number, role (i.e., chairman and vice-chairman of the board of directors) and board seats allocation among trust's members;

- *Call/put options* when trust's members are granted put options on the shares, in part or in whole, held by the other members, at a strike price that is typically equal to "fair" value (the reverse in the case of call options);

- *Valuation*: the 'fair' value of the shares is generally determined by an external expert (usually an investment bank), or it is based on a previously agreed valuation formula;

- *Drag-along rights*: in case a trust's member sells his stake to an outside investor, drag-along rights grant the investor the right to buy out the other members' stakes at the same price and on the same terms as the first shareholder's stake;

- *Tag-along rights*: in case a trust's member sells his stake to an outside investor, tag-along rights grant the other members the right to require the outside investor to buy their stakes at the same price and on the same terms as the first shareholder's stake. Tag-along rights can be viewed as conditional put options granted all shareholders;

- *Dispute resolution and arbitration*: The shareholders agree to follow a specified procedure to resolve disputes. The procedure may specify the appointment of an arbitrator.

Gianfrate (2007) studies a sample of 74 voting trust agreements showing that the gathering of large shareholders in a voting trust determines the binding of the majority of voting rights, allowing, in particular, the largest shareholder to exercise both the majority of board rights and, usually, the direct management of the controlled company. The other shareholders involved within the trust obtain, at least, the right to appoint some board directors and/or the members of the board of statutory auditors presumably in order to monitor the largest shareholder in charge of the company's direct control.

Volpin (2002) investigates the determinants of executive turnover and firm valuation as a function of ownership and control structures in Italy, showing that the presence of a voting trust actually increases the sensitivity of turnover to performance (after a 10% decrease in earnings, executive turnover is 7% more likely if the firm is controlled through a voting trust than otherwise). Furthermore, he points out that firm value (measured as Tobin's *Q*) is significantly larger when control is partially contestable as in the case in which a voting trust controls the firm.

Indeed, Volpin shows that the control obtained through a voting trust agreement is more efficient in comparison with the situation where the control is fully in the hands of a single controlling shareholder. Then, if the voting trust control structure has more beneficial effects when compared with the single controlling shareholder one, the question to be addressed remains whether, in absolute terms, voting trusts are an efficient governance mechanism.

3. Voting Trusts and the Market for Corporate Control: a Stylized Model

Bianchi and Bianco (2006) suggest that Italian shareholders' coalitions, especially in the form of voting trusts, ensure to the members (considered as a whole) a concentration of voting rights sufficient to maintain the control of the companies, in the sense that such trusts perform a function similar to that of pyramidal ownership structures. This implies that those coalitions might reproduce the separation between ownership and control usually performed by pyramids, cross-ownership and issuance of shares with different (or no) voting rights.

Bebchuk et al., (2000) highlight the potentially large agency costs that the separation between ownership and control involves. In particular, they demonstrate that the agency cost imposed by controlling shareholders who have a small minority of the cash-flow rights in their companies can be an order of magnitude larger than those imposed by controlling shareholders who hold a majority of the cash-flow rights. This is because, as the size of cash-flow rights held decreases, the size of agency costs increases, not linearly, but rather at a sharply increasing rate.

The most important decision that can impose significant agency costs on firms where a separation between ownership and control has been attained, is represented by transfers of control (Bebchuk et al., 2000).

Thus, following Bebchuk (1994), we propose a formalization of the corporate control transactions in order to evaluate the agency costs generated when there is a separation between cash-flow and voting rights obtained by enacting a voting trust among large enough shareholders.

The model considers an initial controller I owning a fraction α of company's cash-flow rights. Under the control exerted by I, the value of the company is V_I which consists of sum of cash-flow C_I and private benefits of control B_I . Under a potential new controller, N, the corresponding values would be, respectively, V_N , C_N , and B_N . The a transfer of control from I to N will be efficient if and only if

$$V_I = C_I + B_I < V_N = C_N + B_N.$$

In particular, under the "equal opportunity rule" system of mandatory bid, which implies that non-controlling shareholders are entitled to participate in a transfer of control on the same terms as the controller (Bebchuk, 1994), the initial controller I will sell his control stake if and only if

$$\alpha V_N > \alpha C_I + B_I,$$

meaning that the transfer of control takes place only if the sum of his cash-flow right portion and the private benefits he is able to extract is less than the portion of the value – that basically means price – the potential new controller will attribute to the control of the firm.

The key point of this model relies on the fact that, since α can be as small as desired, the decision of controller I to sell the firm will depend much less on V_I and V_N , the values of the firm in the hands of I and N, than on the relative sizes of B_I and B_N , the private benefits of I and N.

Extending this model to the voting trust mechanism, we are able to show how the separation between cash-flow and control rights obtained through a voting trust, affects the market for corporate control of companies held by such a device.

If that firm is controlled by the voting trust T, then its value is

$$V_T = C_T + B_T$$

consisting of the sum of cash-flow C_T expected by the firm under the control of the trust and private benefits of control B_T extracted by the trust.

Assuming that the trust is composed of n members who own, as a whole, the fraction α of the total cash-flow rights of the firm (C_T), then each i -member of the trust owns the fraction α_i of the cash-flow such as

$$\sum_{i=1}^n \alpha_i = \alpha .$$

The trust is able to extract the private benefits of control B_T which are shared only among trust's members and not with shareholders outside the trust – this descends from the definition itself of private benefits of control – allocating to each member the fraction β_i (such as $\sum_{i=1}^n \beta_i = 1$) of B_T .

Finally, we assume for sake of simplicity that only two states of the world exist: one in which the trust works and one in which the trust is not able to work effectively at all (e.g. the members cannot reach an agreement on major decisions). Hence, the extraction of the private benefits of control is assumed to be allowed if and only if the trust does fully work. We capture this idea stating that private benefits of control B_T are a function of trust effectiveness λ which assumes alternatively the value 1 when the trust works, and 0 otherwise.

In this setting, the value of the stake for the i -member of the trust is V_{Ti} defined as

$$V_{Ti} = \alpha_i C_T + \lambda \beta_i B_T, \text{ such as } \sum_{i=1}^n V_{Ti} = V_T .$$

the i -member of the trust will sell her stake to the potential new controller N if and only if

$$\alpha_i V_N > V_{Ti} .$$

It is worth noting that while the presence of the fraction α_i still implies (as in the general case) that the lower the stake held by the i -member of the trust, the more the decision to sell depends upon the relative sizes of private benefits of control of B_I and B_N , rather than upon the values of the firm V_T and V_N . Moreover, in this model, the decision to sell is dramatically determined by the allocation of private benefits of control (β_i) and, naturally, by the effectiveness of the trust itself.

When the trust works well, the extraction of private benefits is allowed, and λ is equal to 1. Thus, the last expression becomes

$$V_N > (\alpha_i C_T + \lambda \beta_i B_T) / \alpha_i .$$

Conversely, if λ is equal to zero - meaning that the trust's members are unable to extract the private benefits of control - then previous expression becomes

$$\alpha_i V_N > V_{Ti} = \alpha_i C_T .$$

This result implies the intuitive idea that if the i -member of the trust could not enjoy his portion of private benefits of control (e.g. he is rejected from the trust), then he should value his stake no more than the attached fractional claim on the company's cash flow. If this condition is respected for each member of the controlling trust, also the dispersed minority shareholders (who value their shares only

on the basis of their expected cash-flow portion) should sell their shares if and only if

$$(1-\alpha) V_N > (1-\alpha) C_T.$$

It follows that if a potential buyer who assigns to the entire company (or to a single stake in it) a value which is higher than the total cash-flow generated by the firm under the control of the voting trust, then he will succeed in buying the company. (In particular, the new controller is willing to pay something more than the cash-flow rights currently generated by the firm, because he expects to improve the cash-flows due to a superior management of the firm after the takeover, and/or she conjectures to be able to extract more private benefits of control from the company than the voting trusts currently does).

Coming back to the main objective of this paper, from the illustration of this simple model, we are able to draw the hypotheses to be tested in the empirical analysis. Since both the establishing of new trusts aimed to control a listed company as well as the renewal of existing trusts, represent a way of insulating (at least, to a certain extent) the firm from the market for corporate control, thus avoiding a range of efficient transactions (from the market point of view), then at the announcement of such events a negative response from the market is expected.

Conversely, when the termination of a voting trust is announced, and, as a consequence, the

company's openness to potential bids increases, a stock upside should follow.

4. Evidence from voting trusts announcements

Following Gianfrate (2007), we obtain the announcements regarding Italian listed companies controlled by voting trusts from the database *Radiocor/IlSole24Ore*, an Italian financial news agency. We examine the period 2004 through 2006, searching for records about the establishment of new trusts, as well as the renewal or termination of existing ones. We discard, from the sample, the announcements containing other relevant financial information (e.g. announcements regarding earnings, CEO turnover, acquisitions) conveyed to the market together with the information about the trust. We finally find 32 events which we group into two separate sub-samples. The first one includes 21 announcements related to new voting trusts or to the renewals of existing ones. The other sub-sample contains 11 announcements which are referred to the termination of voting trusts.

We find an average two-days (0,1) excess return equal to -1.46% for the "New/Renewal" announcements, and a +6.56% for the "Termination" cases.

Table 1. Cumulative Average Abnormal Returns (0,1) for Voting Trusts' Announcements

	<i>Announcements</i>	Mean	Median	Standard Deviation	Min	Max	<i>t</i> -statistic
New/Renewal	21	-1.46%	-0.83%	2.10%	-6.57%	2.46%	-3.18*
Termination	11	6.56%	4.60%	6.21%	-0.71%	17.30%	3.50*

* significance at 5% level (two-tailed test)

The sign of the market reaction at the announcements is negative for the newly established or renewed trusts, and is positive when the termination of a voting trust is announced.

Though the announcements' sample is limited, those findings suggest that the market considers unfavourably – in terms of firm value – the ownership situations where the control over companies is cooperatively shared among large shareholders.

5. Conclusions

This paper is aimed at illustrating the relation between ownership structures based on multiple large shareholders and control contestability by analysing the case of Italian voting trust agreements.

We formalize a simple model which shows how the separation between ownership and control attained through voting trusts, affects the dynamics of the market for corporate control of firms held by such agreements. In particular, the rationale of such shareholders' agreements is assumed to be the insulation of the controlled company from potential control contests.

We test the insights coming from the model by applying an event-study analysis on a sample of voting trusts' announcements. We find statistically significant abnormal returns in both the event day and the following day. The sign of this cumulative reaction is negative for announcements of new/renewed trusts and positive in the cases of trusts' termination. This finding is consistent with previous findings by Gianfrate (2007) and confirms

the presence of an entrenchment effect linking the ownership structure and the firm value: as a general result, the presence of multiple large shareholders, tied within a voting trust which curbs the company's contestability, is reflected in a lower valuation of the firm.

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CORPORATE GOVERNANCE AND CORPORATE SOCIAL RESPONSIBILITY IN ITALY: ADVANTAGES AND DISADVANTAGES OF A NON-EXPLICITLY-EXISTENT SYSTEM*

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Abstract

The greatest distinctions between corporate governance practices around the world appear to result from differences in law and not from differences in recommendations that emanate from the types of codes adopted. With the evolution of the concept of Corporate Governance the area of connections with the concept of Corporate Social Responsibility has become more and more wide. The possible way to separate ownership and control, so the corporate governance in the private sector of Italian economic system, has not been based on a unique model but on a set of different models for the different kind of enterprises involved. This paper analyses the connection between corporate governance and corporate social responsibility focusing on the Italian case where, since the system of corporate governance has never been clearly defined, the current outcome shows a unique system that well incorporates both concepts.

Keywords: corporate governance; corporate social responsibility; social capital; SMEs; industrial districts

* Although the paper is the result of the work of both authors, § 1.3 and 1.4 should be attributed to G. D'Orio; § 1.5 and 1.6 to R. Lombardo; § 1.1, 1.2 and 1.7 have been jointly written

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1. Introduction

The neoclassical model of the firm is based on the shareholder as the only "principal", all other stakeholders being considered as "agents". This paradigm goes back to the hypothesis that capital is the only one scarce factor of production, while labour is abundant and environment is a "free" good. These premises suppose that the shareholder is the owner of a firm's assets. Capital as an asset can be owned. However, the more intangible assets (such as reputation, trust, human capital, partnership etc.) become fundamental ingredients of value of a firm, the less this paradigm becomes relevant. Based on the neo-classical theory, one of the main challenges for Corporate Governance is to govern the potentially conflicting relationship between the principal and the agent¹, between the creation of shareholder value and the corporate strategy developed by managers. From the perspective of Corporate Social Responsibility, this basic challenge should be enlarged to include all potential conflicts of interest within a firm; this not only from a

shareholders' point of view, but from the broader stakeholders' perspective (Van den Berghe and Louche, 2004, p.13).

There is no formal link between Corporate Governance (CG) and Corporate Social Responsibility (CSR) with the only exception being the OECD guidelines which contain an explicit recommendation to this extent. However, there is an evolving connection between the two. Risk and transparent reporting are essential component of Corporate Governance codices.

Risk in connection with CSR includes the environment, labour, social issues as well as the company's reputation. The value of a corporation can suffer visibly if any of these risks materializes, i.e. by falling revenues or by losing its license to operate. Accordingly a growing number of investors expect that CSR risks are being reported in a meaningful, detailed, quantified and timely manner and they expect corporation to install an effective risk management system, which also takes these CSR risks properly into account.

The attitude towards CSR is very responsive to the corporate governance system, since it exerts an influence on the importance given to different stakeholders. The listing brings in the foreground investors' expectations generally increasing

¹ In corporate governance terms, as it is known, the principal is defined as the shareholder(s) while the manager is seen as the agent.

enterprise exposure towards media and the public entailing a greater importance of the image compared to other companies. If, on the one hand, the reputation is the expression of the company's identity, on the other hand it imposes a special attention to transparency and fairness of behaviour, creating a close connection with the overall development project of the company and the creativity in satisfying the needs of the stakeholders. All this is pointed out by data concerning listed companies, which are higher (or considerably higher) than those related to other companies (Unioncamere, 2003). The debate whether there is a convergence or divergence in CG systems around the world can find useful hints if we consider the concept of Corporate Social Responsibility. The basic corporate form has already achieved a great deal of uniformity; i.e. economies are approaching a world-wide consensus, managers should act in the interests of shareholders and this should include all shareholders, whether controlling or non-controlling. If we include the set of stakeholders in the subjects that managers have to consider in their decision making process, the border within Corporate Governance and Corporate Social Responsibility becomes very thin. There are three principal factors driving economies towards consensus: the failure of alternative models (e.g. manager-oriented, labour-oriented, and state-oriented models of corporate law), the competitive pressures of global commerce, and the shift of interest group influence in favour of an emerging shareholder and stakeholder class. Convergence in corporate law proceeds more slowly than convergence in governance (CG and CSR) and Italy can be a good example of the application of this process.

Because of historical (e.g. importance of the cooperative movement) and structural (the predominance of Small and Medium Sized Enterprises – hereafter SMEs) reasons, the attentiveness to the social relationships of companies has characterized the Italian national economic system. As we will see, the Italian Corporate Panorama is permeated by various corporate social responsibilities initiatives, both at private and public level, that derive from different approaches and tools.

This paper presents in par. 2. an evolution of the CSR and CG concepts, in par. 3 and 4 the actual non-explicitly defined system of CG in Italy and some of its advantages and disadvantages, in par. 5 and 6 the actual state of application of CSR in Italy and one of the most recent initiatives in terms of CSR that incorporates many principle of “good” corporate governance. Paragraph 7 concludes.

2. Some evolutions on CG and CSR concepts: a short survey

Corporate governance has generated intense interest among institutional investors over the past few years

- with particular attention to the area of protecting socially relevant interests - as it has generated interest among large Italian groups which capitalise on the opportunity to protect stakeholders and to create “added value” for them through good corporate governance.

Corporate governance is concerned with the way in which corporations are governed by management. In particular, corporate governance is connected with the relationship between the management of a company and its ownership. A situation that is quite common is that ownership and management do not have the same objectives or subjective aims. For instance, the main objective of management and ownership could be to have the highest possible profit. But shareholders may be interested in such an objective because they prefer to have maximum dividends while management could be interested in high profit because this is a method of acquiring capital to invest without using external financial sources (Hughes 1994; Mayer 1994).

A definition for corporate governance can be built starting from the qualitative goodness of Board operations. Sheridan and Kendall (1992 p. 22) state, “Management is concerned with the company's operations, governance with ensuring that the executives do their jobs properly”. So, corporate governance is a form of quality assurance on the Executive Board's operations.

As Dunlop (1998 p.236) points out, “Corporate governance is widely regarded as the evaluation of the performance of the executive Directors of the company by, or for, the company stakeholders (shareholders, employees, banks and creditors)”. This definition highlights the important role of incentive that the Board receive from the Annual General meeting, in terms of control and reward. Probably the widest and more complete definition of corporate governance can be found in the work of Zingales (1994) in which corporate governance is defined as “the complex set of constraints that shape the ex-post bargaining over the quasi-rent generated in the course of a relationship” (Zingales 1994 p.3). Even in the work of Zingales there is evidence that a main role in this kind of system is played by the initial contract which, however, will be incomplete in the sense that it will not specify the division of surplus in every possible situation. The reason for this incompleteness it is to be found in the fact that it could be too costly to do or impossible because the situation was reflecting uncertainty (Williamson, 1996).

In a public context it may be that the government objective is to maximise profit or a combination of producer and consumer surplus while the main management objective is to maximise a function of the effort in managing the firm, its pecuniary returns and the utility generated by different non-pecuniary aspects of his entrepreneurial activities. For instance, a manager can regard as a non pecuniary reward all the

personal relations deriving from his managerial role, the amount of charitable contributions, a big and fast computer (good for videogames) and possible indirect rewards (monetary or not) deriving from purchase of production input from friends (Jensen and Meckling 1976). Since the objective function of management contains these three different variables, the optimum mix of effort, reward and benefit is characterised where the marginal utility derived from an additional quantity of expenditure in corporation activities is equal to each of the non-monetary benefits, the monetary reward and the disutility of work (effort).

Clearly there are some problems connected with the ownership of the firm and effective control. Basically the main issues to be analysed can be summarised as "environment", "objective" and "behaviour". The variable environment is connected with the availability and nature of information for each actor involved. The variable "objective" can assume different spatial dimensions (single/multiple) for each of the actors involved and the "direction" that the "objective" can have is of fundamental importance too. As previously seen, some objectives can be the same (maximum profit) but the action deriving from achieving the objective could be completely different considering different actors. Instead, in other situations, we could have completely conflicting objective between principal and agent. The variable "behaviour" is completely inter-connected with the other two previously examined variables. Given the nature of information and the nature of the objectives of the different actors, the possible set of behaviour could be large enough to be impossible to control.

The antagonism between capital and labour or between private interest and common good is obsolete, though this is not to say that there is a harmony, but rather that there is a resulting disharmony. The key lies in tension and in conscious searching. CSR begins where dualist thought ends (Van den Berghe and Louche, 2004).

Bowen (1953) provided the first modern contribution to the theme of CSR. He proposed the following definition of the social responsibilities of the businessman: "It refers to the obligations of businessmen to pursue those policies, to make those decisions, or to follow those lines of action which are desirable in terms of the objectives and values of our society" (1953, p. 6). In Bowen's opinion, businessmen are responsible for the consequences of their actions in a sphere somewhat wider than that covered by their profit-and-loss statements (Carroll, 1999, p.270).

The CSR concept evolved in the following years despite some scepticism (Friedman, 1962, 1970) and many authors have underlined the positive relationships between social responsibility and business opportunities in terms of market opportunities, productivity, human competence and improvement of the competitive context (Tencati et

al., 2004), i.e., the quality of the business environment in the location where companies operate (Porter and Kramer, 2002). Managers of firms have obligations to a broader group of stakeholders than the simple shareholders; a stakeholder is "any group or individual who can affect or is affected by the achievement of the firm's objectives" (Freeman, 1984, p. 46). Corporate Social Responsibility "encompasses the economic, legal, ethical, and philanthropic expectations placed on organizations by society at a given point in time" (Carroll, 1991; Carroll and Buchholtz, 2002). Therefore, by pursuing economic, social and environmental objectives the CSR-oriented company increases its intangible assets of knowledge and trust, which support the processes of value creation (Joyner and Paine, 2002). The stakeholder value created makes it possible to reward, in specific and appropriate ways, the different social stakeholders who contribute resources. Sustainability therefore becomes the strategic objective of socio-economic systems and responsible companies (Perrini and Tencati, 2003), which aim to pursue long-term economic development, consistent with promoting social needs and protecting the environment (Margolis and Walsh, 2003).

Corporate governance and CSR are two concepts that draw vigour from the same source: transparency, accountability and honesty.

Business activities and business operations need an ethical foundation, as the colossal downfall of major corporations has recently demonstrated both in the USA and in Europe (Zsolnai, 2002). As scandals spread throughout the corporate sector and into significant global organizations, management researchers have begun to examine ethics and social responsibility from a more global perspective. Doing so has been hampered by the lack of research that has a global perspective. Much of the literature on CSR, which is still in an emergent stage, has a national (US) or regional (Europe) focus. This is not surprising given the different cultures, laws and institutions that provide the context for social responsibility.

The European Union (hereafter EU) is concerned with CSR because it can be a positive contribution to the strategic goal adopted in March, 2000, during the European Council in Lisbon: "to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion" (Commission of the European Communities, 2001, p. 3). The Green Paper (presented by the European Commission in July 2001) suggests an approach based on the strengthening of partnerships among all interested parties (for example, companies, NGOs, social partners and local authorities). After the consultation process on the Green Paper closed on December 31, 2001, the EU has begun to work on a new document. The new Official Communication entitled "CSR: A

Business Contribution to Sustainable Development" has been released on July 2, 2002 (Commission of the European Communities, 2002b).

According to the Green Paper, "CSR is essentially a concept whereby companies decide voluntarily to contribute to a better society and a cleaner environment" (Commission of the European Communities, 2001, p. 4) and "a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis" (Commission of the European Communities, 2001, p. 6). An increasing number of companies recognize social responsibility as part of their identity. This responsibility affects employees and more generally all stakeholders and this in turn can influence corporate success. The Green Paper identifies four factors, which lie behind the growing success of the CSR concept:

1. The new concerns and expectations of citizens, consumers, public authorities and investors in the context of globalization and large scale industrial change;
2. Social criteria, which are increasingly influencing the investment decisions of individuals and institutions both as consumers and as investors;
3. increased concern about the damage caused by economic activity to the environment;
4. Transparency of business activities brought about by media and modern information and communication technologies.

The EU proposes a framework to better understand the different elements of CSR: according to this approach, CSR has an internal and an external dimension. The CSR internal dimension encompasses human resources management; occupational health and safety management; business restructuring; management of environmental impact and natural resources. The CSR external dimension, which goes beyond the doors of the firm and involves many stakeholders, affects local communities; business partners, suppliers, customers and consumers; protection of the human rights along the whole supply chain and global environmental concerns.

Therefore, in order to respond to the pressures coming from society, companies should integrate social and environmental concerns into their business strategies, their management tools and their activities. That means going beyond compliance and investing more in human, social and environmental capital. Finally, the EU underlines the need for a holistic approach towards CSR integrated management in order to include social and environmental aspects into corporate planning, measuring and controlling of processes and to define a long-term strategy which minimizes the risks linked to uncertainty (Tencati et al., 2004, p.177).

The Green Paper defines a general framework for CSR, influencing the behaviour and strategies both in terms of public policies and private initiatives. The project launched in June 2002 by the

Italian Ministry of Labour and Social Affairs on social responsibility of enterprises, as we will see, aims at promoting CSR among companies within this general European framework.

3. Separation of ownership and control in Italy

The possible way to separate ownership and control, in the private sector of Italian economic system, has not been based on a unique model but on a set of different models for the different kind of enterprises involved. The principles and norms of good corporate governance have been developing since the early 1990's, while they have been applied only recently. This can be seen as the way in which the system was self-organising given the fact that in Italy there has never been a law on corporate governance issue. Here we summarise the most common way to control firms in Italy:

i. For all the *individuals firms* (that in Italy represent a very high percentage of all the existing firms²) the individual exerts control with a majority of voting rights. It is more common among small firms and extremely rare among the largest ones.

ii. A *hierarchical group control* is the most frequent corporate governance model; it accounts for 52 per cent of manufacturing activity and is more frequent among larger firms.

iii. *Family control* is the second most relevant model. This is the case where family links exist among those in control or between the latter and non-controlling shareholders.

iv. *Coalition control*: is a model quite similar to the previous one but more complex. The trust-link between entrepreneurs and investors is based on their sharing common values (belonging to the same industrial district, to the same political party etc.). In a sort of way this can be interpreted as a Japanese Keiretsu and might be forged further with formal agreements.

v. The *financial supervision* model, where financial guarantees to non-controlling shareholders are represented by the presence of financial companies with privileged information exerting monitoring (banks, merchant banks, institutional investors etc). This model was basically absent among Italian manufacturing firms in 1992 since the Banking law did not allow the banks to own a relevant quota of shares in a firm.

vi. *Group*: important components of Italian economy are "Groups". A group is a set of companies with separate legal status, which are all subject to the direct or indirect control³

vii. *Voting rights in the AGM*. The Italian law does not adopt the principle of one share-one vote. Shares with limited vote (*privilegiata*) and non-voting shares (*saving*

²This control model accounts in 1992 for approximately 9 per cent of the activity of manufacturing firms with more than 50 employees. See Bianchi et al.1998

³The ways to obtain the direct or indirect control in a group are several and they are not defined directly by the Italian law: The most *common ways* (see Bianchi et al. 1998) are: *through one or more lines of control - of one leadership - an individual, a coalition* of individuals or a government body.

shares) can be issued by listed companies. Even non-listed companies can issue shares with limited vote (i.e., just in an extraordinary AGM). The use of share without voting rights is however not widespread⁴.

viii. For "*società cooperativa*" the rule one share-one vote becomes one shareholder-one vote, according to which each shareholder has only one vote, whatever share of capital he owns. Under the Italian law multiple voting shares are forbidden. Voting caps instead are legal for listed and non-listed companies. The voting cap was very common for privatised companies: before the placement of its shares, the Government used its powers as shareholder to introduce voting cap amendments to the statutes of most of the companies to be privatised⁵.

ix. *Shareholders' agreements*. Another source of separation between ownership and control are shareholders agreements. Shareholders' agreements concerning listed companies had to be notified to Consob, their contents have to be published in the press and they also have to be deposited at the company's register.

x. *Cross shareholdings*. A further source of separation can be found in the use of reciprocal shareholdings. The set of rules in this case is quite complex and it basically dependent on the fact that the firms involved are all listed or are not listed or some of them are listed and some not. The 1998 reform has introduced major changes in this regime. For a comprehensive analysis of this category and all the possible cases see Bianchi *et al.* 1998

xi. *Circular Holdings*. The separation between ownership and control may be obtained also by circular holdings, a device which is in place when a company A holds shares in company B, which holds shares, in company C, which in turn holds shares in A. Circular holdings are neither prohibited nor limited by the Italian law.

xii. *Interlocking Directorates* are not subject to any limitation under Italian law. They are not relevant for anti-trust purposes. It is also to note that no indirect disincentive against such separation tool comes from the legal regime of Directors' conflict of interests: the case law has in fact greatly relaxed such regime (which was originally intended to be quite strict).

At this point, an important feature is to understand which are the legal constraints that are present in Italy among the several forms in which a firm can be legally organised. The most relevant legal distinction is between partnerships, where liability is unlimited for at least some of the owners, and limited liability companies, where liability is, normally, limited. For the former, the legal regime is quite basic and a wider discretion is left to private parties' arrangements. For the latter, the law designs also the internal structure of the company, and is normally mandatory.

An important contribution to identifying the fundamental elements to establish effective corporate governance was the 1996 "Corporate Governance Project for Italy". Its scope was to adapt the US-based COSO Report (Committee of Sponsoring

Organizations, USA 1992) on internal control, and to further examine the roles, responsibilities and processes of various players (shareholders, directors, supervisory bodies, external audit companies and other stakeholders).

The Consob provisions of 1997 charge the board of directors with the obligation of supervising the general trend of operations within the extent of their controls, stressing the importance, among other things, of the exercise of proxies assigned. Many of the issues arising from the above-mentioned project were then resolved via the reform introduced by the Draghi law on corporate governance (which came into force in 1998), while leaving ample room for self-regulation by market regulatory authorities and company statutory independence).

As a consequence, certain corporate governance principles have in fact been stated in subordinate legislation, particularly by the implementing regulations subsequently issued by Consob. A further and fundamental contribution in the Italian context was the Code of Conduct for listed companies, issued in October 1999 by Borsa Italiana S.p.A. and also known as the Preda Code.

The drawing up of the Code by a Committee for the Corporate Governance of Listed Companies, with the necessary competence and authority, received strong support at the beginning of January 1999, showing the Italian business world's need for a definition of "best practice" in company effective management. The Committee deliberately sought conformity of the Code of Conduct guidelines to the international context, with a view to making the Italian situation increasingly comparable to and competitive on the international scene. A recent further confirmation of the importance of the principles of corporate governance was provided by the creation of the STAR segment ("segmento titoli alti requisiti": high qualified security segment), operational since Spring of 2001.

This decision represents a revolution for the Milan stock exchange, as it rewards those companies that best apply certain fundamental corporate governance rules. Following the Freedomland case, which brought under fire the regulations governing company listing and the retaining of such status, the supervisory (Consob) and market management (Stock Exchange) authorities have sought to increase the reliability of investment in listed companies.

The last important legislative act influencing corporate governance in Italy is the legislative decree 19/01/03 no. 6 that has introduced, for the S.p.As (Stock company) two alternative management and control systems, respectively deriving from the German/French and English experience and recommended by the EU Council Regulations on the "European Company By-laws" dated 8 October 2001.

a) The "*dualistic*" system (s. 2409 ff., Civil Code)

This alternative provides for

⁴At the end of 1997, they represented together only 8.4 percent of the total Milan Stock Exchange capitalisation (7.1 percent for nonvoting shares and 1.3 percent for shares with limited vote). See Bianchi *et al.* 1998.

⁵See 1994 law on privatisation by the Italian Parliament.

i) a Management Board, with the same type of responsibilities as those which are attributed to the BOD and

ii) a Supervisory Board whose tasks are wider than those of Statutory Auditors, in that it sees to the appointment and revocation of Management Board members and to the approval of the company's accounts. The Supervisory Board is also exclusively enabled to promote actions in liability against members of the Management Board and to waive such actions by way of settlement out of court. Consequently in a company managed in accordance with this two-tier system the functions of the Shareholders' Meeting are confined to appointing and revoking members of the Supervisory Board.

b) The "monistic" system (s. 2409 sexiesdecies ff. Civil Code)

According to this system, management is entrusted to a regular Board of Directors at least one third of which must be represented by independent members. Supervision is attributed by the Board to a Management Control Committee whose members are chosen from among independent directors. It is

up to the Board to determine the number of members of such Committee. In companies which make recourse to the capital market, the Committee must be formed by no less than three members. At least one member of the Control Committee must be a registered auditor. In both types of governance, save for small unlisted companies, supervision of accounts is invariably entrusted to an external auditor or auditing firm.

Some points have been assessed even for S.r.l. (limited liability company). In the view of the legislator S.r.l should be the swiftest and most flexible tool in the hands of shareholders. Articles of associations will be set forth by shareholders in accordance with their needs. Therefore, they will be less formal and, quite probably, drawn up in the form of contracts.

In line with this very flexible structure, the managing body of an S.r.l. may be freely shaped by shareholders by way of recourse to some alternative solutions as summarised in the following figure:

	Solution 1	Solution 2	Solution 3
Body	Sole Director	Board of Directors (traditional)	Board of Directors not acting as a committee,.
Way of action	Managing Director	It acts as a committee (collectively), presided by a Chairman and by a Managing Director	Formed by a plurality of members having the same powers Depending on the shareholders' choices, such directors may operate severally, severally on certain issues, jointly and jointly on certain matters

Supervision of accounts is entrusted to a Board of Statutory Auditors or to a sole auditor only where the company share capital is in excess of € 120,000 or when the turnover or the size of an S.r.l. are beyond a certain threshold determined by law.

4. The Italian system of corporate governance: advantages and disadvantages

In Italy, dissatisfaction with the state of corporate governance has increased in recent years. This is probably due to the process of privatisation conducted in Italy with the creation of millions of new (and fractional) shareholders that probably do not have the feelings of being protected by the actual structure of corporate governance. In fact, the Italian system of corporate governance is very similar to the U.S. system but there are several differences with the role of institution and institutional investors in the two ways of governance (see Boot *et al.* 1998) and with the structure of economy. The success of the Italian economy is due mostly to the large number of small firms that perform very well. A small firm is one with less than 20 workers and in Italy this kind of firm represents 98% of the total number of firms (see Macey 1998). The solution that these small

firms find to the problem of corporate governance is the simplest possible: they lack the separation of ownership and control that generates agency problems and that basically defines the corporate governance puzzles in more complex systems.

The big differences and the main critics that the Italian system collect are connected to the low ability to fill in gaps in contingent contracts due to the poor legal system and absence of protection for investors' rights⁶. The fact that the duty of loyalty is not an operational concept in Italy for several reasons mean that Italian corporate governance also does not perform very well in terms of its ability to resolve agency problems and this is evidenced by the fact that courts have no expertise or inclination to provide protection for non-controlling investors (Barca 1994, Macey 1998). The exit device has also been unavailable. The failure of financial and non-financial institutions to act as advisers or intermediaries and the high concentration of

⁶In Italy there is not a specific law or a set of recommendations for Corporate Governance. The main document that is used to infer some principles of corporate governance is the law for the OPA (offerta pubblica d'acquisto) done from the Draghi Committee and the Legislative Decree 19 JANUARY 2003 No. 6

ownership, as well as the lack of rules concerning public offers, have prevented this development. Company law, securities law and investment regulations do not provide a framework for institutional investors to play much of a role in corporate governance. The information available to shareholders is also inadequate. Corporate bodies have exercised no independent monitoring. The Board of Directors in Italian companies is generally fully identified with controlling shareholders. The Boards of Auditors whose members are chosen by the majority shareholders can have many problems in terms of conflict of interests.

One of the main characteristics of the Italian model, the system of state-owned enterprises has come under particular attack and in 1992 a process of privatisation was initiated. Major problems have been encountered in replacing the old system with alternative devices (Barca 1997; Roncaglia 1997).

Another difference in corporate governance between Italy and other industrial countries consists of the lack of financial institutions exercising interim and ex-post monitoring via share or debt capital or via financial services. The Bank of Italy holds virtually no stake in non-financial companies. This is the result of the separation between banking and industry introduced by a law promulgated in 1936. No other financial institutions have taken over the role of banks in the ownership structure of Italian companies, partly due to the absence of pension funds as a consequence of the country's broad coverage pay-as-you-go public pension system.

In the absence of financial institution, fiduciary duties and the market for corporate control, corporate governance in Italy has relied on three main actors (Barca 1997): the State, that played a double role as owner and a source of resources for the private sector; pyramidal groups and, last but not least the family and/or coalition control.

The State has directly controlled a major stake (50% of medium size and large companies. It has held 1/6 of the entire agricultural sector (1/8 in France 1/10 in Germany 1/16 in UK). De facto it has held about 80% of the commercial banking system's deposits and an even larger stake of long-term lending banks (Barca 1994). The role of the State in corporate governance is hardly salutary. The politicisation of capital investment decisions inevitably results in sub-optimal decisions on capital allocation in corporate governance system where the State plays a decisive role. So, State activism in the sector is seen much more in a political way than in an economic way. In private firms the role of active actors is fundamental in the system as the Italian one. But even here there are some criticisms that can be made. Institutional investors in general and even banks are characterised by the lack of activism that they perform in their role as creditors. Italy's particular bankruptcy law plays an important role in explaining this behaviour. Banks play a relevant role in the transfer of control when a company is in

financial distress but they do not monitor entrepreneurs' long term strategies (Barca, 1994) and they do not appear particularly active in soliciting the adjustment of companies' ownership structures.

Banks and non-bank financial institutions play a minor part in corporate governance in Italy. In spite of their remarkable share in corporate external financing, feeble bank-firm relations jeopardise the bank's role. The thin and underdeveloped stock market does not provide the appropriate arena for involvement of the other financial intermediaries in corporate governance (Ferri and Pesaresi, 1996).

As previously said, pyramidal control is another device widely used in Italy. This way of achieving separation puts the interests of minority shareholders in all subsidiaries of the groups at particular risk. The head of pyramid looks to the group as a whole but the shareholder of a particular firm of the group wants good performance for his own firm. The company at the top of pyramid if private has been governed by family control⁷ and coalition control⁸ (Bianco *et al.*, 1998).

5. CSR in Italy

A large area gathering the majority of Italian companies is characterized by the presence of enterprises having in common a substantially passive position towards CSR matters. These are mainly very small and small enterprises which usually are not familiar with CSR topics and tools. This does not exclude that these enterprises take into consideration expectations of workers and territory, but their programme implementation is informal and not systematic. This situation is explained by the informality of management aspects in these enterprises, due also to the limited resources they can allocate to the development of specific tools or high-impact projects (Unioncamere, 2003, p.8).

The characteristics of the Italian economy in terms of SMEs and network organizations represent an unique background in which to explore the relationship between CSR strategies and these two industrial specificities. The Italian system has an average of 3.9 employees per company. In industrial spheres, enterprises with over 250 employees account for 19.7% of the total in Italy. Another important feature is that the Italian industrial system is characterized by the widespread diffusion of industrial districts concentrated in Northern and Central Italy, along the Adriatic coast and in a few areas of the South (Becattini, 1987; Lipparini, 2002; Tencati and al., 2004). In some traditional and engineering industries, these districts have a

⁷An ownership structure in which the non-controlling owners belong to the same family as the entrepreneur 22% of total capital Barca 1995

⁸Where the entrepreneur and the non controlling owners share a common value and/or are linked through contracts (13%) Bianco et al. 1997

leadership position in the global market and overall account for over two-thirds of total national exports (Tencati, 2006).

Italian SMEs are an integral part of the local community and their success is often related to their capability to acquire legitimacy and consensus from local stakeholders such as employees, public authorities, financial organizations, banks, suppliers and citizens (Tencati and al., 2004). These local networks are based on informal and tacit relationships. With regard to this point, it is possible to introduce the notion of social capital.

In the contemporary debate about social capital, the aspect of trust is stressed in economics, in sociology the aspect of networks is highlighted, and in political science the aspect of civil society engagement is focused upon. Ahn and Ostrom (2002) make a distinction between three key elements of the concept: trustworthiness, network structures and institutions. The World Bank (1999) sees social capital as a key concept against poverty and inequality. It uses the following definition: "Social capital refers to the institutions, relationships, and norms that shape the quality and quantity of a society's social interactions (...) social capital is not just the sum of the institutions which underpin a society – it is the glue that holds them together".

One can distinguish two main categories of social capital: structural (roles, rules, precedents, and procedures) and cognitive (norms, values, attitudes, and beliefs). Social capital is an accumulation of various types of social, psychological, cultural, cognitive, institutional, and related assets that increase the amount (or probability) of mutually beneficial cooperative behaviour. This behaviour is productive for others as well as for one's self (Uphoff, 2000). The components of social capital are therefore many, varied and, in many instances, intangible as they consist of different types of relationship and engagements. Social capital is unlike other assets that economists call capital because investment in its development does not seem amenable to quantified measurement, even in principle. Social capital is important in CSR because it deals with the engagement in the community in which a firm is expected of to operate in order to succeed; it provides alternative currency for the stakeholder debate; it offers an understanding of the channels and internalisation/externalisation process by which knowledge flows too effectively or not at all; it highlights how firms can increase the effectiveness and efficiency of their external networks with other firms and reduce transactions costs; and how firms can find alternative means of employment, motivation and retention for their employees.

Social capital is about more than getting employees to relate to one another: this is without doubt an aspect of social capital at the micro-level, but it is not the whole picture and myopia in this

regard can lead to the neglect of the social capital which facilitates firms' interactions with their community.

Companies are inevitably and intimately involved with the communities in which they operate. Whilst in one sense they may represent an impermeable and monolithic entity installed in a foreign land, from a different perspective they are diffused, exposed and intimately involved in the communities in which they are located – whether they wish to be or not. They alter the social configuration of the communities, nations and world in which they operate, regardless of whether or not they desire this (Lombardo, 2005, p.12).

The intangible assets in terms of reputation, trust, legitimacy and consensus related to the concepts of social capital are at the basis of the long-term performance of Italian SMEs and of their districts (Lipparini, 2002).

As shown in a broad range of literature (Azzone et al., 1997; Gilardoni, 2000), the particular features highlighted above have historically influenced the diffusion of managerial tools and standards in Italy. A well-known example was the low diffusion rate in Italy of: the ISO standards on Total Quality Management (ISO 9001:1994); the environmental management systems (ISO 14001) and the voluntary environmental regulations such as EMAS (Eco-Management and Audit Scheme). Despite the limited diffusion of managerial tools, responsible business practices seem to be vital and hence an embedded element of the Italian model of capitalism centred on SMEs (Tencati et al., 2004, p.174).

In a context such as the Italian national economic system characterized by variety of structural (the predominance of SMEs and the role of local districts) and historical (e.g., importance of the cooperative movement) reasons that have conditioned the attentiveness to social relationships as a whole, several initiatives on CSR have been promoted to face the rising attention paid by public opinion to environmental protection, product safety and the respect of human and workers' rights. These spontaneous experiences from companies and institutions can be classified into three main groups: private, public and corporative association.

Private Sector Experience

With regard to the private sector, different ambits show a considerable interest in CSR issues from companies and other players. Depending on the tool adopted and its impact on corporate strategy and processes, we can divide the various initiatives into four main groups: adoption of reports/statements and other reporting activities; adoption of managing and certification systems; financial experience (ethical investment funds, rating); other initiatives.

The first group embraces accountability initiatives (on environmental, social and sustainability matters), that is, reporting on the CSR

activities, that companies started voluntarily by using manifold reference standards and methods.

In Italy:

- There are more than one hundred bodies (companies, no-profit organizations, etc.) that publish social reports;
- there are more than one hundred bodies (companies, no-profit organizations, etc.) that publish environmental reports;
- there are almost twenty companies that publish sustainability/social-environmental reports, in line with the triple-bottom-line approach that is being established at the international level.

The second group focuses on the dissemination of CSR managing systems on all its components⁹: environmental, human resource, supplier, information safety systems etc and certification systems by third parties. Environmental labels and quality labels are included in this group.

The third group embraces initiatives and projects that relate to the corporate financial area and the evaluation processes. In this context we mention:

- The phenomenon of socially-responsible managed saving or ethical finance that is acquiring a rising importance. The Forum per la Finanza Sostenibile (Forum for the Sustainable Finance) has among its members the ABI (Associazione Bancaria Italiana – Italian Banking Association), the ANIA and different banking, financial and insurance institutions with the aim to promote the sustainable development among representatives of the financial community
- the Banca Etica (founded in 1998) specialized in no-profit financing, solidarity economics, social and international cooperation.

Entrepreneurial Associations

As it concerns other initiatives, some entrepreneurial associations such as the already mentioned ABI and Federchimica have operative working groups for these issues and different research centers, technical committees which give theoretical and practical advises.

Various organizations promoted by companies and entrepreneurial associations – among which Gruppo di Frascati/Cittadinanza Attiva, Impronta Etica and Sodalitas – work within a framework of CSR with cultural promotion, bestpractice diffusion, stakeholders engagement programs etc. Furthermore, the National System of Chambers of Commerce is particularly sensitive and attentive to promoting CSR among companies working in Italy.

Public Sector Experience

Each Italian region has the possibility of contributing to the promotion of CSR in the drawing up of its development program. So far, many initiatives have

been promoted within the public sector both the regional and provincial level. As far as **Regions** are concerned:

- the Regione Toscana - starting from June 2000 - activated the Fabbrica Etica project to promote SA 8000 certification among SMEs; the certification envisages the activation of supporting training and information services and the allocation of funds to SMEs through the “Programming Complement” target n.2, 2000-2006, regarding financial aid for consultancy services. This financing should cover 50% of the total expense expected. The aim of this program is to reward companies holding a certification in the fields of environmental quality (EMAS or Iso14001) and social responsibilities (SA8000). Moreover, in May 2005 the Regional Government created an ethical regional commission for CSR, whose members are representatives of local stakeholders: Chambers of Commerce, local bodies, non-profit and non-government organization, consumer associations, trade unions and entrepreneurial associations. Three groups work within the Commission on the following items:
 - i. certification of district and production process;
 - ii. ethics in economy and finance;
 - iii. tools for CSR and its applicability to small and medium size companies.
- the Regione Umbria supported CSR with decisive action: two bills were approved, the first - the Regional Act n.20 of 2002 - creates the regional Register of SA8000 certified companies; the second - the Regional Act n.21 of November 12, 2002 titled “Measures for the certification of quality, environmental, safety and ethical systems of Umbrian companies” - provides contributions without security covering 50% of the consultancy and certification expenses, addressed to those companies who implement certifiable management systems. Enrolment in the register entitles the company to priority status for:
 - i. financial incentives, contributions and facilities, according to the regional law;
 - ii. administrative authorizations, according to the regional law;
 - iii. choice of the subject to be invited to tenders for public works or goods and services supplying, when other requirements provided by the law in force are met.
- in addition to the programme “Chiaro, Sicuro, Regolare” (CSR – Clear, Safe, Regular) about working safety and quality, the Regione Emilia Romagna entrusted the Institute for Labour with a research project to detect the conditions that could ease the voluntary access to the Label of Social Quality for regional companies;
- the Regione Marche is a partner of the project carried out by the Training Center of Marche (CFM) – a consortium of Marche’s training companies – aimed at conducting a feasibility study for the establishment of an informative system on corporate social responsibility;
- the Assessorato for Productive Activities of the Regione Campania started an investigating study on local, national and international CSR patterns and best practices.
- The CSR-Vaderegio Project, funded by the European Commission, involves four organizations: Agenda-

⁹ In 2003, there were 52 companies with SA8000 certification, out of 285 global certifications. Italy had the highest number of certified organizations in the world.

Social Responsibility in Scotland of Edinburgh (Scotland), the Flemish Ministry of Labour (Belgium, Flanders), the Novia Salcedo Foundation di Bilbao (Spain, Basque Region) and the Euro Association of Palermo (Sicily). By involving local institutions, the project aims at understanding and promoting CSR at a local level. Furthermore, the Regione Sicily supports the Etiquilias Project that involves the Regional Observatory for the Environment (ORSA), the Euro Association and various Local bodies and cooperatives.

6. The Initiative of the Ministry of Labour and Social Affairs: The “Project on CSR-SC”

The Italian approach to CSR implies a nationally widespread network of highly innovative private and public interventions. It is indeed true that many of the voluntary activities carried out by companies, mostly SMEs, despite a strong relationship with the local community, are scarcely systematic; that is, they are not structured into formalized strategic processes, and they have low visibility outside the company. This approach to CSR that can be defined as a sort of sunk CSR is a frequent phenomenon, but cannot be appreciated and deeply enhanced from the competitive point of view, with traditional interpretation patterns suitable for multinational corporations.

The Project developed by the Ministry of Labour and Social Affairs on CSR in June 2002, called Corporate Social Responsibility - Social Commitment (CSR-SC) has the aim of promoting CSR culture among companies and guaranteeing citizens that the reporting of companies on ethical and social issues is not misleading. Moreover the CSR-SC project has defined a simple, flexible and modular standard that firms can adopt on a voluntary basis in order to implement CSR policies and identify socially responsible companies. This standard is based on a list of key performance indicators to measure social performance of companies. This initiative dedicates particular attention to SMEs. The Ministry of Labour and Social Affairs accepted the proposal of Unioncamere (The Italian Union of Chambers of Commerce) to carry out a survey throughout the Italian territory aiming at providing a reference framework on the extent and features related to corporate social responsibility. The study promoted in order to increase the knowledge needed for the implementation of CSR-SC Project, has involved many stakeholders (business associations, trade unions, universities, NGOs) and the network of Unioncamere.

The survey was conducted in July 2003 by means of telephone interviews (carried out with the CATI - Computer Aided Telephone Interviews - method) on a sample composed of 3,663 companies, which was stratified taking into account three

structural features: business size, economic macro-sector and geographical areas.

The research underlined that business size influences deeply companies' stance towards social responsibility. Middle and large-sized enterprises have a high propensity to CSR; whereas, in very small and small-sized enterprises the commitment to CSR issues is limited, even though they show some signs of interest, in particular:

- the tools expressing values and guiding principles are quite well-known, as well as ISO 14001 environmental certification and EMAS registration;
- a large number of enterprises belonging to the first two business sizes make money donations and sponsorships on a regular basis;
- a high percentage of enterprises require from their suppliers a quality certification of the product/service or adopt it directly;
- enterprises with 20-49 employees implement many practices in favour of employees: flexible hours, meetings on a regular basis to present strategies and results achieved, training for more than 20% of the staff.

The differentiation existing among geographical areas, even though of minor importance, can be attributed to two variables:

- the socio-cultural context;
- the legal- institutional context.

As regards the socio-cultural context a greater attentiveness to CSR was noticed in areas where there is a concentration of services sector and most advanced industry and where companies with foreign capital and companies which are generally more open towards foreign markets are based. With regard to the knowledge of elements related to social responsibility, for instance, values above the average were noticed in Lombardy and in North-East (Unioncamere, 2003).

The second important variable is the legal-institutional context. Importance is hereby given to the noticeable influence of local regulations: in this regard, legal measures boosting the different management systems related to some CSR aspects stand out. During the Third European Conference on Corporate Social Responsibility held in Venice on November 14, 2003, the Ministry of Labour and Social Affairs proposed a two-level standard framework. Common elements of the proposal are the following:

- voluntary approach;
- corporate self-assessment;
- no traditional certification mechanisms;
- a set of performance indicators.

The first stage (CSR Level) is based on the set of performance indicators and on a system of guidelines in order to support companies in the self-assessment of their own social performance and in its reporting through a Social Statement. The main steps of this level are as follows:

- a company decides, on a voluntary basis, to participate in the CSR-SC project and present the Social Statement according to the set of indicators;

- an independent Authority, proposed by the Ministry of Labour and Social Affairs, is expected to be the party responsible for the final evaluation of Social Statements sent by participating companies;
- a comprehensive database will be organized to collect and make available the relevant information on the initiative.

The second stage of the project (SC Level) is based upon companies undertaking a proactive role in supporting the welfare policies promoted by the Government and local authorities. If a company, on a voluntary basis, decides to go beyond the CSR Level (presentation of the Social Statement and review carried out by the independent Authority), it participates, through its own resources, in the projects of social intervention proposed by policy makers. The underlying perspective is to integrate private and public resources according to a modern welfare mix approach and the subsidiary principle.

The CSR-SC Project, as we have seen, has the aim of promoting socially responsible behaviour among companies. In order to guarantee standardization in data presentation and comparability between the results obtained by different companies, the set of performance indicators will serve as an optimal point of reference in preparing the Social Statement. This set is projected according to a flexible and modular approach. In general, it is possible to identify at least three categories of companies that can use these indicators:

- publicly traded companies;
- large private companies;
- small and medium-sized private companies.

Listed companies should implement the most exhaustive reporting process according to a principle of broad disclosure (adopting the complete set of indicators).

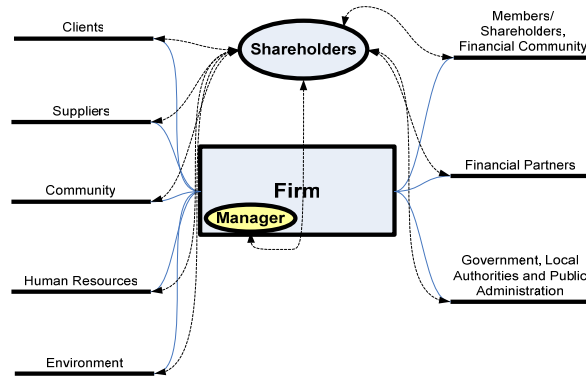
With regard to private companies, the purpose is to identify, within the framework, those measures which best meet information needs without requiring processing efforts which are beyond corporate capacity and resources:

- SMEs should use a set of common indicators;
- large companies should also adopt some additional indicators.

On the basis of the results of more than twenty pilot tests carried out in collaboration with pioneering companies of every size, the Ministry of Labour and Social Affairs proposal organizes the indicators according to a three-level framework (Global Reporting Initiative, 2002):

- Categories: Stakeholder groups which are specifically affected by clusters of indicators;
- Aspects: Thematic areas monitored by groups of performance indicators related to a given category of stakeholders.
- The indicators: Measurements that supply information related to a given aspect. They can be used to check and demonstrate organizational performance. The information can be qualitative, quantitative (physical and technical) or economic-monetary.

The stakeholder categories identified are: 1. Human Resources; 2. Members/Shareholders, Financial Community; 3. Clients; 4. Suppliers; 5. Financial Partners; 6. Government, Local Authorities and Public Administration; 7. community; 8. Environment:



The structure based on stakeholder categories focuses on the relationships and the related performance which companies, and especially SMEs, develop through their activities and behaviour. In the Italian context networks between companies and local stakeholders affect in a direct way the overall corporate performance (Zaheer, McEvily & Perrone, 1998). The survey gives a picture of a group of "selected companies" defined in coherence with the goals of the research project CSR-SC. Although the sample represents the overall population of Italian enterprises in terms of size, sector and geographical distribution, it is not a random sample. In any case, the survey pointed out some specific spheres of interest.

According to the findings of the survey, Italian companies showed a positive attitude towards CSR. Despite an unclear definition of CSR, firms seem to be engaged in socially responsible activities using several tools: specific programs on social issues, sponsorships, donations, direct investments and adoption of codes of conduct. The main reasons at the basis of the CSR initiatives are related to company image and relations with local communities. In particular, the relationship between SMEs and local community seems to be fundamental in order to understand the choices carried out by the companies in this field. This could be explained if we refer to the concept of social capital as key-driver for the long-term success of the firms in the Italian context (Tencati et al., 2004).

The survey identified some factors that could lead to the diffusion of CSR among firms in the near future. From a policy perspective, the public support is a critical factor in fostering CSR behaviour. In addition to fiscal incentives, companies need information on corporate social issues (the lack of publicity on CSR is one of the main obstacles to the diffusion of CSR). Public Authorities have to

develop and spread knowledge about CSR in the business community through promotion and communication.

7. Conclusions

In a liberal economy, without government interference or regulation, the optimal firm behaviour is to ignore externalities, but the welfare economists, conscious that externalities can be very important, developed the thesis that it is the role of government to create stimuli to induce firm to take external factors into consideration. Given the social impact of the new invisible hand – constituted, in an information age, by various pressure groups, however, a forward-looking firm prefers to take into consideration all direct and indirect external effect of its operation, that is it prefers to take its societal responsibility into its own hands. In so doing it also hopes to make further regulation unnecessary.

In theory, CG refers mainly to the mechanisms which protect outsiders and ensure an effective working of the firm, while CSR refers mainly to the objective function of the firm and attention for various stakeholders. CG refers to the system by which business corporations are directed and controlled.

The principles of CG are an integral part of CSR which include:

- the right of shareholders;
- the role of stakeholder;
- disclosure and transparency;
- the responsibility of the board.

To assess the static efficiency of Italian corporate governance, reference can be made to two specific stages in a company's life when corporate governance is especially important: fast growth (and entry) and crises. While an a-priori judgement of the static efficiency of Italian corporate governance is therefore ambivalent, it seems there are no doubt about the negative dynamic efficiency of the system. Dynamic can be defined as a concept of efficiency that takes into account not just existing entrepreneurial skills but also those which would develop if all individuals were given fair access to control.

Several factors played a role in impeding turnover within the entrepreneurial establishment: the financial obstacles to entrepreneurs, particularly new entrants, who lack the right connections; the stickiness of the model of family control; the strong collusion between the top managers of state owned enterprises and top politicians who have helped each other to stay in power. People's abilities to develop new skills have been reduced.

It is probably the case that persistent dynamic inefficiencies, and the related consequent inequality of opportunity for upward social mobility, explain much of the consensus at the beginning of the 1990s for a reform of the entire system of corporate governance centred on a reduced role of State

ownership. But the consensus for reform must be attributed to the perception that on the grounds of static efficiency the disadvantages by then largely out-weighed the advantages.

As regards fast growth and entry, by putting forced saving at the disposal of managers, State ownership mobilises finance for fast development, while family and coalition control allows accumulated savings to be channelled to investment since formal institutions are lacking. But these devices are inadequate to govern the growth of both small and large companies when there are shortages of capital, which should be matched by long-term debt or by private risk capital. The preponderance of short term debt and wide use of collateral are particularly unsuitable for financing fast growth, especially when firms do not have much of a record. Similarly, both family and coalition control tend to prevent the raising of new "outside" risk capital. For an entrepreneur to attract funds to finance his projects, qualities that most people do not possess are required: families' ties or political and social links with well-off members of society. Growth tends to be limited by the capital of incumbent families and coalitions. Several facts seem to corroborate this evaluation: the limited diffusion and high concentration of ownership; the very small size of the stock exchange; and the lack of medium sized firms.

However, in a series of other aspects, the Italian experience may offer some insights of general use, especially in analysing transitional economies. When a crisis occurs, all 3 models, family, coalition and State, tend to reduce the risk that signals of bad performance might too easily unsettle an allocation of control, even when there is no misallocation. This is possibly one of the main advantages of Italian governance environment. On the other hand, due to lack of continuous monitoring, these models may increase the risk of the opposite error: that a misallocation of control, though signalled by bad performance, does not lead quickly enough to transfer control. The relative independence of management from ministerial bureaucracies (serious problem when the latter are inefficient; Perrow 1995) can be another extraordinarily effective tool in separating ownership and control and this can play an important role in states where the all or the majority of corporations are in public hands. This is even more important during stages of powerfully accelerating growth and when shifts in the sectoral balance are needed; especially when a rapid generational turnover in management is also required. Political authorities must neither interfere excessively in management by frequently shifting their goals (Laffont and Tirole 1993) nor collude with management. To avoid collusion, sanctions are needed: the political market replaces the market for corporate control. The State in Italy has transferred substantial funds to firms (owned or not) in order to overcome situations of financial distress. It has

bought out mismanaged companies, has provided subsidies to achieve delayed restructuring and has granted subsidised credit.

For the Italian model of corporate governance to work, state owned enterprises must not be "limited" by special social objectives, such as worker participation or the rescue of ailing companies: the public policy aim of the model should be restricted to the highly relevant one of assuring control to individuals lacking resources to acquire control via ownership. Finally, if there is no functioning political market to guarantee democratic change (this is not the case of Italy of course but in some transition economies there are still some problems of existence of a sort of "political market") of parties in power and if the "missio" culture of public manager is eroded the system is bound to degenerate: top managers and political overseers will inevitably capture one another. Adopting CSR may signify a holistic treatment of the corporate governance system. It generally results in better relations with stakeholders, more transparency and greater capacity for risk management, therefore in an enhanced corporate reputation. Effective CSR has to be developed on a "voluntary basis". Nevertheless, existing national and European legislation, international conventions and other regulations deal with a number of issues that fall within the scope of CSR, whereby companies are legally bound. These are mainly concerned with social problems and environment protection.

CSR is continuously evolving; it has to be truly embedded in corporate values and strategic management process in order to generate long-term results.

This paper contains an outline of the initiatives carried on in Italy in the CSR field. The coexistence of different private and public approaches reflects the complex nature of the Italian economic system. However, Italy is at the forefront of CSR initiatives in Europe and despite the challenging global economic environment, the first signs of the kind of stable, economic growth that CSR promotes are beginning to take place.

The research CSR-SC that Bocconi University and Unioncamere carried out for the Italian Ministry of Labour and Social Affairs synthesizes some critical elements that deserve mention here:

- the relevance of European-wide guidelines;
- the existence of numerous spontaneous CSR initiatives;
- the divide between SMEs and large companies (by size), but also interesting differences by geographical areas and industry.

Stimulated and influenced by the new invisible hand market parties start to consider CSR and good CG as the prerequisite for sustainable growth and welfare within a globalising business environment.

In a competitive environment, firms need to balance the costs involved in coping with externalities while keeping their long-term economic profit in mind.

Numerous pressures to make the business world responsible might lead to creating extreme and unrealistic expectations and defining CSR in too broad perspective.

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INTERNAL AUDIT RISK ASSESSMENT AND LEGAL RISK: FIRST EVIDENCE IN THE ITALIAN EXPERIENCE

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Abstract

The objective of this article is to analyze how Italian Firms comply with the Internal Audit rules regarding the administrative liability of entities and to explain what the effect on the organizational structure was. In particular we collected data from 21 companies listed on the S&P/MIB index by sending a questionnaire to each Internal Audit Director. We show the features of internal audit system required by the 231 Italian Decree and how risk assessment and internal audit could serve as Corporate Governance Instruments. The 231 Italian Decree, like the *Sarbanes-Oxley* Act enhances and extends companies' accountability, transparency and integrity especially in business conduct. The innovativeness of this work is due to the idea of considering these elements as influential for the risk management optimization. As a consequence, a risk reduction can be achieved by improving the organizational and management models. Thought is commonly accepted that the risk optimization leads to a reduction of the cost of capital for the enterprise, there is a difficulty in estimating how much the value provided could be.

Keywords: Internal Audit, Risk Assessment, Legal Risk

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+ "Even if this paper is the result of the shared research of all the authors, paragraph 1 can be attributed to A. Miglietta – Project Coordinator – paragraph 2 can be attributed to M. Anaclerio and paragraphs 3-4-5 can be attributed to C. Bettinelli."

1. Introduction and Objectives

This work aims to investigate how Italian Listed Firms comply with the Internal Audit rules regarding the administrative liability of entities. We considered a group of companies listed on the Italian Stock Exchange at the S&P/MIB Index. The S&P/MIB index shows the trend of equities which are selected considering their liquidity, their free float and their sector representation. It is the new benchmark for the Italian stock market.

The analysis of this group is important to value the Internal Audit efforts implemented after the Legislative Decree 231/2001 which regards the administrative liability of corporations. Under this law the company is liable for crimes committed in its interest or to its benefit by individuals who represent, administer or manage the Company. The crimes which determine the administrative liability of the companies are illustrated in Appendix 1, consider for example: embezzlement detrimental to the State, extortion, misappropriation of public funds (*peculation*), Market Abuse, fraud, corruption, false corporate communications, impediment to control, illicit distribution of profits and reserves etc..

The Company is exempt from liability for the crimes committed by the aforementioned individuals,

if it proves it has adopted and effectively implemented appropriate *organizational and management models* to avoid the crimes. Furthermore it has to have charged an *internal Board* (i.e. Supervisory Body) with monitoring the functioning of and compliance with the models adopted.

The exemption from administrative liability for crimes is, for enterprises, an opportunity to reduce the risk of legal action, lawsuits or juridical proceedings (*legal risk*).

This means that managers can reduce the probability of negative situations and of losses due to Pecuniary penalties, Disqualification penalties, Confiscation and Filings of judgment.

The reduction of *legal risks* is allowed only if the company has implemented organizational and management models which prevent the crimes, this implies an improvement of the Internal Audit Function. Our objective is to show that there are some important connections between these factors, in particular we will illustrate that legal risk can be reduced if the company puts into practice a Risk Assessment Process and an efficient Internal Audit System. These synergies led to the abovementioned risk-reduction which is fundamental for the creation of shareholders value by reducing the cost of capital.

2. Internal Audit and Italian Legislative Decree n. 231

The growing attention that companies operating on the Italian Market now dedicate to problems relating to internal control systems is a significative sign of the fundamental importance that such systems have on the smooth running of the companies themselves.

The need to better and optimize company risk assessment as a critical factor in achieving their own strategic aims, the international and national scandals, often a result of the weak internal control systems of the companies involved and the general inadequacy in the running of the same, as well as the frequent problems of internal revision, organization on behalf of the administrators and management responsibility, are all factors to be considered positive and stimulating because aimed at improving the administration of our companies, in respect of the normative and the interests of all the stakeholders.

Undoubtedly the companies that have from the beginning shown more sensitivity to such problems are those quoted on the Stock Exchange, the majority of which have thought it best to adapt themselves to the indications given in the “Codice di Autodisciplina” (Code). Although not a binding rule for the companies – that remain free to adhere – the Code (recently reviewed in March 2006) has gained the merit of propagating in our economic system the principles of ‘best practice’ in matters of corporate governance, as a system of pre-arranged rules on the planning, management and control of the company activity in its various aspects. In particular, a large part of the non-obligatory normative in the Code refer to the problems regarding the role, the composition, the performance and the responsibilities of the board of administration as well as the adoption of an adequate internal control system, with “rules, procedures and structural organization in order to consent, by means of an adequate procedure of identification, measure, management and observation of the principle risks, a healthy company conduction, that is correct and coherent with the aims that have been fixed in advance”.

Given the entity and the involvement of the structure of the company, the Code provides the board of administration with the assistance of an Audit Committee for the definition of the guide lines of the internal control system as well as for the periodical rating of its adequacy. Furthermore, in order to guarantee even better operative coordination between the Board of Administration and the Audit Committee, the nomination of an Executive Administrator has been recently suggested with the job of supervising the smooth running of the internal control system. In particular, his duties regard the identification of the principle company risks, the execution of the guide lines defined by the Board of Administration and the proposal of the figure of a responsible for Internal Audit.

It is clear that this last intervention introduces the necessity to form an Enterprise risk management,, beginning with the more complex company organizations, with the duty to render the management of company risk a “corporate” aim.

The adoption of systems of company management characterized by an optimization of risk management has slowly but surely touched even those companies that are not quoted on the Stock Exchange, becoming a necessity felt more and more by medium enterprises that operate in our economic system. Such a necessity embraces moreover the regime of responsibility of the administrators disciplined by Art. 2381 c.c, in terms of adequacy of the organizational, administrative and accountancy system of the companies.

Theoretically the civil code provides for a Board of Auditors with the responsibility of supervising the adequacy of the system of internal control.

In such a context can be placed the D.Lgs. 231/2001, that introduce into our regulations the discipline of the administrative responsibility of corporations for a series of crimes – peremptorily foreseen by the decree – committed in their own interests by those that hold posts of representation, administration or direction of the same.

The innovation consists in the fact that if such crimes are committed in the interests of the company, as well as the person or persons who have committed the offence being held personally responsible, the company must respond with heavy financial and / or administrative penalties. This regime of responsibility is applicable only for certain types of crimes: offences against the public administration, company offences, offences against public trust, terrorism, subversive behaviour and crimes against individuals.

The D. Lgs.231 is substantially an ‘open’ normative in the fact that it is subject to continuous integration and up-dating according to the type of responsibility. However the legislative decree does leave a loop hole in that there is a possibility that the company will not have to respond if it can prove that:

1. The Board had adopted and successfully implemented, before the date of the offence, an appropriate organizational, management and control model to avoid the crimes.
2. The supervision of the functionality and the observance of the organizational model has been attributed to Internal Board (supervisory Body) that has freedom of initiative and of control.
3. Someone has committed the crimes eluding in a fraudulent way the organizational model.
4. There has not been insufficient supervision on behalf of the Supervisory Body.

It is possible to note how the adoption on behalf of the company of precautionary methods in order to protect themselves from the risk of crimes being committed, does not in any way constitute an obligation, only for the fact of not having adhered to

the indications in the legislative decree. The implementation of the organizational model constitutes rather the opportunity for the company to revisit that part of the internal control system that gives it the possibility of having an adequate management and risk assessment against those offences specifically foreseen by the D.Lgs. 231, and therefore a minimization of the impact that these would have on the company itself. Therefore, even if there is no normative obligation for an adequate internal control system, it is obvious that the companies that are more sensitive to a culture of company assessment will not want to underestimate this.

It is possible therefore to assert that Internal Audit and organizational, management and control model according to the D.Lgs 231/2001 are fundamental in the context of an optimal management of the company. The risk assessment of the company in all of its aspects and possible manifestations is undoubtedly a necessary condition in order to reach the company aims efficiently and successfully. A company that does not adopt an adequate management system, that permits it to plan its aims and to verify this, by means of a system of regulations and structures oriented to optimize its risk profile, will have difficulty in expanding and resisting competition.

It is certainly obvious though that an optimal internal control system and the necessary up-dating for a functionality has certain costs for the company (not only financial costs, but also in terms of impact on the organizational structures). But it is also true that the company will benefit in terms of risk profile. The adoption of adequate control procedures, will allow the company to reduce its exposition to risk of economical and patrimonial loss caused by those who operate within the company itself.

It is interesting to see how such considerations take on certain relevance on the value generation of the company. In fact on an equal basis of free cash flow generated by management, the company that is able to contain its risk profile, thanks to an adequate internal control system, will be able realize that same cash flow at a tax rate - expression of the cost of the capital in its two components (Equity and Debt) - more content and therefore with a less reduction in generated economic value in respect to those companies with a higher risk profile.

Finally, related to such a theory is the relevance that the risk profile of the company has on the rating placement and the credit merit according to "Basilea 2".

Among the elements and facts that the Financial Institutions take into consideration for the rating, are those of a qualitative nature that can lead back to the governance system adopted by the company and the adequacy of its administration and its accountancy. A company that is found lacking under this profile would certainly benefit from a lower rating and consequently a heavier financial cost, with a higher

impact in terms of devaluation in the generated financial flow.

3. Theory and literature review

Corporate Governance has become an important issue because business activities are nowadays a concern not just for shareholders, but also for the community in general, influencing individuals' savings and investment decisions (Abrahami 2005)¹. In fact Corporate Governance means both directing the company as efficiently as possible and managing the broader responsibilities the company has with its stakeholders. These relationships are the core subject of present laws in force both in the United States and in Europe.

The American experience demonstrates that the *Sarbanes-Oxley Act* (SOA) compliance is a vital device that binds large international and local companies to enhance and extend their accountability, transparency and integrity especially in business conduct and financial reporting. The Sarbanes Oxley Act has a direct and severe impact on all US listed companies which have to fulfil particular obligations regarding information storage, business intelligence, data warehousing, documents management and internal audit. The SOA is mainly dedicated to the following arguments:

Public Company Accounting oversight board, Auditor Independence, Corporate Responsibility, Enhanced Financial Disclosures, Analyst Conflicts of Interest, Corporate and Criminal Fraud Accountability, White Collar Crime Penalty enhancements, Corporate tax returns, Corporate fraud and accountability. Considering the topic of this article, the most significant sections of the Sarbanes-Oxley Act are Sections 302 (Corporate responsibility for financial reports) and 404 (Management assessment of internal controls).

In accordance with Section 302 the principal executive officer is responsible for establishing and maintaining internal controls, has to design such internal controls to ensure that material information relating to the issuer is made known to such officers by others within those entities. Moreover he/she has to present in the report, conclusions about the effectiveness of internal controls.

The signing officer has to also disclose this information to the issuer's auditors and the audit committee of the board of directors.

Moreover Section 404 imposes the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting. It also requires an assessment of the effectiveness of the internal control structure and procedures. The SOA is a complex issue and it concerns all the aspects of

¹ Abrahami, A. 2005 "Sarbanes-Oxley Act Compliance" in *Management Services* 49 (3) :28:32

the company, notwithstanding this, it must to be considered that internal controls are pivotal to the Sarbanes-Oxley Act compliance.

Surely there are a lot of important similarities between the United States and European Union's corporate laws. In the Italian case, most of the rules contained in the SOA are foreseen in a similar manner to those in the Civil Code, in the Legislative Decrees No.58 of the year 1998 and No.231 in 2001, furthermore in Law No. 262 of 2005 ("law for the protection of savings"). It is possible to find a strong resemblance between the SOA and the Legislative Decree 231 taking into consideration that to comply in practice with the Sarbanes-Oxley Act, many companies formed corporate project management teams, frequently consisting of existing internal audit staff.

This kind of team typically has to draw up a personalized structure and methodology for assessing the company's internal control, the setting of projects, strategies and timescales (McNelly and Stephen 2005)². In the report issued by Deloitte & Touche³ it is argued that in the *Sarbanes Oxley era*, Internal audit appropriately structured, can provide great value to an organization, influencing both regulatory compliance and operational excellence. As a matter of fact, internal auditors can reduce costs for the company, by improving accounting controls, financial examinations and organizational support.⁴ As a consequence Wallace (1984) found that the savings that the companies could achieve in bolstering the work of the internal audit (IA) function averaged 10 percent of the independent and external audit fees. In the transaction cost perspective (Williamson 1975,1979,1991)⁵ it would be very expensive for an external IA provider to get the knowledge necessary to perform IA tasks while the firm may already possess the internal knowledge from its functioning activities (Lindow and Race 2002)⁶.

² McNelly, J.S. Wagaman D.D.2005 "Hard Climb is Done, But Trek Continues :Sarbanes Oxley Compliance in Year Two and Beyond" in Pennsylvania CPA Journal.76 (3):1-4

³ Optimizing the Role of Internal Audit in the Sarbanes-Oxley Era, second edition 2006, Deloitte & Touche Report

⁴ Wallace, W.1984 "Internal Auditor can cut outside CPA costs" in Harvard Business Review, 62 (2) 16:20

Wallace, W.1984 "Internal Auditor can reduce Independent audit fees" in Journal of Accountancy, 158 (4) 172:175

⁵ Williamson. O. E. 1975. *Markets and Hierarchies: Analysis and Antitrust Implications*. New York, NY: The Free Press. Williamson. O. E. 1979. "Transaction-cost economics: The governance of contractual relations" in *The Journal of Law and Economics* 22 (2) 233:261. Williamson. O. E. 1991. "Strategizing, economizing, and economic organization" in *Strategic Management Journal* 12 (8) 75:94.

⁶ Widener S.K., Selto F.H. 1999 "Management Control Systems and Boundaries of the Firm: Why do Firms Outsource Internal Auditing Activities?", in *Journal of*

Accordingly with the Agency Theory (Jensen and Meckling 1976)⁷ agency costs are generated by the conflict of interest and information asymmetries between owners and managers of the firm.

In this view IA, may also serve as a monitoring answer to agency costs (Anderson et.al 1993; De Fond 1992; Carey, Simnett and Tanewski 2000)⁸. The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) defined internal control in an effective manner which could be useful to explain the relationship between internal audit and risk assessment. The COSO definition of internal control expands the internal audit's traditional activities, such as practices focused on policies and procedures, to embrace additional elements focused on control environment, information, communication, risk assessment and monitoring. Auditors need more than a catalogue of controls to measure how management deal with risks. Some best practices to be considered are monitoring business activities and performance indicators constantly coordinating with other organization's functions, building up the audit plan based on risk main concerns and getting involved in technology projects (Lindow and Race 2002)⁹. In other words, many internal auditors now offer more mixed control information and guidance than they did as traditional supervisors of only financial control situations (Widener and Selto 1999)¹⁰. An Internal Audit therefore regards how company's activities are managed, organized and monitored (Miglietta Anaclerio 2005)¹¹. The attribution of the risk management role is incorrect, in fact the IA should only *monitor* the risk management process (Protiviti 2005)¹². In the rational decision process, managers

Management Accounting Research, 11 45:73

⁷ Jensen M.C., Meckling W.H. 1976 "Theory of the firm: Managerial behaviour, agency costs, and ownership structure" in *Journal of Financial Economics* 3 305:360

⁸ Carey P., Simnett R., Tanewski G. 2000 "Voluntary Demand for Internal and External Auditing by Family Businesses" in *Auditing: a Journal of Practice and Theory* 19 37:51; Anderson, R. Francis J.R., Stokes D.J. 1993

"Auditing, directorships and the demand for Monitoring" in *Journal of Accounting and Public Policy* 69 (12) 353:375; DeFond, M. L. 1992 "The association between changes in client firm agency costs and auditor switching" in *AUDITING: A Journal of Practice & Theory* 11, 16:31.

⁹ Lindow P.E., Race J.D.2002, "Beyond Traditional Audit Techniques" in *Journal of accountancy* 194 (1) 28:33

¹⁰ Widener S.K., Selto F.H. 1999 "Management Control Systems and Boundaries of the Firm: Why do Firms Outsource Internal Auditing Activities?", in *Journal of*

Management Accounting Research, 11 45:73

¹¹ Miglietta A. Anaclerio M. "Il D.Lgs 231/01 sulla responsabilità amministrativa degli Enti per le PMI: problemi o opportunità per essere più competitivi?", *Convegno Ordine Dottori Commercialisti di Bergamo*, 5 aprile 2006.

¹² Protiviti Independent Risk Consulting 2005, "Barometro dei Risk e del Risk Management italiano" prima edizione Protiviti Inc.

are likely to choose an internal and external control mechanisms combination that maximizes their profit or utility (Jensen and Payne 2003)¹³. For this reason we argue that the IA is strongly connected with strategic management decisions.

According to Woods Brinkley from the Bank of America Corporation, a good risk management is the aptitude to recognize the intended and unintended consequences of the company's actions and strategies. It's a constant activity and, in part, the role of every member of the team¹⁴.

Enterprise Risk Management (ERM) calls for supervision of a company's complete risk selection rather than for many different supervisors managing specific risks.

With ERM a company sets up risk definitions and acceptance levels, it classifies procedures to determine and calculate risks and creates monitoring activities. It is indispensable to value the impact which risks associated with any project can have on the whole business (Banham 2004)¹⁵. The creation of Organizational Models for risk management requests the introduction of the risk element in the planning and control budgets (Colombo and Cencioni 2005)¹⁶. In order to defend assets and create shareholder value, managers should consider enterprise risk management. Several current business failures are due to senior level misjudgement and mismanagement of risk, unsuccessful risk management puts strong business models in danger.

Drew, Kelly and Kendrick (2006) present a model of corporate governance composed of five elements which can support an approach to corporate risk and help in risk management. Those elements are Culture, Leadership, Alignment, Systems, and Structure, they should encourage the addressing of the complexities of risk in meeting strategic objectives¹⁷. Strategists should be interested not only in how risks are distinct and measured, but also in how they are included in the decision making (Drew and Kendrick 2005)¹⁸. Moreover, it is argued that Enterprises that have a corporate risk management approach have also an ethical culture indeed in this age of high risk, the accomplishment

of such a culture entails a longer-term cultural shift (Ewing and Lee 2004)¹⁹.

Even though internal auditors perform many activities and duties that are unrelated to corporate business accounting information systems, many of their responsibilities are related directly to the creation and *monitoring* of accounting information (Moeller and Witt 1999)²⁰.

One of the *primary responsibilities* of internal auditors is to test, evaluate and make recommendations regarding an organization's accounting system and its internal accounting controls. By doing so, internal auditors reduce the risk of fraud and protect assets from theft or loss. Internal auditors generally perform similar activities with similar benefits, particularly when they rely on an organization's internal control. Indeed both internal-and external-auditing texts devote attention to the importance of coordination between internal and external auditors to prevent duplication of effort (Moeller and Witt 1999, Knechel 2000²¹, Jensen and Payne 2003, Widener 1999).

In other words, overall responsibility for enterprise risk is changing not only because of a strategic management initiative but also because of *law* requirements and rules. Both of them require the internal audit function in a company to monitor and evaluate the effectiveness of control systems and the company's risk assessment. The 231 Legislative Decree, by stating the administrative responsibility of the Entities, resolves the problem highlighted by Pae and Yoo²² (2001). The authors argue that when the external auditor liability is excessive firms are willing to under invest in their internal control systems.

4. The Italian Case

Our research was aimed to analyze how the companies were attempting to comply with the Italian Legislative Decree 231 and to explain what the effect on the organizational structure was. In particular we collected data from 21 companies listed on the S&P/MIB index by sending a questionnaire with 51 questions to each Internal Audit Director.

All of them have implemented appropriate *organizational and management models* described

¹³ Jensen K.L., Payne J.L. 2003, "Management Trade-Offs of Internal Control and External Auditor Expertise" in *Auditing: a Journal of practice & theory* 22 (2) 99:119

¹⁴ Brinkley Woods et.al in *Corporate Board*, 2006, 27 (157), 30:30;

¹⁵ Banham R. "Enterprising Views of Risk Management" in *Journal of Accountancy*, 2004, 197 (6), 65:71

¹⁶ Colombo I. Cencioni A. 2005 "Un modello per il controllo integrato della gestione e del rischio" in *Amministrazione & Finanza* 19 33:40

¹⁷ Drew S.A.W.; Kelley P.C.; Kendrick T. 2006 "CLASS: Five elements of corporate governance to manage strategic risk" in *Business Horizons*, 2006, 49 (2), 127:138

¹⁸ Drew S. A. W.; Kendrick T. 2005 "Risk management: the five pillars of corporate governance" in *Journal of General Management*, 31 (2), 19:36

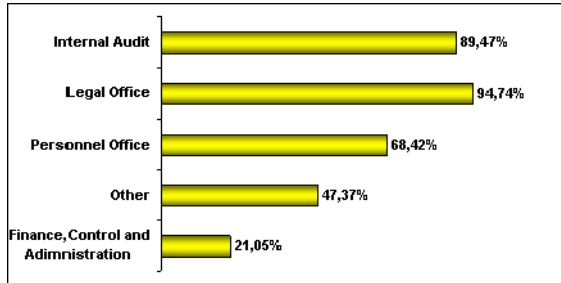
¹⁹ Ewing L.J.; Lee R. B. 2004 "Surviving the Age of Risk: A Call for Ethical Risk Management" in *Risk Management*, 2004, 51 (9), 56:58,

²⁰ Moeller R. Witt. H. 1999. "Brink's Modern Internal Auditing". Fifth edition. New York, NY: John Wiley & Sons Publishing.

²¹ Nichel W. R. 2000. "Auditing: Assurance and Risk". Second edition. Cincinnati, OH: South-Western College Publishing.

²² Pae S., Yoo S.W. 2001 "Strategic interaction in Auditing :An Analysis of Auditors' Legal Liability, Internal Control System Quality, and Audit Effort", in *The Accounting Review* 76 (3) 333:356

by Italian Legislative Decree 231. As shown on Graph 1 the companies examined referred in prevalence to their internal existing departments (Internal audit, Legal Office, Personnel Office, Finance, Control and Administration).

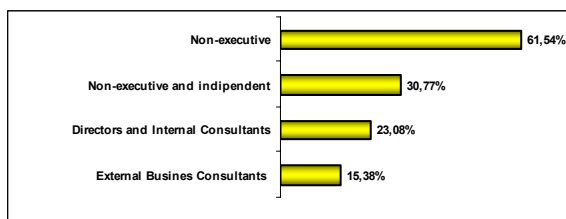


Graph 1. Departments involved

Anyhow, 90.5% combined with the abovementioned internal functions, some external consultants such as lawyers (47.37%), external auditors (36.84%), Business Consultants (21.05%) or Chartered Accountants (5.26%). The implementation of the models required in 76.19% of cases more than 6 months. In the 66.7% of companies examined there is already an *internal Board* (i.e. Supervisory Body) with monitoring functions of the models adopted.

The Internal Board (Graph 2) is composed predominantly by non executives (61.54%), non executives and independents (30.77%), directors, consultants and managers (23.08%), external Business Consultants (15.38%).

This means that the internal board is prevalently composed of internal members. Our findings are confirmed by a similar research made by the Internal Auditors Association²³ where it is shown that the Internal Board has a majority of internal auditors and only 12% of external consultants.

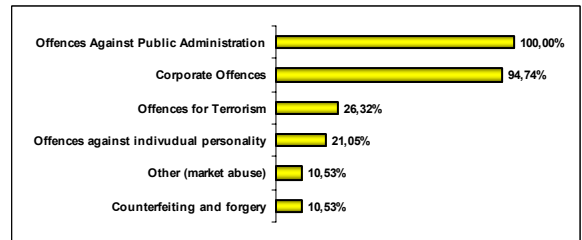


Graph 2. The composition of the internal board

In 52.5% of cases the Internal Board is assisted by external consultants which have to report exclusively to the Board. In all cases the Internal Board must report to the Board of Directors.

²³ “La responsabilità amministrativa delle società” research made by the Pisa University and the Italian Association of Internal Auditors (IIA), they considered 97 listed companies (Italian Stock exchange) the survey is available on www.iiaweb.it.

The companies declared to consider the following kind of *legal risks* as more incident on their activities: offences committed to the prejudice of the Public Administration (100.00%) and corporate offences (84.74%). Graph 3 shows the complete list of crimes including offences such as counterfeiting, forgery, offences committed for the purpose of terrorism or subversion of democratic order; offences against individual personality and Market abuse²⁴.



Graph 3. Legal Risks recognized

With reference to the types of offences indicated above, which are liable to entail a *legal risk* due to the administrative liability of the company, “sensitive” activities (i.e. Risk areas) have been identified, and broken down between those relating to: Purchase department (88.24%), Administrative and Bookkeeping Department (76.47%), Personnel department (64.71%), Finance and Control Department (58.82%), and others (17.65%).

Four Companies out of five intervened specifically in the aforesaid Risk Areas improving the internal process, the delegation schemes, the informative systems, and the whole organizational structure. The most remarkable result is that all the companies recognized that the implementation of some organizational models aimed to improve internal control effectiveness could also improve the risk-management process. Notwithstanding this, we found that it is difficult for all the enterprises to estimate and value how much this reduction would reduce the costs on capital. More than 94% declared that it is impossible to estimate the legal risk reduction due to the implementation of the 231 Legislative Decree model, internal audit system and internal board. In other words there is not, at this moment, the capacity to quantify the value created by the improvement of the Internal Audit System.

5. Conclusion

We considered a group of companies listed on the Italian Stock Exchange at the S&P/MIB Index to

²⁴ These results and the ones of a survey made by the IIAA and Ernst & Young are very much alike, indeed they found that Offences against Public Administration and Corporate Offences were the most probable. The survey was done considering 72 listed and unlisted Italian companies, it is available on www.iiaweb.it.

value the Internal Audit efforts implemented after the Legislative Decree 231/2001 which relates to the administrative liability of corporations. Under this law the company is liable for crimes committed in its own interest or to its benefit by members of the Company.

The Company is exempt from liability for the crimes committed by the aforementioned individuals, if it proves it has adopted and effectively implemented appropriate *organizational and management models* to avoid the crimes. Furthermore it has to have charged an *internal Board* (i.e. Supervisory Body) with monitoring the functioning of and complying to the models adopted.

The exemption from administrative liability for crimes is, for enterprises, an opportunity to reduce the risk of legal action, lawsuits or juridical proceedings (*legal risk*).

This implies an improvement of the internal audit function and the creation of a risk assessment process.

The interaction of internal audit and risk assessment with legal risk leads to the creation of a shareholder value, by reducing the cost of capital and of stakeholders value by reducing the probability of crimes.

For these reasons the goal of a risk management optimization implies a strategic risk factors analysis. The Italian 231 decree, like the Sarbanes Oxley Act, is a device to develop accountability, transparency and integrity of companies. Moreover internal controls are also pivotal to the compliance of the Sarbanes Oxley Act.

We illustrated how Internal audit appropriately structured, can provide great value to an organization, influencing both regulatory compliance and operational excellence. As a matter of fact, internal auditors can reduce costs for the company, by improving accounting controls, financial examinations and organizational support (Wallace 1984).

In the rational decision process, managers are likely to choose an internal and external control mechanism combination that maximizes their profit or utility (Jensen and Payne 2003). For this reason we argue that the IA is strongly connected with strategic management decisions. With Enterprise Risk Management a company sets up risk definitions and acceptance levels, it classifies procedures to determine and calculate risks and creates monitoring activities. Strategists should be interested not only in how risks are distinct and measured, but also in how they are included in the decision making (Drew and Kendrick 2005). As regards the evidence in the Italian Experience we collected data from 21 companies listed on the S&P/MIB index by sending a questionnaire with 51 questions to each Internal Audit Director.

All of them have implemented appropriate *organizational and management models* described by Italian Legislative Decree 231. The companies

examined prevalently referred to their internal existing departments (Internal audit, Legal Office, Personnel Office, Finance, Control and Administration). Anyhow, 90.5% combined with the abovementioned internal functions, some external consultants. The Internal Board (Graph 2) is composed predominantly by non executives. In 52.5% of cases the Internal Board is helped by external consultants who have to report exclusively to the Board. In all cases the Internal Board must report to the Board of Directors.

The companies declared to consider the following kind of *legal risks* as more incident on their activities: offences committed to the prejudice of the Public Administration (100.00%) and corporate offences (84.74%). "Sensitive" activities (i.e. Legal Risk areas) have been identified, and broken down between those relating to: Purchase department (88.24%), Administrative and Bookkeeping department (76.47%), Personnel department (64.71%), Finance and Control Department (58.82%), and other (17.65%).

Four Companies out of five intervened specifically on the aforesaid risk areas by improving the internal process, the delegation schemes, the informative systems, and the whole organization structure.

One of the most noticeable results is that all the companies recognized that the implementation of some organizational models aimed to improve the internal control effectiveness could also improve the risk-management process. Notwithstanding this, we found that it is difficult for all the enterprises to estimate and value how much this reduction reduces the cost of capital.

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Appendix 1

THE ITALIAN LEGISLATIVE DECREE N.231/2001

The Italian Legislative Decree includes the following crimes which determine administrative liability of the companies:

CRIMINAL CODE

- Article 316-bis** Embezzlement detrimental to the State
- Article 316-ter** Undue obtainment of grants detrimental to the State
- Article 317** Extortion
- Article 318** Bribery for the performance of official duties
- Article 319** Bribery for the performance of acts contrary to one's official duties
- Article 319** Bribery for the performance of acts contrary to one's official duties (aggravated pursuant to Article 319-bis)
- Article 319-ter** Bribery for the performance of judicial acts
- Article 320** Bribery of a person responsible for public services
- Article 321** Penalties for bribers
- Article 322** Incitement to bribery
- Article 322-bis** Misappropriation of public funds (*peculation*), extortion, bribery and incitement to bribery of members of the boards of the European Communities and of officials of the European Communities and Foreign Countries
- Article 640, paragraph 2, no. 1** Fraud
- Article 640-bis** Aggravated fraud for the obtainment of public grants
- Article 640-ter** IT fraud
- Article 453** Forgery of money, concerted spending and introduction into the State of counterfeit money
- Article 454** Counterfeiting of money
- Article 455** Non-concerted spending and introduction into the State of counterfeit money
- Article 459** Falsification of stamp duties, introduction into the State, purchase, possession or circulation of counterfeit stamp duties
- Article 460** Counterfeiting of watermarked paper used to make instruments of public credit or stamp duties
- Article 461** Making or possession of watermarks or instruments used for the counterfeiting of money, stamp duties or watermarked paper
- Article 464, paragraph 1** Use of counterfeit or falsified stamp duties
- Article 464, paragraph 2** Use of counterfeit or falsified stamp duties
- Article 270-bis** Associations for purposes of terrorism and for subverting democratic order
- Article 280** Terrorist attacks
- Article 600** Enslavement
- Article 600-bis** Juvenile prostitution
- Article 600-ter** Juvenile pornography
- Article 600-quater** Possession of pornographic material
- Article 600-quinquies** Tourism aimed at exploiting juvenile prostitution
- Article 601** Trafficking in persons
- Article 602** Sale and purchase of slaves

FINANCIAL LAW (TUF)

- Article 184** Information Abuse
- Article 185** Market Manipulation

CIVIL CODE

Article 2621 False corporate communications

Article 2622 False corporate communications detrimental to

shareholders and creditors

Article 2623 False representation in prospectuses

Article 2624 False representation in reports or notices by the accounting firm

Article 2625 Impediment to control

Article 2626 Undue refund of contributions

Article 2627 Illicit distribution of profits and reserves

Article 2628 Illicit transactions on shares or stakes of the Company or of its controlling company

Article 2629 Transactions prejudicial to creditors

Article 2632 Fictitious capital formation

Article 2633 Undue distribution of corporate assets by the liquidators

Article 2636 Illicit influence over the shareholders' meeting

Article 2637 Manipulation (*agiotage*)

Article 2638 Impediment to the performance of duties by public supervisory authorities

Regardless of the Company's administrative liability, if any, whoever commits one of the abovementioned crimes is personally and criminally liable for misconduct committed. Should the Company fail to prove the evidence above, it will be subjected to the following penalties:

Pecuniary penalties: from a minimum of € 25,823.00 to a maximum of € 1,549,371.00.

Disqualification penalties:

disqualification from conducting business;
suspension or revocation of authorizations, licenses or concessions

functional to the commission of the crime;

disqualification from contracting with P.A.;

exclusion from facilities, loans, grants or subsidies;

disqualification from advertising goods or services.

Confiscation of the price or profits from crime.

Filing of judgment.

EQUITY RESEARCH CREDIBILITY IN THE ITALIAN STOCK MARKET

*Enrico Maria Cervellati**, *Antonio C. F. Della Bina***, *Pierpaolo Pattitoni**

Abstract

In this paper we verify the degree of reliability of brokerage analysts' recommendations, with reference to Italian IPOs and measure their long-term performance, distinguishing among affiliated and non-affiliated analysts, to test the conflict of interests hypothesis against an alternative 'superior information hypothesis'. The empirical evidence shows that IPOs recommended by affiliated analysts have a long-run performance that is worse than firms recommended by unaffiliated ones by a relevant amount. This result supports the conflict of interest hypothesis, while it seems to be inconsistent with the hypothesis that underwriter analysts have superior information.

Keywords: Initial Public Offerings, Brokerage Analysts, Conflict of Interests, Market Reaction, Long-run Performance

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Introduction

Recently there has been a lively debate on the role of brokerage analysts in making recommendations to their clients. In particular, most analysts continued to issue 'positive' recommendations even if the stocks, as well as the market, performed very poorly. The problem is: are these analysts overconfident or too much optimistic, or are they just in conflict of interest? By 'conflict of interest' we intend the situation in which the responsibility of an analyst towards his/her clients to provide correct information and the incentive to give recommendations aligned with her bank's interests, with reference to its corporate finance arm. In other words, it could be in conflict for an underwriter analyst to give a negative rating to a firm that a bank has just taken public. Therefore, the analyst could be willing, or forced, to issue a positive report, or to avoid issuing a negative one, even when the firm would deserve it.

One of the main sources of conflict is due to the analysts' compensation structure that seems to be often determined, at least in part, by analysts' helpfulness to the corporate finance arm [Dugar e Nathan (1995), Lin e McNichols (1998), Dechow, Hutton e Sloan (2000)], (also see Bradshaw, Richardson e Sloan (2003) e Lin, McNichols e O'Brien (2003) for an analysis of the relationship between sell-side analysts and corporate finance activities of investment banks and the impact of this effect on the process of issuing recommendations). The other important part of their compensation is

their reputation that is based on the quality and timeliness of the recommendations they provide to investors (the reputation effect analysts' career opportunities has been presented in Hong e Kubik (2003)). These two aspects may conflict when a firm that the bank of the analyst has taken public is under coverage.

We consider the IPO market since in this case the potential conflict of interest is higher. Apart from the fact that this particular market is very profitable for investment banks, in this case the recommendations are particularly valuable since most firms are unknown by investor prior to listing and therefore need coverage to attract attention on them. Finally, a series of positive reports could improve the probability that the underwriter will be chosen for the next security offering. All these elements push on analysts to issue positive recommendations.

One of the implications of this conflict of interest hypothesis is that underwriter analysts could be much more 'optimistic' in their recommendations if compared to unaffiliated analysts, meaning that on average they issue more positive reports than independent analysts. In this case, if the market is efficient, it should react discounting for the difference between affiliated and non-affiliated analysts' recommendations.

There is, however, an alternative explanation of this empirical evidence that we could call 'Superior Information Hypothesis'. It states that investment banks have superior information on firms they have

taken public, therefore their reports would not only be unbiased, but also more accurate. This alternative hypothesis can be considered credible if we think that information asymmetry is very high in initial public offerings. If this explanation results to be correct, then the market should react with a premium to underwriter analysts for the more accurate information they possess. In the post-IPO period this would imply a superior result for investors following underwriter recommendations.

These two alternative explanations are testable, looking at the long-run performance of IPOs differentiated by underwriter relationship.

The present work has two main objectives. The first is to verify if an underwriter analyst has some incentives to issue more positive recommendations than non underwriter analysts. The second is to measure in terms of long-run performance the reactions of the market after the diffusion of the report, to verify the degree of accuracy of the recommendation.

The paper consider the Milan Stock Exchange and in particular two segments of it: the 'Borsa' (more exactly Borsa MTA), i.e. the ordinary segment of the Italian stock market, and the 'Nuovo Mercato' that includes those firms that have high-tech characteristics. We consider the price-sensitive information produced by analysts, with particular attention to 'buy' recommendations, in the post-IPO period, from one day to thirty months.

Using an event study methodology, we find very interesting results.

First, we analyze the time distribution of IPOs in the sample period, finding support for the phenomenon known as 'hot-issue market'.

Second, the market of the studies is quite concentrated: the IPOs in the first quartile of capitalization post-IPO are objective of about 40% of the total number of reports diffused in the first year of negotiation

Third, it seems that underwriter's analysts tend to issue more positive recommendations than analysts from other brokerage firms: non independent analysts display a greater aversion to produce negative reports; they have in fact produced 'non negative' recommendations in about the 94% of the cases whereas the 'negative' reports are just the 2%. The same figures for independent analysts are, respectively, 83% of 'non negative' recommendations and 11% of 'negative'.

Finally, the long-run performance of firms only recommended by their underwriters is significantly worse than the performance of firms recommended by unaffiliated analysts: the difference is significant both after one year (about 43% if measured by CAR and 39% if measured by BHR) and after two years from the IPO date (45% with CAR, 39% with BHR). These results seem to be consistent with the 'conflict of interest hypothesis' while they do not confirm the alternative 'superior information hypothesis'.

The paper is structured as follows: the first paragraph gives a brief review of the literature; the second describes the sample we used; the third highlights the distribution of recommendations; the fourth shows the market reaction to the recommendations; finally we present some concluding remarks.

1. Literature review

The role of reports and of price-sensitive information produced by analysts has been studied in the literature, following different approaches.

Some researches have documented the tendency of financial analysts to be iper-optimistic. Dugar and Nathan (1995), for example, claim that an important component of this iper-optimism is due to the relationship between the financial intermediary that pays the analyst and the covered firm. The prevalence of positive recommendations could be explained by the fact that the analyst is worried about jeopardize the relationship between his bank and the firm that has been taken public.

McNichols and O'Brien (1997) make the hypothesis that iper-optimism could be inferred by behavioral explanation and due to selection bias, i.e. analysts could decide to initiate the coverage of a firm since their valuation are too optimistic. Therefore, financial analysts start covering a firm with positive recommendations.

Womack (1996) measures the market reaction in the United States, after the diffusion of the recommendations.¹ The results highlight that the stocks that have been objective of changes in recommendations show an extra return adjusted for the market significantly different from zero: +2.4% if the rating improves, -9.1% if the opposite event occurs. The asymmetry in the two cases can be explained with the higher frequency with which brokerage analysts tend to improve their recommendations and with the cost associated with the publication of a negative rating on a firm.²

The optimism bias that affects analysts, and its potential effects on the IPO market are studied by Rajan and Servaes (1997). The authors, analyzing a sample of US stock market IPO between 1975 and 1987, highlight that at the moment of listing, analysts systematically overestimate the future earnings (upward bias). The result is that analysts are in general optimistic, particularly in the long run (i.e. when forecasting intervals are longer).

The analysis also extends to the measure of the performance of the stocks that are covered by analysts. In this case the firms with greater growth

¹ Womack's work is subsequent to the study of Stickel (1995) that is based on a sample of 17,000 changes of recommendations issued by brokerage analysts between 1988 and 1991.

² See Belcredi, Bozzi and Rigamonti (2003) on the effects of changes in recommendations in the Italian case.

opportunities record performances significantly lower if compared with their benchmarks, while those with lower expected rates of growth record performances that are higher than the benchmark ones.

Starting with the analysis of returns of a sample of American IPO in the period 1990-91, Michaely and Womack (1999) want to verify two hypotheses. The first, that could be defined as 'superior information hypothesis', affirms that the market reaction is higher, in terms of extra returns, when the recommendation is diffused by an analyst that works for the lead manager of the operation. In this case, it is possible to think that the analyst has superior information since he has closely worked with the firm that has been taken public, during the due diligence period. Superior information should result in a greater degree of accuracy of predictions and, as a consequence, in a higher market reaction. The second hypothesis, the 'conflict of interests hypothesis', instead claims that investors react to a greater extent when the recommendation comes from independent analysts if compared to the publication of a study from non-independent analysts that could have a conflict of interests.

The empirical evidence supports the second hypothesis, since in the long run the IPOs recommended only by affiliated analysts record an abnormal return much lower with respect to those that have obtained positive reports only by non-affiliated analysts. However, the same authors admit that an explanation for this result could be found in a sort of overconfidence or excessive optimism of the analysts that, having followed the firm before listing, are convinced that those firms could never record poor performances. It is difficult, however, to verify this third hypothesis. The solution adopted by the authors is to use a questionnaire sent to analysts and money managers. The answers received support, in the majority of cases, the hypothesis of potential conflict of interests.³

Barber, Lehavy, McNichols and Trueman (2001) analyze how the degree of consensus (i.e. the average judgment resulting from overall coverage of a stock) can help investors to put in place profitable investment strategies. The authors' conclusion is that the semi-strong form of efficiency of the market is probably not violated by the diffused information. The analysis support the hypothesis that the market significantly react to analysts' information but the value of this information decays quite rapidly within four or six weeks from a *buy* recommendation and longer for sell recommendation.

Nevertheless, the authors highlight how, during year 2000 the firms recommended less favorably from analysts have recorded on average market adjusted returns of 48,66% while those most

favorably recommended have lost on average about the 31,20 %, a difference of about 80%.

Bradley, Bradford and Ritter (2003) analyze the recommendations issued by analysts on US IPOs, from 1996 to 2000, with particular attention to the ones immediately following the so-called 'quiet period'.⁴

The authors find that the coverage by analysts initiates immediately in the 76% of the cases, almost always with a positive report. In a five-days window, these covered firms show an average extra return of about 4.1%, relative to a modest 0.1 % relative to stocks not covered. The higher the number of analysts following the firm, the bigger the positive market reaction, showing the greater interest of the market towards stocks covered by analysts, with respect to the ones that are neglected. Furthermore, the authors find that the market does not distinguish among independent or non-independent analysts' recommendations.

With regard to the Italian market, Fabrizio (2001) has done an empirical analysis of the reports published by analysts and collected by the Consob (the Italian Stock Exchange Commission) between 1998 and 1999 on the companies listed in the Milan Stock Exchange. The results highlight that the 58.2% of the studies contained a buy recommendation, while just the 6.1% indicated to sell. The distribution of the reports shows that financial intermediaries are more interested in covering large companies, or firms with good growth opportunities, in particular those listed in the 'Nuovo Mercato'. Furthermore, the author analyses the trading activity of the intermediaries, verifying that in several cases they operated in the opposite direction with respect to the recommendation they had just given to investors.

Bertoni, Giudici, Randoni and Rorai (2003) describe the results of a systematic monitoring of the reports published by financial analysts on the firms listed at the Milan Stock Exchange between 1999 and 2001.

Their analysis highlights some interesting phenomena: (i) the valuations are over-optimistic relative to the real operating performances, particularly in the short run, in a systematic fashion; (ii) the judgments expressed in the reports systematically tend to converge, independently of the market cycles; (iii) the valuations expressed by analysts that work for underwriters and market makers result, in general, the more optimistic, coherently with the conflict of interests hypothesis; (iv) the diffusion, often limited and not timely, of the reports generates asymmetric information between professional and unsophisticated investors, decreasing market efficiency.

³ It clearly remains to be verified if this result is significant and if the sample of analysts and money managers is representative, nevertheless the signal is very clear.

⁴ The quiet period is a time period of twenty-five calendar days following the IPO date on the US stock markets during which the underwriter's analysts are obliged not to issue any report.

2. Sample Description

To reach these ends we consider a precise informative set of reference. We examine all the monographic studies ('reports' from now on) having as objective the IPOs in the Italian Stock Market Exchange between 2000 and 2001, diffused by financial analysts operating on behalf of authorized financial intermediaries. The choice to focus on IPOs is justified by the very critical role of financial analyst in transforming the data coming from the

universe of companies that have been recently listed, and that therefore are less known by the public of investors, in accurate information that the investors can use to take their decisions about trading (The evolution of the role of financial analyst in the brokerage and corporate finance activities of investment banks is analyzed by Chung (2001)). We consider 63 IPOs, 45 in year 2000 and 18 in year 2001 (Table 1).

Table 1. Description of the sample

The sample is constituted by 63 IPOs concluded between the 01/01/ 2000 and 12/29/2001. Information about the operations that took place in 2000-2001 has been obtained from the website of Borsa Italiana S.p.A., the society that administer the Italian Stock Exchange www.borsaitalia.it. The time series of the market indexes MIB (historical MIB), MIB 30 e Numtel are obtained from the database *Datastream*. Part A of the table contains the classification of the IPOs per month and year of conclusion. Part B of the table, instead, highlights the monthly concentration of IPOs distinct per year and market of quotation.

Part A. Monthly distribution of IPOs in 2000-2001 and value (at the end of the month) of the indexes MIB, MIB 30 and Numtel

Month and Year	MIB	MIB 30	Numtel	Number of IPOs
Jan-00	27570	42130	7149	0
Feb-00	32963	49580	14388	0
Mar-00	30727	46693	12081	1
Apr-00	30138	45750	9666	2
May-00	30535	45933	7817	3
Jun-00	30686	46736	6848	4
Jul-00	30649	46429	7342	11
Aug-00	31857	47973	7620	6 ⁽¹⁾
Sep-00	30506	45329	7210	0
Oct-00	31655	47628	6587	6
Nov-00	31427	46483	5757	4
Dec-00	29681	43719	4578	8 ⁽¹⁾
Jan-01	30187	44963	5248	0
Feb-01	27576	40203	4158	1
Mar-01	26705	38991	3795	2
Apr-01	27758	40937	3807	0
May-01	26606	38872	3504	2
Jun-01	25430	37071	2848	5 ⁽¹⁾
Jul-01	24980	36738	2259	5
Aug-01	23865	34637	2199	0
Sep-01	19955	29392	1680	0
Oct-01	20845	30672	2201	0
Nov-01	21870	31736	2613	1
Dec-01	22232	32263	2492	2
Total				63

Part B. Monthly distribution of IPOs by market of quotation

Month	IPOs 2000		IPOs 2001		Total
	Borsa	Nuovo Mercato	Borsa	Nuovo Mercato	
January	0	0	0	0	0
February	0	0	1	0	1
March	0	1	0	2	3
April	0	2	0	0	2
May	1	2	2	0	5
June	1	3	4	1 ⁽¹⁾	9
July	5	6	3	2	16
August	0	6 ⁽¹⁾	0	0	6
September	0	0	0	0	0
October	0	6	0	0	6
November	2	2	1	0	5
December	4 ⁽¹⁾	4	2	0	10
Total	13	32	13	5	63

Source: our elaborations of data of the Milan Stock Exchange and from Datastream.

⁽¹⁾ The monthly total include an operation of multiple listing.

The analysis of the monthly distribution of IPOs with respect to the market indexes shows some interesting results. The number of IPOs appears to be positively correlated to the general index MIB,

which is consistent with the phenomenon known as 'hot-issue markets', i.e. the fact that IPOs are usually concentrated in periods of booms in the stock markets (see Figure 1).

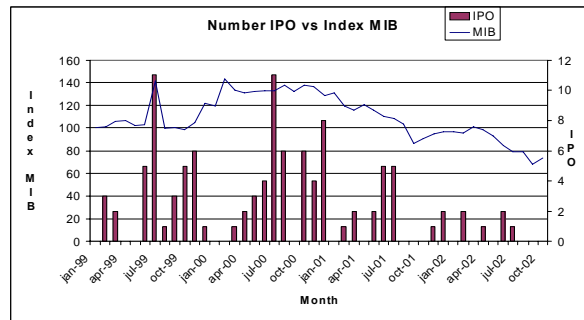


Figure 1. Monthly distribution of the number of IPOs in 2000-2001 and performance of the general market index MIB

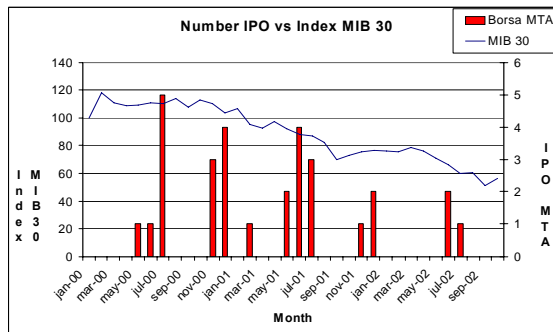


Figure 2. Monthly distribution of the number of IPOs in the Borsa MTA in 2000-2001 and performance of the market index MIB 30

This phenomenon seems to be also confirmed if we consider the IPOs on the ordinary segment of the Italian Stock Exchange ('Borsa MTA') with respect to the index MIB 30 (that includes the 30 largest firms in terms of capitalization) that are concentrated for the two years considered in the sub-periods of May-July and October-December (see Figure 2).

It is interesting to observe the trend followed by the IPOs in the 'Nuovo Mercato' if compared with the Numtel index. Even if this segment has suffered losses of about 28.4% in year 2000 and about 43% in year 2001, almost 80% of the firms that constitute the Numtel went public in these two years.

It should be underlined that the sub-period characterized by the greater number of quotations in the 'Nuovo Mercato', i.e. April-June 2000 with 19 IPOs out of 32, does not seem to be consistent with the above-mentioned observation of hot-issue markets, since there is not a punctual correspondence with the period of maximum increase of the Numtel index between June 1999 and January 2000.

The explosion of the 'Internet Bubble', that in Italy took place in February and March 2000, does not seem to have dissuaded firms and financial intermediaries to conclude the IPO procedure.

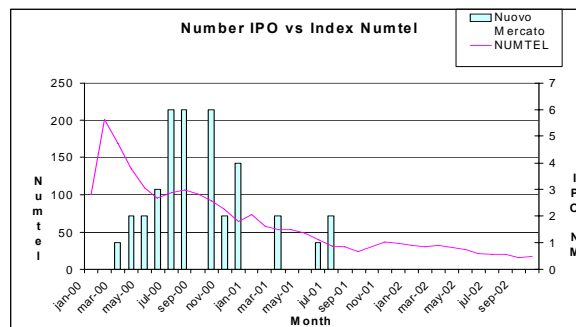


Figure 3. Monthly distribution of the number of IPOs in the Nuovo Mercato in 2000-2001 and performance of the market index Numtel

A partial, even if late, confirm to the hypothesis of reduction of the number of IPOs in correspondence of the bear market is verified starting from January 2001 and for all the year 2002 that has been characterized by a total lack of quotation in the 'Nuovo Mercato' (Figure 3). A possible explanation of the not perfect correlation between the temporal distribution of IPOs in the 'Nuovo Mercato' and the trend of the Numtel index should probably be found in the time that is needed to implement a listing operation. If we would shift the instant of negotiation of the IPOs in the period April-August 2000 by four or five months (the average time needed to conclude the IPO operation) then the choice to go public will appear perfectly justified since it would correspond

with the period of maximum increase of the reference index from the initial values of June 1999.

To value the behavior of financial analysts in issuing recommendations on IPOs, we considered 1,099 reports over the period 2000-2002: 37 (about 3% of the total) are related the pre-IPO period, and 1,062 (about 97%) with regard to the post-IPO period. The main source of information was the website of the Borsa Italiana S.p.A., which includes a dedicated section on IPOs (see Table 2). As highlighted in Part A, the great part of the reports (roughly 83% of the studies considered) refers to firms listed in year 2000, while only 184 studies (about 17% of the total) have as objective firms listed in year 2001.

Table 2. Distribution of monographic studies

Part A. Number of monographic studies per year of IPO

	Year of diffusion			Total	Total (%)
	2000	2001	2002		
No. of studies per IPO in 2000	96 (10%)	562 (62%)	257 (28%)	915 (100%)	83%
No. of studies per IPO in 2001	0 (0%)	74 (40%)	110 (60%)	184 (100%)	17%
Total	96 (9%)	636 (58%)	367 (33%)	1099 (100%)	100%

A greater degree of accuracy can be obtained re-classifying the number of monographic studies with

respect to the first year of quotation for each IPO (see Part B).

Part B. Number of monographic studies starting from the first year of negotiation

	Period of negotiation				Total	Total (%)
	Pre-IPO	1 st year	2 nd year	3 rd year		
IPO 2000	31 (3%)	460 (50%)	370 (40%)	64 (7%)	915	83%
IPO 2001	6 (3%)	154 (84%)	25 (13%)	0 (0%)	184	17%
Total	37 (3%)	614 (56%)	395 (36%)	64 (5%)	1,099 (100%)	100%

In this case, instead of considering the absolute number of reports diffused for every year, one considers as initial reference point the date of the starting of negotiations of each firm and then compute the total number of reports diffused in different windows of time.

In particular, it is possible to consider the reports issued in the sub-periods [t-n, t], (t, t+12], (t+12, t+24] and (t+24, t+36] where t-n represents the period pre-IPO, t is the first day of negotiations for every IPO and a month is constituted by 21 days of negotiation. The vectors obtained in this way permits

to observe how the great part of the studies diffused for the IPOs in 2000 and 2001 are concentrated in the first year of negotiation (respectively the 50% and the 84% of the total of the related years).

This result is interesting considering the duties borne by the financial intermediaries that participate at the IPO process. Following the regulations of the Milan Stock Exchange (See the website of Borsa Italiana), the 'sponsor' nominated by the firm has the duty to publish at least two financial reports in the first year of quotation. In addition, further obligations are required for firms who want to be

listed in the ‘Nuovo Mercato’ that have to choose a ‘Specialist’, i.e. an authorized intermediary that assumes the duty of market maker on the stocks issued. With regard to the degree of coverage, i.e. the number of listed companies in 2000-2001 that have been objective of study at least from the first year of quotation, the figure is 98.48% of the total of the

sample considered (see Table 2, Part C); in fact, only a firm in the ‘Nuovo Mercato’ has not been covered by any report. On average, during the first year of negotiation, firms listed in 2000 have received 10.2 reports, while firms listed in 2001 received 11 reports.

Part C. Degree of coverage of firms objective of study in the first year of quotation

	Number of IPOs objective of study				
	IPOs 2000		IPOs 2001		Total
	Borsa	N. Mercato	Borsa	N. Mercato	
None	0	0	0	1	1
1	2	0	0	1	3
2-5	1	6	4	2	13
6-9	2	15	3	1	21
10-19	6	9	5	0	20
20-29	0	2	1	0	3
≥ 30	2	0	0	0	2
Total number of firms objective of study	13	32	13	4	62
Total number of IPOs	13	32	13	5	63
Degree of coverage %	100	100	100	80	98.40

It is also confirmed the hypothesis, already verified in the literature, of a certain degree of correlation between the average number of reports produced and the post-IPO capitalization of the firm objective of study. Fabrizio (2001), shows that between 1998 and 1999 about 70% of the reports diffused by analysts are concentrated on firms belonging to the first quartile of capitalization (these are roughly the firms that constitute the MIB 30 and the Midex) (The Midex currently includes the 25 largest firms in terms of capitalization after the ones included in the Mib 30, i.e. mid-cap firms). Bertoni, Giudici, Randone and Rorai (2003) find that analysts focus their attention on the post-IPO period and on large cap, the studies in the first quartile of capitalization is in fact more than a half of the whole sample. In Figure 4 it is possible to observe a certain degree of concentration in the number of reports. More than a

half of the studies considered in the sample is referred to less than 25% of the IPOs in the whole period.

It is also possible to consider the distribution of the reports with reference to the capitalization post-IPO. In the first year of quotation, the 16 firms belonging to the first quartile of capitalization received on average 14.4 reports against the lower level of 6.19 reports as the average of the firms in the fourth quartile, confirming the hypothesis that analysts cover those stocks that guarantee greater volumes of intermediation, neglecting ‘thin’, less liquid stocks (See Jegadeesh et al. (2002) for some considerations on the preferences of financial analysts for listed companies with large capitalization and high expected growth rates). The IPOs in the first quartile of capitalization post-IPO amount for about 40% of the total number of reports diffused in the first year of negotiation. The trend is also confirmed for the whole period of observation (see part E).

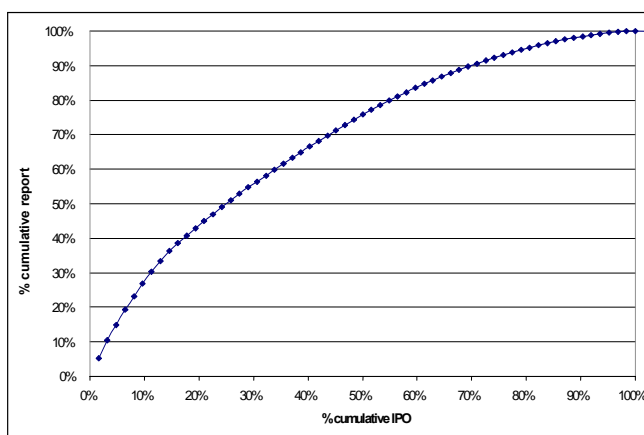


Figure 4. Concentration of reports diffused in the whole period and cumulative percentage of IPOs

Part E. Distribution of the number of reports by quartile of capitalization

Quartile of capitalisation	Whole period		1 st year of negotiation	
	Number of reports	Average number of report	Number of reports	Average number of report
Q1	402 (36.60)	25.12	230 (37.46)	14.37
Q2	282 (25.70)	17.62	151 (24.60)	9.437
Q3	245 (22.30)	15.31	134 (21.82)	8.37
Q4	170 (15.40)	10.62	99 (16.12)	6.187
Total	1,099		614	
Total (%)	(100)		(100)	

A further element to consider is the market share of subjects that produce and diffuse the reports. This industry presents a certain degree of concentration. In fact, in the first year of negotiation, 42 financial intermediaries have diffused studies; the ten more active intermediaries have produced about 73% of the studies in the period considered, confirming the influence that they can exercise on investors. The number of intermediaries issuing studies in the whole period of observation is instead 54, however in this case the ten more active intermediaries have

produce just the 61.5% of the total number of studies considered. In a time period of about 24 months from the IPO date, the intermediaries in the market of the studies increased of about 28% with respect to the first year of negotiation. This seems to confirm the hypothesis that when the firms are quoted, and therefore known by investors, then they become object of interests for the analysts that start to follow them with a periodical coverage (see Table 2, Part F).

Part F. Concentration of the market shares

	Number of studies in the whole period		Number of studies in the first year	
	Number	Percentage	Number	Percentage
First subject	121	9.08%	102	16.60%
First two subjects	237	21.56%	161	26.20%
First three subjects	329	29.93%	218	35.45%
First four subjects	415	37.76%	274	44.55%
First five subjects	476	43.31%	330	53.65%
First ten subjects	676	61.50%	449	73.00%
Remaining subjects	423	38.50%	165	27.00%
Total no. of subjects	54		42	
Total no. of studies	1099	100%	614	100%

3. Distribution of recommendations

To analyze the reliability of the price-sensitive information produced by financial analysts, and of the consequent market reaction, a first step consists in classifying the different types of recommendations. In the whole observation period, we have identified 15 types of recommendations (see Table 3, Part A). To measure the nature of the information produced, it is possible to aggregate together the different types in four fundamental categories. A second aggregation is also possible and may allow to further reduce the set of recommendations in two macro-categories:

‘negative’ and ‘non negative’ recommendations. In the post-IPO period, more than half of the reports is positive. This category is about the 57% of the whole sample of recommendations and can be divided in: ‘explicit’ buy reports (Buy 30%, Add 6%, Accumulate 3%), positive valuations (Positive 3%) and recommendations that are not ‘explicit’ buy but that indicate that the stock is outperforming the market (Outperform 15%). The ‘outperform’ recommendation can be ambiguous: in a bear market a stock can beat the market only for the reason that the benchmark is performing very poorly and not because of the quality of the stock itself. Also the category of ‘neutral’ recommendation is quite

significant: about 30% of the total (Hold 23%, Neutral 3%, Market Perform 3%). The percentage of 'negative' recommendations is instead small, 5% (Sell 2%, Reduce 2%, Negative 1%, Negative Short Term 3%, Underperform 1%). The residual category of 'Other Information' regards those reports without rating and various news or comments; only a 5% of the total regard this category.

Pooling together the first two categories, 'non negative' recommendations reach the 87% of the total number of reports produced by financial analysts.

This first result can be interpreted as an evidence of the optimistic (or at least not pessimistic) attitude of financial analysts regarding IPOs in the sample. A more interesting aspect is, however, to distinguish between 'independent' and 'non independent' analysts (see Table 3 – Part B).

An analyst is considered affiliated if she works for a financial intermediary that has participated to the IPO as a sponsor, global coordinator, specialist or lead underwriter. The unaffiliated (or independent) analysts, instead, work for financial intermediaries different from the above mentioned and that, therefore, have not participated to the listing. Non independent analysts display a greater aversion to produce negative recommendations, or they seem to be more optimistic than independent analysts. The former, in fact, have produced 'non negative' recommendations in about the 94% of the cases (positive 67%, neutral 27%) whereas the 'negative'

reports are 2%: 1% of 'sell' and another 1% of 'reduce'. Optimism or aversion to produce negative recommendations are also displayed by independent analyst, but on a lesser extent: 83% of 'non negative' recommendations (positive 51%, neutral 32%), against a 11% of 'negative' ones. The recommendations more diffuse by independent analysts are 'hold' (27%) and 'buy' (26%). One conclusion, coherent with previous studies, is a substantial homogeneity in financial analysts' recommendations, with a general evidence of a greater degree of optimism of non independent analysts that tend to give more favorable recommendations to the stock that the intermediary for which they work has taken public. This aversion of non independent analysts to produce negative recommendations is more pronounced in the first year of negotiation (see Table 3, Part C).

Negative recommendations are never issued in the short term, furthermore they are about 96% of the total while the 'buy' recommendations reach alone 42% of the total. With regard to independent analysts, it is possible to observe that both 'negative' and 'neutral' recommendations are greater in percentage than the same figures for non independent analysts: respectively the 11% and 31% against no 'negative' and 17% of 'neutral' recommendations.

This result seems at least to confirm that independent analysts are less optimistic or less averse to produce non positive recommendations.

Table 3. Types of recommendations

Part A. Distribution of the monographic studies produced in the whole period of observation

Types of recommendations	Number of studies in the whole period	Values (%)
Buy	331	30
Add	68	6
Accumulate	31	3
Positive	5	0
Positive Short Term	30	3
Outperform	160	15
Positive Recommendations	625	57
Hold	258	23
Neutral	37	3
Neutral Short Term	6	1
Market Perform	27	2
Neutral Recommendations	328	30
Sell	21	2
Reduce	27	2
Negative	6	1
Negative Short Term	28	3
Underperform	9	1
Negative Recommendations	91	8
Other Information	55	5
Total	1099	100

Part B. Type of recommendation divided by nature of the intermediary in the whole period of observation

Types of recommendations	Number of studies Non independent analysts	Tot (%)	Number of studies Independent analysts	Tot (%)
Buy	142	37	189	26
Add	31	8	37	5
Accumulate	10	3	21	3
Positive	1	0	4	0
Positive Short Term	0	0	30	4
Outperform	73	19	87	12
<i>Positive Recommendations</i>	257	67	368	51
Hold	74	19	184	27
Neutral	15	4	22	3
Neutral Short Term	0	0	6	0
Market Perform	12	3	14	2
<i>Neutral Recommendations</i>	101	27	226	32
Sell	4	1	17	2
Reduce	4	1	23	3
Negative	0	0	6	0
Negative Short Term	0	0	28	4
Underperform	0	0	9	1
<i>Negative Recommendations</i>	8	2	83	11
<i>Important Recommendations</i>	15	4	40	6
<i>Total</i>	381	100	718	100

Part C. Type of recommendation divided by nature of the intermediary in the first year of negotiation

Types of Recommendations	Non independent Analysts	Tot (%)	Independent Analysts	Tot (%)
Buy	89	42	130	32
Add	22	10	14	3
Accumulate	2	1	13	3
Positive	0	0	5	1
Positive Short Term	0	0	15	4
Outperform	54	26	35	9
<i>Positive Recommendations</i>	167	79	212	53
Hold	32	15	69	17
Neutral	2	1	47	12
Neutral Short Term	0	0	2	0
Market Perform	2	1	8	2
<i>Neutral Recommendations</i>	36	17	126	31
Sell	0	0	9	2
Reduce	0	0	8	2
Negative	0	0	9	0
Negative Short Term	0	0	21	5
Underperform	0	0	7	2
<i>Negative Recommendations</i>	0	0	54	11
<i>Important Recommendations</i>	8	4	11	3
<i>Total</i>	211	100	403	100

This kind of 'euphoria' or optimism displayed by analysts producing non negative recommendations on IPOs in the short run could be explained if IPOs are found to outperform the market. To test this kind of hypothesis we have to verify the existence of a positive correlation between the distribution of the recommendations and the performance of a portfolio of IPOs in the first year of quotation and in the whole period of observation.

To measure the performance of the IPOs in the sample we have used different methodologies on increasing periods of time (from 1 to 30 days). In particular, the first methodology is to consider 'Absolute Average Returns' (AAR), measuring the performance of the portfolio of IPOs without

adjusting for the market (see table 4, Part A and Graph 1), starting from the first day of negotiation. Even if AAR is a simple methodology, and it is often used to measure the underpricing and overpricing of IPOs in the short run, it is a useful indicator to verify in absolute terms the performance of the single stock and of the whole sample. To evaluate the long-run performance of the sample of IPOs, two methodologies have been used: the CAR (Cumulative Abnormal Return) approach, based on cumulative average abnormal return, adjusted for the market; and the Buy-and-Hold method, based on buy and hold returns (BHRs).

Graph 1 shows three series of AARs: for the IPOs quoted in the 'Borsa', in the 'Nuovo Mercato' and for the total of IPOs in the period 2000-2001.

Even if we could have data for 32 months (672 trading days), we decide to restrict our analysis on a time horizon of 28 months (588 trading days) since the number of IPOs in the sample, decreasing over time, still has an acceptable level of 32, while just after 28 months it reduces to 12.

The results are very interesting, highlighting the fact that, on average, the AARs for the IPOs depend on the market over which they are calculated. In particular, the AARs for the IPOs in the 'Nuovo Mercato' have had, in the long-run, the worst performance (-76.20%), while the best one (-

15.66%), even if negative, regards the IPOs on the 'Borsa'. Clearly, the line representing the whole sample of IPOs is between these two extremes at -58.54%.

Part B of Table 4 shows the long-run performance of IPOs in terms of CARs (see also Graph 2). The CAR methodology (see table 4 – Part B – and Graph 2) is based on the hypothesis that periodical adjustments are made to divide the available wealth in equal parts between the n IPOs. In other words, this kind of strategy implies that, instead of passively maintaining the stocks in portfolio with the quantities initially held, the stock with the best performances are sold while the ones with the worst performances are bought.

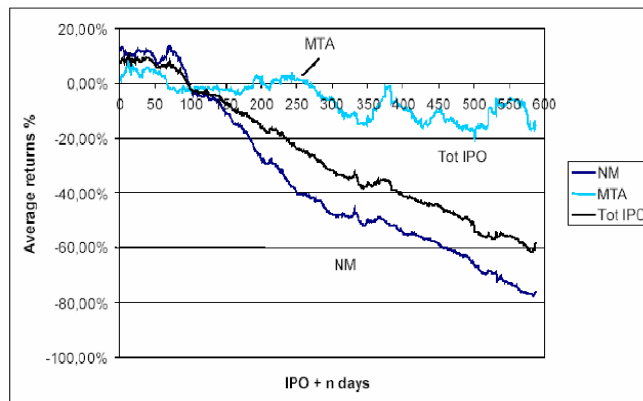
Table 4. Different measures of returns

Part A. Absolute Average Returns, not adjusted for the market

The sample includes 63 IPOs concluded between the 01/01/2000 and the 12/29/2001. The measure of absolute underpricing, not adjusted for any index, for every instant t is given by: $U_{i,t} = Ln (P_{i,t}/P_{i,0})$. $P_{i,t}$ is the market price of stock i in the negotiation day t ; $P_{i,0}$ is the issue price. The performance of the sample is given by the Absolute Average Returns in the period between the first day of quotation ($q-1$) and the instant s (with $s = 630$ days / 30 months). For every instant t , lying between q and s , the AAR_t are given by the average of the returns of the n stocks in the sample, with respect to the first day of quotation $U_{i,t}$:

$$AAR_t = \frac{1}{n} \sum_{i=1}^n U_{i,t}$$

The value of the AAR in the following table is expressed as percentages. In the column IPO + n days there is the period of time (starting from instant $q =$ the day following the first day of quotation) on which has been calculated, for every t , the AAR (the period regards the measure of s) where a month includes 21 trading days.



Graph 1. Absolute Average Returns for IPOs quoted in the 'Borsa' and in the 'Nuovo Mercato' not adjusted for the market in the period 2000-2001

For this reason the CAR methodology has been criticized since it is difficult to replicate it in practice, even because of the high related transaction

costs that it would imply. Furthermore, the cumulative structure of CAR leads to cumulate the estimation error.

Part B. Cumulative Abnormal Return adjusted for the market, using the general index Mib, for the IPOs quoted in the period 2000-2001

The sample includes 63 IPOs concluded between 01/01/2000 and 12/29/2001. The long-run performance of a portfolio of n IPOs (with $n \leq 63$) is given by the Cumulative Average Return of the n stocks, calculated in the period between the first day of quotation ($q-1$) and the instant s (with $s = 630$ days / 30 months):

$$CAR_{q,s} = \sum_{t=q}^s AR_t$$

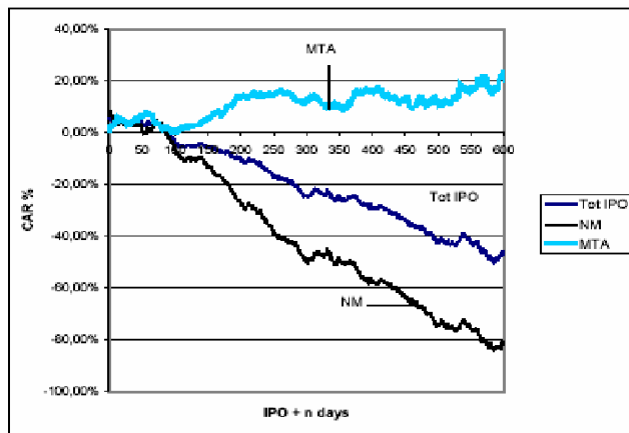
for every instant t , between q and s , the daily average returns AR_t are given by the average of the returns of the n stocks of the portfolio ($ar_{i,t}$)

where the $ar_{i,t}$ are the daily returns of the stock i adjusted for the daily variation of the market index (I): $ar_{i,t} = r_{i,t} - r_{m,t}$. The return of stock i at time t ($r_{i,t}$) is determined by the natural logarithm of the ration between the price of stock i at time t and the price of the stock at time $t-1$ [$r_{i,t} = \ln(p_{i,t}/p_{i,t-1})$]; the same methodology is used to calculate the variation of the market index [$r_{m,t} = \ln(I_t/I_{t-1})$]. The index I represents the MIB index. The CARs are expressed as percentages. In the column IPO +

$$AR_t = \frac{1}{n} \sum_{i=1}^n ar_{i,t}$$

n days there is the period of time (starting from instant q = the day following the first day of quotation) on which has been calculated, for every t , the CARs (the period regards the measure of s) where a month includes 21 trading days.

IPO + n days	Month	No. of stocks	CAR of IPO Nuovo Mercato	CAR of IPO Borsa	CAR of IPO Total
1	-	63	8.47	0.65	5.26
21	1	63	3.54	4.61	3.98
42	2	63	3.40	5.48	4.25
63	3	63	1.09	6.77	3.42
84	4	63	2.00	1.32	1.72
105	5	63	-8.39	0.48	-4.76
126	6	63	-10.39	2.91	-4.89
147	7	63	-12.43	4.87	-5.34
168	8	63	-16.47	7.65	-6.59
189	9	63	-23.92	11.64	-9.35
210	10	63	-28.10	13.54	-11.03
231	11	63	-30.48	15.12	-11.78
252	12	63	-39.27	15.29	-17.03
273	13	58	-42.18	14.92	-18.92
294	14	58	-47.87	11.15	-23.88
315	15	58	-47.10	13.33	-22.58
336	16	57	-47.12	10.01	-23.86
357	17	53	-50.47	9.79	-26.04
378	18	49	-53.52	14.96	-26.34
399	19	47	-58.86	16.07	-28.23
420	20	46	-57.95	14.01	-29.66
441	21	45	-60.81	11.07	-32.54
462	22	45	-64.69	9.87	-35.64
483	23	45	-69.77	11.22	-38.87
504	24	40	-73.02	12.05	-40.82
525	25	33	-76.02	13.92	-42.99
546	26	32	-73.82	16.11	-40.79
567	27	32	-80.63	19.00	-46.34
588	28	32	-83.19	17.59	-49.05
609	29	12	-81.54	20.39	-46.96
630	30	7	-75.86	4.52	-44.14
651	31	6	-65.60	-	-96.68
672	32	2	-20.25	-	-55.25



Graph 2. CAR of the IPOs quoted in the Borsa and in the Nuovo Mercato adjusted for the market, using the general market index Mib in the period 2000-2001

Graph 2 shows three series of CARs: for the IPOs quoted in the 'Borsa', in the 'Nuovo Mercato' and for the total of IPOs in the period 2000-2001.

Using the time horizon of 28 months, the results of the CARs confirm those found for the AARs, in terms of order of long-run performances. The long-

run performance of the IPOs in the 'Nuovo Mercato' is the worst (-83.19%), the best, and positive, are those in the 'Borsa' (+17.59%), the total of IPOs reach the level of - 49.05%.

Part C. Buy-and-Hold returns adjusted for the market, using the general market index Mib, of the IPOs quoted in the period 2000-2001

The sample includes 63 IPOs concluded between the 1st January 2000 and the 29th December 2001. The long-run performance of a portfolio of n IPOs (with $n \leq 63$) is given by the Buy-and-Hold Return of the n stocks, calculated in the period between the first day of quotation ($q-1$) and the instant s (with $s = 630$ days / 30 months):

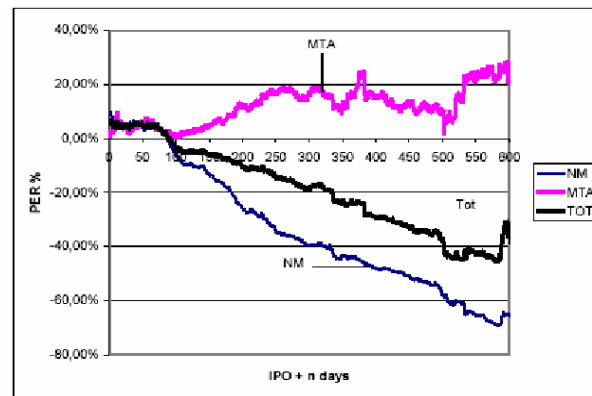
$$BHR_{i,t} = \left[\prod_{t=q}^s (1 + r_{i,t}) - \prod_{t=q}^s (1 + r_{m,t}) \right]$$

The average excess return for every period, PER_t (Portfolio Excess Return), is the average of BHR_i ; n is the number of stocks on which PER is calculated. The return of stock i at time t ($r_{i,t}$) is determined by the natural logarithm of the ration between the price of stock i at time t and the price of the stock at time $t-1$ [$r_{i,t} = \ln(p_{i,t}/p_{i,t-1})$]; the same methodology is used to calculate the variation of the market index [$r_{m,t} = \ln(I_t/I_{t-1})$]. The index I represents the MIB index. The PERs are expressed as percentages. In the column IPO + n days there is the period of time (starting from instant $q =$ the

$$PER_t = \frac{1}{n} \left(\sum_{i=1}^n BHR_{i,t} \right)$$

day following the first day of quotation) on which has been calculated, for every t , the PERs (the period regards the measure of s) where a month includes 21 trading days.

IPO + n days	Month	No. of stock	PER of IPO Nuovo Mercato	PER of IPO Borsa	PER of IPO Total
1	-	63	9.27	0.65	5.74
21	1	63	3.29	4.53	3.80
42	2	63	6.23	4.82	5.66
63	3	63	3.97	6.37	4.96
84	4	63	1.47	1.89	1.65
105	5	63	-7.58	0.48	-4.28
126	6	63	-10.03	3.03	-4.68
147	7	63	-12.60	3.99	-5.80
168	8	63	-16.14	6.39	-6.91
189	9	63	-22.04	9.29	-9.20
210	10	63	-27.06	10.44	-11.69
231	11	63	-28.45	16.36	-10.52
252	12	63	-34.90	17.48	-14.49
273	13	60	-36.10	17.73	-15.68
294	14	60	-38.98	14.42	-18.78
315	15	58	-39.38	18.36	-17.48
336	16	57	-42.58	11.07	-22.46
357	17	53	-44.09	11.34	-24.90
378	18	49	-45.29	22.56	-24.09
399	19	47	-47.77	15.50	-28.92
420	20	46	-48.81	12.83	-30.05
441	21	45	-49.90	11.26	-32.23
462	22	45	-51.91	9.64	-34.13
483	23	45	-54.20	10.42	-35.53
504	24	40	-58.08	7.23	-42.19
525	25	33	-60.51	16.40	-44.51
546	26	32	-64.52	23.46	-41.71
567	27	32	-67.38	23.31	-43.89
588	28	32	-67.78	26.46	-40.29
609	29	12	-64.92	60.57	-42.11
630	30	7	-63.09	-55.98	-62.07
651	31	6	-73.34	-	-73.34
672	32	2	-80.69	-	-80.69



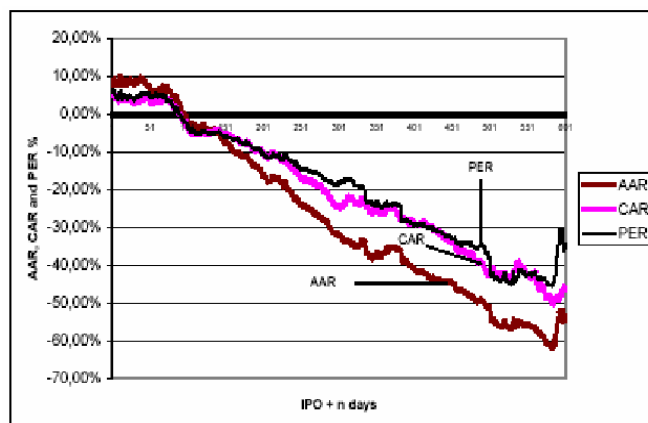
Graph 3. PER of the IPOs quoted in the ‘Borsa’ and in the ‘Nuovo Mercato’ adjusted for the general market index in the period 2000-2001

To ameliorate the drawbacks associated with the CAR methodology, an alternative method have been proposed to measure the long-run performance. This method, called Buy-and-Hold, presents the advantage of showing the result achievable ‘in practice’ by an investor that, in a certain moment, would invest the same amount of money in the stocks of the sample and liquidate this sum in the precise instant in which the periodical return is measured (see table 4 – Part C – and Graph 3). Both for CARs and BHRs, the analysis has been performed using as a benchmark for the market the MIB index. Part C of Table 4 presents the long-run performance of IPOs in terms of BHRs (see also Graph 3). The results found using the BHR methodology and calculating the Portfolio Excess Returns (PER) are similar to the ones obtained above, in terms of the order in the long-run performances: - 67.78% for the IPOs in the ‘Nuovo Mercato’, +26.46% in the Borsa and - 40.29% in total.

Graph 3 shows three series of PERs: for the IPOs quoted in the ‘Borsa’, in the ‘Nuovo Mercato’ and for the total of IPOs in the period 2000-2001.

Graph 4 compares the three series of long-run average returns for the sample of 63 IPOs in the period 2000-2001: the AAR, not adjusted for any index, the CAR and the BHR, both adjusted using the Mib index. The AAR, being not adjusted, gives the worst performance, while CAR and BHR give similar results. The analysis performed so far highlights that the attitude to produce positive recommendations is not significantly related to the performance in the period considered. In fact, the distribution of ratings shows the prevalence of positive recommendations in all the periods taken in consideration, even in bear markets. This result appears to be quite robust since it holds using different methodologies based on absolute or risk-adjusted measures of returns.

Apart from the optimism of financial analysts, this result seems to imply that the activity of research coverage can be used as a tool for booster-shooting operations, i.e. the support of the price of poor performing stocks. This last phenomenon appears to be more observable for non independent analysts.



Graph 4. AAR, CAR and PER of the sample of IPOs quoted in the ‘Borsa’ and in the ‘Nuovo Mercato’ in the period 2000-2001

2. Market Reaction to Recommendations differentiated by underwriting relationship

The conclusive step of our analysis consists in verifying the market reaction to the recommendations produced by the analysts. We want, in this case, to measure the degree of reliability of the information produced by the analysts using the long-run performance of the IPOs of our sample. The subset of information used is the vector that has as elements the reports diffused by analysts in the first year of negotiation (615 observations).

In this period we considered only the first recommendation and eventual changes in the series of recommendation, while the simple reiteration of a rating was not taken into consideration as an 'event'.

The 'event' is defined as the issue of the recommendation. The market reaction to the events should allow us to verify if the investors react in a different way to reports produced by independent or not independent analyst. The IPOs in the period 2000-2001 are thus aggregated in four main categories: (1) IPOs that have received buy recommendations only by non independent analysts (17 firms); (2) IPOs that have received buy recommendations only by independent analysts (9 firms); (3) IPOs that have received buy recommendations both by independent and non independent analysts (26 firms); (4) IPOs that have not received any buy recommendation (10 firms). The analysis of long-run performance allows identifying if there is a bias in the report of non independent analysts, i.e. if they are affected by

errors. Following the theory of efficient markets, if non independent analysts have better information that are not yet included in the stock prices, then those stocks should, in case of a buy recommendation, perform better than stock recommended by independent analysts.

To measure the performance of the sub-samples of IPOs considered above, two approaches have been used. The first measures CAR and BHR adjusted for the market using the MIB index for all the IPOs, while the second calculates CAR and BHR adjusted using the MIB index for the IPOs quoted in the ordinary segment of the Italian Stock Exchange, and the NUMTEL index for the IPOs quoted in the Nuovo Mercato. The main results are showed in what follows.

The data contained in table 5 represents the core results of the paper. The results are impressive: after 28 months, there is about a 56% difference between the long-run performances of IPOs recommended by non independent analysts (-73.93%) and independent analysts (-17.48%). After one and two years, the differences are still important: almost 35% in the first case, and more than 45% in the second. This result is very important since it implies that the market recognize, at least in the run, that affiliated analysts are overly optimistic or in conflict of interests. Even if we expected a difference in the performance of affiliated and independent analysts the results were quite surprising, therefore other measures of long-run performance were used to test the robustness of our results.

Table 5. Distribution of IPOs by underwriter relationship

Part A. CAR adjusted for the market, using the general index Mib, for IPOs in the period 2000-2001 divided by underwriter relationship

The sample includes 63 IPOs, concluded between the 1st January 2000 and the 29th December 2001. For each IPO we consider the recommendation diffused by brokerage analysts during the first year of negotiation (615 observations). Each firm has been classified by the underwriter relationship. We define underwriters banks that participated to the IPO as a sponsor, global coordinator or lead manager.

We define non underwriter those intermediaries that do not participated to the IPO in the terms above mentioned. With the expression 'buy' recommendation we intend explicit suggestions to buy the stock (buy, add or accumulate). With the expression 'no buy recommendation' we intend all the recommendations that are not an implicit buy suggestion (hold, neutral, marketperform, sell, reduce, underperform, negative short term, etc.). For each category of firms, the long-run performance of a sub-portfolio formed by n_j IPO (with $j=1,2,3,4$ and with $n_1 \leq 17$, $n_2 \leq 9$, $n_3 \leq 26$ e $n_4 \leq 10$), is given by the cumulative average returns of the n_j stocks calculated in the period from the first day of quotation ($q-1$) to the instant s (with $s = 630$ days/30 months):

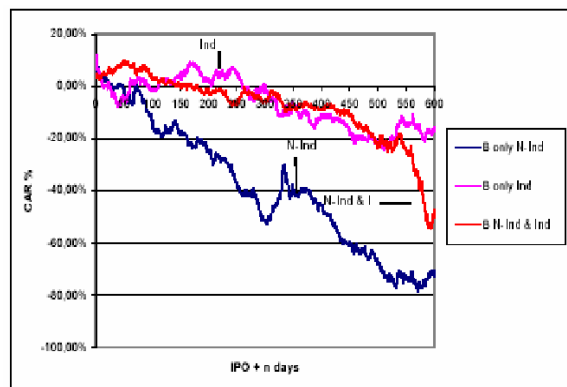
for every instant t , between q and s , the daily average returns $AR_{j,t}$ are given by the average of the returns of the n_j stocks included in the sub-portfolios ($ar_{i,t}$)

$$CAR_{q,s} = \sum_{t=q}^s AR_{j,t}$$

$$AR_{j,t} = \frac{1}{n_j} \sum_{i=1}^{n_j} ar_{i,t} \quad \text{with } j = 1,2,3,4$$

where the $ar_{i,t}$ are the daily returns of the stock i adjusted for the daily variation of the market index as earlier described.

IPO + n days	Month	CAR of IPO with BUY from non independent $n_1 = 17$	CAR of IPO with BUY from independent $n_2 = 9$	CAR of IPO with BUY from both $n_3 = 26$	CAR of IPO with no BUY recommendation $n_4 = 10$
1	-	3.14	11.53	3.94	10.60
21	1	1.93	-0.73	5.55	12.30
42	2	0.84	-7.75	7.75	10.34
63	3	-6.60	1.45	7.89	8.47
84	4	-5.17	1.86	6.99	1.21
105	5	-16.54	-1.02	3.38	-8.52
126	6	-17.39	3.00	1.20	-5.83
147	7	-17.61	3.52	0.87	-7.84
168	8	-21.94	8.41	0.55	-11.91
189	9	-21.93	3.42	-2.01	-19.24
210	10	-28.46	3.86	-2.09	-16.80
231	11	-28.21	4.21	-2.45	-22.81
252	12	-38.86	4.39	-6.00	-28.57
273	13	-41.16	-4.90	-2.45	-37.73
294	14	-51.18	-0.35	-5.51	-46.87
315	15	-47.31	-5.61	-2.78	-46.52
336	16	-33.51	-8.27	-9.26	-55.52
357	17	-41.35	-9.26	-8.20	-58.86
378	18	-40.79	-12.83	-7.69	-58.34
399	19	-45.53	-11.06	-8.80	-61.63
420	20	-52.55	-13.28	-8.22	-60.27
441	21	-59.01	-14.53	-10.78	-61.13
462	22	-60.68	-19.74	-14.53	-64.33
483	23	-65.88	-19.70	-17.03	-68.33
504	24	-68.41	-22.47	-19.39	-67.84
525	25	-73.67	-19.12	-24.57	-64.65
546	26	-71.87	-13.63	-23.26	-64.13
567	27	-76.21	-15.38	-33.84	-68.41
588	28	-73.93	-17.48	-50.55	-63.82
609	29	-65.01	-19.83	-52.32	-60.79
630	30	-75.71	-11.39	-49.78	-60.05



Graph 5. CAR adjusted for the market, using the general index Mib, for IPOs in the period 2000-2001 differentiated by underwriting relationship

In Part B of Table 5 we used the BHR methodology, obtaining similar results. The difference is still important, both at one year (almost

the 30%) and two years (more than 39%), and after 28 months reach 60%.

Part B. BHR adjusted for the general market index of the IPOs in the period 2000-2001 differentiated by underwriting relationship

The sample description is the same as part A, while the methodology used here is *Buy-and-Hold*:

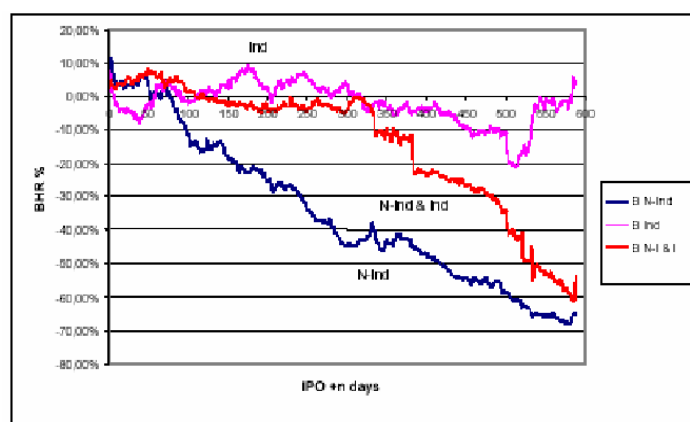
$$BHR_{j,t} = \left[\frac{1}{n_j} \sum_{i=1}^{n_j} \prod_{t=q}^s (1 + ar_{i,t}) \right] - 1 \quad \text{with } j = 1,2,3,4$$

IPO + n days	Month	CAR of IPO with BUY from <i>non independent</i> $n_1 = 17$	CAR of IPO with BUY from <i>independent</i> $n_2 = 9$	CAR of IPO with BUY from <i>both</i> $n_3 = 26$	CAR of IPO with no BUY recommendation $n_4 = 10$
1	-	3.67	7.47	4.21	12.62
21	1	2.95	-5.08	4.75	13.17
42	2	6.20	-6.58	6.13	15.23
63	3	0.17	2.81	6.11	12.25
84	4	-3.75	1.90	5.37	3.56
105	5	-13.45	-1.38	0.33	-4.41
126	6	-15.69	3.02	-2.83	-0.53
147	7	-17.50	2.99	-4.39	-1.71
168	8	-21.75	7.25	-4.74	-5.25
189	9	-22.53	3.94	-7.23	-10.47
210	10	-27.62	1.71	-8.04	-13.87
231	11	-26.87	5.22	-6.18	-19.25
252	12	-34.23	4.91	-10.01	-23.69
273	13	-37.05	0.92	-8.57	-26.42
294	14	-44.23	3.19	-10.66	30.43
315	15	-43.83	0.19	-8.20	-29.80
336	16	-41.24	-1.93	-19.50	-33.39
357	17	-43.71	-4.17	-22.60	-36.42
378	18	-43.21	-4.28	-23.84	-34.69
399	19	-46.67	-3.74	-23.17	-38.05
420	20	-50.47	-5.59	-23.72	-37.07
441	21	-53.83	-8.02	-26.04	-36.78
462	22	-54.26	-10.97	-28.05	-39.33
483	23	-56.76	-9.67	-30.55	-40.14
504	24	-58.63	-19.56	-41.05	-40.96
525	25	-62.61	-15.64	-49.47	-41.56
546	26	-65.21	-0.93	-52.05	-42.83
567	27	-66.75	-3.44	-56.25	-43.35
588	28	-64.71	4.66	-53.52	-45.74
609	29	-41.30	-5.84	-71.16	-71.87
630	30	-47.90	-57.14	-81.59	-71.42

The two methodologies used to measure the long-run performances of the IPOs confirm the intuition underlying the hypothesis that non independent analysts have an incentive to recommend the firms that are taken public by the financial intermediary for which they work, often irrespectively of the quality of the firm. In other words, there can be a substantial conflict of interest between the responsibility of the analyst towards her investors and the incentive to produce positive

recommendation on the firms quoted by the intermediary for which she works.

The sanction of the market in terms of long-term performance is quite evident and significant if we observe table 6, where we verify the statistical significance of the mean differences between underwriter and non-underwriter analysts, finding that they are highly significant both using CARs or BHRs.



Graph 6. BHR adjusted for the general market index of the IPOs in the period 2000-2001 differentiated by underwriting relationship

Table 6. Non-Independent and Independent analysts comparisons.

IPO + n days	Month	Mean differences between Non-Independent and Independent only			
		Mean Δ CAR%	t-Stat	Mean Δ BHR%	t-Stat
7	-	-0,22%	-0,0798	6,10%	2,2637 **
21	1	2,66%	0,7550	8,04%	2,3172 **
126	6	-20,39%	-2,5086 **	-18,71%	-2,3715 **
252	12	-43,25%	-3,5702 ***	-39,13%	-3,3009 ***
378	18	-27,96%	-2,4453 **	-38,93%	-3,6069 ***
504	24	-45,94%	-1,8224 *	-39,06%	-1,8483 *
588	28	-56,45%	-2,1338 *	-69,37%	-1,9877 *

Statistically significant * = 10%, ** = 5%, *** = 1%

Firms that have received positive reports only by non independent analysts have the worst long-run performance, even if compared with firms that do not receive any buy recommendation in the first year of negotiation. Another clear evidence of the hypothesis of conflict of interest is the better performance of IPOs only recommended by independent analysts.

The market reaction seems therefore to be based not on the evidence of the different quality of the analysts (i.e. the 'superior information' hypothesis) but on the status of independence of the analyst.

It remains to be ascertained if the lack of credibility of the non independent analyst is due to overconfidence or over-optimism of these analysts or just to the potential conflict of interest.

4. Conclusion

The purpose of this paper was the study of analyst recommendations of IPOs to test two different hypothesis: the 'superior information hypothesis' and the 'conflict of interest hypothesis'. The first affirms that underwriter analysts have superior information about the firms they have taken public, acquired through the due diligence process. If this is true, then their recommendations should be more accurate than those issued by independent analysts and therefore the long-run performance of the IPOs recommended by underwriter analysts should be better than the performance of firms recommended by independent analysts. The empirical evidence that we found shows the contrary and is consistent with the hypothesis of conflict of interest, i.e. that affiliated analysts have a strong incentive to issue positive rating for firms that their bank has taken public. The conflict of interest is between the responsibility towards their clients and the incentive to operate in line with the bank interests.

The post-IPO long-run performance is significantly worse for firms that were recommended by underwriter analysts than the performance of firms recommended by independent analysts. The

market reaction seems therefore to be different, depending on the nature of the underwriter relationship.

To conclude, it is possible to argue that the empirical evidence that we found is consistent with the conflict of interest hypothesis, but not with the one based on superior information. Potential improvements in corporate governance regulation both for the broker-side and the firm-side could probably reduce in the future conflicting behaviors of analysts and managers.

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INVESTMENT VALUE OF RECOMMENDATIONS IN THE ITALIAN STOCK EXCHANGE

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Abstract

Financial analysts' research activity seems to be important for investors in their investment decisions. Understanding if financial analysts' reports can influence the market and the degree of reliability of their forecasts has been a theme lively debated in the academic literature but also in the press, mainly because of recent financial scandals. The main objective of the paper is to calculate the investment value of financial analysts' recommendations on companies listed in the Italian Stock Exchange and to verify the possibility of profiting from relying on the average consensus of recommendations. We have enclosed in the analysis all the 16,634 reports issued between the 1st January 1999 and the 23rd July 2004 and available on the website of the Italian Stock Exchange, constructing a unique database for Italy. After classifying companies by quarter, five portfolios are formed based on analysts' average consensus to calculate the excess returns of each portfolio in each quarter. Our results suggest that analysts' recommendations have indeed investment value, even if investors should carefully consider neutral recommendations that can be considered as negative ones. These results, furthermore, give some interesting regulatory suggestions for a policy maker that wants to ensure transparency in the markets.

Keywords: stock market, information, investments

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1. Introduction

Financial analysts' research activity seems to be very important for investors in deciding in which companies allocate their wealth. This is mainly due by the fact that gathering all the information necessary for investment decisions involves very high costs for single unsophisticated investors. Understanding if analysts' reports can influence the market and the degree of reliability of their forecasts has been a theme lively debated in the academic literature but also in the press, mainly because of recent financial scandals (See, for example, the analysis of the Parmalat case proposed by Ferrarini and Giudici (2005) and the implications in terms of reliability of the information disseminated by financial analysts).

The paper calculate the investment value of analysts' recommendations on companies listed in the Italian Stock Exchange and verify the possibility of profiting from relying on the average consensus of recommendations. We have enclosed in the analysis all the 16,634 reports issued between the 1st January 1999 and the 23rd July 2004 and available on the website of Borsa Italiana (Borsa Italiana S.p.A. is the

managing company of the Italian Stock Exchange). Our database is unique, since it includes all the publically available reports in the considered period. Following art. 69 of the Consob (Consob (Commissione Nazionale per le Società e la Borsa) is the authority responsible of supervising the Italian Stock Exchange and the listed companies) Regulation on Issuers, in fact, all the reports issued by analysts must be transmitted to the Consob and, simultaneously, to Borsa Italiana that publish them. The archive of Borsa Italiana can be accessed on a free basis and includes reports issued from January 1999. To verify the value of the recommendations we have classified companies by quarter, based on the average consensus by analysts, and we have formed five portfolios based on this consensus. Furthermore, we have calculated the excess returns of each portfolio in each quarter. As far as we know, this is the first paper that proposes for Italy such an analysis. The results seem to support the hypothesis of the investment value of a portfolio strategy based on the average consensus of financial analysts. In the

period considered, in fact, the portfolio that includes the stocks with more favourable recommendations records an average performance of 6.92% if calculated with the buy-and-hold returns (BHR) methodology and of 4.24% if we use the cumulative abnormal return (CAR) methodology, while the portfolio that includes the stocks with less favourable recommendations records a performance of -9.70% and -12.37% with BHR and CAR respectively. The strategy of an hypothetical investor that, following analysts' recommendations, buy the most recommended stocks and sell the less recommended ones, would yield about the 16.6% (both using the BHR and the CAR methodologies). It is interesting to note the behavior of the portfolio that only includes the stock that receives neutral recommendations. Whereas, theoretically, this portfolio should record an abnormal return close to zero, empirically we find that its performance is -2.27% with BHR and -4.55% with CAR. Investors seem therefore to recognize the potential conflict of interests of financial analysts; in particular when negative recommendations can damage the relationships with the covered company.

The rest of the paper is organized as follows: the second paragraph gives a survey of the literature, the third presents the methodology applied and the database used, the fourth comments the results obtained and concludes.

2. Survey of the literature

Several empirical studies in the academic literature have focused on the predicting power of financial analysts, among others Diefenbach (1972), Bidwell (1977), Groth, Lewellen, Schlarbaum, Lease (1979), Copeland and Mayers (1982), Dimson and Marsh (1984).

Womack (1996) analyzes a sample of 1,573 analysts' recommendation changes, issued between 1989 and 1991, with respect to 822 companies, listed in the US stock market.¹ The analysis uses the information contained in the database of First Call Corporation (now Thomson Financial), a company that records in real time all reports issued by analysts. The empirical evidence shows that the stocks subject to a recommendation change records an abnormal return significantly different from zero: positive (+ 2.4%) in case of upgrade, negative (-9.1%) in case of downgrade.² The asymmetry between the two values can be explained with the greater frequency with which analysts tend to issue

upgrades and with the greater cost of issuing a negative report. Several cases are known both in the academic literature and in the financial press of analysts that have been excluded from informative meeting or that have not received relevant information from the management of a company on which they issued a negative recommendation. Thus, an analyst face a trade-off between the need of issuing reports that are reliable, to defend her reputation, and the necessity to maintain good relationships with the management of the covered companies.³ The empirical results clearly show that stocks prices and volumes are influenced by recommendation changes. The author highlights that analysts are particularly good in stock picking but also in market timing, however they mostly issue positive reports and focus on companies with higher capitalization.

Barber, Lehavy, McNichols and Trueman (2001) assess the effective profitability of portfolio's strategies based on the average consensus of analysts' recommendations. Whereas Womack's perspective is "analyst-oriented and event-time" (e.g. to measure average price reaction to changes in analysts' recommendations), the perspective of Barber et al. is "investor-oriented and calendar-time". In other terms, while the first study investigates the analysts and time is measured with the classical event study methodology, the second one focuses on investors and the analysis is performed in real calendar time. This approach permits the authors to measure directly the abnormal gross returns to a number of investment strategies and to estimate portfolio turnover and the associated transactions costs incurred in implementing them. The data used in the paper come from the Zacks database for the period 1985 to 1996, which includes over 360,000 recommendations from 269 brokerage houses and 4,340 analysts. For the sample period, Barber et al. find that buying the stocks with the most favorable consensus recommendations earns an annualized geometric mean return of 18.8%, whereas buying those with the least favorable consensus recommendations earns only 5.78%. After controlling for market risk, size, book-to-market, and price momentum effects, a portfolio that includes the most highly recommended stocks provides an average annual abnormal gross return of 4.13% while a portfolio of the least favorably recommended ones yields an average annual abnormal gross return of 24.91%. Thus, purchasing the securities in the top portfolio and selling short those in the lowest portfolio yields an average abnormal gross return of 75 basis points per month.

In a subsequent research Barber et al. (2003) extend the sample period including 2000-2001, highlight that the more highly recommended stocks

¹ Womack's work is subsequent to the study of Stickel (1995) that is based on a sample of 17,000 changes of recommendations issued by brokerage analysts between 1988 and 1991.

² The Cumulative Abnormal Return (CAR) on a three days window centered on the event day and adjusted for the size of the companies considered is 3% for buy recommendations and -4.7% for sell recommendations.

³ See, the cases reported in Belcredi, Bozzi and Rigamonti (2003).

earned greater market-adjusted returns during the 1996-1999 period than did the less highly favored stocks. For the 2001-2000 period, the opposite is true. The poor returns of most favored stocks prevailed during most months of 2000 and 2001 and characterized both tech and non-tech stocks. The authors found evidence consistent with the possibility that this reversal was a result of analysts' reluctance to turn away from small-cap growth stocks during this period, a time when such stocks significantly underperformed the market.⁴

The technique of consensus-based portfolios is also used by Boni and Womack (2003) which examine the competition between analysts. To add value to the recommendations, analysts specialize in the study of few stocks. The period considered is from 1996 to 2001. This work highlights that the returns achievable through strategies based on their reports and on changes of recommendations, record a Sharpe ratio that is five times greater than the one associated with a "price momentum" strategy. In particular, a strategy consisting in buying stocks that have been upgraded and selling stocks that have been downgraded is able to generate a monthly return of 1.4%, about the 18% per year. After a month from the change of recommendation, the returns from the stocks recommended by analysts are positive for 53 firms out of 59. Analysts' competition reduces the opportunity to profit from changes of recommendation: portfolios formed with stocks followed by a great number of analysts generates lower returns.

These results are also coherent with the broad definition of market efficiency given by Grossman and Stiglitz (1980), since positive returns are necessary to compensate for the costs needed to collect information. It seems, thus, that analysts' recommendations have investment value to investors. Using the theoretical framework proposed by Grossman and Stiglitz, and with regard to the Scandinavian countries, Von Nandelstadh (2003) investigates the investment value in analyst recommendations. If the stock market is efficient in the Grossman and Stiglitz sense, then investors should not earn net abnormal returns by using analyst recommendations. In 1994-2001, the financial analyst community's covered universe has outperformed the corresponding market index portfolio. The results show that a strategy based on the average consensus has value for investors and that excluding from the analysis the recommendations issued by investment banks the investment value grow even further. Furthermore,

⁴ See also the recent research of Jegadeesh, Kim, Krusche, Lee (2004). According to these authors' framework the level of the analysts' consensus does not contain incremental information when it is issued in correspondence with other predictive signals. It is the change in the analysts' consensus, rather than the level, to be informative.

the companies that have received the greatest number of positive recommendations are generally characterized by high market capitalization, international coverage and market-to-book ratio as well as by a positive trend of the prices in previous months. However taking into account the transaction costs arising from trading, the analysis does not find abnormal returns that are reliably different from zero, unless we do not exclude from the sample the banks.

3. The investment values of analysts recommendations

3.1 Description of the dataset

The database contains all the reports issued between the 1st January 1999 and the 23rd July 2004 and available on the website of Borsa Italiana. However, we would like to highlight the fact that at the end of July 2004, the archive on the website contained about 17,000 reports,⁵ while the number of studies received by Consob was about 25,000.⁶ There can be different explanation of this difference. The reports online, for instance, can be only a part of the reports available at Borsa Italiana.⁷ An alternative explanation is that intermediaries send all the reports to Consob, but only a part to Borsa Italiana. Of course, this behavior would result in contrast with the Consob Regulation on Issuers. It would be desirable to solve this "dilemma", and we believe that Consob, as the authority supervising the Italian Stock Exchange should verify this anomaly and make available the results of this inquiry.⁸ Starting from the whole sample, we have cleaned it eliminating reports that were not useful for our analysis, i.e. eliminating reports that were double, non monographic, without any recommendation or where it was ambiguous.

The final sample includes by 12,791 reports issued by 68 financial intermediaries on 235 listed companies. In the Appendix, we propose the main descriptive statistics of the sample of reports with recommendation, that constitutes the starting point of subsequent analysis. Comparing the number of reports received by each company with its size, it is evident that analysts focus their attention on bigger

⁵ Precisely, 16,634 reports.

⁶ In Consob, at the end of 2003 there were 21,032 reports, while at the end of 2004, 28,646. The arithmetic average is 24,839, almost 25.000 reports therefore. Clearly, this is not the exact number of studies received by Consob at the end of July 2004, since not necessarily the reports are issued uniformly during the year; however it can serve to compare with the number of reports available in the Stock Exchange website.

⁷ Emanuela Conti (R&D Office Borsa Italiana - Borsa Italiana Group), however, assured that it seems that only few studies (about 150) are available only in paper version.

⁸ To the best of our knowledge there is no such clarification available.

companies. Observing table 1, it is clear that the companies belonging to the first quartile of

capitalization received more than 57% of the reports, compared to a 7% of the last quartile.

Table 1. Distribution of reports per quartile of market capitalization (size)

Quartile of capitalization	Average capitalization	No. of reports
Q1	9,776.4	6,716
Q2	836.15	2,804
Q3	187.56	1,353
Q4	46.69	821

We find support to the empirical evidence presented in the literature that financial analysts focus their attention on stocks with higher market capitalization (See Womack (1996) on the American market. For Italy, see Fabrizio (2000) and Cervellati, Della Bina (2004). A possible explanation is that analysts work more on big companies, since they are characterized by higher volumes of transactions on which the financial intermediary for which they

work can earn higher trading and brokering commissions. A simple analysis of the degree of correlation between the number of reports issued and the number of covered companies, highlights that a small number of intermediaries produce the greatest part of studies, showing the an high degree of concentration in the sector (see table 2).

Table 2. Concentration of market shares

	Number of reports issued in the entire sample	
First intermediary	1,176	9.19%
First two intermediaries	2,332	18.23%
First three intermediaries	3,338	26.09%
First four intermediaries	4,181	32.68%
First five intermediaries	4,903	38.32%
First ten intermediaries	7,682	60.04%
Remaining 58 intermediaries	5,109	39.96%
Total number of intermediaries	68	
Total number of studies	12,791	100%

Furthermore, we highlight that only few intermediaries cover most of the companies, while the remaining prefer to focus just on few listed companies. Comparing the number of report issued by financial intermediaries with the number of companies, it is clear that the subjects that are more active in issuing reports are also the ones that cover the greatest number of companies. This highlights the importance of checking for potential conflict of interests of intermediaries that have a relevant position in the research sector. Analysts use a variety of systems in their recommendations: five, six or three points scale, or even numeric systems. For this reason, it is difficult to compare ratings issued by different analysts. Since, furthermore, few intermediaries report the rating systems they use, it is necessary to pay attention to compare recommendations that seem to be similar, but that are issued by analysts for different financial intermediaries that use different rating system. In other words, the same recommendation could mean different things in different rating systems. To

compare different rating systems it is opportune to use a homogeneous scale (In Italy, Belcredi, Bozzi and Rigamonti (2003) use a eight-points scale, while Fabrizio (2001) a four-points scale). We decided to use both a three-points and a five-points scale, to uniform our analysis to the prevailing international literature in this field. The first scale represents the simplest type of rating system since it divides the recommendations in positive, neutral and negative, using the ratings buy, hold and sell. The second scale, the most used in the literature and by analysts, is instead a five-points scale: buy, add, hold, reduce and sell. This rating system permits a wider range of ratings adding a moderate positive rating (add) and a moderate negative judgment (reduce) (Sometimes, the terms *add* and *reduce*, are used as synonymous of *outperform* and *underperform*. See Cervellati, Della Bina and Giulianelli (2005). Classifying the different types of recommendations with respect to the chosen systems, in tables 3 and 4 we present the annual distribution of recommendations between 1999 and 2004.

Table 3. Annual distribution of reports by type of recommendation (five points scale)

Year	Buy	Add	Hold	Reduce	Sell	Total
1999	14 (0.11%)	28 (0.22%)	6 (0.05%)	3 (0.02%)	0 (0%)	51 (0.40%)
2000	514 (4.02%)	300 (2.35%)	337 (2.63%)	59 (0.46%)	49 (0.38%)	1,259 (9.84%)
2001	1,006 (7.86%)	547 (4.28%)	1,028 (8.04%)	182 (1.42%)	112 (0.88%)	2,875 (22.48%)
2002	966 (7.55%)	601 (4.70%)	1,011 (7.90%)	202 (1.58%)	74 (0.58%)	2,854 (22.31%)
2003	1,072 (8.38%)	1,034 (8.08%)	1,369 (10.70%)	270 (2.11%)	126 (0.99%)	3,871 (30.26%)
2004	584 (4.57%)	446 (3.49%)	698 (5.46%)	95 (0.74%)	58 (0.45%)	1,881 (14.71%)
Total	4,156 (32.49%)	2,956 (23.11%)	4,449 (34.78%)	811 (6.34%)	419 (3.28%)	12,791 (100%)

Table 4. Annual distribution of reports by type of recommendation (three points scale)

Year	Buy	Hold	Sell	Total
1999	42 (82.35%)	6 (11.76%)	3 (5.88%)	51 (0.40%)
2000	814 (64.65%)	337 (26.77%)	108 (8.58%)	1,259 (9.84%)
2001	1,553 (54.02%)	1,028 (35.76%)	294 (10.23%)	2,875 (22.48%)
2002	1,567 (54.91%)	1,011 (35.42%)	276 (9.67%)	2,854 (22.31%)
2003	2,106 (54.40%)	1,369 (35.37%)	396 (10.23%)	3,871 (30.26%)
2004	1,030 (54.76%)	698 (37.11%)	153 (8.13%)	1,881 (14.71%)
Total	7,112 (55.60%)	4,449 (34.78%)	1,230 (9.62%)	12,791 (100%)

From the above tables it is possible to note how the reporting activity of analysts is increased in the last years, and the percentage of positive recommendations is always greater than the percentage of negative ones (In 2004 the number decreases, but this is due to the fact that we have reports just until the 23rd July).

Considering table 4, in fact, it is evident that, in the whole period considered, 7,112 reports (55.6% of the total) report a positive recommendation, while only 1,230 (9.62% of the total) a negative one. This evidence is well known and debated in the literature. Usually researchers have advanced two main explanations: analysts' excessive optimism or conflict of interests. The first hypothesis refers to the

fact that analysts seem to be too optimistic on the perspectives of the stocks they follow. The second one argues that analysts prefer not issuing any report instead of issuing a negative one.

Classifying the recommendations based on the current and previous rating it is possible to form a matrix of the changes of recommendations, highlighting the frequency of upgrades and downgrades. As it is possible to see from tables 5 and 6, the greatest part of the reports does not contain changes of recommendation: in the five-points scale the unchanged reports are the 84.06%, while in the three-points scale are the 86.94%.

Table 5. Summary table of changes of recommendations (five-points scale)

Changes of recommendation	Number of reports	Percentage
Unchanged	9,253	84.06%
Upgrade	851	7.73%
Downgrade	904	8.21%
Total	11,008	100%

Table 6. Summary table of changes of recommendation (three-points scale)

Changes of recommendation	Number of reports	Percentage
Unchanged	9,570	86.94%
Upgrade	687	6.24%
Downgrade	751	6.82%
Total	11,008	100%

Not every report contains the previous rating, since some of them are initiation of coverage and others are preceded by reports in which there is no recommendation. Considering this fact, the sample size reduces to 11,008 reports for which we also have the previous rating.

Table 7 presents the selection criteria of the reports with current and previous rating, that constitutes the basis for construct the matrices of changes of recommendations.

Table 7. Summary table of reports with current and previous ratings

Total number of monographic studies	16,634	100%
Studies that are double, without rating, with ambiguous rating	(3,843)	(23.10%)
Total number of monographic studies with rating	12,791	76.90%
Studies without previous rating	(1,235)	(7.42%)
Total number of monographic studies with previous rating	11,556	69.47%
Studies without current rating*	(548)	(3.29%)
Total number of monographic studies with previous and current rating that form the sample of observations	11,008	66.18%

* In this category we consider monographic studies for which it does exist a previous rating, but that have not been included in the matrices of changes of recommendation since, for example, the valuation of the stock has been temporarily suspended or since the analyst that initially covered the stock is changed.

Observing the matrices of the changes of recommendations, it is possible to note that the greatest part of unchanged positions is referred to, in a five-points system (table 8), to *buy* (28.98%), *add* (18.85%) and *hold* (29.51%) recommendations; and in a three-points system (table 9) to *buy* (50.50%) and *hold* (29.51%) recommendations. The

percentage of upgrades, furthermore, is less, even if slightly, to that of downgrades. Considering the five-points scale, the upgrades are the 7.73%, while the downgrades are the 8.21%. With reference to the three-points scale, the upgrades are only the 6.24%, while the downgrades are the 6.82%.

Table 8. Matrix of changes of recommendation (five points scale)

		Previous Rating					
		Buy	Add	Hold	Reduce	Sell	Total
Current Rating	Buy	3,190 (28.98%)	152 (1.38%)	198 (1.80%)	14 (0.13%)	5 (0.05%)	3,559 (32.33%)
	Add	142 (1.29%)	2,075 (18.85%)	280 (2.54%)	47 (0.43%)	1 (0.01%)	2,545 (23.12%)
	Hold	239 (2.17%)	274 (2.49%)	3,248 (29.51%)	111 (1.01%)	31 (0.28%)	3,903 (35.46%)
	Reduce	20 (0.18%)	30 (0.27%)	130 (1.18%)	507 (4.61%)	12 (0.11%)	699 (6.35%)
	Sell	5 (0.05%)	2 (0.02%)	51 (0.46%)	11 (0.10%)	233 (2.12%)	302 (2.74%)
	Total	3,596 (32.67%)	2,533 (23.01%)	3,907 (35.49%)	690 (6.27%)	282 (2.56%)	11,008 (100%)

Table 9. Matrix of changes of recommendation (three points scale); percentages in parentheses

		Previous Rating			
		Buy	Hold	Sell	Total
Current Rating	Buy	5,559 (50.50%)	478 (4.34%)	67 (0.61%)	6,104 (55.45%)
	Hold	513 (4.66%)	3,248 (29.51%)	142 (1.29%)	3,903 (35.46%)
	Sell	57 (0.52%)	181 (1.64%)	763 (6.93%)	1,001 (9.09%)
	Total	6,129 (55.68%)	3,907 (35.49%)	972 (8.83%)	11,008 (100%)

This result seems in contrast with the previous studies in the literature, but it is possible to explain it considering the fact that the greatest part of the period considered refers to bear markets. It is, furthermore, coherent with the hypothesis of overoptimism of the analysts.⁹

3.2 Methodology

In this paragraph, we describe the methodology used to determine the value of an investment strategy based on the average consensus of analysts' recommendations. As a first step, we have calculated, for each period and company, the average consensus. As time period of reference we have chosen the quarter. The reason is twofold: on a practical ground, to have enough recommendations in each portfolio in every period, we could not use a monthly basis as it has been used in other studies in the literature;¹⁰ from a theoretical point of view we argue that the quarter constitutes for many portfolio managers the right period for performance evaluation and portfolio rebalancing, more often if the investment is managed through banks or mutual funds. To determine the average consensus on a company, in a given quarter, it has been necessary to attribute a numeric value to each rating.

The scale that we have used is the following: Buy = 1; Add = 2; Hold = 3; Reduce = 4; Sell = 5. The average consensus per quarter for a company is calculated as the sum of all the ratings issued by analysts on that company in the quarter, and diving by the number of reports in the same period. Formally:

$$\bar{A}_{i,t} = \frac{1}{n_{i,t}} \sum_{j=1}^{n_{i,t}} A_{i,j,t} \quad (1)$$

where: $\bar{A}_{i,t}$ is the average consensus on company "i" in quarter "t"; $A_{i,j,t}$ is the individual ratings contained in each of the $n_{i,t}$ reports issued in the quarter on the considered stock; $n_{i,t}$ is the number of reports issued on stock i in quarter t .

The average consensus thus calculated, however, does not allow to have an idea of the degree of agreement or disagreement among analysts that have issued ratings on the considered company. We have, therefore, decided to introduce a simple measure of dispersion of the recommendations around the average consensus.

As a measure of dispersion we have used the standard deviation:

$$D_{i,t} = \sqrt{\frac{\sum_{j=1}^{n_{i,t}} (A_{i,j,t} - \bar{A}_{i,t})^2}{n_{i,t}}} \quad (2)$$

where: $D_{i,t}$ dispersion level, for quarter "t", around the average consensus; $\bar{A}_{i,t}$ average consensus on company "i" in quarter "t"; $A_{i,j,t}$ is the individual ratings contained in each of the $n_{i,t}$ reports issued in the quarter on the considered stock; $n_{i,t}$ is the number of reports issued on stock i in quarter t .

Once classified the companies following the average consensus in each quarter, it is possible to form portfolios based on this consensus.

Five portfolios have been formed, for each quarter:

⁹ See Cervellati, Della Bina, Giulanelli (2005).

¹⁰ See Barber et al. (2001).

- portfolio 1:** companies with the highest ratings, i.e. those with average consensus in between 1 and 1.5
- portfolio 2:** companies with positive ratings, i.e. those with average consensus in between 1,5 and 2,5
- portfolio 3:** companies with an intermediate consensus, i.e. those with consensus between 2,5 and 3,5
- portfolio 4:** companies with a slight negative consensus, i.e. those with consensus between 3,5 and 4,5
- portfolio 5:** companies with a very negative consensus, i.e. those with consensus between 4,5 and 5

To evaluate the performances for every quarter of these portfolios we have used two distinct methodologies: CAR (*Cumulative Abnormal Return*) and BHR (*Buy and Hold Return*). CAR methodology consists in summing the excess returns recorded in the considered period. More formally:¹¹

$$CAR_{i,s} = \sum_{t=1}^T (R_{i,t} - E(R_{i,t})) \quad (3)$$

where: $CAR_{i,s}$ is the cumulate abnormal return of company “ i ” in quarter “ s ”; $R_{i,t}$ is the return of company “ i ” in day “ t ”; $E(R_{i,t})$ is the expected return of company “ i ” in day “ t ”. The difference $R_{i,t} - E(R_{i,t})$ represents, therefore, the abnormal return of company “ i ” in day “ t ”. Once obtained the CAR for every company, we have computer CARs for the portfolios as an average of the CARs of the companies in each portfolio for every quarter.¹² More formally, the portfolio CAR in each quarter is given by:

$$CAR_{p,s} = \frac{\sum_{i=1}^n CAR_{i,s}}{n} \quad (4)$$

where: $CAR_{p,s}$ is the abnormal return of portfolio “ p ” in quarter “ s ”; n is the number of stocks forming the portfolio p .

A limitation of the CAR methodology, however, is that it assumes that one should periodically adjust the portfolio to equally distribute the wealth invested in the portfolio among different stocks. Using the BHR methodology, the return in each quarter of a stock is expressed as:

$$BHR_{i,s} = \prod_{t=1}^T (1 + R_{i,t}) - \prod_{t=1}^T (1 + E(R_{i,t})) \quad (5)$$

where: $BHR_{i,s}$ is the excess return of stock “ i ” in quarter “ s ”; $R_{i,t}$ is the return of stock “ i ” in day “ t ”; $E(R_{i,t})$ is the expected return of stock “ i ” in day “ t ”.

The portfolio BHR is just the average of single stocks BHRs:

$$BHR_{p,s} = \frac{\sum_{i=1}^n BHR_{i,s}}{n} \quad (6)$$

where: $BHR_{p,s}$ is the excess return of portfolio “ p ” in quarter “ s ”; n is the number of stocks in portfolio p . Following Barber and Lyon (1997) we consider as an estimate of the expected return $E(R_{i,t})$ the return of a market index $R_{m,t}$.¹³

To calculate daily returns for individual stocks we have decided, following the main contribution in the literature, to use different methods for CAR and BHR. For CAR we have used a continuously compounded return¹⁴, whereas for BHR a discrete compounded return.

Lastly, to test the null hypothesis that the returns calculated with BHR or CAR are equal to zero for the sub-sample of n companies forming the portfolio, we use the standard parametric tests proposed by Barber and Lyon¹⁵.

3.3 Results

In this paragraph, we examine the investment value of a strategy based on the average consensus of analysts’ recommendations. For each portfolio and every quarter, we have determined the average consensus of ratings issued on each stock from analysts that have outstanding recommendations on that stock in the considered quarter. We have also calculated excess returns, adjusted by the market returns, using CAR and BHR methodologies. If analysts’ recommendations have value, ordering the portfolios from 1 to 5, with 1 representing the portfolio containing the best ratings and 5 the portfolio containing the worst ones, we would expect to observe the following effects:

- portfolio 1 should have the most positive adjusted excess return;
- portfolio 2 should have a positive excess return, but lower than portfolio 1;
- portfolio 3 should have adjusted excess returns close to zero;
- portfolio 4 should have a negative adjusted excess return;
- portfolio 5 should have the most negative adjusted excess return.

¹³ The market index used here is the Mibtel (Milano Indice Borsa Telematica), a global index representing the general trend of the stocks listed in the Italian Stock Exchange.

¹⁴ Using the continuously compounded return one assumes that $P_t = P_{t-1}e^{R_t}$, where R_t is the rate of return during the period $(t - 1, t)$.

¹⁵ See Barber and Lyon (1997).

¹¹ See Barber, Lyon (1997) and Lyon, Barber, Tsai (1999).

¹² The underlying assumption here is that the total amount invested in each portfolio is equally divided among all the stocks.

Table 10 shows the total return in each quarter for every portfolio. The returns are all statistically significant and reflect the expectations, confirming our hypothesis. The “Average Dispersion”, reported in second column of table 10, measures the degree of agreement between analysts within each class of

rating. By construction, it represents the standard deviation, adding additional information with respect to the mere average consensus in the class. It would be possible to have the same average consensus, but a different dispersion and, therefore, a rather different degree of agreement.

Table 10. Summary results for every portfolio in quarter t

Portfolio [Class]	Average Dispersion	Total number of reports	BHR(t)	t-Stat	CAR(t)	t-Stat
Portfolio 1 [1 - 1.5]	0.21	1,942	6.92%	4.5033***	4.24%	5.3385***
Portfolio 2 [1.5 - 2.5]	0.70	6,898	2.01%	3.6426***	0.55%	1.0205
Portfolio 3 [2.5 - 3.5]	0.39	3,366	-2.27%	3.1332***	-4.55%	6.1156***
Portfolio 4 [3.5 - 4.5]	0.52	531	-5.29%	2.3631**	-8.56%	3.9064***
Portfolio 5 [4.5 - 5]	0.00	54	-9.70%	3.2324***	-12.37%	3.5922***

Statistical significance : * = 10%, ** = 5%, *** = 1%

With reference to table 10, take for example portfolio 1, that presents a low average dispersion, equal to 0.21. However, it should be considered that the range of the class is only 0.5, from 1 to 1.5, therefore the incidence of the average dispersion is 42%. Portfolio 2 is the one in which single ratings are more dispersed, 70%, followed by portfolios 3 and 4 with, respectively, 52% and 39%. Portfolio 5 has no dispersion.

Table 10 contains other interesting results. Considering the number of reports in each portfolio, it is evident that the portfolios that have the greater number of reports are those containing non-negative ratings.

This result can be addressed using different explanation. The first one supports the hypothesis of

an “optimistic bias” of analysts that tend to view the stocks that they follow too favorably (This explanation is proposed by the behavioral approach to finance, that relate psychology and finance).

The second hypothesis claims that analysts are reluctant to issue negative ratings, to avoid problems with the management of the covered companies. A third explanation can be that analysts simply follow, on average, stocks with better performances.

Figure 1 clearly show that the adjusted returns of the five portfolios are in line, both considering the BHR and the CAR methodology, with the level of average consensus of analysts’ recommendations. This seems to confirm the investment value of a strategy based on analysts’ consensus.

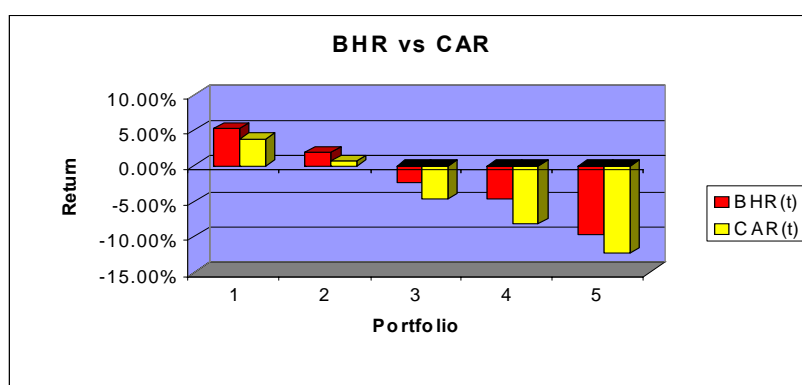


Figure 1. Total average return computed for every portfolio in quarter t

Portfolio 1 has recorded an average return of 6.92%, with reference to all the quarters considered, using BHR and 4.24% with CAR. Portfolio 5, instead, had a performance of -9.7% with BHR and -12.37% with CAR.

Adopting a portfolio strategy based on the consensus of financial analysts, i.e. buying the stocks with the more favorable recommendations and selling the least recommended ones, an investor could gain an abnormal return of about 16.6%, both with BHR and CAR, as highlighted in table 11 that

contains the differences between quarterly average returns. It seems, therefore, that analysts' recommendations have real investment value for investors. However, the present analysis does not take into account transaction costs. It is necessary to take into account the commissions, as well as the bid-ask spread and the other costs related to transactions to calculate the net return for investors.

The paper by Barber et al (2001) shows, in fact, that taking into account these costs, the abnormal returns recorded following analysts' recommendations tend to disappear.

Von Nandelstadh (2003), with reference to Scandinavian markets, finds no abnormal returns, once that it takes into account transaction costs. It is interesting, however, to highlight that investors can obtain positive abnormal returns if they follow only the recommendations of analysts that do not work for a bank.

The results for portfolios 2 and 4 seem to be in line with expectations as well.

The former has recorded an average return of 2.01% with BHR and 0.55% with CAR, while the latter has realized -5.29% with BHR and -8.56% with CAR (This value (0.55%), however, it is not statistically significant). The results for Portfolio 3 are instead somehow surprising, or at least of difficult interpretation. This portfolio should theoretically have an excess return close to zero, while for our sample it recorded a -2.27% with BHR and a -4.55% with CAR. A possible explanation of these negative returns can be advanced referring to the incentives that analysts have to issue a neutral rating, instead of a negative one. Several studies in the

literature, but also articles in the financial press, have shown that analysts can face several problems after issuing a negative recommendation. There have been cases in which analysts have been excluded from meetings with the managers of a company or from receiving relevant information after having issued a negative recommendation. Analysts therefore face a trade-off between issuing correct ratings, to build their own reputation, and maintain good relationships with the management of the companies they follow to have access to the necessary information they need for their research activity. It seems that this trade-off pushes analyst to be upward biased, i.e. the tendency to issue neutral ratings while instead they should issue negative ones, or even not to issue negative reports at all (The bias induced by omitting to issue negative reports is well illustrated by Fabrizio (2001).

In table 11 we provide the differences between annual returns on the five portfolios, for BHRs and CARs, referred to the whole period considered. The differences in terms of annual returns among portfolios are of relevance and statistically significant, in particular the difference between "extremes" (portfolio 1 and 5) is large (16.61% with BHR and 16.60% with CAR) and significant at the 1% confidence level. It is worth to notice that only the differences between portfolios 3 and 4 for BHR and between portfolios 4 and 5 for CAR are not statistically significant, probably due to the fact, already discussed in the paper and in literature, that hold and reduce ratings can be considered as negative recommendations, not significantly different from sell ratings.

Table 11. Differences between average quarterly returns for each portfolio (t-Stat in brackets)

Part A. Comparison between the five portfolios using average BHR

	Portfolio 1 [1 - 1.5]	Portfolio 2 [1.5 - 2.5]	Portfolio 3 [2.5 - 3.5]	Portfolio 4 [3.5 - 4.5]	Portfolio 5 [4.5 - 5]
Portfolio 1 [1 - 1.5]	0.00%	-	-	-	-
Portfolio 2 [1.5 - 2.5]	4.91% (3.0069)***	0.00%	-	-	-
Portfolio 3 [2.5 - 3.5]	9.19% (5.4101)***	4.28% (4.6990)***	0.00%	-	-
Portfolio 4 [3.5 - 4.5]	12.21% (4.4967)***	7.30% (3.16630)***	3.02% (-1.2817)	0.00%	-
Portfolio 5 [4.5 - 5]	16.61% (4.9297)***	11.71% (3.8380)***	7.42% (2.4052)**	4.41% (-1.1777)	0.00%

Part B. Comparison between the five portfolios using average CAR

	Portfolio 1 [1 -- 1.5]	Portfolio 2 [1.5 -- 2.5]	Portfolio 3 [2.5 -- 3.5]	Portfolio 4 [3.5 -- 4.5]	Portfolio 5 [4.5 -- 5]
Portfolio 1 [1 -- 1.5]	0.00%	-	-	-	-
Portfolio 2 [1.5 -- 2.5]	3.68% (3.8273)***	0.00%	-	-	-
Portfolio 3 [2.5 -- 3.5]	8.78% (8.0774)***	5.10% (5.5398)***	0.00%	-	-
Portfolio 4 [3.5 -- 4.5]	12.80% (5.4904)***	9.12% (4.0372)***	4.01% (1.7338)*	0.00%	-
Portfolio 5 [4.5 -- 5]	16.60% (4.6991)***	12.92% (3.7074)***	7.82% (2.2201)**	3.81% (0.9331)	0.00%

Statistical significance: * = 10%, ** = 5%, *** = 1%

To test the hypothesis that neutral ratings can be associated with negative judgments by the analysts, we furthermore divide the stocks in two portfolios, respectively formed by companies with non-negative consensus (1 |--| 3), including the hold ratings as non-negative, and the ones with negative average consensus (3 |--| 5). Observing table 12, it is possible to note that the first portfolio, with an average

dispersion of the ratings equal to 0.45, has recorded a positive average excess return of 2.10% with BHR and 0.13% with CAR (this value (CAR= 0.13%), however, is not statistically significant) while the second portfolio has realized, with an average dispersion of ratings of 0.57, a negative excess return (-4.46% with BHR and -7.73% with CAR).

Table 12. Total average return per quarter calculated dividing among stock with non negative recommendations (1 |--| 3) and with negative ones (3 |--| 5)

Class of Recommendations	Average Dispersion	Total number of reports	BHR(t)	t-Stat	CAR(t)	t-Stat
Non negative [1 -- 3]	0,45	11,463	2.10%	3.8964***	0.13%	0.31586
Negative [3 -- 5]	0,57	1,328	-4.46%	3.0099***	-7.73%	5.2196***

Statistical significance: * = 10%, ** = 5%, *** = 1%

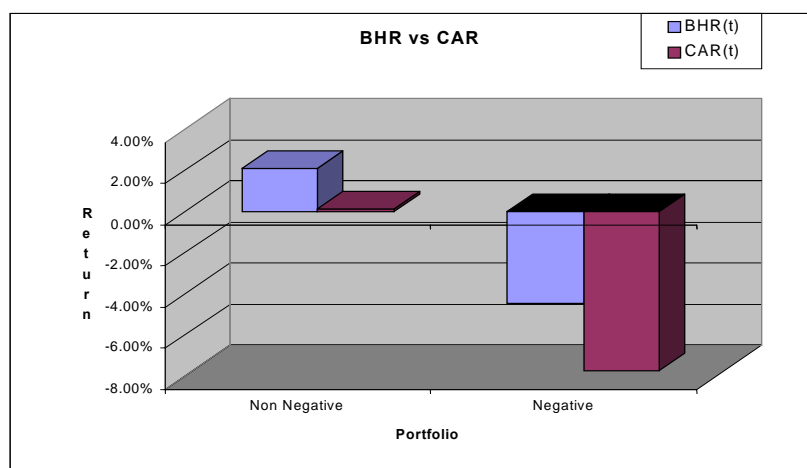


Figure 2. Total average return per quarter calculated dividing among stock with non negative recommendations (1 |--| 3) and with negative ones (3 |--| 5)

Note: the rating hold is included in the portfolio of “Non Negative” recommendations (1|--|3)

Coherently with the hypothesis that neutral recommendations should be considered as negative

ratings, in table 13 and figure 3 e present an alternative classification.

The first portfolio now includes only strict positive ratings ([1 |-- 3]), excluding neutral recommendations, while the second portfolio

includes non positive ratings ([3 |--| 5]), including this time the hold rating.

Table 13. Total average return per quarter calculated dividing among stocks with positive recommendations (1 |-- 3) and with non positive ones (3 |--| 5)

Class of Recommendations	Average Dispersion	Total number of reports	BHR(t)	t-Stat	CAR(t)	t-Stat
Positive [1 -- 3]	0,54	10,593	3.37%	5.3497***	1.42%	3.28006***
Non Positive [3 -- 5]	0,29	2,198	-3.48%	4.3206***	-6.00%	7.39231***

Statistical significance : * = 10%, ** = 5%, *** = 1%

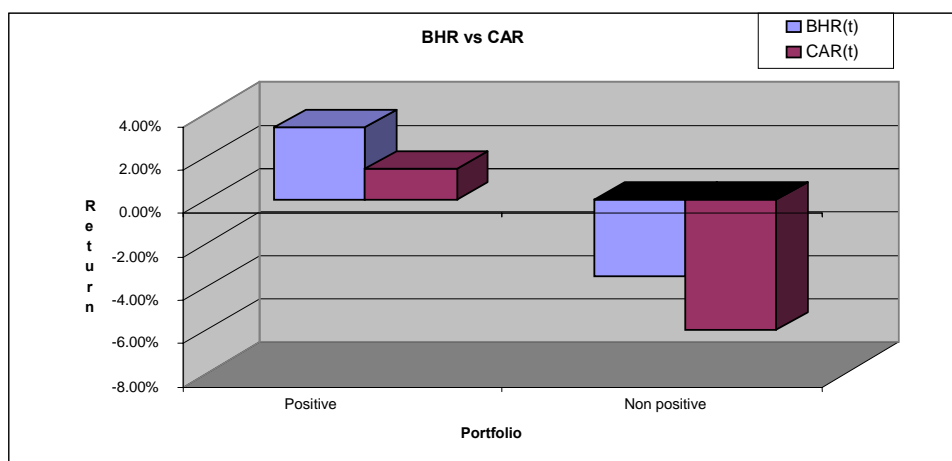


Figure 3. Total average return per quarter calculated dividing among stock with positive recommendations (1 |-- 3) and with non positive (3 |--| 5)

Note: the rating hold is included in the portfolio of “Non positive” recommendations (3|--|5)

In this alternative definition, the first portfolio records an adjusted return of 3.37% with BHR and 1.42% with CAR, with an average dispersion of ratings of 0.54; whereas the second portfolio realizes a performance of -3.48% with BHR and -6% with CAR, with an average dispersion of 0.29. We should highlight that the positive returns associated with the “Positive” ratings portfolio are higher than before.

At the same time, the returns of the “Non Positive” portfolio are better than before, since now we have added the neutral recommendations to this second portfolio and eliminated from the first one. First of all, we should note that the number of reports in the second portfolio increases, with benefits in terms of robustness of the results. In fact, whereas in the first classification (non negative “vs” negative) the CAR was not statistically significant, in this alternative definition, not only is significantly different from zero, but it is also higher in magnitude. Furthermore, while the average dispersion in the positive portfolio almost remains the same, the one associated with the second portfolio dramatically decreases, suggesting a higher degree of agreement between non-positive ratings, once neutral and negative recommendations are

pooled together (It slightly increases in absolute terms for the positive portfolio, but since the range of ratings narrows, in relative terms it decreases. For the non positive portfolio the decrease is even bigger if we consider the wider range of ratings that are now included in the non positive portfolio).

Conclusions

The paper examines the possibility of profiting from an investment strategy based on the average consensus of analysts’ recommendations.

If on one hand individual and institutional investors can be willing to bear the cost for analysts’ reports, on the other hand market efficiency tells us that those reports should have no value. Therefore, it remains to be verified if analysts recommendations have or not investment value.

We have then created a database including the recommendations issued by analysts in monographic studies issued between the 1st January 1999 and the 23rd July 2004 and publicly available on the website of the Italian Stock Exchange. First of all, we have performed a descriptive analysis of the sample,

highlighting some interesting features of the reporting activity in the Italian stock market.

From a comparison between the number of reports received from each company and its size, we have shown that analysts prefer to issue reports on bigger companies. An explanation of this phenomenon is that, since bigger companies are characterized by a higher number of transactions, they could allow for some economic benefits deriving from the commissions on trading and brokering activity.

Few intermediaries produce the majority of reports and the more active in issuing studies are also the ones covering the majority of firms. This evidence highlights the importance of controlling for potential conflict of interests of intermediaries that have a relevant position in the market of reports.

Considering the distribution of recommendations issued by analysts, we have also shown that the percentage of positive ratings is always greater than the fraction of negative ones. This evidence can be explained in two alternative ways: analysts can show excessive optimism in their reporting activity, or they can just omit to issue a negative report to avoid problems with the management of the companies, that is the main source of the information they use.

Apart from this preliminary and descriptive analysis of the sample, to verify if analysts' reports have any investment value, we have formed five portfolios, dividing stocks on the base of the average consensus for each quarter of the sample. We used the CAR and BHR methodologies to calculate average abnormal returns of the five portfolios for each quarter and for the period as a whole. Comparing excess returns of each portfolio in the entire period of time that we have considered with the level of average consensus of analysts' rating, we found results in line with our intuition.

Portfolio formed by very or moderately positive ratings record a positive excess return, while portfolios with very or moderately negative ratings have shown negative excess returns. The portfolio containing neutral ratings gives instead ambiguous results. From a theoretical point of view, it should record excess returns close to zero. The results, instead, show negative excessive returns both with the CAR and BHR methodologies. An explanation, well-accepted in literature, is that neutral ratings can be considered as negative ones, since in general analysts tend to issue very few reduce or sell ratings.

After having performed the proper tests for statistical significance, we find that analysts' recommendations have indeed investment value if we consider a horizon that is at least annual, or that take into consideration the whole sample.

The results shown thus far have not considered transaction costs. We should include these costs in the analysis to see if analysts' recommendations really convey investment value or if they, even if positive, would not be sufficient to cover those costs.

Future research will have to consider this aspect. More generally, however, we can conclude that seems that investors can rely on analysts' average consensus, with a caution, to consider very carefully neutral recommendations that, as shown in the literature, can be considered as negative ones. The reporting activity seems therefore to significantly influence the investment decisions of investors, and under this light it can be seen the increasing amount of regulation of the Italian and European legislators. The main objective of these regulations on reporting activity is in fact to favor the diffusion of transparent and timely relevant and price sensitive information to help investors in their decisions.

In this regard, we argue that legislators should impose more precise criteria on the more delicate aspect contained in the recommendations, i.e. the neutral rating.

If one objective of regulation is to enhance transparency and disclosure, then it is necessary that investors really understand the meaning of every recommendation.

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Appendix: descriptive statistics of the monographic studies included in the database constructed from the Borsa Italiana S.p.A. website, 1999-2004

The number of listed companies (column 2) includes all the companies for which the stocks are negotiated on regulated markets managed by Borsa Italiana S.p.A., for every year of reference. The number of covered companies (column 3) is the number of companies with at least one valid recommendation with rating for year of reference recorded in the database of Borsa Italiana S.p.A. The number of covered companies (column 4) is furthermore expressed in percentage with respect to the number of listed companies. The market capitalization of the covered companies (column 5) is the percentage ratio between the sum of capitalizations of the covered companies and the sum of capitalizations of the listed companies, calculated at the end of the reference period. The average and median number of intermediaries that issue recommendations with rating per every covered company (columns 6 and 7) is highlighted, as well as the average and median number of covered companies per intermediary for every year of reference (columns 8 and 9). The last column presents the number of intermediaries with at least one recommendation during the year. We consider the listed companies that are objective of a monographic study, recorded in the database of Borsa Italiana S.p.A. and issued between September 1999 and July 2004.

Year	No. of Listed Companies	N. di Covered Companies	Covered companies		Intermediaries		Covered companies per intermediary		Number of intermediaries
			% of Listed Companies	% of the Market Capitalization	Average	Median	Average	Median	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1999	270	44	16%	39%	1.2	1	8	5	7
2000	297	148	50%	85%	4.4	3	16	11	40
2001	294	183	62%	84%	6.4	4	23	11	50
2002	295	178	60%	85%	6.7	4	23	15	51
2003	279	181	65%	92%	6.5	4	27	21	43
2004	276	166	60%	90%	5.2	3	25	18	34

PATH-DEPENDENCY AND CORPORATE GOVERNANCE IN ITALY: THE POLITICAL ORIGINS OF DEBT FINANCING

Antonio Nicita* and Riccardo Vannini**

Abstract

In this paper we investigate the emergence and the co-evolution of institutional complementarities between debt and equity as alternative financial instruments in the case of Italy. We focus on the evolution of Italian firms (related to the benchmark years from 1952 to 1991). Through the data collected we observed the collaterals that firms were able to transfer to loan institutes. We also examined the factors which made difficult to switch to equity financing, comparing the rate of profitability of Italian firms with alternative investments. The results show a financial structure for Italian firms that rely exclusively on debt, independently of the public or private nature of firms' property and of the economic sector. This anomaly seems to be the consequence of path-dependencies between "political origins" and firm's governance structure in Italy.

Keywords: corporate governance, debt financing, equity financing

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1. Introduction

In recent years, an extensive body of studies has dealt with the issue of convergence versus diversity in corporations' ownership and control in contemporary economic systems. Most of these works have compared corporate governance models through the lens of the New Institutional Economics (NIE) theory of the firm and have stressed the role of the legal nature of corporations beside the traditional agency costs theories (Allen and Gale, 2000; Becht, Bolton and Röell, 2002). According to this literature two main systems of corporate governance might be distinguished (Bratton and J.A. McCahery, 1999; Allen and Gale, 2000): a *market system* characterised by dispersed shareholding and thick, liquid trading markets, and a *hierarchical control system* characterised by a hard control exerted over the management by a principal or a coalition of principals (banks, families, etc.), thin trading and non-controlling stakes. While the former system may be found in US and UK, the latter has been experienced in a variety of forms by Germany Italy, Japan, and many other countries. The main question addressed recently by this scholarly literature is whether one of the two stylized corporate governance systems is characterized by some relative competitive advantage over the other and can thus prevail in the global market. Some of these systems have recently undergone through serious economic and institutional crises. This leaves unsolved the problem of convergence *versus* diversity in corporate models.

Recent works have emphasized the role plaid by historical conditions and legal origins in shaping path-dependency and diversity in corporate governance patterns (Bebchuk and Roe, 1999; Schmidt and Spindler, 2002; Beck, Demirgüç-Kunt and Levine, 2003; Djankov, Glaeser, La Porta, Lopez-de-Silanes and Schleifer, 2003), while some others have announced 'the end of history' in corporate governance models (Hansmann and Kraakman, 2003).

Despite the a high degree of uniformity achieved by the recent wave of corporate law reforms in many developed countries, the question of diversity in corporate governance is still an issue, as far as the emergence of institutional complementarities among corporate governance domains pushes towards self-reinforcing equilibria shaped by local historical conditions. In this respect, the rise of diversity in governance systems calls for an explanation of path-dependency phenomena in governance as in financial structures which shape, at the same time, firms and markets, sheltering national systems from external competition (Bebchuk and Roe, 1999; Hall and Soskice, 2001; Aoki, 2001; Schmidt and Spindler, 2002). Corporate governance changes are not merely financial either technological matters, rather they occur in a given institutional framework, in which economic, legal, political and organisational issues are bundled in a complex institutional order, shaping all the relevant agents and their actions (La Porta, Lopez-de-Silanes, Schleifer and Vishny, 1998; Becht, Bolton and Röell, 2002) and crafting "institutionalized linkages between the organization

domain and the financial transaction domain [...] (Aoki, 2001)".

In this paper we apply the notion of institutional complementarity (Milgrom and Roberts, 1990; Topkis, 1998; Aoki, 2001) to the study the relationship between corporate governance and corporate finance in Italian firms in order to enlighten new insights in the well-known trade-off between equity and debt financing.

2. Debt, Equity and institutional complementarities

Our focus here is not on agency costs rather on an extension of 'Transaction Costs Approach' (TCE) to corporate finance. Williamson (1988) emphasized the relationship between corporate governance and corporate finance, considering the financial choices in corporate governance as endogenous adaptation, in a world of incomplete contracts, to technological choices.

According to the TCE's framework, projects for which physical asset specificity shows a low degree ought to be financed by debt, whereas, as the degree of asset specificity increases, equity should be the preferred financial instrument. Asset specificity limits the possibility of re-deploying the resources in alternative uses and, in the case of bankruptcy¹, it limits also the related protection of bondholders' pre-emptive claims. In order to finance projects characterised by high levels of specificity, the board of directors should thus switch to the selective intervention that is typically allowed by equity finance. The holders of common stocks are the firm's ultimate residual claimants and, in the event of bankruptcy, they are the only agents entitled to get what is left after everyone else is paid. For this reason, they have a fairly limited interest in the risks associated potential low liquidity of the specific assets to be financed. The main result of the transaction-cost approach is that, as transactions costs become relevant in the analysis of corporate finance, a new governance structure, called 'dequity', might be implemented. 'Dequity' combines the best properties of debt and equity and allows some form of selective intervention which in turn enables the firm to select the appropriate combination of debt and equity which provides the appropriate degree of assets specificity.

However in spite of growing interdependence and globalization, there is no a clear evidence on corporate governance and finance models converging towards a unique model of 'dequity' financing. Nicita and Pagano (2003) explain the emergence and persistence of diversity in corporate models by focusing on the path-dependent co-evolution between 'governance' and 'finance' in corporate governance systems due to the emergence

of institutional complementarities between the degree of assets specificity in the firm (i.e. its technological structure) and its financial structure.

On the other side one can imagine also a co-evolutionary interdependence between debt and equity. In this respect, the call on the equity market coincides with an increase of the social capital through the inlet of a new liquidity by some new entrepreneurs/investors. For instance, in the Italian civil law, equity (*capitale sociale*) is the share of financial asset which could not be withdrawn by owners, until corporation's dissolution or its bankruptcy. This attribution underlines a peculiar security duty, because it could be an indicator of the trust that the corporation deserves from third parts, given that is a means for their guarantee². As a consequence a co-evolutionary path-dependency might emerge between equity and debt. A call on equity market in T_0 makes easier a call on the market of debt in T_{+1} , as a result of the larger guarantee for creditors³ in virtue of the higher firm's equity. Besides, the granting of a loan by a bank or by a lending institution sends a signal to the market about the health and wealth of the corporation⁴. In a third period T_{+2} new entrepreneurs/investors could seize this signal and receive the incentive to acquire new shares of the firm's risk capital, because of the good future outcomes foreshadowed⁵. Due to the presence of institutional complementarities (Aoki (2003:208) "[...] The second class deal with an inter-linkage among institutions that may arise in a situation where agents may not strategically coordinate their choices across different domain because of

² Definition of Equity (*capitale sociale*), in Enciclopedia della Banca e della Borsa, Compagnia Edizioni Internazionali, Roma, Milano. 1971. Translation by the authors.

³ For instance, managers of an Italian s.p.a. couldn't give back initial and following awarding of firm's partners, without a modification of the partnership agreement (through a resolution of the stakeholders meeting). Creditors could prevent this modification because equity is a warranty for the funds entrusted to the corporation (art. 2445 cod.civ.).

⁴ Ross 1977 studied how manager's choice between debt and equity could be a mean to signal the real state of the corporation.

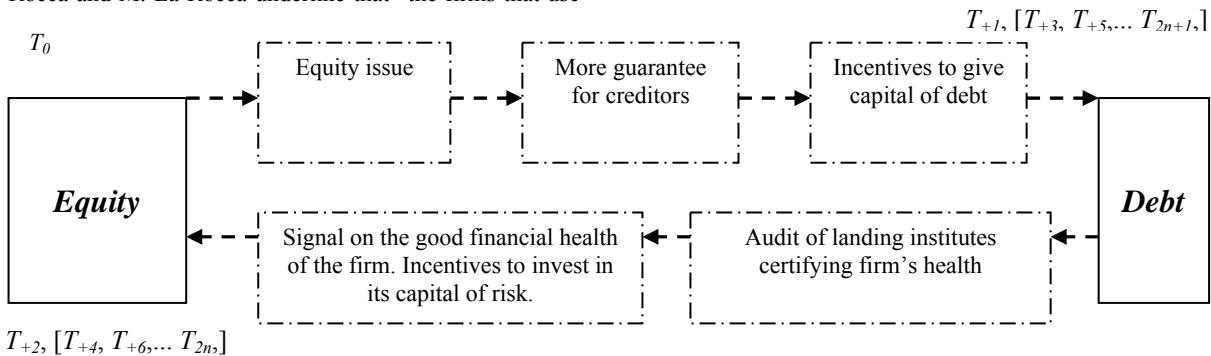
⁵ Nicita and Scoppa (2004) observe that the crucial condition, in resolving problems of adverse selection through the use of signaling, stands on the hypothesis that the signal consists in an activity or in a decision of the agent that could be easily observed by the principal. Moreover its sending must be convenient for the agents with the best characteristics, while, at the same time, it must result expensive for agents who cannot afford those characteristics. Under other hypothesis everyone could exploit the incentive to send a signal and it will be useless. For this reason an inverse relation between agents' characteristic and the cost of sending is necessary.

Serious and important audits made by lending institutes, and their continuous monitoring on the firm's patrimonial situation made possible to send wrong signal only under the hypothesis that the corporation spread false news about its financial condition with altered balance. Therefore sending false signal results very expensive for the heavy sanction about the crime of false accounting (art. 2622 cod.civ. *False comunicazioni sociali in danno dei soci o dei creditori*).

¹ Another explanation based on debt capacity constraints is developed by Hart and Moore (1994).

a limited scope of choices, limited perceptions, or for other reason, but their choices are parametrically affected by prevailing rules of actions choices (institutions) in other domains. As a consequence there may arise interdependencies of institutions across domains, which we will conceptualize as institutional complementarities) an efficient governance structure allows the use of both debt and equity as a trigger for a virtuous circle, leading firms to an higher level of efficiency in financing (About the optimal mix between debt and equity structure E.T. La Rocca and M. La Rocca underline that “the firms that use

debt as source of finance can benefits based on tax advantage, thanks to the interest deductibility, reduction of asymmetric information and managerial discipline. Vice versa, there are some costs related on the use of debt on the presence of financial distress, agency problem and loss of financial flexibility”. E.T. La Rocca and M. La Rocca Capital Structure, debt-maturity structure and local financial development: an empirical analysis in Italy. On SSRN. 2006).



This perspective, as noted above, is satisfactory only under an efficient organization of the institutions: a change in the rules of their functioning would mean a change of the institutional context (North 1990)⁶ breaking the virtuous circle. For this reason we argue that it is necessary to analyze the relationship between financial market and the firm's governance structure. This work analyzes in particular the peculiarity of the Italian case, where the virtuous circle is replaced by the heavy use of only one of the financial tools. In the next section we elaborate from a data set the level of warranty given by Italian firms to the banks, observing on the one hand the level of capitalizations (*ex-ante*) and on the other hand the performance improvement (*ex-post*). In third sections we provide some possible explanations for the results observed. The last section gives a brief survey and final remarks.

3. The Italian case

3.1 A brief survey

The research has been conducted taking as sample the larger Italian firms (rated by turnover) in the benchmark years 1952, 1960, 1971, 1981, 1991⁷.

⁶ “Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction [...] In the Jargon of the economist, institutions define and limit the set of the choices of individual” (North 1990). In particular, according with Barca (1997), we argue that “the economic history of a country, with its success and failure, could be read usefully as the history of the rules of a game; this rules are formal (currency, market, Law, contract, organization) and informal (cultural belief, code of conduct, trust and fiduciary duties).” (Barca 1997: X, translated by the authors.)

⁷ Data's source Mediobanca for 1952, 1960, 1971; R&S

Starting from the definition of *leverage*⁸, we draft two different indexes, the first to measure the call on the market of *debt*, the second for the *equity*.

[1.1] $E_i = \text{company's capital}_i / \text{Assets}_i$ [i is 'the i -th firm of the sample].

[1.2] $D_i = \text{medium-long term debt} / \text{Assets}_i$ [i is 'the i -th firm of the sample].

In particular 1.1 permits, on the one hand, to estimate how equity weighs on the capital's structure, on the other hand, the degree of capitalization for the Italian firms. Results confirm previous studies⁹: persistent immaturity for the Italian system in the growth of an equity market (Italian equity market is the smaller between the most industrialized countries) and a general situation of undercapitalization for the firm taken as sample.

The common explanation given in related literature calls for the public structure of Italian capitalism¹⁰, the economic familiar relations¹¹ the

for 1981, 1991.

⁸ Leverage is some measure of a firm indebtedness to the size of its overall asset base. Alan J. Auerbach, *leverage, new palgrave money and finance*, 1972, pag.574-577.

⁹ See among the others, Pierluigi Ciocca, *Il progresso economico dell'Italia permanenze, discontinuità, limiti*. Il Mulino, Bologna, 1994.

¹⁰ “The presence of a strong public firm stigmatizes one of the peculiar treat of Italian capitalism to such an extent that its structure has been defined as mixed (by State and Market). This peculiarity stands not only in the dimension, owned by the State, of our economic system, [...] but mainly in the role of replacement that public firms carried out both in comparison to the public administration and to the financial system.: Fabrizio Barca e Sandro Trento, “La parabola delle partecipazioni statali: una missione tradita”, in *Storia del capitalismo Italiano*, a cura di Fabrizio Barca, Donizzelli, 1997, Roma, Pag.185. Translation by the authors.

pyramidal structure of the groups¹², and the rift between bank and firm¹³: in other words, the peculiarity of the Italian corporate governance. Figure 1 compares 1.1 to 1.2 showing, historically, an heavy impact of debt (up to five times superior) in respect of equity. Reasons for this disproportion are several, and track their selves down in the evolution of Italian economy, where, unlike other countries with ancient industrialization, a heavy share of production, was (and is still) provided by small firms (Fuà 1983). Inevitably this means greater difficulties in the call on the equity market. The reasons lies in the presence of economies of scale, tied with the reduction of agency and enforcement cost, for the creation of governance rules for the protection of non-controllers stakeholders.

With reference to major Italian firms other reasons for this unbalance between debt and equity could be discovered. In particular, a transactions cost analysis reveals how potential entrepreneurs could get discouraged to become owners of big Italian firms, due to firm's property assets, always concentrated in the hand of few families¹⁴. This means

a high disincentive for new owners, to gain access to big firms' property. Moreover there was a chronic scarcity of information about the financial situation of these firms. Ernesto Rossi¹⁵ shows the problematic situation for the main Italian firms stressing, for example that Snia Viscosa and Pirelli¹⁶ gave not the value of its turnover neither the number of its employees, Edison¹⁷ dose not make public its annual pay-off. The opposite has happened in those countries where firms are characterized by a spread property asset (Barca 1994). Moreover, a similar result could be found in Italian public firm. In fact, a crucial role was recovered by important public holding, as IRI¹⁸ or ENI¹⁹, owner of a large share of the Italian firms. Although, in the original intention of Beneduce²⁰ and Menichella²¹, IRI would have had to remain functional to a temporary phase of Italian economy²², the property assets of those firms remained public until the beginnings of nineteen's.

¹¹ See among the others Fabrizio Barca 1994, 1997, Magda Bianco e Paola Casavola 1996.

¹² "Pyramidal structure joined with public property, fiduciary (frequently familiar) relation between investor and entrepreneur, statute solution, pre-emption's clause and cross shareholding agreement accord, granted, in Italy the right degree of separation between principal (the one that predates capitals) and agents (the one that manage capitals). These instruments became the replacement for this peculiarity that were deficient or absent in Italy: the market of firm's control, *ex-post* court's supervision and the continuous monitoring by institutional investors and landing institutes. Fabrizio Barca, Francesca Bertucci, Graziella Capello, Paola Casavola, "La Trasformazione proprietaria di Fiat; Pirelli e Falk dal 1947 a oggi" in *Storia del capitalismo Italiano*, a cura di Fabrizio Barca, Donizzelli, 1997, Roma, Pag. 157.

¹³ The rift between bank and firm, together with the imposition of the banking specialization, prevents the development of strict relations between banks and firms[...], in contrast with Anglo-Saxon countries we observe the absence of middlemen for the firm's control[...]not much developed is the role of institutional investors. Magda Bianco e Paola Casavola, "Corporate governance in Italia": Alcuni fatti e problemi aperti in *Rivista delle società*, 1996.

¹⁴ Concerning to the allocation of control in the major Italian firms, in the immediate second post-war period, we observe that large part of these firms were under the strict and adamant control of some entrepreneurial families. In particular heirs of Parodi-Delfino owned more than 90% of BDF, Falk had the property of more than 70% of the homonym firm, while Agnelli family had the control of 70% of FIAT. Instead Montecatini was an example of spread ownership, with 54599 shareholders in 1946. Anyway just 0,17% of these shareholders had the property of more than 31% of firm's equity (Zerini 1947: 127; Amadori and Brioschi 1997: 120). We want to underline the presence of a strong disincentive for the call to the capital of risk. "[I]n Italy the money saver/ shareholder

was an intruder able to be manipolte in the stok exchange dynamics" (Amadori and Brioschi 1997: 122. Translation by the Authors).

¹⁵ E. Rossi. *Capitalismo Inquinato*. Edited by R. Petrini, Laterza, Roma-Bari, 1993.

¹⁶ Snia Viscosa was one of the larger Italian firms of the chemical sector in the last century with the strongest incidence for Italian producer in the world market. The Pirelli Group has a long industrial tradition, it was built at the end of 800, now it is ranked among the world's leaders in every sector in which it operates.

¹⁷ Edison was the larger Italian firm in the production of electric power until 1963

¹⁸ IRI (Institute for the industrial rebuilding- *istituto per la ricostruzione industriale*) has been a holding totally owned by the State. Created in 1933, in order to avoid the failure of the main important Italian bank, IRI become the owner of large part of Italian industrial system, originally owned by this bank jointly. In particular IRI since 1940 to 1990 was the main Italian industrial group.

¹⁹ ENI is an Italian important group, its operating activities are: oil, natural gas, electricity generation, engineering and construction, petrochemical business. Created by Enrico Mattei in 1948 until 1998 this group was totally owned by the State.

²⁰ Alberto Beneduce was a well-known Italian scholar and politician in the early years of the last century. In particular in 1933 Beneduce has been the main promoter and organizer of IRI, and its president until 1939.

²¹ Donato Menichella was a big name of the Italian economic and political scene of the firs part of the last century. Before he has been nominated governor of the Italian central bank in 1948, he has been since 1934 the general director of IRI.

²² See among the others Giovanni. Siciliano, *Cent'anni di borsa in Italia: imprese e rendimenti azionari nel ventesimo secolo*, Il Mulino, Bologna, 2001. Fabrizio Barca and Sandro Trento, "La parabola delle partecipazioni statali: una missione tradita", in *Storia del capitalismo Italiano*, a cura di Fabrizio Barca, Donizzelli, 1997, Roma,

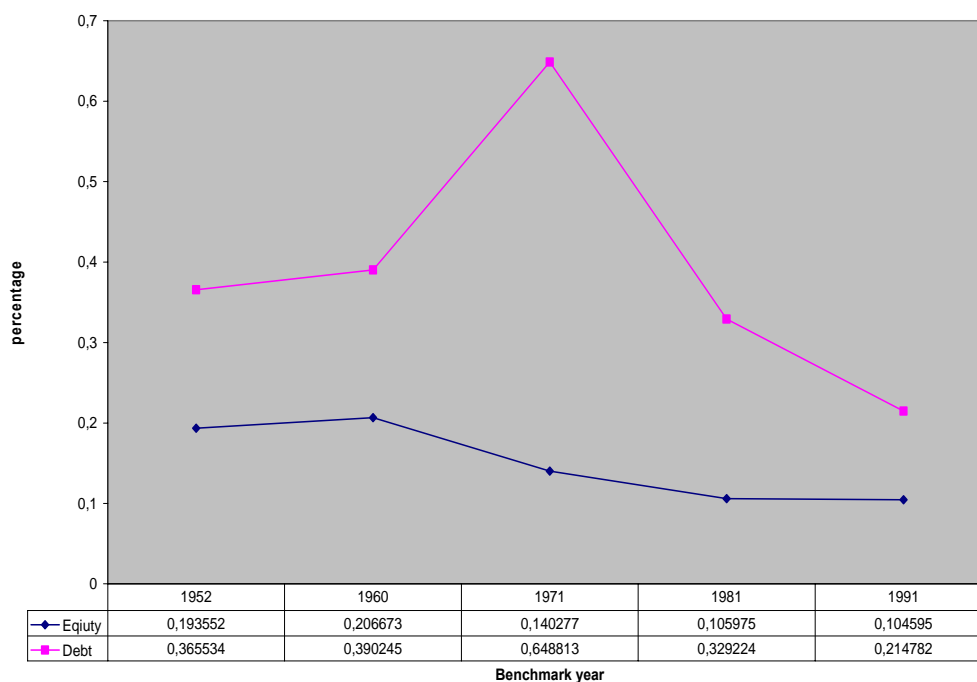


Fig. 1 Data shows the average value for each benchmark years

These elements together led to a growth financed almost exclusively by debt, inadequate under financial profile and, in general harmful for the equilibria of Italian economy; in fact they were the cause of many State's interventions in the Italian economy as, *i.e.*, corporate rescues²³.

These common explanations are supported in our analysis by an empirical study on the efficiency of the financial choices.

3.2 A quantitative analysis

The Italian law outlines three main roles, relating to equity's characteristics: the first is an organizational duty, the second a role of bond and the third a role of guaranty. In particular, equity constitutes the share of the firm's patrimony unavailable until the corporation's dissolution or its bankruptcy. Therefore, creditors look at the equity as the main warranty²⁴ on the credits allowed to the firm, when

²³ Several authors focus on this issue. Among the other see for example Barca 1994, Barca and Trento 1997, Ferri and Trento 1997, De Cecco 1997, Fortuna 2001, Conte and Piluso 2006, Bainchi *et alii* 2006.

²⁴ Cerrato e Zamperetti (2004) note as the article 2438 of Italian Civil Code (*aumento di capitale*) is the expression of a general principle of transparency and correctness in the process of capital issue. This article prevents the emission of new share until the issued are entirely paid. Therefore the article defends the effectiveness of equity in protection of third parts, potentially deceived by the value of a theatrically capital in witch they trust as real.

In the same direction moves Modulo (2003) in comment to the article 2348 of Italian Civil Code. He notes how the reform 2003 introduces a specific and expressed responsibility in protection of partners and third parts. The

the company becomes insolvent. The Italian Civil Code gives a special protection to creditors, allowing them the right to block the extraordinary dissolution regarding the reduction of equity (art. 2445 Cod Civ.).

Lower values of equity should make the call on the market of debt more difficult, for the reason shown above. Nevertheless it is necessary to explain that equity is just a part of the judgment about the health and the profitability of a firm²⁵: in fact, landing institutes base their valuations on complex procedure²⁶.

norm aim to prevent to S.p.a. ostentation towards third parts of equity, composed principally by credits of the firm towards partners.

Guaranty function is even expressed thought the discipline of its reduction (art.2445 *riduzione del capitale sociale*). The reform of this article was inspired in actuation of the enabling act (art.4, comma 9, lett.c), legge 3 Ottobre 2001, n. 366). It foresees that reform is aimed to a simplification of the discipline of equity reduction; eventually to amplify the hypothesis of a real reduction of equity with the exclusive goal of the creditor's protection.

²⁵ The model of determination of the economic capital, in the valuation of a firm, is based on various factors; is principally founded on the future rent that firm foresees to persecute, considering the alternative investment, the risk of the activity and the liquidity. Giorgio Pellati e Luigi Rinaldi, *La valutazione d'azienda*, edizioni Il Sole 24 Ore, Milano, 2005.

²⁶ The valuation of a firm is conduct with complex methodology, different according to its stadium of life. If we hypothesize the cessation of activities, or the dissolution of the company, valuation will consist in a mere aggregate of assets that will be liquidated. Different is the situation when we have continuity on the side of the

Creditors, in case of insolvency, could satisfy not just on the non callable equity, but even on the social patrimony²⁷ as a whole, where firms' patrimony symbolizes the complexity of legal relationship (active and passive) referring to the firm²⁸. For this reason we thought it is necessary to verify if there was any correlation between indebtedness and some indicator of the firm's performance. From the data we have selected the value of the fixed technical assets [fta_i] and the turnover [t_i]. We developed the following linear regression with last square method's (OLS):

$$[1.3] \quad D_i = q + (\alpha t_i) + (\gamma fta_i) + \varepsilon_i \quad [\text{with } i \text{ is the } i\text{-th firm of the sample and } fta_i, t_i \text{ the dependent variable and } \varepsilon_i \text{ the residual error}].$$

The high degree of correlation between fixed technical assets and turnover (r^2 0,836) shows an inability for the model to explain the correlation between debt and the measure of the firm's performance. In other words we can obtain more precise results by two different regressions using first the turnover as dependent variable and then the fta_i (results are showed in appendix).

To verify if a particular value of one element (debt index) is in general followed by the presence of a second element (firm's performance), the previous linear regression was replaced by the following:

$$[1.4] \quad D_i = q + (\alpha t_i) + \varepsilon_i,$$

$$[1.5] \quad D_i = q + (\gamma fta_i) + \varepsilon_i \quad [\text{with } i \text{ is the } i\text{-th firm of the sample and } fta_i, t_i \text{ the dependent variable and } \varepsilon_i \text{ the residual error}].$$

When we find a certain relation, for meaningful value (some value of the estimator related to the variation of the independent variable on the dependent one), this points out the manner in which

firm management, but under different property assets; in this circumstance firm is such an investment for the production of a future rent. In our study we consider continuity on the side of the management and the same property structure, we have as a parameter for the valuation of the firm the *capitale di funzionamento* (that is a peculiar reorganisation of the budget items done in order to stress the earning referred to a precise period), in Italian accounting law we have as direct reference one of the balance sheet documents: *stato patrimoniale*.

²⁷ We refer to these kind of firms where we observe a diaphragm between the patrimony of the partners and firm's patrimony. In Italian civil law we refer to the office of limited responsibility (*responsabilità limitata*). Responsibility of partners is limited by the share of capital that they subscribed, in fact for the obligations, acquired in name of the firm, respond just the firm with his own patrimony: in such a case the autonomy is perfect. (art. 2325, comma 1 e 2352, 2463, comma 1 cod. civ.) (Buonocore 2005)

²⁸ Gianfranco Campobasso, *Diritto Commerciale*, Utet, 2005

the dependent variable weighs on debt, in other words how the turnover (for the 1.1) and the fixed technical assets (for the 1.4) weigh on debt index. For equation 1.4. the value of R^2 (*varianza spiegata*) is less than 1%. This shows a substantial inability for the model to explain the debt modification as dependent to the variation of the fixed technical assets. The Coefficient referred to the independent variable shows a value that confirms the previous thesis (see the appendix). Another important result emerges from the analysis of the scatter diagram where it is evident the absence of any kind of correlation between debt index and fixed assets. The same results emerge from the 1.4. In particular we can verify from the examination of R^2 that there is no correlation between turnover and leverage index.

To explain in simple words what emerges from this study, we could observe that Italian firms kept on receiving funds from landing institutes, although they have no warranty back neither with a consistent equity, neither with wide profit margin or an increases of the fixed technical assets. Before observing the reasons why it could have happened, we need to consider first the equity side: potential investors could have received some warranty for their investments? What was the risk rate of the profitability of the Italian firm's capital?

The index of global profitability (ROE²⁹) permits us to value the capacity of a firm in attracting capitals from potential investors. We built this index for a larger sample of Italian firms.

This time our data involve the first 200 Italian firms (rated by turnover) in the benchmark years 1952, 1960, 1971, 1981 e 1991³⁰. The index shows the average profitability for capital unit. The investment in a capital unit of a firm is efficient only if the rate of this investment is greater than the other alternative considered on the market, with the same level of risk. We proceeded assembling the value of ROE for each benchmark year and calculating its average value. This average value represents the expected rate of profitability (TRE^e) for those investors that decide to acquire randomly capital shares of an Italian firm of the sample, and maintaining these stocks for one year.

Subsequently we have compare TRE^e with the rate of government bond in the same years, to analyze the efficiency of state investments. To have a precise valuation we introduce the level of risk associated. The risk of a portfolio investment increases with the difference between each possible realization of the rate of profitability (ROE of each single firm of the sample) and its expected value (the average ROE).

²⁹ The index of global profitability ROE (return on equity) state the rate of return of the capital of risk of a firm with the ratio between net income and creditor's equity.

³⁰ Data's source database imita.db.

Years	R.O.E	Variance	Standard deviation.	government bond ³¹
1952	10,23%	3,28%	20%	5,10 % ³²
1960	7,82%	2,19%	15%	5,56% ³³
1971	-2,39%	4,60 %	21%	6,83% ³⁴
1981	10,56%	22,85%	48%	15,29% ³⁵
1991	17,35%	20,05%	45%	12,44% ³⁶
Average value	9,96%	11 ,07%	33%	7,93%

Fig 2. Average Roe of the firm of the sample, risk and rate of state found

Quantitative measure of the risk is provided by the variance of the distribution of the rate associated to the single firm of the sample³⁷. Values are shown in figure. 2.

This measure shows that a high rate of ROE is counterbalanced by a high risk's degree (on average risk is three time higher than its profitability), hypothesis of non selected investment not justify a high volatility³⁸, anyway.

As it is evident, the high degree of risk associated with the rate of profitability of the Italian firms is not a justification for slight margins of profit in comparison with government bond. We sustain that a rational economic agent had not the incentive, in those years, to invest in the capital of risk of an Italian firm.

Next section tries to address some possible explanations.

4. Explaining path-dependency and corporate governance in Italy

4.1 Political origins of corporate governance

“The costs of transacting arise because the information is costly and asymmetrically held by the parties to exchange and also because any way of the actors develop institutions to structure human interactions results in some degrees of imperfection of the markets” (North 1990)³⁹. According with North

³¹ Data are taken from *Bollettino statistico Banca d'Italia*. Tipografia della Banca d'Italia. Roma.

³² Treasury redeemable stock acquired in October 1952, and term-time 1954

³³ Treasury redeemable stock, data for consolidated stock is 4,88%

³⁴ Treasury redeemable stock with term-time April 1th 1972

³⁵ Treasury stock with term-time April 1th 1982

³⁶ Rate of B.O.T. term-time

³⁷ Variance is an absolute measure of the risk: for this reason financial analysts use to employ in their analysis its square root (called standard deviation).; this index is directly comparable with the TRE.

³⁸ Although the technical term is standard deviation in the world of business this concept is summarized with the word volatility or rather price's waver around an average value, calculated in a defined period.

³⁹ D.C North. Institutions, Institutional change and

we want to show that system of firms and banks with their complex interconnection arises as a reaction of a transaction cost system. In particular we argue that the firms as institutions choose their governance structure according with the complex system of norms, sanctions, monitoring system and social interaction that shape human behaviour⁴⁰. In the next paragraphs we try to demonstrate one of the possible causes that origin the imbalance in favour of debt. In particular we underline that the firm's choices were not irrational and that there was an alignment with the “complex set of constraint that shape the *ex post* bargaining over the quasi-rents generated in the course of a relationship [...] the outcome of the bargaining will be affected by several factors besides the initial contract (Zingales 1999)⁴¹.

In some recent works⁴² Pagano shows the correlations between ownership dispersion and employment protection. As it is shown in the next figure⁴³ employment protection is higher where is lower the degree of dispersion of ownership. We can assert, following Pagano (2006), that the high degree of ownership concentration is reached as a replay of employment protection in a process of circular causation. This process happened particularly in those European countries with aristocratic origins, or, in other words, where the condition that existed when “big business” emerged in the country, entailed the rise of a strong entrepreneurial class and weak democratic institutions⁴⁴. Entrepreneurs employed

economic performance Cambridge University press, 1990. Pag. 108

⁴⁰ Economic literature uses to distinguish between two different forms of governance. The more general one referring to the complex system of norms that affect *ex post* bargaining and one other refers just to the agency costs that arise from the problem of ownership dispersion.

⁴¹ L. Zingales. Definitions of “Corporate governance”. In *New Palgrave of Law and Economics*, 1999, pp. 497-503

⁴² Ugo Pagano “Political Origins of Corporate Governance” preliminary draft written for the Workshop on the Politics of Corporate Governance organized in Copenhagen on 29-30 September by the Center for Corporate Governance (CCG) and the Center for Economic Business Research (CEBR).

M.Belloc and Ugo Pagano. “Co-Evolution Paths of Politics, Technology and Corporate Governance”. *ECGI (European Corporate Governance Institute) Working Paper, Law Working Paper* n. 36//2005 (May2005)

⁴³ M. Belloc and Ugo Pagano (2005)

⁴⁴ “The case of “aristocratic origins” can be schematized in this way. Society had been used for a long time to a concentration of political and economic power in the hands of few families (the royal family and the aristocracy). The rule of dynastic succession had been accepted as the legitimate way of transmitting political and economic power and upward mobility was strongly discouraged: individuals were supposed to fill the same social roles of their parents and upward mobile individuals were often despised. When large firms became the best suited for economic development, the new industrial aristocracy, which controlled them even beyond the means of their considerable wealth, was not challenged by an established

their resources and made efforts to consolidate their positions of control as countervailing power of the growing trade union position. As a consequence, resources involved in this process were not designated to a realignment of the firm's governance in order to attract capital of risk by new investors.

On the other hand investors were not willing to destine their found to invest in big firms' equity because of the impossibility of determining firms' governance. This condition, jointly to the scarce presence of institutional investors and the lack of investors protections, got the basis for the process of cumulative causation leading to the concentration of ownership and the imbalance of financial tools.

In particular in the *post-war* period we observe that a large share of the Italian big enterprises was owned by the State. The presence of the State in Italian economy was determined to replace the lack of big investors different from the other that control the private big firms. To open to the market of equity could have meant the implementations of the power in the same hands and the constitutions of a strong economic power, able to influence in a relevant way the political decision. De Cecco (1997) underline this peculiar aspect of the Italian system, stressing that the role of the State in Italian economy was determined, among the other causes, by the lack of trust in markets dominated by great economic power.

In this frame Barca (1997 *b*) observes the presence of a link of mutual convenience between the power of the public sector (formerly dictatorial, subsequently democratic) and the power of private industries' lobbies. In this relation, the former gave guarantees for a technical and stringent management and the latter had a relative independence from the public sector. The path dependencies between political origins and the corporate governance, in absence of an institutional shock (as it happened in Japan) determined the bank-centric system of Italy.

The lack of warranty have no explanation anyway, In fact, according with previous paragraphs we note an unjustified recourse to the capital of debt in comparison with the use of equity as financial channel. In fact, loans allotted by landing institutes were not granted, neither with broad margin of capitalization, neither with a correspondence between the growth of debt and growth of performance (fixed technical assets and turnover)⁴⁵. We presuppose that landing institutes replaced classical warranties (capitalization and expected good performance) with some other element, determining the same situation for both public and private owner in the financial choices As it shown in fig.2).

To grant loans for public firms there was, beyond any other kind of warranty, the State as entrepreneur, which throughout its internal revenue could replace the lack of warranties of its firms. Instead private firms have, on the one hand relevant and positional information on the political and economic choices of the State⁴⁶, on the other hand various form of financial support and credits on easy terms⁴⁷ in virtue of the public interest that those firms covered in terms of contribution to GDP, defence of employment and benchmark for Italian economy⁴⁸.

Such a situation makes possible that the more important Italian firms become independent from the need of a call on the capital of risk, in virtue of the fact that large part of financial requirement was satisfied on the market of debt.

Effects go beyond the original intentions of the State's short time support. Independency from equity discouraged a corporate governance rearrangement (for example, efficient rules on the side of minority shareholders); this means on the one hand less incentives for new entrepreneur/investors in giving their founds in the risk's capital of Italian firms, on the other hand the missed development of the Italian stock exchange.

democracy. The new industrial giants were embedded in a society where, in spite of numerous rebellions, dynastic power was still widespread and accepted as legitimate. Capitalist dynasties could increase their power thanks to their own wealth and to the accumulation of capital that large-scale firms allowed. They could also extend their control beyond their wealth thanks to pyramids and other financial arrangements. Members of the large owning families served as managers of the firms. Small shareholders had no chance to fire these "dynastic" managers and professional managers were confronted with a socially exclusive wealthy group, which enjoyed a "de facto" tenure thanks to its family links. Faced with the concentrated interests of capitalist dynasties, workers reacted by concentrating their interests into unions and social-democratic parties". Ugo Pagano "Political Origins of Corporate Governance" preliminary draft written for the Workshop on the Politics of Corporate Governance organized in Copenhagen on 29-30 September 2006 by the Center for Corporate Governance (CCG) and the Center for Economic Business Research (CEBR). Pag 9.

⁴⁵ See the appendix.

⁴⁶ For example see the role of Pirelli and Fiat in the realization of the main Italian Freeway Milan-Naples.

⁴⁷ See for example Colombo's Law of 1959 for the founding and support to small and medium firms; Sabatini's Law (1965) gives incentives to realize investment in fixed capital, The law for special intervene in the south to go over the dualism in production; or to the Ossola's Law (1976) with incentives for the exportations.

⁴⁸ Fiat, for exemple, according to Michelsons (1997) had in organizational and economic sense a role of means and screen between local productive system and foreign market. "This peculiarity permitted to small firms a growth protected from the action of market, while technical competences were transmitted trough direct investment or by fiat itself". A. Michelesons. "Grande fabbrica e minime imprese: l'indotto Fiat negli anni del boom economico". In *Comunità di imprese* a cura di F. Amatori e A. Colli. Il Mulino, 1997. Pag. 90. Translated by the authors.

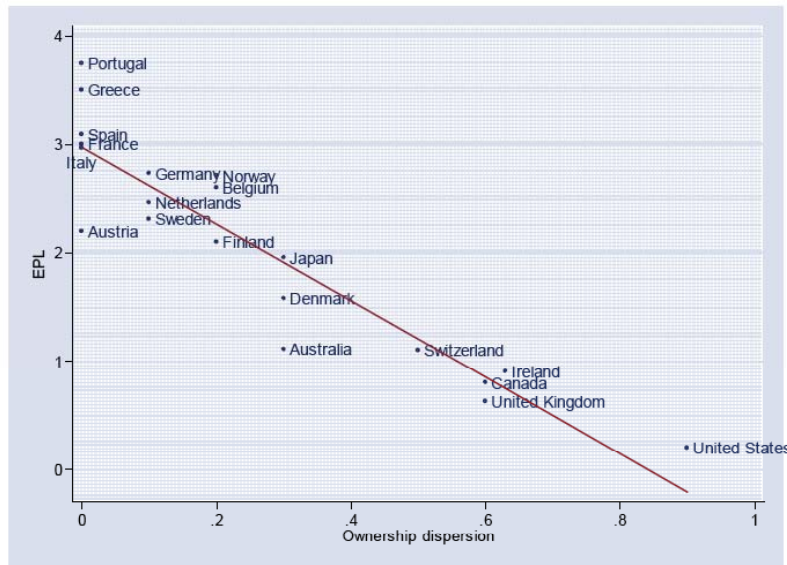


Fig. 1: Employment protection and ownership dispersion

Fig 3 Employment protection and ownership dispersion, In Belloc and Pagano (2005)

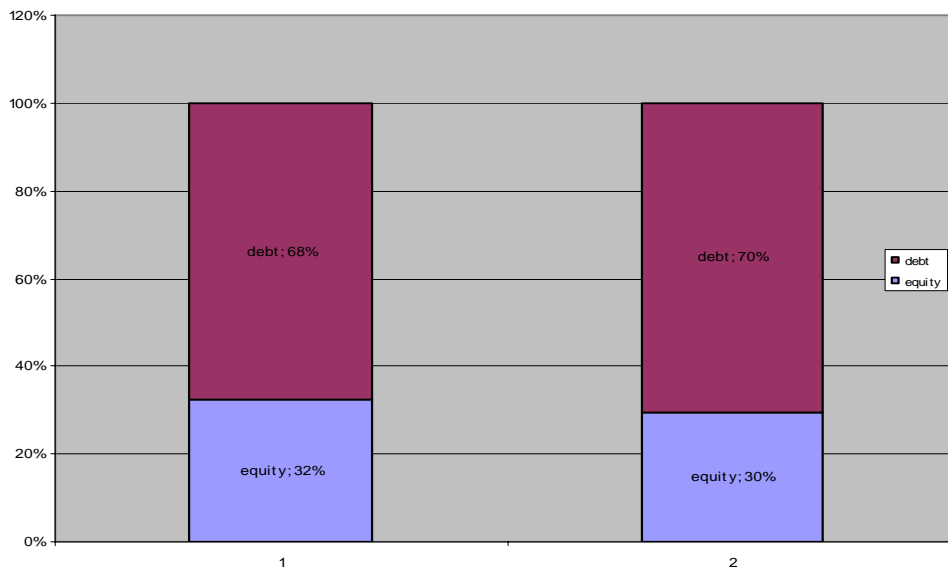


Fig. 4. Column one shows the composition between debt and equity for the public owner column two for the private one

We stress that this kind of choices (debt-oriented system and missed governance’s reorganization) were not irrational, but are the consequences of the complex system in which firms were involved. Close to the “political origins” and the role of the State there was another important factor affecting firms’ financial choices: the absence of a competition in the credit’s market.

Several works on the effects of banking competition on financial stability highlights its negative impact in terms of increased incentives to take risks (Matutes and Vives 1996, Helmann *et Alii*

2000). In particular according with Petersen and Rajan (1995) banks can sustain the cost of a starting relationship with new borrowers only if its market power allow it to recover the cost at later stages if such entrants turn out to be successful. As a consequence we expect to find a greater number of new entrants (in the non-financial market) where banks have market power. Otherwise, Cetorelli and Strahan (2004) leads an empirical research asking whether concentration of market power in banking has an effect on the number of firms in a given sector and on firm average size. Empirical evidence shows

that “bank with market power erect an important financial barrier to entry”⁴⁹ in order to protect the profitability of their existing borrowers. Important conclusion leads us to reconsider the interconnection between financial and non-financial market. In particular Spagnolo (2004) shows that “by controlling borrower’s choice of managers and managerial incentives, a concentrated or collusive banking sector can implement collusion and monopolize otherwise competitive downstream product market”⁵⁰

Moreover we observe many links between bank and firms, in particular analyzing boards of directors of a relevant sample of Italian firms Luzzatto Fegiz in 1928 observes that “leafing through the yearbooks of [these company] the same names repeat again itself [...] and often the same persons occupied two or three pools and sometimes twenty or more” (Luzzatto Fegiz 1928: 127).

A more recent study, lead by Ferri and Trento (1997) analyzing a sample of financial and non financial firms reveal that this interconnection between bank and firms slowly decrease, but links between different credit institute become thicker step by step⁵¹. The analysis of the interconnections is important because of empirical evidence reveals that “more frequent are contact between firms, [...] more easy is the disclosures of relevant information and coordination between companies” (Ferri and Trento 1997: 414. Translated by the Authors). Results show that despite prohibition, there was strong cooperative bonds between banks and firms, in particular bonds are observed between public credit institute and both, public and private, firms but just on this direction: names in board of public bank often slide in the board of public and (especially) private companies, but not vice-versa .

Anyway, without assuming the presence of collusive situation, in this frame we observe the presence of a particular kind of foreclosure. Foreclosure effect is generally defined as the exercise of power on a market in order to extend the firm’s dominance not on this specific market, but on an adjacent one. This kind of activity manifest itself through the exercise of exclusive practise⁵² in order

to damage competitors on the downstream market, in virtue of the control of an essential input in the upstream market.

Foreclosure effect is not directly referable to the Italian credit market, in fact the call on the capital of risk was not forbidden, but the Italian policy (in the banking management) gives a strong incentive to recur to the competitor financial tool anyway. The public management of the investment bank was another element that improved the this peculiar situation of the main Italian firms permitting, on the one hand, the growth of national industries, but on the other hand missing the trigger of the virtuous circle between financial tools, for the full availability of finance, with the lowest cost.

On the contrary where banks are not concentrated and “where credit markets are more competitive product market should also be more competitive, and R&D investment should be more intense” (Spagnolo 2004: 24).

The peculiar situation of the bank system, jointed with the strong role of the State and the politic origins of Italy leads to a system isolated from the dynamics of competition in financial and non-financial market⁵³. These kind of consideration are imputable to political an ideological interest, finalised to protect public firm and the public administration of economy (Marchetti 1997, Barca e Trento 1997). In fact in the Seventies, while other states were enacting or reforming their competition law, an investigation commission of Italian Parliament came to the (curious) conclusion that Italy didn’t need an antitrust law, because a problematic situation of competition was not revealed⁵⁴. Nevertheless, although in these years competition was not considered an efficient tool encouraging economic welfare and technological progress, inefficient effects of anticompetitive practices were not eliminated.

arise when the bottleneck good is used as an input (e.g., an infrastructure) by a potentially competitive downstream industry, or when it is sold directly to customers, who use the good in conjunction with other, perhaps complementary goods (e.g., system goods or aftersale services). In the former case, the firms from the competitive segment that are denied access to the necessary input are said to be “squeezed” or to be suffering a secondary line injury. In the latter case, the tie may distort or even eliminate effective competition from the rivals in the complementary segment”. Patrick Rey and Jean Tirole. ”A primer in foreclosure”. In *handbook of industrial organization III*. Edited by M. Armstrong and R. Porter

⁵³ “Beneduce system shows [...] it was not able to work in open economy with different nexus of power. It was a financial circuit for the allocation of scarce resource an for the protection of domestic good.” (De Cecco 1997: 399. Translation by the Authors).

⁵⁴ F. Ghezzi, M. Maggiolino, P. Magnani e G. Mangione. *Appunti di Diritto Antitrust e Disciplina della concorrenza sleale*. Università Commerciale Luigi Bocconi, Milano, 2003.

⁴⁹ N. Cetorelli and P. E. Strahan. “Finance as a Barrier to Entry: Bank Competition and Industry Structure in Local U.S. Markets”. *FRB of Chicago Working Paper No. 2004-04 SSRN Jun, 2004*. Pag. 28.

⁵⁰ G. Spagnolo. Debt as a (credible) device: Everybody happy but the consumer. In Working paper of economics and finance N. 243. Stockholm School of Economics, 2004. Pag. 24.

⁵¹ G. Ferri and S. Trento “la dirigenze delle grandi banche”. on *Storia del capitalismo Italiano*, edited by di Fabrizio Barca. Donizzelli, , Roma 1997.

⁵² “[...]foreclosure refers to a dominant firm’s denial of proper access to an essential good it produces, with the intent of extending monopoly power from that segment of the market (the bottleneck segment) to an adjacent segment (the potentially competitive segment). Foreclosure can

5. Final remarks

According with Williamson (1988), we defined debt and equity as effective form of corporate governance with different cost of functioning. Only through the simultaneous use of both tools we can guarantee the efficient specificity of the assets with the lowest transaction costs. We want to stress that the problem of Italian capitalism lies, neither in the absence (scarcity) of capitalist, neither in the scarcity of capital. We observe that Italy could be a *mine* of entrepreneurial ability and faculty of saving, its weakness and strength lies elsewhere. In particular “with its peculiar institutions Italian capitalism had been able -or had been not- to combine capitalist with assets and to select and renew its politic and economic managerial class” (Barca 1997 a : XI).

The role of the State in Italian economy was the one of temporary alternate⁵⁵, allowing the completion of many crucial investments, in periods of slump (The great depression of thirties) or in period of rapid growth (when the completion of some investment valuated as crucial for the growth of Italian economy).

It all happens in a *post-war* period, in the temporary absence of an entrepreneurial class. Many authors (see for example De Cecco 1997 or Conte and Piluso 2006) noted as this virtuous role of the State, as guide for the Italian economy, was replaced step by step by a policy of mere support without any reorganization of the governance structure⁵⁶. In our opinion this reorganization did not take place because Italian firms could satisfy their need of funds only with their favourite position on the market of debt. In fact State’s support and the public management of the banks made up for equity for both public and private firms, through particular laws, incentives and corporate rescues. Given these elements and the politic origins of Italian capitalism

⁵⁵Analyzing the Italian economic policy, concerning the role of the State and, in particular the function of Beneduce’s IRI, De Cecco stresses that this policy was “extraordinarily careful at the Italian structural condition, Italy in fact was a big power just for its wide population and its geo-politic position; It was the reason why Italy was sentenced to accelerate its growth, endowing itself with an economic structure able to preserve its geo-politic condition, without the momentary presence, neither of a strong entrepreneurial bourgeoisie, neither of firms and saving.” (De Cecco 1997: 392, Translation by the Authors).

⁵⁶ It concerns economic and industrial policy of broad support to the public firms, as these suggested by Saraceno, assigning to the company owned by the State “improper burdens”, or the successive policy of “national champions”. Barca and Trento (1997) assign to this inefficiency in the relation between property and management the slump of the public firm and the successive impossibility of a rescue in a contest previously dominated by a great inflation (during seventies and eighties) and restraint to the public balance during the nineties.

Italian firms had a unique equilibrium in debt, and a substantial independence from equity.

As a first consequence, this independency from equity obstructed the growth of an Italian stock market comparable with the one of the other industrialized countries. Secondly the position of the Italian corporation on the equity market becomes weaker, making firms in need of a stronger State’s support. We want to underline that it is not the role of the State that causes the break-up of the virtuous circle, but the wrong policy that didn’t escort grants with any incentive for a governance rearrangement. Anyway public administration of the banks jointly with particular economic policy permitted, on one side, the growth of the Italian corporation, but denied, on the other hand, the trigger of the virtuous circle between financial tools.

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Appendices

✓ [1.4] $D_i = \alpha + (\alpha t_i) + \epsilon_i$ [with i is the i -th firm of the sample, t_i the dependent variable and ϵ_i the residual error].

Dependent Variable: DEBT

Method: Least Squares

Sample(adjusted): 14 109

Included observations: 64

Excluded observations: 32 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.300127	0.026063	11.51525	0.0000
FATTURATO	-5.76E-09	5.16E-09	-1.115501	0.2689
R-squared	0.019675	Mean dependent var		0.285750
Adjusted R-squared	0.003863	S.D. dependent var		0.181581
S.E. of regression	0.181230	Akaike info criterion		-0.547353
Sum squared resid	2.036337	Schwarz criterion		-0.479888
Log likelihood	19.51531	F-statistic		1.244341
Durbin-Watson stat	1.496702	Prob(F-statistic)		0.268941

✓ [1.5] $D_i = \alpha + (\gamma \text{fta}_i) + \epsilon_i$ [with i is the i -th firm of the sample, fta_i the dependent variable and ϵ_i the residual error].

Dependent Variable: DEBT

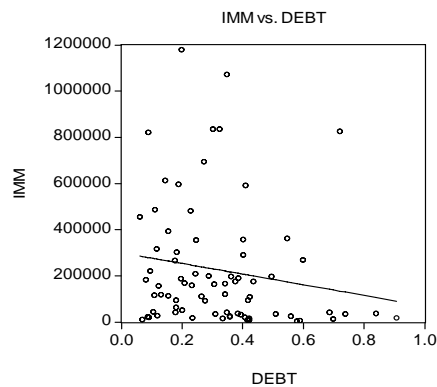
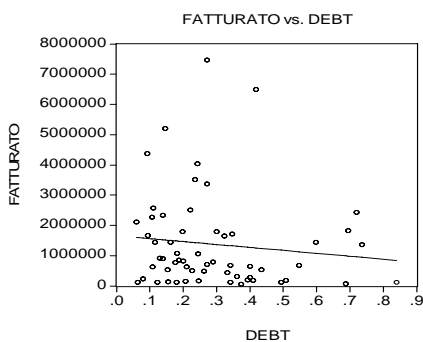
Method: Least Squares

Sample(adjusted): 1 109

Included observations: 93

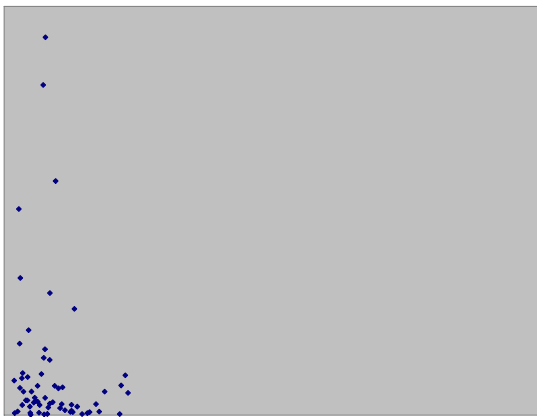
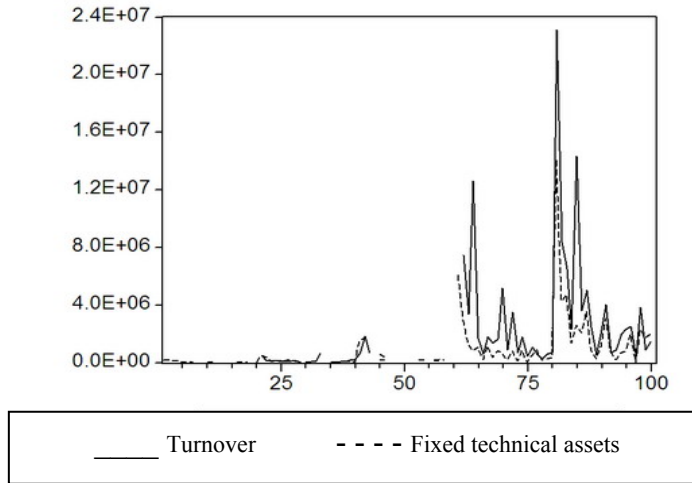
Excluded observations: 16 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.321802	0.021585	14.90854	0.0000
IMM	-1.55E-08	1.14E-08	-1.357975	0.1778
R-squared	0.019862	Mean dependent var		0.310206
Adjusted R-squared	0.009092	S.D. dependent var		0.192055
S.E. of regression	0.191180	Akaike info criterion		-0.449935
Sum squared resid	3.326020	Schwarz criterion		-0.395471
Log likelihood	22.92199	F-statistic		1.844095
Durbin-Watson stat	1.633791	Prob(F-statistic)		0.177829



✓ [1.3] $D_i = \alpha + (\beta t_i) + (\gamma fta_i) + \varepsilon_i$ [with i is the i esima firm of the sample and f_{t_i}, e_{t_i} the dependent variable and ε_i the residual error].

We proceeded with two different regressions (1.4 and 1.5) for the following reasons. The high degree of correlation between fixed technical assets and turnover (r^2 0,836) shows an inability for the model to explain the correlation between D_i and this proxy of the firm's performance. Results are showed in following pictures:



Scatter diagram 1:

X: Debt Index

Y: Turnover



Scatter diagram 2:

X: Debt index

Y: Fixed technical assets

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