



THE IMPACT OF EXPENSING STOCK OPTIONS IN BLOCKHOLDER-
DOMINATED FIRMS. EVIDENCE FROM ITALY

*Andrea Melis**, *Silvia Carta***

Abstract

Accounting for stock options and executive remuneration have been one of the most debated and controversial issues in accounting regulation and corporate governance. The purpose of this study was to explore the impact of the mandatory adoption of IFRS 2 for accounting of stock options in Italian non financial listed companies. This paper has investigated the economic consequences of recording the cost of stock options at its fair value, in terms of its impact on the companies' reported earnings, and other key financial performance indicators, such as diluted earnings per share (EPS) and return on assets. The impact of the mandatory recording of the cost of stock options measured at its fair value has generally reduced the reported earnings and other key performance measures moderately. Despite some evidence of creative accounting which was found concerning the elusion of the substance over form principle for the accounting of stock options plans set up before 7th November 2002, accounting regulation has increased the level of disclosure by making companies report the "true" cost of stock options in their Profit or Loss. Based on 2004 stock-based remuneration disclosures of the value of options given to directors and employees, the expensing of options have a material negative impact on nearly 30 per cent of the sample firms' reported income and diluted EPS. The mandatory adoption of IFRS 2 seems to have relevant implications for corporate governance as it has reduced the information asymmetry between corporate insiders and outsiders on the "true" cost of stock-based remuneration.

Keywords: stock options, blockholders, Italy

**Department of Ricerche aziendali, University of Cagliari, Viale S. Ignazio 17, 09126 Cagliari – Italy
melisa@unica.it,*

***Department of Ricerche aziendali, University of Cagliari, Viale S. Ignazio 17, 09126 Cagliari – Italy
silviacarta@unica.it*

Introduction

The use of stock options as remuneration device and its accounting method has represented one of the most debated and controversial issues during the last decades, both in the accounting and in the corporate governance literatures. Financial reporting and corporate governance are highly interrelated systems (e.g. Whittington, 1993; Bushman, Smith, 2001; Melis, 2004). In particular, financial reporting constitutes an important element of the corporate governance system, as it may potentially reduce the

information asymmetry between corporate insiders and outsiders.

The recognition of stock option plans (and equity-settled share-based payments, in general) as a cost in Profit or Loss is a recent outcome of a long debate between standard-setter bodies and industrial associations (Guay *et al.*, 2003). In the US the final result was the issue of a revised version of SFAS 123R (2004); in Europe, the outcome was the mandatory adoption of IFRS 2 (2004) imposed by the European Commission to the listed companies of its Member States. Both the two standards have required the mandatory recognition of a cost for stock options,

measured at the fair value of the equity instruments at the grant date.

Accounting is concerned with how economic actors process information and make decisions. It cannot be considered simply a neutral technique for economic decision-making as it is able to sanction the distribution of wealth among corporate stakeholders, including shareholders (e.g. Horngrén, 1973; Rappaport, 1977). Both the issue of the SFAS 123R in the US and of the IFRS 2 by the IASB has been the outcome of a significant lobbying activity by constituents (e.g. Shelton, Stevens, 2002; Zeff, 2002; Giner, Arce, 2007). This was due to the relevant economic consequences that the accounting regulation of stock options could have had on the wealth of corporate stakeholders, and on corporate governance in general. In particular, the concerns about executive remuneration represent a major aspect of the rationale for enhanced corporate governance (e.g. Core *et al.*, 2003; Jensen *et al.*, 2004).

The main purpose of this study is to measure the impact of the mandatory adoption of IFRS 2 for accounting of stock options in Italian non financial listed companies. This paper will investigate the economic consequences of recording the cost of stock options at its fair value, in terms of its impact on the companies' reported earnings as well as on other key financial performance indicators, such as diluted earnings per share (EPS) and return on assets (ROA). The empirical results will be analysed taking into account the corporate governance implications that stock options' expensing might have, in terms of reducing information asymmetry between corporate insiders and outsiders on such a key issue as the cost of stock option-based remuneration.

As noted by Chalmers and Godfrey (2005), any concern about the economic impact of expensing stock options is settled if the change does not significantly affect reported accounting measures used by investors to assess companies' performance. Using stock options disclosures, previous studies have provided evidence that if stock option-based remuneration was to be expensed, it would significantly affect key financial performance indicators of high-growth US companies (Botosan, Plumlee, 2001), and of large non-US companies listed on the NYSE and/or NASDAQ (Street, Cereola, 2004). However, Street and Cereola (2004) found that the materiality of the effect varied significantly by country. Chalmers and Godfrey (2005) found that the concerns about stock option expensing was not material for most of Australian listed firms.

This paper extends previous literature by analysing Italian non financial listed companies, on which there is a scant empirical evidence. As Italy is one of the first countries, internationally, to adopt fully IFRSs, Italian listed companies provide an interesting sample and an early opportunity to examine the impact of the mandatory IFRS 2

adoption. The choice of a non-Anglo-Saxon country for a single country case study seems useful to extend previous literature findings which mainly focused on Anglo-Saxon companies (Botosan, Plumlee, 2001; Chalmers, Godfrey, 2005), or on non-Anglo-American companies listed in Anglo-Saxon stock exchanges (Street, Cereola, 2004).

The remainder of the paper is organised as follows. Section 2 summarises the Italian financial reporting regulation on stock options before and after the IFRS adoption in 2005. The research design and methodology is discussed in Section 3. In Section 4 results are presented and analysed. Section 5 concludes.

The Italian regulation on stock options: a synopsis

The adoption of IFRS 2 has completely changed the accounting for stock options in Italy. Italian accounting standards (CNDC-CNR, 2001, OIC, 2007) have never issued any standard on share-based payments, nor do they deal specifically with it yet.

The accepted practice was driven by a 1998 CONSOB¹³⁸ recommendation, which required Italian listed companies to disclose the details of the stock options given to directors and senior managers in the notes of the accounts as well as to credit equity when the options were exercised by the holders. Before 1998, information regarding stock options was not publicly available. As a matter of fact, the diffusion of stock options in Italy is relatively recent. Fixed wages have been the main ingredient of executive remuneration and, in general, equity-based schemes were rarely adopted by Italian non financial listed companies in the 1990s (Melis, 1999). Stock options plans started to be more widely adopted since 1998-1999 (Bertoni, 2002; Zattoni, 2003). The event that fostered the adoption of these plans by Italian companies was the 1998 Tax Reform which provided strong fiscal incentives for beneficiaries (Zattoni, 2007). The diffusion of stock option plans seems dependent on 'external' factors, such as a favourable fiscal treatment in comparison to cash and other in-kind remuneration (Di Pietra, Riccaboni, 2001; Quagli *et al.*, 2006; Zattoni, 2007), and the accounting treatment of this transaction (Quagli, 2006).

Until 2005 the recording of the cost of stock options was voluntary even for listed companies. Stock-options were basically an off-balance sheet operation, as almost none of the companies that gave stock-options to its directors, senior management (or other employees) as part of its compensation recognised such cost in their Profit or Loss. This creative accounting practice led to a reduction of the costs reported in the Profit or Loss, and could have

¹³⁸ CONSOB is the Italian public authority responsible for regulating and controlling the Italian securities markets.

had economic consequences in the cases in which the unrecognised cost was material.

In 2005 the mandatory adoption of IFRSs has obligated Italian non financial listed companies to recognise the fair value of stock options as an expense in their Profit or Loss (IFRS 2, 2004). The cost of stock option plans is to be measured at the fair value of the equity instrument granted multiplied by the number of instruments the company estimates that will be exercised.

Research design and methodology

Our study extends previous literature by examining the impact of stock options' expense recognition for non financial listed companies based in a non-Anglo-Saxon country. Specifically, the key research question that this paper seeks to answer is: is the impact of expensing stock option material in Italian non financial listed companies?

The investigation has been conducted in terms of the ability of IFRS 2 to improve the perception of the cost of stock options to financial statements' users. This ability was explored in terms of impact of the cost of stock option on the companies' reported earnings and other key financial performance ratios, such as diluted EPS and ROA.

Sample selection

This study focused on Italian non financial listed companies (including real estate companies) which has been required to adopt IFRSs since 2005. Banks and insurance companies and other financial institutions have been eliminated in view of the peculiarities of the financial industry and its specific regulation. Non domestic companies listed in the MTA International segment¹³⁹ have been discarded as they were not required to prepare and present their financial statements according to Italian GAAP. The complete directory of Italian non financial companies listed both in 2004 and 2005 that was required to adopt IFRSs¹⁴⁰ was analysed. Among them, 61 companies which adopt stock option plans in 2004 have been identified and analysed.

The great majority of the companies in the sample that recorded the cost of stock options in their Profit or Loss since 2005 used to treat stock option as an off-balance sheet operation beforehand. Based on an in-depth analysis of their consolidated financial statements, sixteen companies were eliminated from the sample as they recorded no cost as they choose to use one of the transitional provisions (IFRS 1, 2004, para 25b-c; IFRS 2, 2004, para 53-58) that allow the

non-adoption of IFRS 2 for specific stock option plans.

Hence, 45 companies comprise the final sample (a list is reported in the Appendix). Among them, three companies had chosen to record the fair value of the stock options' cost in Profit or Loss before the mandatory adoption of IFRS 2 required them to do so (see ESOP 2004-No impact in table 1).

INSERT TABLE 1 ABOUT HERE

Data collection

For each company, data have been gathered from consolidated financial statements referring to the years 2004 and 2005. The period considered was selected to allow to conduct a natural experiment to measure the impact of the accounting regulation on stock options' expensing. The same financial reality referring to 2004 results has been measured twice by each company: all the companies chosen for the investigation have been required to prepare and present their own 2005 consolidated financial statements according to IFRSs, presenting, at the same time, the 2004 data (which had been prepared according to Italian GAAPs) according to IFRSs.

We investigated the impact of the mandatory adoption of IFRS 2 on firms' key performance indicators by comparing performance ratios calculated using actual 2004 reported financial figures with pro-forma ratios calculated using the 2004 reported numbers adjusted as if the stock options were expensed over the period. Specifically, we measured the impact of the unrecognised cost on the reported income (unrecognised cost of stock option / reported income) and we constructed the pro-forma key financial performance measures (ROA, and diluted EPS), based on the 2004 Italian GAAP data, as follows:

¹³⁹ MTA International is the segment within Borsa Italiana's MTA regulated equity market dedicated to the trading of shares of non Italian issuers already listed in other EU regulated markets.

¹⁴⁰ We excluded listed companies that were not required to adopt IFRSs in 2005, in accordance to CONSOB regulation. See CONSOB (2005, para 81bis, 82bis).

$$\text{- impact on pro-forma diluted EPS}_{ITA\ GAAP} = \left[\frac{(\text{Diluted EPS}_{PRO\ FORMA} - \text{Diluted EPS}_{ITA\ GAAP})}{|\text{Diluted EPS}_{ITA\ GAAP}|} \right]$$

where diluted EPS_{PRO-FORMA} is equal to:

$$\left[\text{Diluted EPS}_{ITA\ GAAP} - \left(\frac{\text{Unrecognized cost of stock option}}{\text{Weighted number of shares}} \right) \right]$$

$$\text{- impact on ROA}_{ITA\ GAAP} = (\text{ROA}_{PRO\ FORMA} - \text{ROA}_{ITA\ GAAP})$$

where ROA_{PRO-FORMA} is equal to

$$\left[\frac{(\text{Reported income}_{ITA\ GAAP} - \text{Unrecognised cost of stock option})}{\text{Total Assets}_{ITA\ GAAP}} \right]$$

Impacts on IFRS-based figures has been measured accordingly, by taking into account that diluted EPS_{PRO-FORMA} is equal to:

$$\left[\text{Diluted EPS}_{IFRS} + \left(\frac{\text{Cost of stock option}}{\text{Weighted number of shares}} \right) \right]$$

and ROA_{PRO-FORMA} is equal to

$$\left[\frac{(\text{Reported income}_{IFRS} + \text{Cost of stock option})}{\text{Total Assets}_{IFRS}} \right]$$

Data for the unrecognised cost of stock options, reported income, and pro-forma diluted EPS and ROA (i.e. the difference between 2004 Italian GAAP figures and the IFRS-converted figures) were hand-collected from the consolidated financial statements.

Results

Sample demographics

Table 2 provides a brief overview of the sample, in terms of size (total revenues and assets), and profitability.

INSERT TABLE 2 ABOUT HERE

The sample includes firms which are all controlled by a block-holder, i.e. a (group of) shareholder(s) that owns at least 10 per cent of voting rights, but have diverse financial characteristics: some are (highly) profitable, some others are loss making. Firms analysed are at various growth phases. The characteristics of the sample allow to extend the findings of previous literature which mainly focused on high-growth US companies (Botosan, Plumlee, 2001), large non-Anglo-American companies listed in the US (Street, Cereola, 2004), or Anglo-Saxon companies (Chalmers, Godfrey, 2005).

Impact of expense recognition

The mandatory adoption of IFRS 2 has increased the perceived cost of stock options at the eyes of the

financial statements' users. The overall impact of the cost of stock options on reported financial performance is moderate, although sometimes material. The impact on Italian GAAP income (pro-forma diluted EPS) is 8 % (14,13 %¹⁴¹) on average. This result is influenced by few values that deviate significantly from the mean. In fact, the median impact is 2.34 % on Italian GAAP income (2.68 % on diluted EPS¹⁴²). Similar results have been obtained on IFRS-based 2004 data (see table 3).

INSERT TABLE 3 ABOUT HERE

The framework of the IASB (1989, para 30) considers that information is deemed to be material if its omission, misstatement or non-disclosure has the potential to adversely affect the decisions of financial statements' users and/or management's discharge of accountability. The materiality of an item in the statement of performance may be judged by comparing the item to the operating profit for the current reporting period. Along with previous literature on the subject (see Botosan, Plumlee, 2001; Street, Cereola, 2004; Chalmers, Godfrey, 2005), we adopted as a non-binding quantitative threshold (more than or equal to 5 %) to assess materiality.

¹⁴¹ This value does not include the companies that already recorded the fair value of the stock options' cost before the mandatory adoption of IFRS 2.

¹⁴² See note 4.

Our findings suggest that the fair value of stock options on the pro-forma Italian GAAP reported income (pro-forma Italian GAAP diluted EPS) is material for 31 % (29 %) of the Italian non financial listed companies with stock option plans. The impact on ROA is never material. Similar results are obtained on IFRS-based data.

These results underestimate the materiality of the impact, as our estimate is based on the costs that have actually been disclosed in the consolidated financial statements. In fact, nearly 50 % of the companies whose reported impact is not deemed as material (i.e. < 5 %) has underestimated the “true” cost of stock options by adopting one of the transitional provisions (IFRS 1, 2004, para 25b-c; IFRS 2, 2004, para 53-58) that allows the non-adoption of IFRS 2 for specific stock option plans. This choice may be considered creative in the sense that it was in accord to what allowed by accounting regulation, but elusive of the substance over form principle. Future application of IFRS 2 will have to be applied to all stock-based compensation, thus the materiality of the cost might increase.

Impact of stock options' expense recognition and firms' characteristics

We specifically investigate whether the impact of expensing stock options on reported income and key financial indicators is associated with companies' growth phases (Botosan, Plumlee, 2001), size (Zattoni, 2003), or industry (Apostolou, Crumbley, 2005). We tested three main hypothesis through the coefficient of Bravais-Pearson to measure the correlation between cost of stock options and its impact on ITA GAAP and IFRS reported income¹⁴³, and a χ^2 test with regards to industry.

Growth

Botosan and Plumlee (2001) argued that high-growth firms tend to use stock option plans more extensively than “mature” firms. Thus, we expected that:

Hypothesis 1: The impact of stock option expensing is positive related to firm's growth.

Growth was measured as the percentage variation of the firms' total assets in 2002, 2003 and 2004. Table 4 shows that a relationship between the variables does not exist (see table 4). The hypothesis may be rejected. In Italy there seems to be no significant difference between high- and non-high growth firms concerning the impact of stock option expensing.

Size

On a sample of Italian (financial and non financial) listed companies, Zattoni (2003) found that larger

firms tend to use stock option more extensively than other firms. So we expected that:

Hypothesis 2: The impact of stock option expensing is positive related to company size.

We choose total assets in 2004 as a proxy for company size¹⁴⁴. We found a weak positive relation between size and the magnitude of the cost of stock options (ρ -value = 0.2333), while there is a weak but negative relation between size and the impact of the cost on reported income (ρ -value = -0.1409) (see table 4). This evidence may be explained by considering that while it seems logical that larger firms give greater stock-based remuneration packages (as overall remuneration is usually linked with company size, see e.g. Jensen *et al.*, 2004), the significance of the impact is deflated by the larger amount of assets (revenues) that characterises large firms.

INSERT TABLE 4

Industry

Firms in new-economy sectors are often considered to make a significant use of stock options plans (see, *inter alia*, Zeff, 2002; Apostolou, Crumbley, 2005; Avallone, Ramassa, 2006). So we expected that:

Hypothesis 3: The impact of stock option expensing is material in firms which operate in new-economy sectors.

Firms have been grouped into three types of industries (manufacturing, regulated market and new-economy) because of the small number of firms in several single industries. Manufacturing companies are defined as companies that make tangible goods. New-economy industry includes high-tech, services and design industries, i.e. industries in which intangibles play a major role in production. Regulated industry includes companies where the production of goods or services is supervised by the State authorities to safeguard the public interest (telecommunications, energy, and public utilities).

To examine the relation between industry and impact of cost on reported income we used a χ^2 test. Evidence is mixed. We found that the materiality of the impact of stock options on IFRS-based reported income is significantly related to the sector in which the firms belong to ($\chi^2 = 5,8098$, significant at 10%), while its relation on ITA GAAP reported income is not significant ($\chi^2 = 4,4487$)¹⁴⁵.

Concluding remarks and implications for corporate governance

The economic consequences associated with the mandatory expense of stock option in non-Anglo-

¹⁴³ We also run the same tests using the impact on diluted EPS as dependent variable, but we found no significant difference. Given the very low impact on ROA in all cases, we did not expect to find any relation with firm's characteristics.

¹⁴⁴ We also tried total revenues of the companies in 2004 as a proxy for size, and the relation is even lower (ρ -value = 0.1586).

¹⁴⁵ Same results were obtained on pro-forma diluted EPS.

Saxon listed companies are largely unknown. This paper has conducted an exploratory study on the economic consequences of the mandatory adoption of IFRS 2 among Italian non financial listed companies, in terms of its impact on the companies' key financial performance measures.

Empirical evidence on Italian non financial listed companies has shown that the impact of expensing the cost of stock options measured at its fair value was moderate on average, but sometimes material. The findings indicate that absent requirements that stock compensation expense be recognized, a material upward bias was reflected in performance indicators (reported income and diluted EPS) of nearly 30 % of the Italian non financial listed companies that had stock options plans in 2004. The impact on ROA was never material

The mandatory adoption of IFRS 2 seems to have relevant implications for corporate governance. According to the so-called perceived-cost view (see Murphy, 2002), the use of option-based remuneration has arisen thanks to the favourable accounting treatment, which has made the perceived cost of a stock option much lower than its economic cost (Hall, Murphy, 2003). Companies had strong incentives to give stock options to their directors instead of cash, because stock option did not negatively affect their Profit or Loss.

The mandatory adoption of IFRS 2 has improved the disclosure on the cost of stock options. By reducing the information asymmetry between corporate insiders (i.e. executive directors and controlling shareholders) and outsiders, it allows minority shareholders and other stakeholders to improve their perception about the "true" cost of stock options plans. Although, some evidence of creative accounting was found concerning the elusion of the substance over form principle for the accounting of stock options plans set up before 7th November 2002, the "perceived" cost of stock options should be now more clear. The reduction of the information asymmetry has implications for corporate governance as corporate outsiders may better safeguard their interests (Mallin, 2002).

We found no significant relation between the magnitude of the impact of the cost of stock options and firms' characteristics such as growth phases and company size. This might be due to the fact blockholder-dominated companies might adopt stock options plans for reasons that are different from Anglo-Saxon public companies (Alvarez-Perez, Neira-Fontela, 2005; Zattoni, 2007). Further investigation on this issue seems needed. As the great majority of the listed companies around the world is characterised by a concentrated ownership and control structure (see La Porta *et al.*, 1999; Barca, Becht, 2001).

The study's limitations are acknowledged. This paper focused on a single country analysis. This choice fostered internal validity, however the extent to which the results of this study may be applied to

other countries is limited. Future research could investigate the impact of the mandatory adoption of IFRS 2 across a wide range of countries.

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Appendices

Table 1. Recording the cost of stock options plans

	N.	%
ESOP (IFRS 1, para 25b-c)	3	4.92
ESOP (IFRS 2, para 53-58)	13	21.31
ESOP 2004 – No impact	3	4.92
ESOP 2004	42	68.85
Total	61	100.00

Table 2. Sample firms characteristics

Amounts are presented in thousands of euros.

	Mean	Median	SD
Total asset (2004)	7,084,289	1,216,050	16,894,653
Total revenue (2004)	4,885,148	876,389	13,644,506
Reported income (2004)	293,620	28,114	1,263,186.57
Cost of stock option	2,542	658	5,597.69

Table 3. The impact of the (unrecognised) cost of stock option on key performance indicators

Key performance indicators	Mean	Median	SD	Max	Min
ITA GAAP Reported income	-7.99%	-2.34%	0.19676	-123.74%	-0.05%
IFRS Reported income	-13.71%	-1.76%	0.59158	-398.32%	-0.04%
ITA GAAP diluted EPS (1)	-14.13%	-2.68%	0.41975	-256.72%	-0.04%
IFRS diluted EPS	6.28%	1.75%	0.10552	51.32%	0.04%
ITA GAAP ROA (1)	-0.19%	-0.09%	0.00263	-1.22%	-0.0012%
IFRS ROA	0.17%	0.08%	0.00227	0.86%	0.0011%

Linear regression	Reported income ITA GAAP	Reported income IFRS	Cost of stock option
Size (assets - 2004)	- 0.1409	- 0.0903	0.2333
Size (revenues - 2004)	- 0.1261	- 0.0782	0.1586
Growth	-0.2720	-0.0715	-0.1062

(1) This value does not include the companies that already recorded the fair value of the stock options' cost before the mandatory adoption of IFRS 2.

Table 4. ρ Bravais-Pearson

1	ASTALDI	16	ESPRINET	31	MONDADORI
2	AEDES	17	EUPHON	32	PININFARINA
3	BENETTON	18	FIAT	33	PIRELLI
4	BULGARI	19	FINMECCANICA	34	PIRELLI RE
5	BUONGIORNO	20	FULLSIX	35	RCS MEDIAGROUP
6	CAMPARI	21	GEOX	36	RECORDATI
7	CDC	22	GRUPPO ESPRESSO	37	REPLY
8	CLASS EDITORI	23	INDESIT	38	SABAF
9	CREMONINI	24	INTERPUMP GROUP	39	SAFILO
10	DMT	25	IRIDE	40	SAIPEM
11	DUCATI	26	ITALCEMENTI	41	SEAT PAGINE GIALLE
12	EDISON	27	LOTTOMATICA	42	SNAM
13	EL.EN	28	LUXOTTICA	43	SORIN
14	ENEL	29	MARR	44	TARGETTI SANKEY
15	ENI	30	MEDIASET	45	TXT