THE ITALIAN BANKING FOUNDATIONS DURING THE FINANCIAL CRISIS: SOME THOUGHTS ON CORPORATE GOVERNANCE AND ACCOUNTING ISSUES

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Abstract

Banking Foundations are both non-profit entities and key investors in Italian banks. Since the beginning of the 1990s, they have supported their banking concerns, receiving in exchange growing dividends used to finance their granting activity. However, the recent financial crisis has severely questioned this symbiotic relationship. Due to the high concentration of their resources in the equity capital of the Italian banks, Foundations have dramatically suffered the ongoing market downturn, cutting their grants by 50% in 2011, with negative consequences on the welfare of the local communities in which they operate. The poor attention traditionally showed by Banking Foundations on the adoption of risk diversification techniques is probably due to the existence of weak corporate governance mechanisms and to the lack of transparency characterizing their financial reports. Indeed, the adoption of accounting criteria exclusively based on historical data hampers the comparability of the financial information and allows income-smoothing techniques that threaten the stewardship function of the financial documents. Therefore, this paper proposes the introduction of a mark-to-market disclosure in the Banking Foundations' financial statements, stressing the fundamental role that financial information based on current values can play in improving the accountability process and, consequently, in increasing the efficiency and the effectiveness of the investment strategies.

Keywords: Banking Foundations, Financial Crisis, Institutional Investors, Historical Cost Accounting, Mark-to-Market Accounting, Stewardship Function

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1. Introduction

Banking Foundations (hereafter BFs) are non-profit entities whose activities are mainly focused on grant-making to cultural, social and charitable initiatives. BFs were founded in the early 1990s when the traditional Italian *Casse di Risparmio* (Savings Banks) ([1]) spun off their banking assets to found joint-stock companies – *Banking Concerns* (hereafter, BCs) – whose size and governance mechanisms were adequate to the changed international market scenario (ACRI, 2010).

In order to guarantee a smooth transition from the public sphere to the private one, BFs were initially required by law to maintain majority ownership of the newly founded joint-stock banks. Subsequently, several laws and regulations encouraging the Foundations to relinquish their shareholdings were promulgated with the aim to foster a diversification in the ownership structure of the Italian listed banks (Butzbach, 2007).

Notwithstanding these legislative interventions, the investment portfolio of most of the BFs continues to be highly concentrated on banks' equity capital. Indeed, the BFs still represent the largest investors in Italy's banking sector and remain extremely influential in the Italian financial sector.

Hence, the long-term performance of BFs is strongly correlated to the financial equilibrium of the BCs. The strategic choices and the governance mechanisms adopted by the former inevitably influence the economic results reached by the latter. At the same time, the ability of the BFs to effectively carry out their philanthropic activities depends on the portion of earnings distributed by BCs (Ayadi, Schmidt and Valverde, 2009).

A closer inspection highlights the existence of a symbiotic relationship between BFs and BCs, from the 1993 to the crisis. On the one hand, BFs supported banks by providing the assets necessary to carry on an effective lending and investment activity. On the other hand, the BCs constantly offered a high dividend payout, transferring growing resources that Foundations used to increase grants and improve their status in the local community in which they operate.

Such an idyllic relationship has been seriously questioned by the recent financial crisis. Indeed, in the last few years, with the intent of not losing control of the financial institutions, BFs have been forced to inject € 6bn into their BCs. In this way, BFs have played an important role to carry out the necessary recapitalization of the Italian banks. However, at the same time, they have further increased their exposure to banks, so suffering from the cutting of dividends and the market downturn that have involved the Italian financial sector. By 2010, BFs have been forced to cut grants by 50% and have lost both € 17bn of value and the consensus of their stakeholders (Filtri and Guglielmi, 2012).

The financial crisis has therefore shed light on important drawbacks characterizing the Italian financial system and requires a deeper analysis on the relationship between BFs and BCs. In particular, considering the influence that the BFs – as core shareholders of many banks – still exert in the Italian financial sector and, at the same time, the role that these institutions play as promoters of local communities' welfare, it is extremely important to examine the quality of their accountability mechanisms and identify the corporate governance and accounting systems that could be implemented in order to improve the stewardship process (on the stewardship role of financial accounting see: Bushman and Smith, 2001; Armstrong, Guay and Weber, 2009).

The remainder of the paper proceeds as follows. The next section describes the Italian institutional settings and the origins of the BFs. Section 3 analyzes the relationship between BFs and BCs and the impact that the recent financial crisis has exerted on it. The fourth section focuses on the accountability instruments adopted by the BFs. In particular, it assesses the criticalities in their reporting system and evaluates how the introduction of a mark-to-market accounting could increase the transparency on their investment strategies. Section 5 concludes.

2. The origins of the Italian BFs

Italy has 88 BFs whose capital amounts to approximately € 50bn ([2]). BFs are regional, private, not-for-profit entities supervised by the Ministry of Economy and Finance (MEF). BFs engage solely in socially oriented and economic development undertakings. Their institutional purpose is to provide support to various collective-interests sectors (art and culture, education, research, support to the underprivileged, local community development) through projects directly implemented or through a grant making activity (ACRI, 2010).

These institutions were originated at the beginning of the 1990s as the result of the privatization process of the Italian banking industry. At that time, more than the 50% of the Italian banks were state-owned and the industry as a whole was suffering from below average return due to its extremely high fragmentation and anachronistic governance systems. Therefore, the government needed to transfer the sector towards the market, trying – at the same time – to avoid a foreign takeover in a period characterized by low rate or returns and small availability of domestic private capital (Giorgino and Tasca, 1999).

The solution was given by the so-called *Amato Law* (Law n. 218, 30 July 1990) which required the Italian Savings Banks (*Casse di Risparmio*) to transfer their banking operations to newly formed joint-stock companies and to turn themselves into Foundations to pursue public interest, economic development and socially-oriented activities. Consequently, two different entities were created: on the one hand, the "*banking concern*" (BCs) that aimed to achieve adequate profitability through credit facilities; on the other hand, the "*conferring entity*" (the Banking Foundation) whose main purpose was to finance non-profit projects through dividends they get from the joint-stock company.

However, the *Amato Law* represented only a first step of the privatization process. The *Amato Law* required BFs to maintain majority ownership of the banks. As a result, after the promulgation of the act, most of the new joint-stock companies (the banking concerns) were 100% owned by the BFs.

In order to give a significant impetus towards a more open banking system, in 1994 and in 1998 two more acts were promulgated (*Dini Law*, n. 474/1994; *Ciampi Law*, n. 461/1998). These provisions introduced fiscal incentives for share dismissals and obliged the BFs to relinquish control of the banks and to gradually diversify their risk (Carletti, Hakenes and Schnabel, 2005) ([3]).

The aim pursued by these laws and by the several MEF's instructions was to weaken the strong relationship between the BFs and the BCs created during the first part of the privatization process. For this reason, the Regulator forbade the appointment of people involved in the Foundations in the governing bodies of the bank and banned the control or the joint control of the banks. Moreover, BFs were formally required to adopt principles of prudence and portfolio diversification in order to assure the capital preservation.

The result of these reforms was the entrance of new shareholders in the equity of the banks that carried out an important recapitalization and an effective corporate restructuring of the Italian banking industry. During the last two decades, the number of Foundations holding more than 50% of the banks' equity capital have regularly declined (from 89 in 1990 to 15 in 2010), while an increasing number of these institutions (approximately the 20%) have left the shareholder base of their banking concerns.

Table 1. Equity interests of BFs in BCs (number of foundations)

	1990	1995	2000	2005	2010
Majority shares (> 50%)	89	62	23	16	15
No shares	0	1	9	15	18
Minority shares (< 50%)	0	26	57	57	55
			Foundations holding < 5%		*21*
			Foundations holding < 20%		*14*
			Foundations holding < 50%		*20*

Source: ACRI (our elaboration)

Notwithstanding the legislative interventions briefly described above, some of the BFs have never diversified their resources and still retain a strong grip on their banks (Filtri and Guglielmi, 2012). Indeed, unlike most of their international peers, BFs have decided to concentrate their investments in the BCs in order to exercise control or significant influence on their operational and strategic choices (Moscariello and Pagani, 2012; Ayadi, Schmidt and Valverde, 2009).

Table 2. % of banks' equity capital held by BFs
(with the exclusion of Foundations holding less than 2% of share capital)

Banks	2002	2004	2006	2008	2009	2010
Unicredit	37.57%	20.14%	9.44%	8.88%	8.88%	7.93%
Intesa San Paolo			14.80%	22.49%	24.83%	24.81%
Mediobanca				2.59%	5.99%	5.62%
Carige	58.70%	43.37%	40.44%	44.08%	44.06%	44.06%
UBI Banca				4.56%	4.53%	4.53%

Source: Consob (*Italian Stock Exchange Commission*) (our elaboration)

A deep analysis of the relationship between BFs and BCs is therefore essential in order to understand an important aspect of the structure of the Italian financial system. In particular, the recent financial crisis has highlighted the role played by BFs in ensuring stability to the Italian banks by providing resources necessary to the recapitalization of the financial institutions. However, it has also shed light on important drawbacks concerning the presence of the BFs in the equity capital of the BCs, drawing the attention on the weakness of the accountability process implemented by the BFs.

3. The relationship between BFs and BCs and the impact of the financial crisis

Given the cultural and charitable nature of BFs activities and their significant presence in the ownership structure of the most important Italian listed banks, it is possible to assert that the Foundations play an active role both as important *institutional investors* and as *philanthropic institutions* (Benessia, 2009).

BFs represent the core, long term shareholders of Italy's main banks and, as such, they play a fundamental role in the corporate governance of Italian banks. In particular, acting as "substantial minority shareholder", Foundations financially support banks and represent an important "internal mechanism" for monitoring managers and reducing agency costs (Shleifer and Vishny, 1986). They have the incentive to collect information and to monitor the management of the banks, filling the "governance gap" related to the higher opaqueness and the greater government regulation characterizing the banking industry with respect to other sectors (Ciancanelli and Gonzalez, 2001; Levine, 2004). Moreover, as long-term investors, they do not seek speculative interest rate of return or strong capital gains and do not follows the *ups and downs* of the market (Caprio and Levine, 2002; Polo, 2007; Bassanini and Reviglio, 2009).

At the same time, as philanthropic entities, BFs promote the social and cultural development of the local communities in which they operate, addressing their activity to 21 fields explicitly indicated by the law ([4]). They fund their grant making activity with the proceeds generated by their endowment capital which has been traditionally invested in three different areas: a) strategic stakes in the BCs; b) other diversified investments (government and corporate bonds, private equity, hedge funds, mutual funds, commodities); c) direct activities run by the Foundations.

As showed in Table 3 below, the strategic investments in the equity capital of the BCs (a legacy of their origins as conferring entities of the newly founded joint-stock companies) still represents an extremely high portion of the BFs' assets.

Table 3. % of BFs' investments in BCs equity capital (major Italian listed banks in 2010)

Foundations	Banks	% over total financial investments
C.R. Padova e Rovigo	*Intesa San Paolo*	90.30%
C.R. Firenze		84.59%
C.R. Bologna		41.16%
Compagnia San Paolo		56.04%
Fondazione Cariplo		71.53%
Fondazione MPS	*Monte dei Paschi di Siena*	71.53%
Fondazione CRT	*Unicredit*	29.26%
C.R. Verona		95.58%

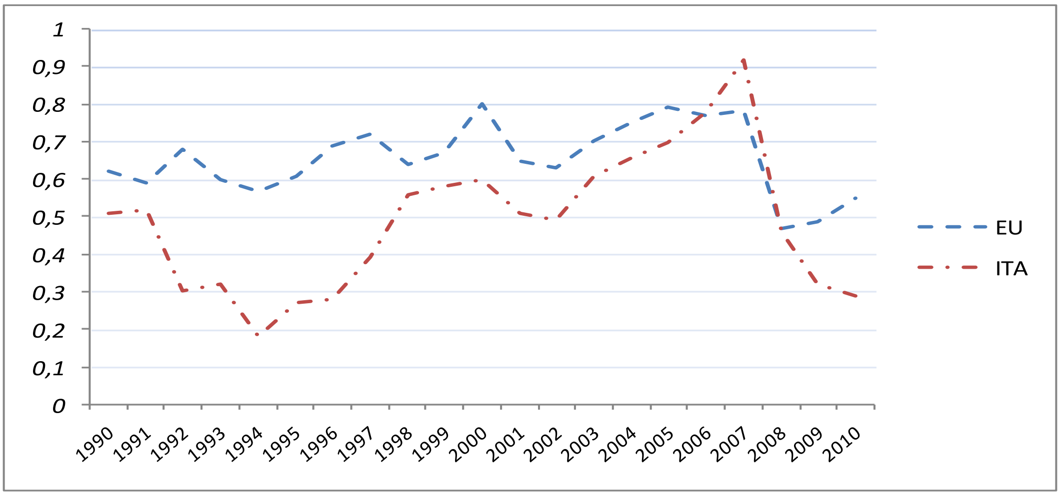
Source: ACRI (our elaboration)

The investment in the bank may represent up to 90% of the book value of some Foundations' shareholdings, and several Foundations are sometimes simultaneously important shareholders in the same bank.

It is therefore reasonable to assert that the aptitude of the BFs to preserve their capital and ensuring, at the same time, the stability of the grant making activity is strongly related to the periodic results of their BCs.

In this respect, an historical analysis shows that the highly concentrated investments in Italian banks have not paid off for BFs in terms of financial returns. Indeed, the Italian banks never outperformed EU peers on dividend yield, and they did not offer more stable *Dividend per Share* and *Earnings per Share* either.

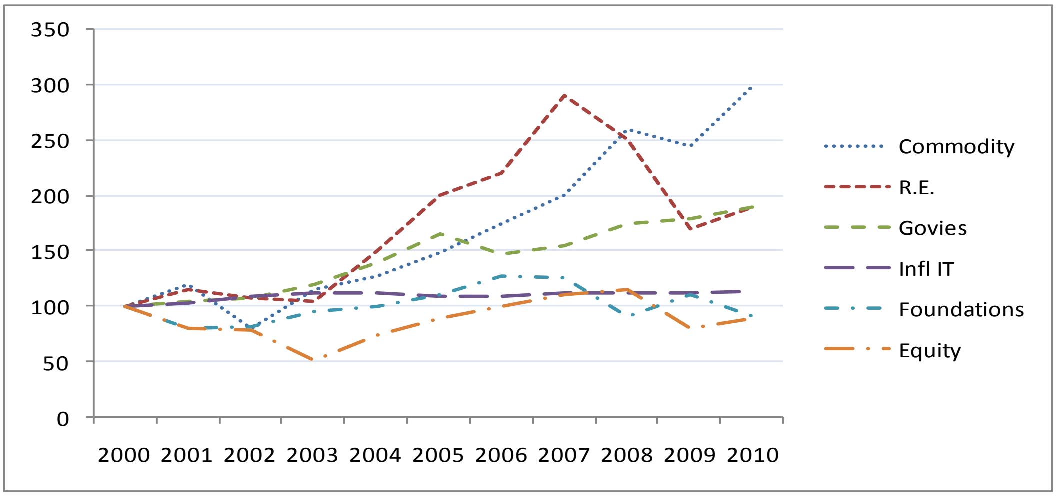
Figure 1. Banks' ROA: Italy Vs. EU banks, 1990 – 2010 (%)



Source: Mediobanca Security

Consequently, during the decades 2000 – 2010, the market value of BFs' assets decreased of about 7%, thus testifying that the bank investment has not been the optimal one for BFs to pursue their statutory goals.

Figure 2. Returns comparison: Foundations Vs. assets classes, 2000 – 2010



Source: Mediobanca Security

This evidence demonstrates that the strong relationship between BFs and BCs cannot be explained exclusively by the objective to maximize the investments' rate of return. On the contrary, the high concentration of the Foundations' resources in the equity capital of a single bank can be considered as a clue of their intention to privilege the "private benefits of control" over a proper risk diversification strategy (Shleifer and Vishny, 1998; Zingales, 1994). Local governments – that run most of the Italian BFs – might for example use their influence over the resources of the banks to meet special interests groups and achieve territorial goals (Boeri and Guiso, 2012). ([5]).

The stability that the Foundations bring to the Italian financial sector must therefore be weighed against the opportunity costs they introduce as a consequence of the inefficient allocation of their resources (AGCM, 2009). These costs have significantly increased with the explosion the latest financial crisis.

Indeed, the advent of the financial crisis in 2008 has forced BFs to further increase their exposure to banks, so definitely exacerbating the drawbacks related to a poor portfolio diversification.

During the financial crisis, Foundations have ensured the necessary stability and liquidity to the banking industry, thus playing a fundamental counter-cyclical role in the financial markets (Moscariello and Pagani, 2012). Foundations injected € 6bn new capital into their BCs, confirming their commitment to bridge banks out of the damps ([6]).

However, such a massive intervention of BFs in the recapitalization process of the Italian banks can also be explained by the intent of the institutions to preserve their controlling interests in the BCs ([7]). In some circumstances, Foundations have decided to contract debts in order to subscribe the rights issues, so increasing their portfolio concentration, worsening their leverage ratio and dramatically reducing their investments' liquidity. Indeed, as bank profits evaporated because of the financial crisis, so did the dividends received by Foundations. As a result, in three years, Foundations have been forced to cut their grants of the 50% and have experienced a decreasing of their total worth of about € 17bn.

Nowadays, the deterioration of BFs financial position, associated to the lower expected future profitability of their BCs and the growing request of aid from the local communities, raises doubts on the ability of Foundations to carry out their activities in the next future (Boeri and Guiso, 2012).

The financial crisis has therefore severely questioned the traditional symbiotic relationship between BFs and BCs. It has shed light on the inefficiencies characterizing the BFs' investment strategies, underlining – at the same time – the ineffectiveness of their reporting systems.

Indeed, as a result of the accounting principles adopted by the Foundations, the negative implications briefly described above on the Foundations' assets value have only marginally emerged in the BFs' financial statements. Due to the high costs associated to the collection and the subsequent elaboration of the information, stakeholders have not been able to detect the constant deterioration of BFs' resources and have not exerted significant pressure on BFs' managers to adopt appropriate risk diversification techniques. Therefore, a higher transparency in the BFs' financial statements and the adoption of accounting criteria able to obtain more timely and comparable information appear to be necessary in order to increase the accountability process and lead towards a more efficient use of the resources.

The next section compares the measurement approaches adopted by BFs - mainly based on the traditional historical cost accounting (hereafter HCA) – with a mark-to-market model (hereafter MTM), analyzing the impact that the latter might exert on the stewardship role of the financial statements and, consequently, on the investment strategies implemented by BFs.

4. The stewardship function of the MTM accounting model in BFs' financial statements

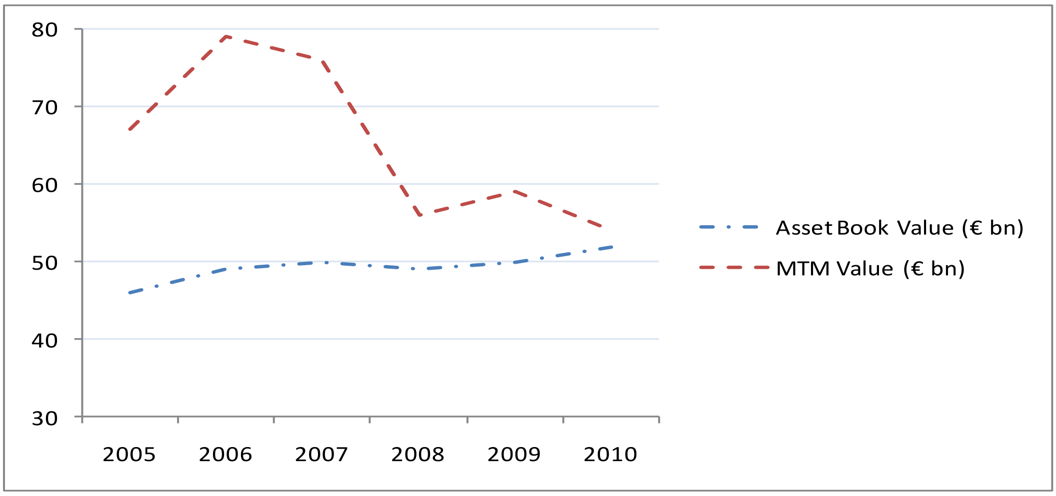
In accordance to the Italian accounting principles, the measurement process of the financial instruments held by BFs is mainly based on the HCA. With the exception of the financial assets labeled as "available for sale" – for which the Italian civil code requires a "lower of cost or market" (LOCOM) valuation – and the derivative instruments – whose current market value has to be constantly disclosed in the notes to financial statement –, the financial instruments belonging to the category of "strategic" or "held-for-maturity assets" have to be measured at their historical costs and impaired only in case of a persistent decrease of their value. Moreover, a disclosure about the fair value of these assets is required in the notes to financial statements whenever the market value is lower than the carrying amount, but they are not impaired as the difference between the two value configurations is deemed to be temporary and, therefore, unable to affect the recoverable amount of the assets ([8]).

Clearly, the adoption of the HCA does not sharply reflect the economic change in the value of the BFs portfolio as it generally ignored movements in the price level of the assets/liabilities. According to the HCA principles, the recognition of deltas in MTM are in effect recorded only when they are realized through buying/selling activities. Therefore, given that the majority of Foundations' portfolia are composed by "strategic stakes" that, by their nature, are hardly traded, the HCA can offer a misleading picture of BFs' financial position and provides ample room to the managers for accounting manipulations.

Indeed, the HCA does not always allow monitoring the trends in the economic value of the resources available. In the absence of a disclosure concerning the time series of the market price of the securities, stakeholders cannot estimate the opportunity costs of the investments and, consequently, cannot evaluate the quality of the management of funds ([9]) (Ronen, 2008; Abdel-Khalik, 2011).

As to the BFs, it is important to notice that, since 2006, they have been experiencing a constant decrease in the market value of their strategic assets. The positive gap between the fair value of the equity stakes in the BCs and their historical cost has progressively shrunk. However, no information has been given to the stakeholders until 2011, when the spread between the current and the book value of the strategic assets has become negative.

Figure 3. Foundations asset: MTM Vs. accounting value (€ bn)



Source: Mediobanca Security

Table 4. Book-value Vs. Market-Value of the % of shares held by Foundations

Foundation	Bank	% of shares	Book-Value €/ml	Mkt-Value €/ml	Difference between BV and MktV
Cariplo	Intesa Sanpaolo	4.95%	1.522	760	-761
Sanpaolo	Intesa Sanpaolo	9.72%	3.419	1.492	-1.926
MPS	Monte dei Paschi	50.45%	5.207	2.205	-3.002
CariVerona	Unicredit	4.26%	3.232	640	-2.591
CRT	Unicredit	3.32%	1.085	454	-631
Cariparo	Intesa Sanpaolo	4.84%	1.473	743	-729
CariRoma	Unicredit	0.90%	509	128	-381
CariCuneo	Ubi Banca	2.23%	192	50	-142
Carisbo	Intesa Sanpaolo	2.71%	576	416	-160
CariFirenze	Intesa Sanpaolo	3.32%	902	509	-392
Carige	Carige	44.06%	1.067	980	-86
Carimonte	Unicredit	2.89%	543	385	-158

Source: Borsa Italiana (*Milan Stock Exchange*) (our elaboration)

The users of the BFs' financial statements have not received timely information about the opportunity costs borne by the organizations as a result of the low diversification and have not been able to assess the quality of that investment.

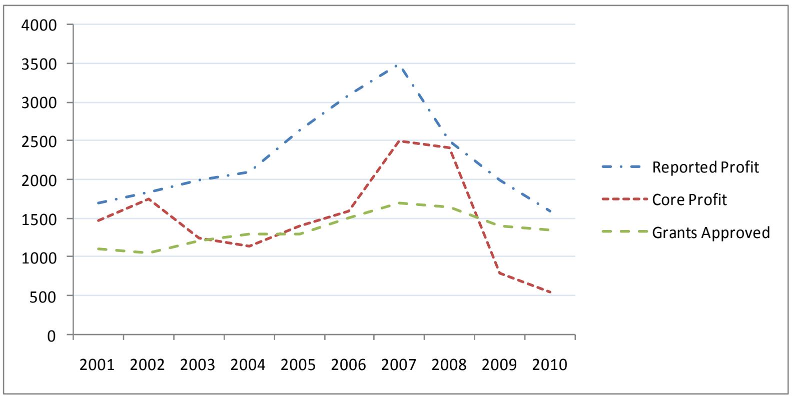
Furthermore, the accounting literature has already demonstrated that HCA-based financial statements actually give a dominant power to the managers over the communication process. The managers have the opportunity to smooth the income of their company by deciding when to sell their financial assets (the so-called *cherry picking* phenomenon) (Barlev, Haddad, 2003).

In years of low realized profits (mainly through dividends and bond coupons), the management of the BFs can sell and repurchase their assets (whose book value is lower than the current market value) with the intent to transform an economic profit in an accounting one. Similarly, in years of extra-profit, earnings can be managed through the impairment of assets carrying a latent loss or through a sudden variation in the usual trading strategies. Hence, the "manager's voice" is clearly heard and is highly reflected in the financial reports of the Foundations, so weakening the stewardship function of the BFs' statement of financial positions.

In particular, a deep analysis of the BFs' accounting income over the last ten years shows that the core profit (real cash, dividends, interest on investments and trading profits) is generally lower than the reported earnings (given by the core profit plus cosmetic operations of sell and buyback and other profit management operations). This result is likely due to the intention of the BFs' managers to increase the reported earnings in order to justify a stable outflow of the annual grants and, so doing, to meet the special interests of protected groups.

A financial reporting system exclusively based on the HCA model, in effect, does not allow to immediately capture the qualitative difference between the core profit and the reported one. In particular, what has not emerged in the financial statements of the Italian Foundations is that, since 2009, the amount of approved grants – on average – has outpaced the core profits, so threatening the sustainability of BFs' model in the new environment shaped by the financial crisis.

Figure 4. Core profits Vs. reported profits and grants approved (€ m)



Source: Mediobanca Security

Then, the introduction of a MTM/fair value accounting model appears to be useful for controlling the actions of managers, evaluating the careful and responsible management of funds and, so doing, forcing the insiders to implement more efficient investment strategies (Whittington, 2008; Nissim and Penman, 2008) ([10]). Indeed, the MTM model reduces the "manager's voice" in favor of the "market's voice" and obliges managers to take into account the economic environments and the variations it causes in the value of the assets. Furthermore, the fair value method provides comparability of financial statements, by giving equivalent values for a financial instrument, regardless of the date on which it was acquired (Barlev, Haddad, 2003).

For this reason, a fair value disclosure – in addition to the historical data already included in the statement of financial position – might improve the accountability process of the Italian Foundations. In effect, the stewardship dimension of the financial reporting is necessarily concerned with monitoring the past as well as predicting the future. It is the comparison of expected events (current market values) with past events (historical costs) that generates information useful for the investors to evaluate past performance and, thus, to fulfill the stewardship objectives of the financial statement (Whittington, 2008).

In effect, the coexistence of both the measurement approaches allows the construction of a "stewardship quality index" (SQI) that in its original version can be represented as (Abdel-Khalik, 2011):

$$SQI = \frac{FV - HC}{HC}$$

or

$$SQI = \left(FV \big/ HC\right) - 1$$

where:

HC = historical cost, that represents the benchmark against with management decisions could be evaluated;

FV = fair value, given by the current market value of the financial asset.

SQI > 0 represents a good indicator of stewardship quality, and vice versa.

However, it is worth noting that *SQI* will be greater than zero if the current market values of the financial assets held by the Foundation will be higher than their book values. Hence, the *SQI* is not able *per se* to capture the information relating to a negative variation of the assets' fair value, whenever their current market prices continue to be above the purchase prices. Considering that the Italian accounting standards require a fair value disclosure only when the market value of the financial assets is lower than their carrying amount, the stakeholders might not receive useful information concerning the opportunity costs associated to the choice to retain an asset.

For this reason, an alternative index concerning the stewardship quality of the management is represented by a dynamic version of the *SQI* that can be computed as follows:

$$\Delta SQI = \frac{FV_{t+1} - FV_t}{HC_t}$$

In this case, in order to have a positive stewardship quality index, it is not sufficient that the current market values of the financial assets are greater than their carrying amount. Indeed, the managers can demonstrate a careful and responsible management of funds only if $FV_{t+1} > FV_t$.

Finally, the annual rate of the return (*return index*) of the Foundation will be given by the following expression:

$$return = \frac{core.revenues_{t+1} - core.\cos ts_{t+1}}{market.value_t} + \Delta SQI$$

where:

core revenues = dividend, interests, pure trading profits;

core costs = salaries, operational expenses, rent.

The rate of return based exclusively on accounting numbers is then adjusted by considering, on the one hand, the market value of the resources used during the period and, on the other hand, the result of the dynamic version of the stewardship quality index.

As showed in Chart n. 3 and in Table n. 4, in the interval between 2005 and 2011, the ΔSQI of most of the BFs would have been lower than zero, so exercising a negative impact on the annual *return index* of the Italian institutions.

The introduction of a MTM disclosure would have therefore helped to reveal to regulators and investors the misuse of the financial resources by the BFs. This would have alerted stakeholders to the Foundations' financial troubles and forced BFs' managers to adopt effective diversification investment strategies in order to reverse the risk-return profile of their portfolia.

Conclusions

Italian BFs represent important institutions in the Italian social and economical environment. Indeed, they play three fundamental roles as: 1) promoters of local communities' welfare; 2) core shareholders of Italy's main banks; 3) supporters of the Italy's economic progress. Good corporate governance mechanisms in BFs are, therefore, essential in order to contribute to the stability of the Italian financial system and to the social and cultural development of the Italian regions in which they operate.

To this regard, the implementation of a full mark-to-market disclosure in BFs' financial statements might represent an important instrument to increase the transparency of BFs financial reports, improve the accountability process to the stakeholders and, so doing, forcing the managers to adopt more efficient and effective investment strategies.

Indeed, unlike most of their international peers, BFs' investment portfolio is generally extremely concentrated, with a resource allocation principally directed to the equity stakes of the Italian banks. Because of the lack of a proper diversification strategy, over the decades 2000 – 2010, the market value of BFs' assets has decreased of about 7%. During the last three years, as a consequence of the financial crisis, Foundations have cut their grants of the 50% and have experienced a decreasing of their total worth of about € 17bn.

However, such a negative implications on the Foundations' assets value only marginally emerged in the financial statements prepared according to the HCA principles. As consequences, stakeholders have not been able to detect the constant deterioration of BFs' resources and have not exerted significant pressure on BFs' managers to adopt appropriate risk diversification techniques.

In effect, an HCA system does not sharply reflect the economic change in the value of the BFs portfolio. It generally ignores movements in the price level of the assets/liabilities, unless they are realized through buying/selling activities. Furthermore, the historical cost measurement approach allows BFs' managers to manipulate earnings – through cosmetic operations of sell and buyback and other profit management operations –and smoothen the fall in grants to meet the special interests of protected local groups.

For this reason, the introduction of a full fair value disclosure alongside the recognition of the historical costs might represent an important instrument for improving the stewardship function of the financial statements and helping stakeholders in evaluating the careful and responsible management of funds.

Indeed, the fair value method provides comparability of financial statements as it offers equivalent values for financial instruments, regardless of the date on which they were acquired. Moreover, a comparison between assets' fair value and their historical cost and the implementation of an intertemporal analysis of the movements in the current prices of the assets allow to set up "stewardship quality" indexes that might be used to evaluate the efficiency and the effectiveness of the investment strategies implemented by BFs' managers.

The adoption of a SQI by the Italian Foundations during the last five years would have timely revealed the drawbacks caused by the strong relationship between BFs and BCs, forcing managers to reverse the risk return/risk profile of BFs'portfolia to the benefits of both the local communities and the Italian financial system

Notes

1. *Casse di Risparmio* were Italian Saving Banks, dating back from the 15th century. Saving Banks used the proceeds from the banking activity to fund philanthropic initiatives for the good of the local community.

2. Originally, there were 89 Foundations, but they become 88 as a consequence of a merger between two of them in 2004.

3. Small-sized Foundations (with total assets lower than 200 million of Euros) were exempted from the obligation to invest no more than 50% of their capital into share of the banks.

4. The most representative are: art, charity, research and technology, education, local development, public health and medicine, aid to the elderly, environment protection, family and family values, sport, public infrastructure.

5. The Financial Times defined Italian Banking Foundatinos as "*anachronistic entities: an important regional part of Italy's complex and controlling political economic* sistema" (September, 2010).

6. "*The foundations have been an anchor for Italian banks. They have accompanies them through the worst storms of the financial crisis, strengthening their capital and reserves* […] *Many have accepted sacrifices in the short term, thus contributing to the soundness of the system, the ability of banks to supply credit to the economy, and the enhancement of their own investment in the long term*". Former Governor of the Bank of Italy, Draghi M. (2009).

7. "*The Italian experience of banking foundations is positive* […] *for the role they have played as stable, solid shareholders* […] *However, the Italian experience of public banks is vivid in our memory. Certain relationships between local economic groups, public banks and politics proved disastrous for the banks [...] No one wants to turn back*". Former Governor of the Bank of Italy, Draghi M. (2009).

8. Italian civil code, articles n. 2426 and 2427-bis. In case of "strategic assets", the civil code also allows the use of the "equity method". In this case, the carrying amount of the investment changes proportionally and in accordance to the variations of the net assets of the investee company.

9. Consider the following example: the CFO of a firm invests the firm's liquid funds in marketable securities (treasury bills). Assume the following information:

- On January 1, 19X1 the firm buys TB for $ 1,000;
- On December 31, 19X1 the price of the TB is $ 1,300;
- On December 31, 19X2 the price of the TB is $ 1,100.

According to the HCA model, the TB's year-end fair value is not recognized. Therefore, the manager may sell the securities at the end of the second year and generate profits. No indication is given to the fact that the manager gave up a chance of making money (opportunity costs). See, Barlev, Haddad, 2003, pag. 399.

10. In this paper, mark-to-market is used as a synonymous of fair value accounting. Indeed, mark-to-market accounting is a subset of fair value accounting. More precisely, fair value accounting requires companies to report asset values in a three-level hierarchy, based on the liquidity of the assets. Hence, fair value accounting is equivalent to

mark-to-market accounting for Level 1 asset (assets for which observable market transactions and market information are available). In effect, the quoted price in an active market provides the most reliable evidence of fair value and it shall be used without adjustment to measure fair value. However, fair value accounting corresponds to a "mark-to-model" accounting when a price for an identical asset is not observable or a market does not exist (Level 2 or Level 3 assets). In this case, the quoted price does not represent fair value at the measurement date as the market is inactive and the asset has some specific characteristics that make it different from other assets for which observable market transactions are available.

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