Dipartimento di Impresa e Management

Financial Reporting and Performance Measurement

THE FINANCIAL REPORTING QUALITY: EARNINGS MANAGEMENT AND AUDIT COMMITTEE EXPERTISE.

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I HAVE studied many times
The marble which was chiseled for me—
A boat with a furled sail at rest in a harbor.
In truth it pictures not my destination
But my life.
For love was offered me and I shrank from its disillusionment;
Sorrow knocked at my door, but I was afraid;
Ambition called to me, but I dreaded the chances.
Yet all the while I hungered for meaning in my life.
And now I know that we must lift the sail
And catch the winds of destiny
Wherever they drive the boat.
To put meaning in one's life may end in madness,
But life without meaning is the torture
Of restlessness and vague desire—
It is a boat longing for the sea and yet afraid.

George Gray

Introduction

We elaborated this thesis moving from the necessity expressed by the national and international literature to clarify the role and the importance of the Corporate Governance System, to guarantee the quality of the information addressed to the actual and potential investors. In a regulatory context that fixed as scope the one to improve the trust of the market frayed by the economic crisis and the various financial scandalous as Enron, Dot Com bubble and in Italy where the Parmalat case still make discuss.

The first chapter introduce the topic we will focus on for the whole thesis: the mandatory Financial Reporting, whose quality we attempt to measure. To do this we consider one of the most summarize proxy of the financial statement itself: earnings.

Unluckily this approach risks creating confusion between the concept of financial reporting quality and earnings quality and for this reason we dedicate a whole paragraph to clarify the two concepts and to compare them to highlight their consistent differences, since the former is referred to the presentation while the second is relating to the substance of the company’s performance.

After the presentation of the financial reporting quality as proxy for the quality information, we will justify this statement relating the level of the former with the main market entities that measure the trust of the investors: market liquidity, cost of equity and cost of debt.

In the bottom part of the first chapter, we will introduce the Gatekeepers of the financial reporting quality and suddenly we focus our attention on the corporate governance system, distinguish within an internal and external part.

In the context of internal component, we will concentrate our attention on the Board of directors and the Audit Committee that is delegated by the Board for the reliability assurance of the financial reporting.

Then, the second chapter will present the approach we decide to use to measure the financial reporting quality: the degree of earnings management. In first place, we define the earnings manipulation phenomenon and its possible kinds: real and accrual earnings management. Then we will focus on the accrual earnings management because even if both type influence the financial report at the end; the former is either difficult to detect from the observation of the Statement and it requires a deeper analysis of the single company businesses.

Instead, we cannot observe the accrual earnings management but we can just estimate it: to do this we firstly present both the method used in either the professionals or academic field: accounting and statistical based methodologies. Then, we explain in depth the latter, since it is the method we will use in the third chapter to detect earnings management through the recognition of abnormal accruals. To do this we will define the concept of accrual that is originated substantially from the matching principle.

Then, we define the normal accrual concept as the level of accrual that is normal to be expected in consideration of the economic cycle of the company. To explain this concept we will serve of the Jennifer Jones model, used by the economist to detect earnings management during the import relief investigation in 1991 but adapting it to serve in the general case of attempt detection.

Last but not least, we will deal with the earnings management incentives, we present the kinds of reason that lead the management to implement manipulation policies and the direction earnings management takes in function of the types of incentives the executives are “affected” to.

The third chapter consists of the empirical research and substantially match the issues discussed in the former two chapters. Indeed, the analysis wants to examine the relation existing between the expertise of the Audit Committee members and the earnings management incurrence measured as explained in the second chapter.

To do this we serve of a sample of 146 Italian listed companies and we run an Ordinary Leas Squares cross-sectional analysis controlling for the ownership structure and Board of directors' characteristics that have been generally accepted as "natural" factors in the determination or discouragement of the earnings management. Furthermore, after the selection of the best expertise that ensure more than other the financial reporting quality we run an additional analysis this time with the aim to discover the best mixes of expertise for the earnings management detection.

1 The financial reporting disclosure

Corporate disclosure plays two important roles in the capital market: the valuation and the stewardship role. The valuation role let the investors to evaluate the profitability of investment opportunities. Under the stewardship function, instead the disclosure allows investors to monitor the use of capital, once provided.

In the first case, disclosure has an ex-ante informational role, while in the second, investors do use the information disclosed ex-post, to evaluate, among others, the level of managerial effectiveness.

The former function it is the practical application of the Agency Theory (applied to the financial market) in the context of which is assumed that the buyers (shareholders and debtholders) are less conscious of the good's value than the sellers (companies) are. In this kind of situation, a rational buyer, unable to distinguish the quality level of the goods (stock or obligation) will give each one an average value (in the middle between the highest and lowest actual value); this phenomenon in the long term will lead to the exit from the market of good-quality sellers. Definitely, the persistence of these circumstances will lead to reduction in the size of the market that eventually will collapse (HEALY & PALEPU, 2001). Therefore, the existence of a reliable communication channel between informed and uninformed parties reduces information asymmetries, thus preventing the market failure (TROMBETTA & BOZZOLAN, 2012).

Instead, the stewardship role ensures the correct administration of the resource by the managers that according with the theory of the agency run the business on behalf of the shareholder (JENSEN & MECKLING, 1976). Managers, who are self-interested, have incentives to act to expropriate investors' resources, looking for pecuniary benefit as illegitimate bonuses and non-pecuniary as relaxing at work and not being productive.

Even in this case, the function of the corporate disclosure is central to reduce the gap of information between principal and agent.

1.1 Capital market outcomes of disclosure activity

This paragraph has the aim to explain a general company's motivations and incentives to provide a high-quality disclosure, as we will see soon these lied on the reactions of the market.

These consequences have the shape of proxies very important especially for a public company:

- Market liquidity;
- Cost of equity;
- Cost of debt.

The first proxy is measured not at firm level but at stock exchange level, nevertheless the company that participates to a given stock exchange market will favour of the reputation of the later. This is also because of the requirement in terms of disclosure completeness and reliability.

Thus, the Market liquidity is the easiness to sell a security in the secondary market. It is influenced by the information asymmetry gap that introducing the risk of an adverse selection and the raising the transaction cost, that lead to a price discount deriving from the risk to bargaining with a counterpart more informed. The discount either favour the raising of the bid-ask[1] reducing the volume of securities exchanged in the market, making it illiquid. The quality of disclosure, having the power to decrease the gap of the asymmetry information can mitigate the adverse selection risk and improve the liquidity in each stock exchange.

In fact, firms that are listed in exchange stock market that requires more transparent disclosure have lower bid-ask spread and higher trading volume (LEUZ & VERRECCHIA, 2000).

The cost of capital raises because of the unreliable information embedded by the company's disclosure just when the risk connected to the disclosure are not diversifiable[2]. Prior research on this issue (LEUZ, C., & VERRECCHIA, R. E.2005) demonstrates easily and not surprisingly that the disclosure quality affects the variance of the cash flows, but since this kind of risk is easily diversifiable it cannot improve the cost of capital. Anyway, the same research demonstrates that a reliable disclosure has a direct effect on the assessed covariance with other firms' cash flows, since it influences the investor's perception. Then, the disclosure affects the cost of capital even in an indirect manner affecting real decision that are taken just to make more attractive the actual financial statement and influence the distribution of future cash flow, not in growth prospective but just to raise funds in the short term, through the exhibition of greater earning[3].

Cost of debt. The studies that link the disclosure quality with the cost of debt are less copious than those regarding the cost of equity. Nevertheless, these show the same

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[1] A bid-ask spread is the amount by which the ask price exceeds the bid price for an asset in the market. The bid-ask spread is essentially the difference between the highest price that a buyer is willing to pay for an asset and the lowest price that a seller is willing to accept to sell it. Source: http://www.investopedia.com/terms/b/bid-askspread.asp

[2] Model valuation as the CAPM and the portfolio theory emphasize the importance of distinguish between diversifiable and not diversifiable risk; thus, a risk, in this case the disclosure one has to be undiversified to make raising the cost of capital.

[3] An example is the cut of cost of Development and Research even if these may be profitable investment to show higher earnings in the current Financial Statement.

opinion in describing the effect that the reliability of the company's information has on its cost of debt. In fact, according with them seem that Firms with greater disclosure quality scores relish a minor interest cost of issuing debt since a superior disclosure send to the debtholder a message of reliability and reduce their suspicion of potential default whose the cost of debt is a diminishing factor. In general, the disclosure reliability improves its relative importance in situations as financial crisis where there is more market uncertainty and minor expectations about the firms' performance as reflected by the variance of stock returns. Since debt financing is an important alternative financing source to the stock market for publicly traded firms especially in the circumstances mentioned above. (SENGUPTA, P. 1998)

1.2 Financial reporting quality

At the state of the art, although the globalization of the financial market would require it, a universal method to measure the disclosure quality has not been developed.

In fact, the literature grew around a narrow sense of communication quality, with the ability of accounting values to provide functional information for decision making purposes, by their capability to oversee the achieved and to foresee prospective performance on reliable data (FRANCIS, J. R., KHURANA, I. K., & PEREIRA, R. 2003)

1.2.1 Financial reporting quality vs Earnings quality

Many studies related to earnings management defines it as a practice that getting worse the earnings quality (DECHOW, P., GE, W., & SCHRAND, C. 2010), actually, according with the definition of the CFA (ROBINSON, T. R., HENNIE VAN GREUNING, C. F. A., HENRY, E., & BROIHAHN, M. A. 2008). earnings quality is embedded in the in quality of the reported result that are in any case as concept linked to the actual performance and can be measure in terms of sustainability rather than reliability, a different concept is the reported earnings that it is a function either of the actual performance but also of the accounting activity. Thus, as it is showed in the table below it is not the earnings as concept to be managed but its representation acted through the Financial report operations.

Anyway, the alternative use of earnings quality and financial reporting quality in the context of earnings management can be justified by the fact that the earnings are the synthesis of the financial reporting quality and its quality depend tightly by the former one, thus even if the two concepts are substantially different, they are still tightly connected.

Table 1: Financial reporting quality vs Reported outcome quality

Financial Reporting Quality	***Quality of reported outcome***
• ***Decision-useful information***	• Sustainable activity
• ***Faithful representation of economic reality***	• Adequate returns
• ***Compliant with standard***	• Increases the company's value

Source: CFA Institution

The table 1 identifies the different proxies used to measure the financial reporting quality, whose level results from the usefulness information degree to forecast future cash flows and the attitude toward the precise description of the operating performance versus the ones of the reported outcome, whose aim is to increase the company's value. Summarizing it is possible to assert that the former represents the reliability of the financial data while the later regards directly the substantial performance of the company.

Furthermore, it is possible to state that these two concepts, as quickly mentioned above are interconnected since a correct assessment of earnings quality is possible only when there is some basic level of financial reporting quality. Over this sufficient level of reporting quality, an improvement of this allow the user of financial reporting to raise their ability to assess earnings quality. These simple relations are summarized in the table below.

Table 2: The relation between financial reporting and earnings Quality

		Financial Reporting quality	
		Low	**High**
Earnings quality	**Low**	LOW financial reporting quality impedes assessment of earnings quality and impedes valuation	HIGH financial reporting quality enables assessment. HIGH earnings quality increases company value.
	High		HIGH financial reporting quality enables assessment. LOW earnings quality decreases company value

Source: CFA institution

However often poor earnings quality is the reason behind the poor quality of the financial report. For example, aggressive accounting choices[4] are made to hide poor

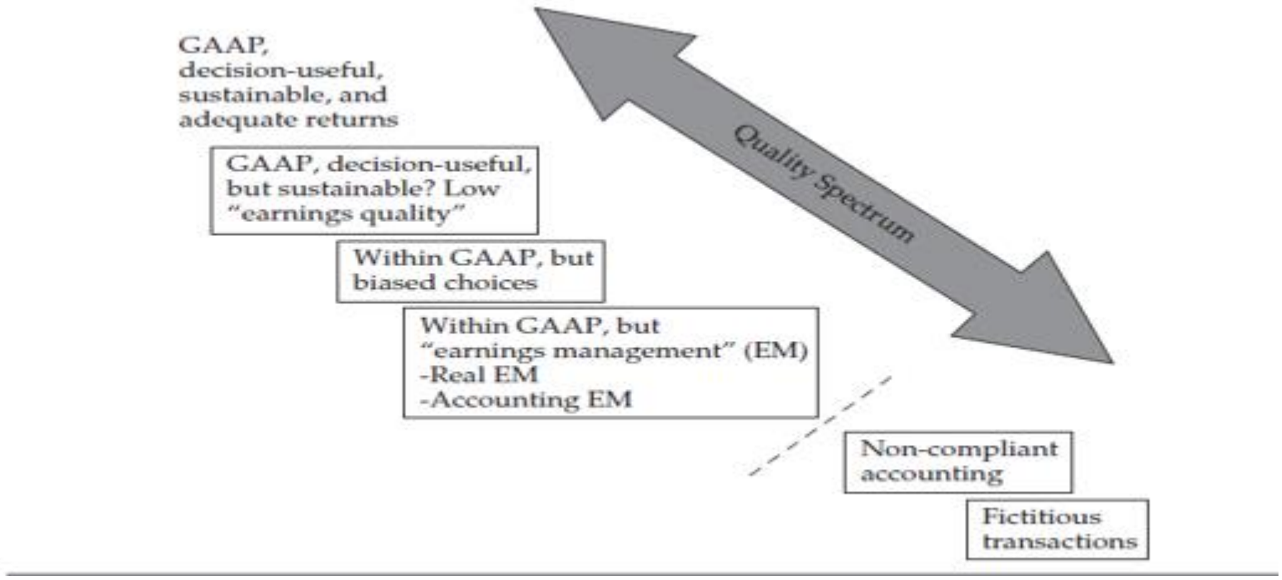
[4] The practice of over valuate the cost and revenue that are object of estimates. Aggressive accounting is also known as "creative" or "innovative" accounting and in the worst, most fraudulent cases, is referred to as "cooking the books." Its contrary is the conservative accounting practice that consider the worse scenario in the context of accrual evaluation.

performance. In fact, objectively a company that has a good performance has not any reason to make it easy to be understood and appreciated from the stakeholder. Nevertheless, can even happen that a company with good performance has financial report likewise good for any other reason than just a poor quality internal control.

1.2.2 The spectrum of Financial Reporting Quality

Since there are many levels of financial reporting quality, the figure below can help the reader to identify its various shades and its interactions with the earnings quality. In fact, it shows the quality spectrum of the Financial reporting that combined with the proxies of the earnings quality conduct to one of the scheme section. The most promising situation in absolute are the two situated at the top on the left, these ensure a situation in which the high level of reporting quality allow to evaluates the earnings quality.

Fig.1: The spectrum of Financial Reporting Quality



Source: CFA institute

Then, the fact that the first represents a high earnings quality and sustainable and the second a low one and unbearable results it is not of interest in this place since the focus of this thesis regard the earnings management and its effect on reporting quality.
Anyway, for completeness's sake we will make an example of situation in which it is recognized a certain financial reporting quality but the earnings quality is low because it is unbearable in the long term. A situation of this kind can be for example one in which the most relevant part of the EBIT has not as source the operative component of the income statement but the non-recurring one such as the gain deriving from a favourable exchange rate of a multinational company.[5]

[5] This example is referred to the case of the Toyota Motor Corporation, a Japanese automobile company as reported by a Wall Street Journal article (Back 2014). This company earnings for the third quarter of 2014 improved of 88% relative to the prior quarter but the volume of sale was impressively dropped. In fact, the reason for the earnings improvement was almost totally sustained by the weaker yen, either because the company produced almost the car in Japan and because the company sells most of its car outside of Japan.

Before, dealing with issue of the earnings management the clarity requires an elucidation about the role assumed by itself over the most impressive accounting scandals of the last years. The most striking ones cannot be imputed to the earnings management but have been perpetrated through practise that are commonly catalogue under the violation or departures from the international accounting principles and the simulation of fictions transactions.

Under these cases it is quite difficult if not impossible correctly to assess the earnings quality because a cross sectional comparison with other companies or a time series analysis misses the most basic element of forcefulness, namely the respect of common principle used to represent the company's results, or even the nothingness in the latter case.

An example of departures from the international accounting principles is the Enron case (accounting issues discovered in 2001) that through complicated off-balance sheet transaction underestimated the indebtedness level and overestimates the profits (PETRICK, JOSEPH A., AND ROBERT F. SCHERER 2003).

The fictions examples called also creative accounting unlikely are quite easy to find, although they were not easy to discover at the time of occurrence. They consist of false data with the aim to improve the company's performance and in this way to raise resources from the investors or to hide the misappropriation of the company' assets.

An impressive and Italian example is the Parmalat case, discovered in 2004, (NARDONE JESSICA 2016) when Managers simulate even accounting cash.

1.3 The Gatekeepers

The information asymmetry in the financial market is harmful because it leads to an adverse selection that in the long term leads to the exit from the market by the healthier company that does not have the way to demonstrate their better quality. In fact, to raise the financial resource companies need to run the activity and to make profitable investment.

To overcome the information asymmetries problem the firms can send some signals as smoothing current income or choosing the quality of the auditors, taking certain financial decision as residual dividend policy[6]. Unlikely there are many caveats behind the signalling mechanism since they are not a direct guarantee of the financial situation quality but just the demonstration that the company is available to send costly signalling to raise resources.

Another problem is that the signalling can be explained in various way depending on the operational context, furthermore to explain and interpret the signals are needy a certain financial and governance expertise that of course not the whole crowd of the investors possess.

The demand for individuals able to interpret the signals sent by the company has raised the Gatekeepers figure, financial experts that spread their interpretations of financial signal though the intermediaries means (COFFEE, J. C. 2006).

The most important Gatekeeper according with Ronen and Yaary are:

> *Analyst*: Financial experts that making trend and fundamental analysis make suggestion about the company features more profitable.
>
> *Auditors:* They have the commitment to issue an opinion about the fairly representation of the financial situation of the company in relation to the accounting principles.[7]

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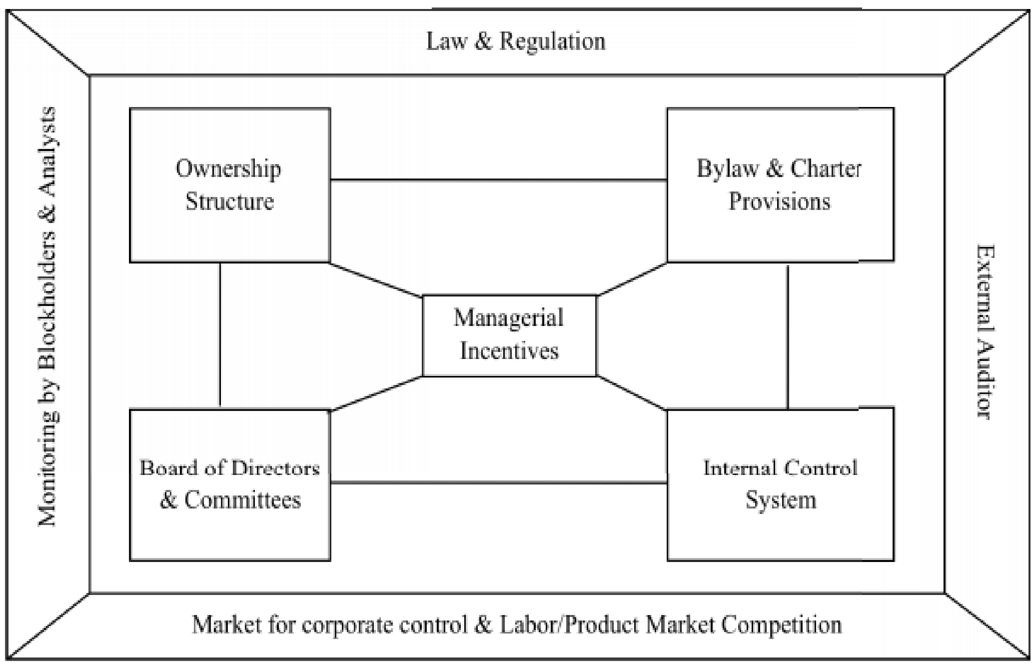
[6]Since there are three main approaches to dividends: residual, stability or a hybrid of the two, the choice of the residual method is the only one that ensure that just the earning part not addressed to business purposes are issued to the shareholder, not affecting in any way the business of the company. Source: http://www.investopedia.com/walkthrough/corporate-finance/5/dividends/policy.aspx

[7] The audit is mandatory for the public company but can be required also as a voluntary procedure by company that want send a signal of reliability especially to the private lenders such as the Banks.

Board of directors and Audit Committee: Director monitor the management with the aim to guarantee the shareholder wealth.

Fig.2: The Gatekeepers Framework



Source: (Cohen et al., 2004).

The recent scandals of WorldCom and Enron have taken the public opinion to wonder what the Gatekeepers did while the bubbles grew and "whether the failure of gatekeepers to deter earnings management were the exception or the norm" (RONEN YAARI, 2003).

To run efficiently their guarantee role the Gatekeepers need to satisfy two important requirements: not being biased and to possess that financial expertise that make they able to interpret in the correct way the firm's signals.

Since this thesis intends to analyse the monitoring of the financial statement reliability and the detection of earnings management by a company point of view, highlighting the instruments it has made this activity more effective in the following paragraph we will analyse in depth just the gatekeepers internal to the firm, namely the Corporate Governance System.

1.4.1 Corporate Governance

We employ the corporate governance definition enounced in the "Principle of Corporate Governance" of the Organization for the economic cooperation and development that describes the Corporate Governance system as a mechanism that sets and monitors the rights and duties of the company's stakeholder. In addition, the OECD has provided a complete framework of a Good Corporate drawing down four main principle, one-to-one:

1. The protection of the rights of shareholders;
2. the equal treatment of all shareholders;
3. the company accountability toward the totality of the stakeholder;
4. *The ensuring of a timely and transparent disclosure.*

Relating to our main research topic the principle we will focus on is the fourth. The prior researches on this issue have been divided in two field, the first related to the ownership structure and the second has analysed the characteristic of the board of directors. The choice of these two issues can be explained through the pyramidal structure composed of principal-agent relationships respectively between the shareholders and the board of director; the latter and the senior management.

1.4.1.1 The ownership structure and the earnings manipulation

When the earnings management is analysed in function of the ownership structure the results are often interpreted in function of the regulatory system and precisely connected with the protection of the minor shareholder in the country where these studies are based.

We can identify three different situations in which the ownership structure has the power to influence the probability of earning manipulation events:

1. The management participation to the ownership body (WARFIELD, T. D., WILD, J. J., & WILD, K. L. ,1995);
2. The presence of Block holders;
3. The involvement of institutional investors (BALSAM, S., BARTOV, E., & MARQUARDT, C. 2002).

Relating to the first point the conclusion of the Warfield & CO. study concludes that the size of discretionary accruals is contrariwise related to managerial ownership. Precisely, the absolute value of discretionary accruals is more than double that for companies with under 5 percent of ownership as compared to corporations whose managers own 35 percent or more. The result of this study can be interpreted as the incentive of the managers to achieve the positive results analysed in the paragraph 1.1.2 about the reliability of the financial statement and the company value.

Relating to the presence of Block holder the results of the studies having this issue as topic are directly connected with the regulatory background of the country Sample. In fact, the study placed in the West Side of the World, where the minority shareholders are more defended the use of the power of the Block holder is addressed toward the attempt to defend the company value (in this way to better off) improving the reporting quality instead than try to better off at the expenses of the minority shareholder since this is made quite impossible by the law in force; while in the East Side of the World (FAN, J. P., & WONG, T. J. 2002). The Block holder exploit their power to improve their benefit manipulating the discretional accruals in a direction favourable to expropriate the minority shareholder wealth[8].

Lastly, an important role in the reduction of the earnings management recourse would be run by the presence of the institutional investors among the rows of the shareholders such as Bank and Professional Investment Funds. The great experience and expertise in reading and interpret the accounting data, make them in the condition to analyse better the information disclosed by the company. In this way, they deter the running of accounting manipulations.

1.4.1.2 The Board of Directors

The Board of director is the fiduciary body that governs the firm on behalf of the shareholder, thus more the property is spread more the board of directors' role is important. The Board has two different roles: monitoring the management, reviewing

[8] Example of this kind of expropriation can arise when the block-holder group benefits from self-dealing transactions in which profits are transferred to other companies it controls or de facto expropriation through the pursuit of objectives that are not profit-maximizing in return for personal utilities.

the disclosure among which there is also the financial report, the second is to provide a series of strategical decision, as firing a CEO and the choice of another new one.
The directors to execute their bivalent role need information, the source of this information derive from the most informed part in the company: the Management. In fact, in providing the information the management is conscious about the fact that these will be used to make key decisions but also to evaluate its work; this fact can lead potentially to a sort of antagonistic relationship between the Board of director and the management.
This prospect is not to be hoped; instead, it is to be hosted since in this case the management will deliver as less documentation and information as possible. Furthermore, in any case, the executives would looking for the Board; this situation will lead even in the short term to a suboptimal equilibrium in the decisional process within the administrative body of the company.
This argument advances the matter of the stability between the authority of the executives and the Board and its consequence on the board's dual roles.
The literature proposals two sights: the first is that directors present the optimal mix of expertise and monitoring ability to satisfy optimally the need of the firm[9]; the latter promote the idea that the board has just a façade role and it would represent just a "rubber stamp" of the CEO's choice (MIZRUCHI, M. S. 1983).
Thus, at the light of these studies and with concern to the earnings management; although in theory the Board should make efforts against its occurrence. Actually, in the practical reality can happened that it colludes with the management in the attempt to run these practice, when the two powers are not balance and the Board is at the mercy of the management willingness.

[9] Brick, I. E., & Chidambaran discovery that the governance composition depends on industry's investment prospects and business variable such as business model and the recourse to the differentiation strategy N. K. (2010).

Thus, individuated the source of the potential failure of the Board, it will result easy for the reader to understand the link that will be analysed afterwards, between a series of characteristics of the board itself, that have the attitude to capture the monitoring ability of it, and the probability of the E.M arise. These characteristics are:

- The Board Size;
- the Weight of the Independent Directors;
- the CEO Duality;
- The Multiple-directorship.

The literature seems unanimous in individuating the different factors that influence a company's board size: the firm's size, the complexity of operations and the ownership profile. Regarding the first factor the relation seem obvious, the complexity of the operations these can be derived for example by a business strategy based on the diversification, in the end the ownership structure refers to the difference existing among the shareholder cluster in terms of interest that require the same number of Board directors to be represented. Unlikely, the same univocal opinion does not recur in the case of the relation between the Board size and the earnings management practice. First referring to what exposed above about the bivalent value of the Board (as façade and as actual monitor). When the board is just a mere rubber print of the CEO's decisions, it is quite difficult analyse the direction of such relation. Some studies advanced the hypothesis that in this case, a larger board could be more difficult to manipulate while a smaller board may be the signal that potential director conscious of the situation refuse to sit on the Board chairs. Anyway, these are mere observation whose impossibility to be generalized cannot originate any useful insight. Instead, when the monitor results to be an actual monitor, since the researches that examine the relation between board size and performance results (LIPTON AND LURCH, 2010) conclude that a smaller size of the Board leads to an easier and less costly information flow from the management to the directors and among the directors, also the monitoring activity will result more effective due to the same factors valid for the performance improvement. In this case, we will expect a positive relationship between board size and earnings management.

By another point of view may be valid the opposite hypothesis, when the board size is symptoms of multiple expertise directors, these make more effective the monitor process making true the opposite hypothesis than the one presented above.

In the end, both these hypotheses may be true since the relation between size and earnings management may be simply not exist since the board size can be read just in line with the existence of the correlation with other variables and the connection in discussion is simply confounded with these other variables (HARRIS, M., & RAVIV, A. 2006). The most important variable is common considered is the proportion of insider directors that they consider more valuable than the outsider ones since they treat the cost deriving from the loss of precious information from the insider more expensive than the agency-cost they lead with them within the Board. Since the size of the board would be the function of the percentage of independent director to determine its relationship with the earnings management practices, the correlation the two variables may confuse the actual effect each of them have on the earnings management, leading to ambiguous result.

Regarding the presence of independent directors[10], empirical evidence gives rise to insight of a different nature.[11]

There are studies that demonstrates the way in which the presence of independent directors has a significant impact in term of reduction of the earnings management. In line with the theory that assign to the independent directors a monitoring role living the insiders the strategical one, their presence will translate in a greater reliability of the Financial Statement data.

Anyway, it is required to specify that all these studies have their field of application in the US market, marked by the characteristic of the widespread ownership. On the contrary researches that analysed companies with a concentrated ownership did not provide the same evidences.[12]

Another field investigated by international matrix studies is the correlation between CEO duality - namely the coincidence of CEOs and board of directors - and manipulation of profits.

The idea that concentrating decision making power of two body in the same person may limit its independence and limit its monitor ability is well accepted in the agency

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[10] A director is independent if he/she is not an executive, if he has not or has not had recently such relationships even indirectly to influence his/her judgement ability. Spa, E. (2015). Codice di autodisciplina. Borsa Italiana Spa, Committee for the Corporate Governance in the listed companies, Milan

[11] With concern to this issue we will focus on the simple relation since being an insider or at least an affiliate improve the probability to collude with the management, embedded the case of the earnings management perpetration. In fact, related to the subordinated relationship with the company exist three kind of directors: the insider directors, namely the employees, outsider directors more commonly called independent directors and the affiliates that are a sort of mix that are not staffs but are connected with the company because ex-employees, customer or suppliers; in reason of their hybrid nature the affiliates director are often part of the independent cluster but we will consider them in the same manner as the independent ones according with the definition of self-discipline Code of Borsa Italiana.

[12] The result was achieved, among others, by the Parch and Shin study of 2004 which deals with Canadian listed companies and that detect, despite the presence of earningsss manipulations, no relationship between them and the percentage of

theory (FAMA & JENSEN, 1983; BRICKLEY ET AL., 1994). This is because CEO duality concentrates power in the CEO's position, potentially allowing for more management discretion.

Recently a survey noted that those companies that did register E.M policies, most likely of the allegedly innocence's, present the two charges in the same subject (UWUIGBE, U., PETER, D. S., & OYENIYI, A. 2014).

Another relevant factor that favour the Earnings Management raising is the multi-directorship phenomenon, namely the presence at the same time of a single director in more than one firm's Board. A large percentage of studies dealing with this issue based their theoretical point of view on the agency theory (FAIRCHILD AND LI 2007) and argue that the incidence of multiple appointment threats the level of monitoring by the board over financial reporting process leading to a lower degree of financial reporting quality[13].On the other hand, from a different outlook directors who work among multiple boards may develop a greater reputation, functional to deter managers' selfish behaviours (BADOLATO, P. G., DONELSON, D. C., & EGE, M., 2014)

1.4.3 The forefront Role: The Audit Committee

In carrying out its functions the directors form a series of committee to make the decision about various themes well timed and well informed, in this way they can easily create a sort of expertise around a given subject. The most relevant for our analysis is the Audit Committee, it has the delegation in the monitoring activity of the financial

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independent directors. This study is significant for Canadian financial market analysts, developed in the same way as the US ones, but characterized by highly concentrated property structure

[13] Ad instance, BEASLEY, M. S. (1996) asserts that the number of multiple appointments is positively related with the probability and earnings management and negatively related with the degree of conservatism.

reporting reliability and internal control practices and the impediment and detection of the Earnings management practices.

2 The Earnings management

Since the depth of the earnings management phenomenon and its assumptions and implications, multiple and multifaceted are the definitions proposed by academics and professionals related to earnings management.

Preliminarily, it seems useful to note that it is not a generally accepted reality that the earnings management is a negative practice, even if it affects the quality of the financial report since it leads to the misrepresentation of itself. Anyway, for completeness’s sake follows some literature definitions, embedded the ones that give a neutral interpretation of the earning management that clear the relation between financial reporting style and earnings management.

Per Davidson, Stickney and Weil, Earnings Management consists of the discretionary intervention implemented by the Managers, who take advantage of the standard setter accounting options to represent a desired "desired" level of profit from the market view. (WEIL, R. L., O'BRIEN, P. C., MAHER, M. M., STICKNEY, C. P., & DAVIDSON, S. 1998).

In the Shipper approach, usually, unethical and selfish managers commit Earnings Management, in the reporting process, to maximize informational asymmetry in their favour at the expense of "outsider" investors to achieve a personal profit.

(SCHIPPER, K. 1989).

Healy and Whalen individuate Earnings Management when management uses subjective evaluations, in the reporting process and in certain structural transactions, to alter the financial statements to deceive shareholders regarding the company's income earnings and/or to obtain private benefits that derive from management remuneration plan (HEALY, P. M., & WAHLEN, J. M. 1999).

In general, the definitions have their common denominator in the discretionary roles of the executives, in the process of drafting management statements and in related processes of communication and information of economic and financial data.

The use of discretion by management in the process of drafting the financial report is the result of the adopted editorial style that comes from the variety of alternative treatments. The multiplicity of potentially available behaviours sets up a sophisticated taxonomy of the style of drafting the documents, ranging from prudent to fraudulent to a neutral / moderate and aggressive approach (DECHOW, P. M., & SKINNER, D. J. 2000).

With prudent style, we mean that, in the preparation of the financial statements, in addition to the strict observance of the accounting principles and the information objectives they pursue, technical solutions and prudential valuations are taken, preferring prudence over the relevance whenever possible. For neutral and moderate style, we intend that the accounting principles in the drafting of financial statements are complied with both in the form and in the disclosure purpose assigned to them. For aggressive style, let us say that in compiling the financial documents, principles are always respected in form but not in substance. We will be squeezed in the presence of a fraudulent style when one or more accounting principles have not been applied or applied just in the form in the preparation of the financial statements "with the intention of deceiving" (MATTIE, M. M. 2006).

2.1 Earnings management types

The earnings management can be achieved in two ways: recording discretionary assessments of company facts, or by way directly connected with the company operations, these operations in object are put in place just to produce a given effect on the Financial report. In other ways, the reader should distinguish between real and disclosure earnings management.

The Real earnings management is achieved through a temporal and subjective allocation of certain costs and / or revenues and are directly reflected in the company's economic and financial situation.[14]

Differently, valuation policies are implemented through a discretionary basis of the balance sheet accounts and affect "only" the processes of communication and information.

Specifically, the policies of accrual earnings management are originated in two different areas of discretion, which hold respectively the classification of the accounts on the statement schemes (shifting earnings management) and to the assignment of a given value estimated to the accounts (accrual earnings management).

The action place of the shifting earnings management is the income statement, since in its context it is possible to classify the accounts alternatively as recurrent or not recurrent income components, its recurrence does not imply a variation in the earnings but make unclear the operational activity outcomes to the information users.

The accrual earnings management practices are realized right before the closing period of the accounting process, through the valuation of the operations that since do not resolving themselves in the exercise necessitate a quality-quantitative determination seeing also at the prospective performance of the company.

The real earnings management practices have historically attracted poor attention from the scholars because of the difficulties of implementation and measurement. However, in the last year, since the practice of disclosure E.M have become more difficult to implement due the introduction of standard setter always less permissive and the controls more tights, the real earnings management in the practice have become more

[14] For a systematic analysis of the real Earnings management should be consulted Roychowdhury, S. (2006).

pervasive than in the past. In fact, they are very expensive and difficult to be detected and thus attainable in terms of sanctions coming from the regulator market bodies.

2.2 Accrual earnings management policies

Since the conceptual reference framework and in general, the ways of earnings are managed has been identified and rough out, it seems useful to focus on the analysis of the "accrual earnings management" policies. Nutshell, they are a series of practices used to manipulate the operating income through - instrumental use of valuation at the time of writing of the Financial Statement.

Indeed, as mentioned in the general description of the earnings management phenomenon, the work of the balance sheet editors is run through a series of assessments, both objective and subjective, to assign values to the balance sheet items, reflecting operating events that have been concluded or still ongoing at the end of the administrative period.

Specifically, they referred to the assessments of the issues that are still in running, which require a necessarily subjective approach. In fact, the evaluations that "naturally" present a subjective apportion can be, as recognized in the definition of the earnings management concept used to achieve some given goals (see par. 2.3). Consequently, although the level of applicability of the subjectivity on such valuations cannot go beyond the boundaries defined by the rules and accounting principles. In fact, the discretionary nature of the valuations entails, in any case, a natural damage of the principle of neutrality which should always be the mainstay of the of the Financial Statements editing process.

2.2.1 Detecting accrual earnings management

Earnings management studies investigate the use of discretion by managers in drafting and presenting accounting information to achieve simple or complex goals of various kinds. Broad and varied literature exists, especially in the last three decades, it elaborated increasingly complex methods to improve the recognition degree of earnings management policies.[15]

From reading several papers on the subject, we conclude that it is possible to classify the methods used to prove the earnings management in two categories:

- Procedures using the tools of accounting analysis[16];
- Procedures using statistical techniques and methods.

The former are more used in the professional context and are focused on the variations for the singular balance sheet indexes across various administrative exercise, nutshell the horizontal analysis; or on the cross- sectional analysis among various companies; the so called vertical analysis that shows its best results just when it is used when the reference framework is a single industry[17]

The statistical methods are the most used ones in the contest of the scholar researches and based on the object of the analysis, it can be divided in:

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[15] "Given the complexity of the phenomenon in question it is not surprising that it has come to operationalize it and measure its size in different ways. and to measure their size in a different way, using methods that find their roots in different disciplines" Prencipe A. Earningss Quality 1996.

[16] For a complete scrutiny of this kind of procedure see BADANHAUSSEN *Earnings quality and the accounting methodologies of detection* 2001.

[17] For a thorough examination of the methods using the tools of accounting analysis see Jan Hofmann 2005

-procedures based on the estimation of singular accrual.

-procedures based on the appraisal of the total accruals;

The approach of the single accrual is founded itself on the study of a single balance sheet account. In fact, the hypothesis under analysis assumes that managers manipulate that single issue to achieve the income desired. For those procedures are highlighted in the analysis for the detection of the earnings management phenomenon just those changes in balance sheet items and respective cost and revenue considered risky. The model coming from this kind of procedure even if have some intrinsic limitations, have the pro to be quite clear in individuate the marginal of subjectivity since the strict field of analysis; furthermore, they show all their potentiality in some industry where there are few balance sheet items that can be manipulated even in a large volume such as the item of Loss Provision for bad debt in the Bank Sector (MCNICHOLS, M., & WILSON, G. P. 1988).

The *ratio* behind the total accrual approach assumes that the subjectivity choice of the management finds its way through the spaces existing in the net of the economy recognition preinciple.[18] In fact the earnings management arise among the cost recognition determined discretionary by the management.

Moving from the economic recognition principle it is possible to divide the operative income before extraordinary items in three subcategories (HRIBAR, P., & COLLINS, D. W. 2002):

[18] The application of this principle is based on the match between the cost and revenue of the period driven also by a cause-effect nexus.

1. FCFO (Free cash flow from operation) created by the business activity
2. The “normal” or “non- discretionary accruals”
3. The “discretionary accruals”

To move3 on in the explanation of the model used to detect earnings management looks needy to describe the two methods used to compute the operative accruals and some specification about themselves.

$$Accruals= (\Delta CA- \Delta Cash)- (\Delta LC-\Delta FCL)$$

CA = current asset,

Cash= liquid assets

LC = current liabilities,

PCF = Financial current Liabilities (short-term financial debt and tax debts)

D&A. = Depreciation and amortization

The first thing to highlight about this equation is that we consider the current asset and liabilities since the long ones are difficult to be manipulated if not impossible to be manipulated within the accounting principle, then are excluded from the computation the current financial liabilities since their amount inscription is “authorized” by the bank and this is controlled by the audit company. Then the depreciation and amortization are added since we consider as earnings (following the original arrangement of Jennifer Jones) the EBITDA.

The second and easiest approach for the computation of the accrual consist in the following equation:

Accruals=Net Income- FCFO

This approach is more intuitive; actually, the term representing the earnings can be placed with the EBITDA based on the characteristics of the background where the analysis is taking place.[19] Furthermore is not interchangeable the Free cash flow from operation with the free cash flow or at least is not advisable since the manipulation activity is not usually (almost never) able to attain also the financial activity as it legitimate by several studies (RICHARDSON, S. A., SLOAN, R. G., SOLIMAN, M. T., & TUNA, I. 2005).

The latter part is the fundamental one for the earnings management detection since it measures the track and the strength of the earnings manipulation policies that have been taken in place by the administration body.

Moreover, from a merely practical point of view in determining discretionary accruals, it is necessary to estimate a model by which it is possible to determine the normal level of accruals in each period from which the discretionary accruals represented by the residuals of the model are derived.

The estimation of the total accruals remains a valid tool to detect the earnings management even if over the year detractors of these methods have blame these methods of incapacity to individuate the explicative factors for the accruals normal levels; overestimating in this way the actual level of discretionary accruals and in turn earnings management (DECHOW, P. M., SLOAN, R. G., & SWEENEY, A. P. 1995). committing in this way the statistical error of second type [20].

2.3 The earnings management incentives

[19] For example, Jennifer Jones used in her study the EBITDA just because it was the measure used by the Trade Union to determine the presence and the amount of damage for the local companies deriving from the foreign ones

[20] The second type statistical error is the error that incur when a wrong hypothesis is accepted as truth.

Differently for what concerned the earnings management definition process the literature seems quite concordant relating the distinction of the incentives that drives the earnings management practices:

- Capital Market Incentives;
- contractual incentives;
- political cost incentives.

2.3.1 Capital Market Incentives

In general, the capital market incentives embedded all the situations in which the application of the earnings management policy is an instrument to influence the trend of the stock prices.

Furthermore, the incentives linked to the capital market can be further divided in incentives that incur currently during the company's life such as the urgency to smooth earnings to give outside the impression of a riskless investment (DEFOND, M. L., & PARK, C. W. 1997) or corresponding with a certain event arise. We divide the capital market incentives in two sub-categories:

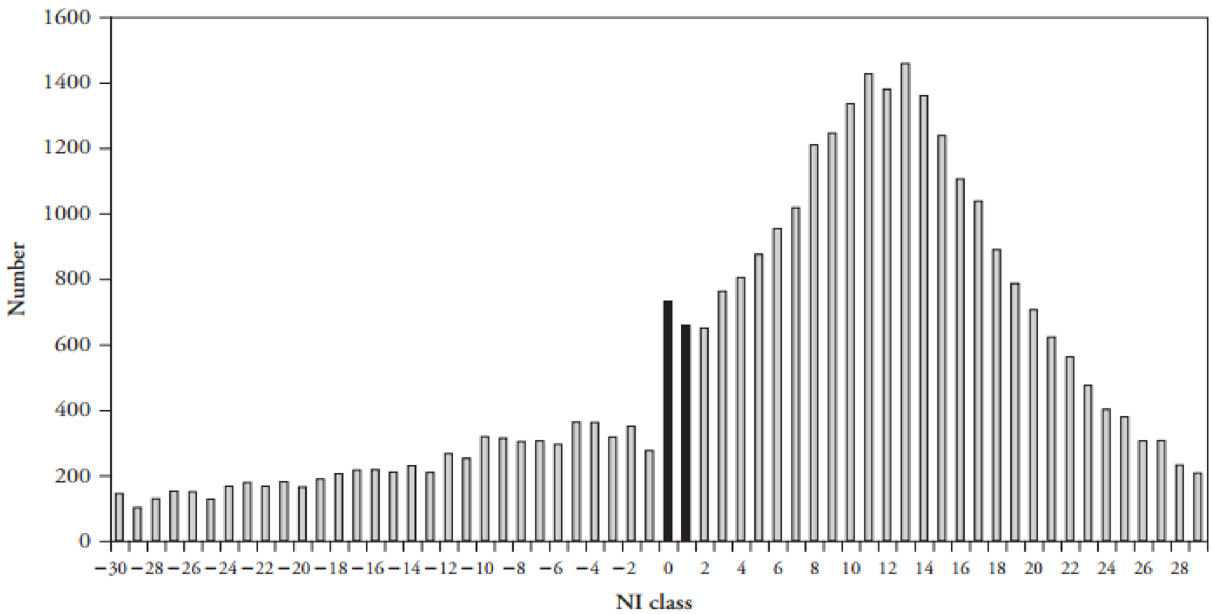
- Incentives of ordinary nature
- Incentives of Extraordinary Nature

The former regards the achievement of critical profitability thresholds to avoid the financial market and analyst's disappointment. In the reference literature, three profit margins are identifiable:

1. Earnings equal to or less than zero;
2. Income results equal to those achieved in the previous year;
3. Income results equal to or greater than analysts' expectations.

Regarding the loss avoidance sentiment, the figure below describes this tendency. It has been extrapolated from a research[1] (Dechow, Richardson, and Tuna, 2003) whose sample consist of the all publicly traded company in US between 1988 and 2003. The horizontal axis reports the ranges of net income scaled for the market equity value and the vertical one the number of companies that recorded the given net income scaled for the equity market value. According with our insight the research shows as there is a certain propensity to record a non-negative net income scaled by the equity market value rather than to record a loss as it is highlighted in the figure. This peculiarity in the distribution has been tied by the researchers, at least in part to a discretional motivation of the management.

Fig. 3: The loss avoidance attitude



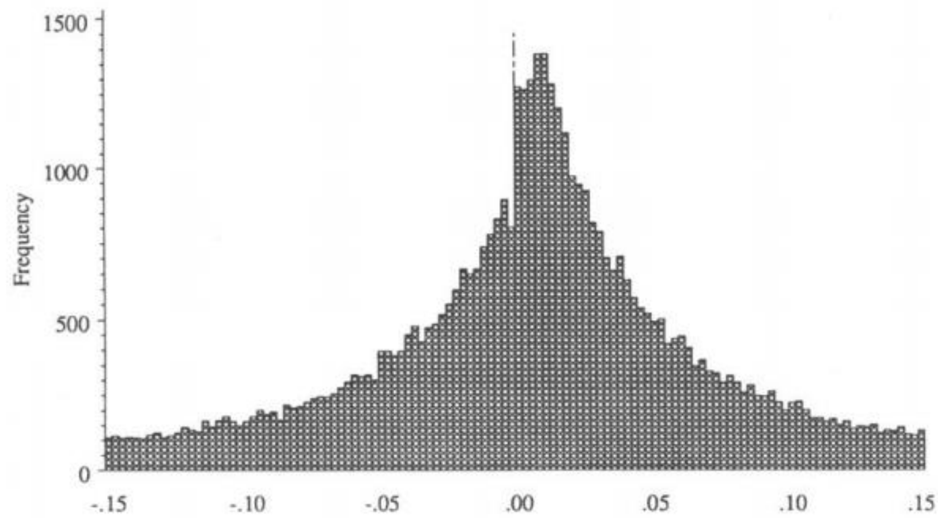
Source: Dechow, Richardson, and Tuna (2003).

The evidences of the earnings smoothing phenomenon is the observation that firms avoid to report reduction in earnings relative to the earnings publicized in the same quarter of the prior year (BURGSTAHLER, D., & DICHEV, I. 1997). In Fact managers in their annual relations tend to emphasize the importance of earnings improvement[21] .

This attitude of the management to manipulate the earnings has been demonstrated by the research cited above and synthetized by the figure below that shows as the modal datum is a zero-earnings variation scaled for the price to allow the comparability among two consecutive years.

[21]This image the importance this datum has in every choice of the management and probably also the accounting ones. Emphasis leave to

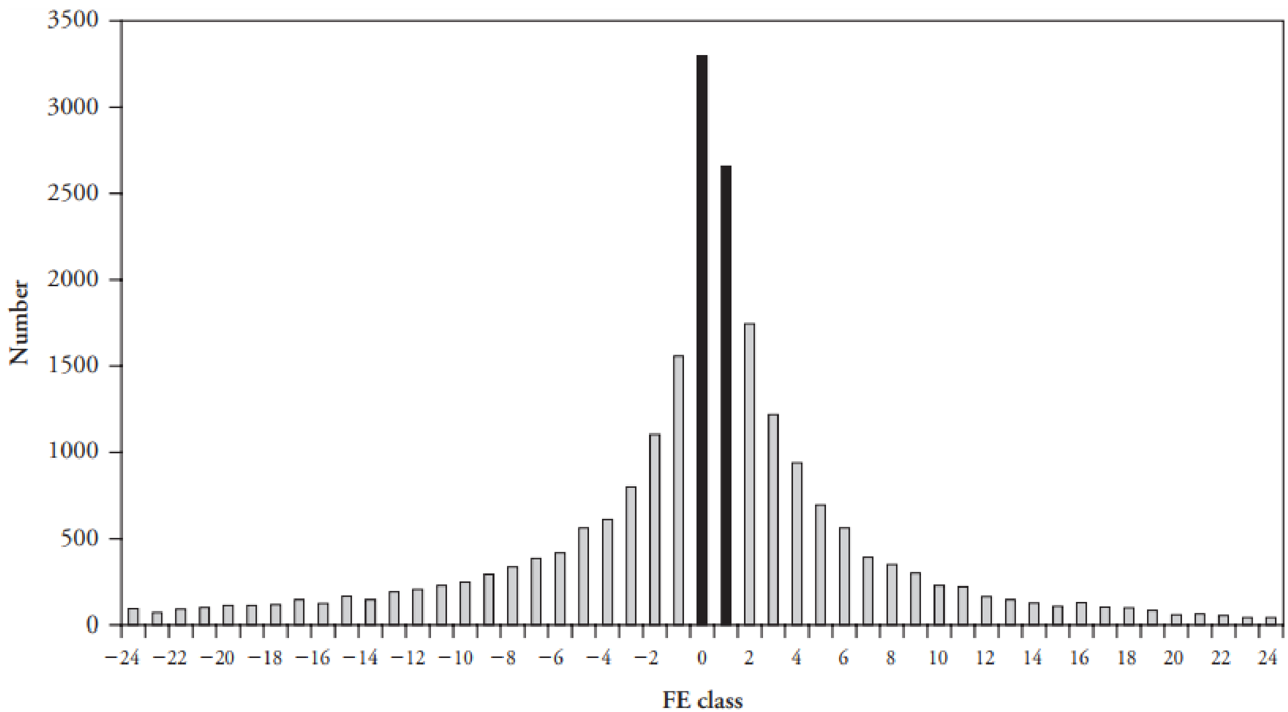
Fig. 4: Earnings Change Between interval period



Source: Burgstahler, D., & Dichev, I. (1997).

Another target whose achievement is strongly appreciated by the financial market is the matching between the earnings reported and the one forward by the analysts. Regarding this issue the figure below belonging to the research already mentioned above shows as the forecast error defined as the difference between the analyst prevision and the reported earnings has its modal statistical datum in the zero of the distribution, in addition it is interesting also that more company slightly exceed the zero-forecast error rather than to miss it. This evidence can have two different drivers, the former is the earnings management to match the analyst expectation and the second may be earnings expectations management perpetrated by the sell analyst[22] to match the company's desire as expressed by the management.

Fig.5: The analyst benchmark



Source: Dechow, Richardson, and Tuna (2003).

Regardless the specific threshold the basic premise is that the market, even if it is conscious that in proximity of certain profitability thresholds are incurring some earnings manipulation, it is not able neither to detect nor to purify the effects of these manipulation from the earnings reported (outcome of the earnings management practices).

[22] Sell - side analysts work at firms that sell trading and related services

Instead, the extraordinary nature incentives arise when the company is involved actively or passively, in procedure having as object the stocks trade on the market. In this case, the preliminary condition is that the market is not able to perceive in advance the existence of manipulation in the data underlying its assessments.
In the context of the broad literature, it is possible to individuate three typologies of events extraordinary:

- The Initial Public Offering (DuCharme, L. L., Malatesta, P. H., & Sefcik, S. E. 2001).
- The improvement of the capital through the issuance with payment of new shares (Teoh, S. H., Welch, I., & Wong, T. J. 1998).;
- The hostile takeover; (Easterwood, C. M. 1997).
- Management buy out

The initial public offering, the SEO and the hostile takeover are events that incentive the management to improve Management buy-out. To gain more resource in the former two case and to deter the minority shareholder to sell their shares to the promulgator of the hostile takeover in the last case. Instead, regarding the management buy-out[23]; the managers in the attempt to pay as less as possible such operation disclose earnings that devaluate the real performance of the company, thus minimizing the earnings and the price (Perry, S. E., & Williams, T. H. 1994).

23The management buy-out is the appropriation of the property of the company through the purchase of the majority block of shares by the current management

2.3.2 Contractual incentives

Contractual incentives arise when the implementation of earnings management policies is functional to achieve objectives relative to contract or covenants and to avoid costs or receive benefits.

For simplicity's sake, we decide to divide the incentives that we placed under the umbrella of contractual ones in two kinds. The former embed the case of contracts based on the remuneration of the managers, that we will define from then onwards simply remuneration incentive and the latter are the case in which the earning is manipulated to not violate the covenants limit, this incentive from then onwards will be instead called Covenants incentives.

The Remuneration incentives raise moving from the salary system of the management and especially of the CEO. Institutionally the compensation of the top managers is set by the Board of directors who links the compensation package to some key performance indexes, whose entity is not exhaustive but imply many accounting measures.[24] Thus, when the compensation is linked to the financial statement data as the earnings; this can happen for example in a direct manner through the bonus or even in an indirect one, through the stock options[25]. Since the existing link among the stock option and the earning, in the meantime usually the price of the stocks tends to be in line with the

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[24] Some of the Key performance index more used are: accounting returns such as ROE and ROI, Sales Revenue, Earnings multiples indicators.

[25]A stock option is a right allowed by a part to another one to buy a stock in a given moment at the price of a past moment. This financial instrument is used in the financial market to align the goals of the managers to the one of the property. In fact, a manager that holds a stock option ha the same interest of a common stockholder to see the price of the stock increasing.

historical earnings trend, it is normal to expect that the management will tend to over valuate the earnings as much as its compensation is directly linked to such proxy.

Regarding covenant incentives, there are many contractual terms that a bank can impose before to grant a debt to the companies as request of guarantee or collateral, furthermore it is a common practice toward the lenders to design contracts that limit the firm to behave against their interest. These restrictions are named debt covenants and can be both affirmative or negative. Affirmative covenants consist of minimum requirements based on accounting numbers. Ad instance lenders can require the accomplishment of a minimum earnings. Negative covenants can imply the prohibition of certain investment or financing activity or dividend payment to avoid the jeopardization of the capital running by the shareholders at the debtholder’s expenses.

The covenants violation can be also quite expensive due to the renegotiating cost or simply due to the consequences deriving in terms of reputation; thus in general we can conclude that the covenants provide a very intense incentive to the management, to strategically use the accounting discretion allowed to them. In fact, a common behaviour is the one to avoid reporting earnings that lie under the minimum one.

2.3.3 Political cost incentives

The third type of incentives is the one linked to the political costs. Earnings management practices can be put in place to reduce costs related to compliance with current legislation either regarding tax matter or the regulation of the sector in which the company operates or even to increase the benefits deriving from the respect of the latter.

Indeed, especially the companies that are heavily regulated even in terms of price (see utilities), because of their public utility, use to manipulate the earnings so as not to incur in a reduction of the price for the service provided.

So, in these cases earnings management tends to write off the earnings to avoid the attention of the regulator bodies and therefore to incur in their unfavourable actions by the imposition of a lower price, as mentioned earlier.

If, instead, we want to discuss about policy costs regarding a general business concept, taxes should be the most prevalent topic of the discussion. In fact, fiscal nature incentives that literature tends to include amongst the political costs are quite common amongst the (αἴτια)[26] of the earnings management. Then, Executives sometimes decide to use alternative accounting methods which the only attempt is not only pursuing earnings management, but also fiscal evasion.

[26] L'aitia in ancient greek means deep cause that is the used to highlight a reason as the real motives that has drived a fact or a phenomenon as in this case the earnings management, it is used to distinguish the real reason by the alleged ones that are instead called Πρόφασις (the pretext).

3. The Audit Committee Expertise and the Earnings Management: An empirical analysis

3.1Research hypotheses

The role of audit committee on disclosure quality is crucial, since the Board delegates the oversight over financial reporting process to such committee. For this reason, the literature regarding the Audit committee in general is quite copious, but in particular, the most relevant portion of such literature regards the relation existing between the AC characteristics (e.g. expertise and independence multiple directorship, tenure, etc...) and financial outputs (e.g. fraud, restatement, and earnings management incurrence). In particular, the relation between Audit committee and Earnings management is a recurrent theme especially because of it is not objectively recognizable as a restatement.

Therefore, in the light of the national and international literature and with reference with the issues discussed along the previous chapters, the hypotheses underlying the empirical investigation proposed in this thesis are set out below.

H1: Accounting experts, within the Audit Committee are the most effective ones to deter and detect earnings management practices.

The rationale behind this matter is that Audit Committee members face along their daily activities issues regarding both the accounting and the audit process. Indeed, the recording process and its mechanisms as well any manipulation of itself can be understood through a depth knowledge and experience characterized by a high degree of accounting sophistication (DE FOND ET AL 2005).

Furthermore, accounting experts are also more able to identify and assess alternative treatment under the accounting principles as well to implement a constructive discussion around the appliance of new accounting policies. (BEASLEY, M. S., CARCELLO, J. V., HERMANSON, D. R., & NEAL, T. L.2009).

In detailing, regarding the accrual policies, Carcello et al. 2006 consider the role of both non-accounting and accounting Audit Committee members and discover that only the formers make to record:

- Lower discretionary accruals: we can define the accrual discretional when their presence in the balance is due not to business condition but reflect simply a management choice.
- Higher earnings response coefficients: namely the reactivity with which vary the equity returns following an announcement from the management of an earning with a quite large unexpected portion. It is thus an evidence of the reliability that investors have toward the company disclosure
- Higher accounting conservatism: it is an attitude to put the company is the worst scenario with reference to the valuation activity of revenue and cost.

While the first hypothesis presented above focuses on the expertise valuation in absolute term, the second hypothesis, formalized below, intends to discover the perfect mix of expertise within the Audit Committee relative to the decrement of the incurrence and the impact of the earning management along the Financial Statement of the company under analysis.

H2: Given the presence of at least an accounting expert within the AC, the participation of non-accounting experts who hold business and industry expertise, as long as financially literates, can made the committee under analysis more effective.

In detail, the expertise that we will consider in our analysis over the accounting one are four:

- Financial
- Legal

- Managerial- Supervisory

Financial expert can be defined people whose background it is characterized by an experience in a Bank of Investments, by the fact to have worked as analyst or as any other role in the context of financial management. This expertise if not directly connected with the financial statement knowledge, as the accounting expertise should not being undervalued; since it can help the audit committee members that hold such expertise to understand the economic substance and especially the industry mechanisms even better than a bookkeeping expert does. (HILLMAN, A. J., & DALZIEL, T. 2003).
Then, it has been demonstrated (KRISHNAN, J., WEN, Y., & ZHAO, W. 2011) that the audit committee legal knowledge it is connected with improvements in company financial reporting reliability. In fact, legal experts are alert to lawsuit that could be originate by litigation relative to the data of the accounting reports. Thus, it is probable that legal professionals on Audit Committee provide a supplementary improvement to its monitoring role.
Lastly, a supervisory-managerial background deriving from CEO experience, managerial studies can improve the Audit Committee ability “to fix” internal control lacks. This aspect will be highlighted when this expertise will come from an entrepreneur experience that as it is known consist also in supervise employees with financial reporting duties. (GOH, B. W. 2009).

3.2 Sample Definition

Moving from the prospective that the empirical research to which this third chapter is devoted aim to test whether the characteristics of corporate governance and the audit committee play a role in the prevention of earnings management policies.

We choose as space of analysis regarding the governance data, the years range 2013-2015, we take this decision for multiple reasons: the first is to conduct a survey as much as possible updated, secondly, to respect a profile of "neutrality" about the effects of the introduction and application of international accounting standards[27].

The source of the Governance data have been multiples and the sorting activity of these has required a long filing activity, thus does not still exist any database that collect systematically the governance data we need for this research. Thus, after a first step during which the Relation of Corporate Governance have been collected; successively we have extract the information relative to the characteristics of the governance we were interested to. In the most of the cases, we found such relations on the *Borsa Italiana* website. Then, when some Relation of Corporate Governance was not available on the web site of Borsa Italiana, already mentioned above, we download such relations from the corresponding company website.

In particular, within the Relation of Corporate Governance particularly difficult has resulted the collection of the data referred to the mix expertise of the Audit committee for each company. In fact, in almost half of the cases, a short biography of the Audit committee member and in general of the whole Board body was reported within the Relation, but when this was not present, to obtain these information we have recorded the expertise for any single Audit Committee member.

[27] For clarity's sake is well to remember to the reader that the introduction process of the international accounting principle among the Italian listed companies started in 2005, for this reason our sample had to be as far as possible from this date to allow the neutrality of the effect cause by this normative newness.

Instead, regarding the sample time of the financial data, we need to distinguish among the observation and the analysis of the data. Indeed, the first one gather the data from 2006 to 2015 while the second one did not use the 2006 since it has been used just to compute the variation used to the computation of the dependent variable, whose process will be explained in the following paragraphs.

Definitely, the collection of the financial data has been less time-consuming than the Governance ones. In fact, through the database AIDA (HTTPS://AIDA.BVDINFO.COM/VERSION-201787/HOME.SERV?PRODUCT=AIDANEO) we collect the balance-sheet number whose selection and use will be illustrated in the following paragraphs.

Regarding the companies that enter in our sample; the cluster of start was the set of Italian listed companies, with some adjustments that are following presented.

Specifically, in order to ensure greater homogeneity and representativeness of the investigated phenomena, we exclude from our start sample consisting of the whole set of Italian listed companies (193) financial, banking and insurance companies (20). In fact, we decide to develop the Jones model to detect earning management and this model moves its observation starting from the analysis of the total accrual data. Thus, we should use companies whose nature can fit with this kind of estimate process. In fact, the exclusion of the financial companies can be justified by the fact that the management employ their allowed discretion on the estimates of the account is focused on few account as the Loan Loss Provision in the case of the banks financial statement, and not generalized over the total accrual amount. The second type of company we excluded are the public utilities company (4), as their characteristics in terms of governance and ownership structures, resulting from an articulated regulatory framework and regulation would of course have affected the analysis.

Then since our subject of analysis is the Audit Committee we eliminate from our original sample also that companies that do not have an audit committee because they entrust the Audit Committee role to the Statutory Auditor (19 companies) or because simply did not accomplish to the self-regulation of the listed companies (4 companies).

Definitely, the selected sample result composed of 146 Italian public companies listed on the Borsa Italiana Market and operating in the industrial sector, we can define our sample unbalanced since we consider even those firms that behind the 2013 and 2015 have interrupted their activity for some reason (e.g. fusion, failure etc.)

3.3 The Process of Data Analysis

The empirical research consisted in a three-step analysis. First, the variables (dependent, independent, and control) of the proposed analysis model were identified. Secondly, we execute a merely descriptive analysis of the variables identified previously. Finally, to test the relationship between the identified and estimated earnings management variable, multivariate linear regression model was developed and implemented using the ordinary least Squares methodology.

3.4 Variables Definition

To test the underlying hypotheses of this research, the first step is the one to estimate the earning management from the financial statement data of each company. Firstly, we identified the earnings manipulation variable (dependent variable) in the level of discretionary accruals and then we estimated such amount. Subsequently, we define and organize the independent and control variables.

3.4.1 Dependent Variable: Discretionary accruals

As mentioned above to detect the earning management we employed the model developed in 1991 by Jennifer Jones, the model of discretionary accruals,
Miss Jones moved from the assumption that any company can have a highest level of accruals and not run any kind of earning management. In fact, an high level of total accruals can be easily justified by business-related reasons such as the operating cycle and economic growth, then she gets to the conclusion that the residuals of a regression model that explain the business reasons are the signals of the existence of accruals based simply on management choices. (JONES, J. J. 1991).
Therefore, the difference between the level of total accrual recorded in the financial statements and the one considered normal based on the reference business conditions identifies the discretionary accruals that will reverse to the opposite side of the income statement during the subsequent years.[28]
The Modified Jones model consists of the following equation:

[28] Regarding this issue Jennifer J. Jones points out: Since the sum of a firm's income over all years must equal the sum of its cash flows, managers must at some point in time reverse any "excessive" earningsss-decreasing (or increasing) accruals made in the past.

$TA_{it} / TA_{t-1} = \beta_0 + \beta_1 (1/TA_{it-1}) + \beta_2 [(\Delta Revenues\text{-}\Delta receivables)\text{-} / TA_{it-1}] + \beta_3(GPPE / TA_{it-1}) + \varepsilon$ (DECHOW, P. M., SLOAN, R. G., & SWEENEY, A. P. 1995).

TA= Total accrual given by the difference between the Net Income and the FCFO[29]

(ΔREV-ΔREC) it = revenues in year t less revenues in year t - 1 for firm i;

PPE_{it} = gross property, plant, and equipment in year t for firm i;

Ait-1 = total assets in year t-1 for firm i;

ε = error term in year t for firm i;

i=1...N firm identification number (N= 146);

t = 1... T, year index for the years included in the estimation period for firm i (T ranges between 1 and 3).

The most important term of this formula is the error or residual that represents the discretionary accruals component. Furthermore, the fact that we divide both terms of the equation by the lagged assets deserves a comment. In fact, this is done to reduce the heteroscedasticity effect and thus to eliminate the size effect that would make more difficult to compare the results referred to different companies.[30]

Regarding the explicative factor, we consider the revenue not in absolute terms but in their variation and after subtracting the receivables. We execute the subtraction to represent better the cash earnings. In fact, the receivables is an item of the balance sheet quite easy to manipulate. Definitely, the net value of the receivable variation factor intends to capture the growth of the company business that justify the variation of the total accruals. Instead, we consider the Property plant and equipment in their total amount since the total depreciation amount and not its variation is included in the computation of the total accrual measure[31].

Definitely, we use the Greek letters according with the convention of the regression to use such alphabet to represent the coefficient and for the intercept. The second step following the definition of the model used to estimate the earnings management occurrence, p would be the choice of the procedure to estimate the coefficient of the regression that will be subsequently used as tolls to estimate the result of the model: the "normal" accruals.

Exist two styles to estimate the coefficient we are interested to: the cross-sectional analysis and the time series analysis, we are going to explain the functionality of both them and then we will clarify the reason, related to our sample nature, we chose the second one.

To explain those two approaches, we will start explaining what they have in common, in fact, we could implement both through a multivariate regression whose dependent

[30] If we do not do this the model will be prevailed by the big companies and would not take in account the small ones data

[31] See the second chapter of this thesis

variable is the total accruals datum and the two independent variables the explicative factors explained above.

The main difference between the two methods is the time horizon considered and the number of companies included in this regression. In fact, according with the cross-sectional analysis our sample has to be divided in sub-sample as many are the industry identified in it and the time horizon can be also one single year, the cross- sectional analysis run the regression one company at a time but use the historical data of the company.

Anyway, both methodologies have caveats. Indeed, the former depend too much on the definition of industry and the difference among the businesses of the companies that are collected in a same industry can quite easily invalidate it. Instead, the cross-sectional analysis lose its validity when in the sample are embedded “young” companies since to work and to be effective it requires at least 5 years of financial data, and then it is quite sensitive to change in the strategy and structure of the single company such as fusion and other change in the long-term plan.

Definitely, we decide to use the second approach in relation to the nature of our sample; in fact, it collects multiple industries and since the process of grouping companies into them is quite complicate. Thus, we decide to implement the second approach given that our sample listed companies and then we have the possibility to the access of databases that collect until ten years of financial data, for the same reason in our sample are not present young companies.

Then moving to the actual process, for the computation of the discretionary accrual, we use the financial data from 2006 to 2012 to build our estimation sample; in this way, we assume that in average there were not earnings management recurrence over this estimation sample.[32]

Once launched the regression for the 146 companies through our estimation sample the following step will be calculate normal accrual in our main sample as the intercept β_0+ the coefficient β_1 * cash revenue growth + the coefficient β_2 * properly plan equipment. Then discretionary accruals are simply accruals less our estimate of normal accruals.

Now since the years for which we compute, the discretionary accruals are three we will obtain our dependent variable through a simple arithmetic average among the three years.

Furthermore, since the ambition of this thesis is the detection of the earnings management through the observation of the discretionary accruals as we already have discussed in the second chapter the earnings management can take either direction, alternatively inflating or deflating the actual earnings. Thus, since in this context we are not interested about the direction of the earning management in relation to the governance but just in its essential incurrence, to make easier the detection of such incurrence we decide to compute the absolute value of the average of the discretionary accrual as computed over the sample period.

After all the direction of the earnings management phenomenon will be probably useful when the moment to apply the principle in the practical field will arrive, especially to link the incurrence of such phenomenon with a given incentive, but until that moment we will consider just the size of the discretionary accrual and not also its sign.[33]

[32] This assumption is quite safe since the earnings management is not a phenomenon that can last for more than 5 year because of the reversals effect that take the earnings toward the actual level of the actual cash flows.

[33] For example, the implementation of an earnings management practices to deflate the actual earnings when the incentive are the political one or to smooth the earnings or to inflate the earnings when the main goal is to beat the analysts'

3.4.2 The independent Variables

The table below collects our test variable: according with prior studies accounting experts Audit Committee member is who has a background as accountant or Professional Auditors. Legal experts, the first non-accounting experts are the one who have a legal background holding a law degree and eventually working as lawyer. Then Finance experts are the ones who have an experience in the investment banking for example analyst. Finally, the supervisory expertise is the most general one and embrace whoever has a degree in management or simply an entrepreneurship experience as CEO. Moving from the classification designed above, we identify four dichotomous variables.
The first proxy ACC report the value one (1) if the committee has at least one member who respect the parameters mentioned above to be considered an accounting expert and zero (0) otherwise.
Similarly, the other variables are coded 1 if the Audit Committee has at least one member with the reference expertise and 0 otherwise.

Table 3: Test Variables

Similarly, the table 4 expose the 16 variables corresponding to the same number of expertise mix that is possible to meet in the Audit committee along the sample of our analysis:

The first four variables capture cases when the Audit committee includes:

a) One accounting expert but no legal finance or supervisory experts;

b) One legal experts but no accounting finance or supervisory experts;

c) One finance expert but no legal finance or supervisory experts;

d) One supervisory expert but no accounting legal or finance expert

Variable Name	*Measurement*
ACC	1 when the AC of the firm i has at least an accounting expert An 0 otherwise throughout the sample period
LEG	1 when the AC of the firm i has at least a legal expert An 0 otherwise throughout the sample period
FIN	1 when the AC of the firm i has at least a finance expert An 0 otherwise throughout the sample period
SUPER	1 when the AC has at least a supervisory expert An 0 otherwise throughout the sample period

The remaining nine variables are permutation from having two or three of the four kind of expert within the Audit Committee.

The last variable expresses the extreme case when all the four kind of experts are sit on the Audit Committee of one single companies. This can happen also when the members number of an audit committee is minor than four[34] because in several cases one single member boast more than one expertise

Table 4: Test Variable (Mix expertise)

Variable Name	***Measurement***
ACC_Only	1 if the AC of the firm i contains at least one accounting expert but no legal, finance or supervisory during t (the sample period); 0 otherwise
LEG_Only	1 if the AC of the firm i contains at least one legal expert but no accounting, finance or supervisory during t (the sample period) 0 otherwise
FIN_Only	1 if the AC of the firm i contains at least one finance expert but no legal, accounting or supervisory during t (the sample period) 0 otherwise
SUPER_Only	1 if the AC of the firm i contains at least one supervisory expert but no legal, finance and accounting during t (the sample period) 0 otherwise
ACC & LEG	1 if the AC of the firm i contains at least one accounting and one Legal expert but no finance or supervisory during t (the sample period) 0 otherwise
ACC & FIN	1 if the AC of the firm i contains at least one accounting and Finance experts but no legal, accounting and supervisory during t (the sample period) 0 otherwise
ACC & SUPER	1 if the AC of the firm i contains at least one accounting and supervisory experts but no legal or finance during t (the sample period) 0 otherwise

[34] Three, is in particular the recurring number since the code of listed companies self-regulation put it as bottom line limit.

FIN & LEG	1 if the AC of the firm i contains at least one Finance and legal expert but no accounting or supervisory during t (the sample period) 0 otherwise
FIN & SUPER	1 if the AC of the firm i contains at least one Finance and supervisory experts but no legal or accounting during t (the sample period) 0 otherwise
LEG & SUPER	1 if the AC of the firm i contains at least one legal and supervisory expert but no finance or accounting during t (the sample period) 0 otherwise
ACC LEG & FIN	1 if the AC of the firm i contains at least one accounting, legal and finance expert but no supervisory during t (the sample period) 0 otherwise
ACC LEG & SUPER	1 if the AC of the firm i contains at least one accounting, legal and supervisory expert but no finance during t (the sample period) 0 otherwise
LEG FIN & SUPER	1 if the AC of the firm i contains at least one legal, finance and supervisory expert but no accounting during t (the sample period) 0 otherwise
All expertise	1 if the AC of the firm i contains at least one accounting, finance, legal and supervisory expert during t (the sample period) 0 otherwise
Any expertise	1 if the AC of the firm i contains any experts of the ones considered and 0 otherwise

3.4.3 The Control Variables

The following table 5 reports the control variables employed in this analysis. All the control variables regard the Board of directors, considered by several studies as congenital factors that influence the accrual quality (FRANCIS, J., LA FOND, R., OLSSON, P. M., & SCHIPPER, K. 2004), and the ownership structure since our hypothesis intend to test the additional effectiveness lead to the board by the expertise of the Audit Committee members.

The first two variables regard the ownership structure and are the proportion of relevant Shareholding and the indication for the presence of institutional investors. The former is measured through the average of the three years' observation while the second is a dichotomous variable that is 1 one if in each year is recorded the presence of at least one institutional investor and 0 otherwise. The four variables that remain regard instead the

Board of directors: The Board size and the multi-directorship[35] are average number of any single year of observation. In particular, the multi-directorship variable is also the average respect to each person within the Board, over the sample years; we execute this operation to reduce the effect that a single person within the Board can have against the whole variable. Then, the proportion of independent[36] directors, as well as the multi-directorship variable is constructed to reduce the board size effect, thus as the ration between the independent directors in the Board and the total number of themselves. The last variable is again a dichotomous proxy that assume the value 1 when the person of the CEO is the same of the Board of directors' president and 0 otherwise.

Table 5: Control Variable

Variable	***Measurement***
Relevant Shareholding	Average proportion of total outstanding shares held by the majority shareholder in firm I during the sample period
Institutional Investors	1 if among the shareholders there is at least one institutional in the firm I during the sample period 0 otherwise
Board Size	Average number of the board components in the firm I during the sample period
Multi-directorship	Average number of position in Board of Directors for each administrator of the firm i beyond the same, during the sample period
Ind. Directors %	Average proportion of independent directors in firm I during the sample period
CEO Duality	1 if the person in charge as CEO is also the chairman of the board 0 otherwise

[35] The arrangement take in consideration for the recording of the observation regarding the multi-directorship are the charge among public companies or Bank and Insurance Board.

[36] In the Corporate Governance relation exist two meanings of independence one takes as source *Testo Unico della Finanza. Decreto legislativo 24 febbraio 1998, n. 58.* And the self-regulation code for the listed companies in this thesis we take as refence the later one.

3.3 Research Design

Next, after the variables individuation, we moved to the first observation of our result. In fact, before the main analysis, we observe the result of the descriptive statistic and we commented the most relevant result. Then we focused on the main analysis to test the validation of our hypothesis; to do this we employed a cross sectional analysis to properly verify the association between accounting, legal, finance, supervisory expertise, and earnings management on our sample.

The fact that the discretionary accruals imply higher probability that the management is involved in some earnings management practices deserves a brief comment, hence, a significant positive regression coefficient for any of the background proxies (i.e. ACC, LEG, FIN,SUPER) would advocate lower financial reporting quality for the firm who has among the Audit Committee member the expertise above recalled.

Then the second regression model inspects how much the different mix of expertise among the Audit Committees affects the financial reporting quality, in term of earnings management incurrence.

As in the first regression, the coefficients signal the level of affection of the different mixes of accounting, legal, finance, supervisory, expertise among the Audit Committees of the sample companies.

3.5 Empirical results

3.5.1 Descriptive Result

The table 6 relays summary statistics (Mean, Median, first and third Quartile) on the control variables for the 146 sample firms.

The data show that the mean of the relevant shareholding slightly exceeds the 50% and even the first quartile does not fall below the 40%. The fact that almost every sample companies have a majority shareholder is probably due to an Italian attitude where the spread shareholding is not common at the contrary of in US market. Then, the datum relative to the institutional investor share over the ownership highlights the highest involvement of the banks in the Italian listed companies. This datum makes the reflection open about the historical role of the bank in the Italian economy, in addition the fact that even the first quartile did not report a value minor than 1 makes the fact even more interesting since it is symptomatic of the overbearing nature of the phenomenon.

The mean size of the Board of Directors is almost nine, the fact more interesting about this datum is the big standard deviation that we record and this should open a debate about which factor influences this variable and the explanation for the existence of so much difference of it, among various companies[37]. (BOONE, A. L., FIELD, L. C., KARPOFF, J. M., & RAHEJA, C. G. 2007)

The mean proportion of independent director is almost a half and it looks adequate to satisfy the arguments of the self-discipline who requires that an adequate number of directors are independent in order to be the majority of the internal committee and to allow the execution of the Board in defiance of any possible conflict of interest.

Then the CEO duality is not a phenomenon so common among our sample even if this is probably true just for the listed companies since the most of the general Italian companies are famous for their medium size and traditional familiar setting; both attributes that make more likely the overlapping of the two offices on the same person.

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Variables	Mean	1/100	5/100	Q1	Median	Q3	95/100	99/100	St. Dev.
Rel. Shareholding	0.516	0,034	0,095	0.400	0.535	0.626	0,86	0,93	0.188
Institutional Investors	0.910	0,000	0,000	1,000	1,000	1,000	1,000	1,000	0.285
Board size	9.568	5,000	5,000	7,000	9,000	11,000	15,000	17,000	2.912
Ind. Directors %	0.423	0,041	0,200	0.333	0.400	0.545	0,676	0,827	0.157
CEO Duality	0.296	0,000	0,000	0,000	0,000	1,000	1,000	1,000	0.458
Multi-directorship	1.797	0,000	0,000	0.584	1.358	2.220	5,645	7,485	1.695

Ultimately, the data regarding the multi-directorship proportion reflects an Italian phenomenon, that has been more than once criticized especially from the international literature (CROCI, E., & GRASSI, R. 2014)., explained in part by the tendency of company to fall into pyramidal groups. Anyway, it is not spread over the whole sample as we highlighted with the level of the standard deviation (1,7). It would be interesting to understand if the habit to take over the role of administrator in more than a company, in the most extremes case even until 10 is equally common among the director who are member also of the committee and thus bear more responsibilities.

Table 6: Descriptive results

Descriptive statistic for the period 2013-2015. The sample consist of 146 Firms.

Note:

see table 3 for variables definition

The table 7 contains the descriptive statistic relative to our second hypothesis, and thus it reports the mean and the standard deviation of the sample firms that record the different mixes of expertise kinds in the AC presented in the previous table 4.

Table 7: Descriptive results (mix expertise)

Descriptive statistic for the period 2013-2015. The sample consist of 146 Firms.

Variables	*Number of companies*	*1/100*	*5/100*	*Q1*	*Mean*	*Median*	*Q3*	*95/100*	*99/100*	*St.dev.*
					DISCRETIONARY ACCRUALS					
ACC_Only	12	0,006	0,013	0,025	0.049	0,045	0,067	0,107	0,109	0.037
LEG_Only	6	0,009	0,017	0,033	0.057	0,065	0,636	0,172	0,176	0.056
FIN_Only	11	0,001	0,012	0,025	0.049	0,050	0,076	0,160	0,163	0.043
SUPER_Only	11	0,000	0,009	0,021	0.042	0,044	0,087	0,152	0,156	0.059
ACC & LEG	16	0,005	0,014	0,028	0.103	0,107	0,165	0,199	0,208	0.127
ACC & FIN	26	0,007	0,046	0,089	0.102	0,099	0,143	0,187	0,189	0.160
ACC & SUPER	9	0,006	0,022	0,054	0.093	0,127	0,132	0,150	0,178	0.160
FIN & LEG	4	**0,009**	**0,018**	**0,125**	**0.235**	**0,180**	**0,267**	**0,286**	**0,345**	**0.384**
FIN & SUPER	9	0,001	0,017	0,022	0.043	0,085	0,103	0,187	0,193	0.058
LEG & SUPER	6	0,003	0,012	0,098	0.144	0,150	0,198	0,198	0,245	0.122
ACC LEG & FIN	4	0,002	0,011	0,088	0.154	0,147	0,192	0,199	0,264	0.246
ACC LEG & SUPER	6	0,004	0,016	0,097	0.172	0,159	0,234	0,250	0,253	0.265
LEG FIN & SUPER	3	0,001	0,010	0,043	0.090	0,109	0,174	0,179	0,194	0.155
ACC FIN & SUPER	14	0,000	0,007	0,033	0.065	0,095	0,100	0,136	0,156	0.088
All expertise	5	**0,000**	**0,013**	**0,019**	**0.024**	***0,080***	***0,065***	***0,068***	***0,098***	***0.015***
Any expertise	3	0,003	0,007	0,054	0.172	0,110	0,133	0,150	0,153	0.225

Note:

See table 4 for variables definition

The number of companies in this case consist of the number of company (within our sample of 146 firms) that make recording the mix of expertise of the corresponding row during the sample period.

The data presented on the table designate that the bottommost mean value of discretionary accruals is recorded with reference to the firms whose Audit Committee boast all expertise among its sits (0,0249) in addition the value of the mean is corroborated by the so small value of the standard deviation (0,0154) that give further significance to the mean. Instead, the lowest mean of the dependent variable is recorded in correspondence with Financial and legal expertise (0.235); almost suggesting a sort of conflict between the two categories; anyway, the high standard deviation (0.384) and the low number of observation (4) do not confer reliability to this insight.

3.5.2 Regression results

We report the result from the regression analysis of the discretionary accruals, representatives of the earnings management signals in table 8.

Table 8: Regression Result

Variable	Expected sign	Parameter estimates	p-value
Intercept	?	0.043	0.537
Relevant Shareholding	-	-0.008	0.845
Institutional Investors	-	0.062	0.159
Board Size	?	-0.001	0.685
Ind. Directors %	-	-0.039	0.043**
CEO duality	+	-0.027	0.327
Multi-directorship	?	0.009	0.202
LEG	-	0.038	0.079*
ACC	-	-0.611	0.001***
FIN	-	-0.019	0.451
SUPER	-	-0.033	0.205
Adjusted R^2		0,295	
F-test		13,000**	

Notes:

See table 3 for variable description

*, **, *** symbolise significance at the 0,10; 0,05; 0,01 levels.

Regarding either our regressions the first important thing to note is the level of the Adjusted R^2 (0,2957); (0.3124)[38] and the F test (13, 15) , in fact while the first provide us the evidence that our model and thus our independent variable captures a sufficient variation of the dependent variable. The level of the F test allow us to reject the null hypothesis according to which all our variables would have a coefficient equal to 0.

[38] We use the R^2 instead than R because the high number of variable would have affected the validity of its level. A level around 0,3 may be considered low in absolute terms, but actually it is quite acceptable if we consider that the field of our analysis is the an economic-social one.

The results designate that Earnings Management is negatively (-.011) and significantly (p-value=0.0012***) related to the presence of at least an accounting expert member among the Audit Committee, unrelated to finance (-0.451) and super (-0.205) and positively (0.038) and significantly related to the attendance of a legal expert. Thus, this result confirms the international requirement for the Audit Committee Members to be financially literate. But also the demand of Audit Committee member to be equipped with a deep knowledge of the Accounting system (RAGHUNANDAN, K., & RAMA, D. V. 2006). to allow the detection of when an alternative accounting policy is used to favour the reality representation and when instead it is an insidious mean to persecute the earnings management practices and obscuring the real performance of the company. Anyway, these results over to justify the relation between the accounting expert presence and the financial reporting quality, highlight also the negative relationship between the earning management incurrence and the presence among the Audit Committee members of legal expert. In fact, except sporadic cases, such experts cannot develop the knowledge to ensure the reliability of a financial reporting and their knowledge would serve better other kind of committee such as the relation among correlated parties. (GORDON, ELIZABETH A., ELAINE HENRY, AND DARIUS PALIA).

Furthermore, the outcomes of the multi-variate regression show that the most significant control variable is the one regarding the proportion of independent directors. Indeed, its coefficient is negative related to the earnings management incurrence: this result is intuitive especially in reason of the observation made in the first paragraph of this chapter regarding the independence as board member characteristic to entrust a neutrality judgement on the financial reporting quality.

Regarding the process verification of the second hypothesis, we are going to do an amendment to the variables. We eliminate the legal expertise and all its permutation because of the impossibility of the excel software to perform a regression with more than sixteen variables and at the light of the first regression that already make evident the difficulties met by the legal experts within the Audit Committee to deter the earnings management incursion.

After this brief specification follows the table 9 that collect the result of the regression of the discretionary accruals in relation to the control variables and the mix of financial expertise within the audit committee in the context of our 146 firms sample.

Our findings advocate that, while a single expertise alone does not affect significantly the Audit Committee effectiveness, the mix of accounting, supervisory and finance expertise is the best one to ensure the financial reporting quality recording the lowest level of discretionary accruals.

This result is further endorsed by the datum related the “any expertise” variable that is the only expertise mix that is positively and significantly related to the discretionary accrual and thus the potential earnings management occurrence.

Thus, these results provide supportive evidence of how the resource dependence theory finds a positive feedback in the collaboration of different expertise belonging anyway to the economic background. In fact, if by one hand the financial experts can add value through their industry and market responsive arrangements and setting, the supervisory experts have more expertise in the negotiation techniques and in the art to find well-balanced compromises that in this case they will direct toward managers in charge with the reporting activities.

Table 9: Regression Results mix expertise

Variables	*Expected Sign*	*Parameter Estimates*	*p-value*
Intercept	?	0.096	0.142
ACC_Only	-	-0.074	0.118
FIN_Only	-	-0.076	0.123

SUPER_Only	-	-0.071	0.148
ACC & FIN	?	-0.034	0.439
ACC & SUPER	?	-0.051	0.347
FIN & SUPER	?	-0.076	0.151
All expertise	?	**-0.072**	***0.099**
Any expertise	?	**0.032**	****0.026**
Blockholder	-	-0.001	0.781
Institutional Investors	**-**	0.063	0.157
Board size	?	-0.002	0.546
% amm. Ind.	-	**-0.039**	*****0.009**
CEO duality	+	-0.026	0.350
Multi-directorship	+	0.009	0.211
Adjusted R^2		0.312	
F-test		15***	

Notes:

See table 4 for variable description

*, **, *** symbolise significance at the 0,10; 0,05; 0,01 levels.

Conclusion

This thesis moving from the monitoring role of the Audit Committee on the financial reporting reliability researched the member expertise that best fit with this attempt.

Since we consider among the expertise not only the economic ones as the international studies traditionally did, we analyse besides the accounting, finance and managerial-supervisory, in fact, we consider among the expertise analysed also the legal one. To better reflect the Italian reality where is common use to find lawyers and in general people with a legal background amongst the Audit Committee member.

Anyway, from our regression analysis legal expertise resulted the less useful for the earnings management inhibition, indeed it was the only variable related to the discretionary accruals level and thus earnings management. This evidence opens an interesting debate about the need to require mandatory an economical background to be part of the Audit Committee.

Anyway, not all the economical expertise resulted equally able to inhibit the earnings management risk since the regression parameter more relevant resulted the one regarding the accounting members, this result confirm our first hypothesis per which the professional accounting and auditors hold the perfect combination of knowledge and experience to disease out the earnings manipulation attempt of the management.

Then, regarding the best mix to avoid the earnings management incurrence. The software tool used to compute the regression outcome required the reduction of variables number. Thus, after the decision to exclude the legal expertise and all its permutation, we have been able to collect the result and confirm our hypothesis that assume a mix as much various as possible as the best to warrantee the financial reporting quality.

Anyway, this thesis embed two limit. The first derive from the methodology to estimate the discretionary accruals, in fact, it being related to the past activity of our sample firms, since it is a time-series analysis approach and thus not consider the transformation and variation strategy of the company itself along the sample period. Thus, this limit leads potentially the analysis to record a false earnings management positive detection even when we may consider the accrual level as normal for the actual activity of the business but abnormal if compared to the past data that we used to construct the model. Anyhow, we cover this risk with the use of a large sample.

The second limit it is structural and regards the assumption that it is the company to make the choice of a type of AC member. Thus, we don’t consider that it is possible that accounting experts and in general the more qualified for the role of audit committee members do not simply join companies’ boards, instead it is more probably that to protect their reputation they choose the companies who judge with the higher integrity under the financial reporting quality (BEASLEY 2009).

This suggests that the exogenous risk as exposed above may biasing our analysis.
In general this thesis highlights a progressive path of the Corporate governance system from an institutional view that see it body just as a façade to the resource based view that implements the active role of the board and its committee to improve the credibility of the company through real activities and not just with excellent curriculum vitae.

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Summary

The quality of financial reporting disclosure

Corporate disclosure plays two important roles in the capital market: the valuation and the stewardship role. The valuation role let the investors to evaluate the profitability of investment opportunities. Under the stewardship function, instead the disclosure allows investors to monitor the use of capital, once provided.

In both these cases, the function of the corporate disclosure is central in reducing the gap of information between principal and agent.

It is important to highlight that the companies have a series of incentives in guaranteeing a good quality financial reports; the incentives result connected with some financial proxies, namely Market Liquidity, Cost of Equity and Cost of Debt.

The quality of disclosure, having the power to decrease the gap of the asymmetry information can mitigate the adverse selection risk and improve the liquidity in each stock exchange.

In fact, firms that are listed in exchange stock market that requires more transparent disclosure have lower bid-ask spread and higher trading volume.

The cost of capital raises because of the unreliable information embedded by the company's disclosure just when the risk connected to the disclosure are not diversifiable.

Then, the disclosure affects the cost of capital even in an indirect manner affecting real decision that are taken just to make more attractive the actual financial statement and influence the distribution of future cash flow, not in growth prospective but just to raise funds in the short term, through the exhibition of greater earning.

Firms with greater disclosure quality scores relish a minor interest cost of issuing debt since a superior disclosure send to the debtholder a message of reliability and reduce their suspicion of potential default whose the cost of debt is a diminishing factor.

The Gatekeepers

To overcome the information asymmetries problem the firms can send some signals as smoothing current income or choosing the quality of the auditors, taking certain financial decision as residual dividend policy.

Signals can be explained in various way depending on the operational context, furthermore to explain and interpret the signals are needy a certain financial and governance expertise that of course not the whole crowd of the investors possess.

The demand for individuals able to interpret the signals sent by the company has raised the Gatekeepers figure, financial experts that spread their interpretations of financial signal though the intermediaries means.

The most important Gatekeeper are analyst, auditors, Board of directors and Audit Committee.

To run efficiently their guarantee role the Gatekeepers need to satisfy two important requirements: not being biased and to possess that financial expertise that make they able to interpret in the correct way the firm’s signals.

Since this thesis intends to analyse the monitoring of the financial statement reliability and the detection of earnings management by a company point of view, highlighting the instruments it has made this activity more effective in the following paragraph we will analyse in depth just the gatekeepers internal to the firm, namely the Corporate Governance System.

The Board of Directors and the Audit Committee

The Board of director is the fiduciary body that governs the firm on behalf of the shareholder, thus more the property is spread more the board of directors' role is important. The Board has two different roles: monitoring the management, reviewing the disclosure among which there is also the financial report, the second is to provide a series of strategical decision, as firing a CEO and the choice of another new one.

In carrying out its functions the directors, form a series of committee to make the decision about various themes well timed and well informed, in this way they can easily create a sort of expertise around a given subject. The most relevant for our analysis is the Audit Committee, it has the delegation in the monitoring activity of the financial reporting reliability and internal control practices and the impediment and detection of the Earnings management practices.

The Earning Management

In general, the definitions of Earning Management have their common denominator in the discretionary roles of the executives, in the process of drafting management statements and in related processes of communication and information of economic and financial data.

Usually, unethical and selfish managers commit Earnings Management, in the reporting process, to maximize informational asymmetry in their favour at the expense of "outsider" investors to achieve a personal profit.

The use of discretion by management in the process of drafting the financial report is the result of the adopted editorial style that comes from the variety of alternative treatments. The multiplicity of potentially available behaviours sets up a sophisticated taxonomy of the style of drafting the documents, ranging from prudent to fraudulent to a neutral / moderate and aggressive approach.

The earnings management can be achieved in two ways: recording discretionary assessments of company facts or by way directly connected with the company operations, these operations in object are put in place just to produce a given effect on the financial report. In other ways, the reader should distinguish between real and disclosure earnings management.

Specifically, the policies of accrual earnings management are originated in two different areas of discretion, which hold respectively the classification of the accounts on the statement schemes (shifting earnings management) and to the assignment of a given value estimated to the accounts (accrual earnings management).

Since the conceptual reference framework and in general, the ways of earnings are managed has been identified and rough out, it seems useful to focus on the analysis of the "accrual earnings management" policies. Nutshell, they are a series of practices used to manipulate the operating income through - instrumental use of valuation at the time of writing of the Financial Statement.

Specifically, they referred to the assessments of the issues that are still in running, which require a necessarily subjective approach. In fact, the evaluations that "naturally" present a subjective apportion can be, as recognized in the definition of the earnings management concept used to achieve some given goals. Consequently, although the level of applicability of the subjectivity on such valuations cannot go beyond the boundaries defined by the rules and accounting principles. In fact, the discretionary nature of the valuations entails, in any case, a natural damage of the principle of neutrality which should always be the mainstay of the of the Financial Statements editing process.

Until this moment, we referred more than once to the subject who perpetrate the earnings management: the executives but there are different reason because these professionals choice to run these practise, reasons that we define incentives.

In particular, there are three different kind of incentive: Capital market, contractual and political cost incentives.

Capital market incentives can be of ordinary nature or extraordinary one.

The former regards the achievement of critical profitability thresholds to avoid the financial market and analyst’s disappointment. In the reference literature, three profit margins are identifiable : earnings equal to or less than zero, income results equal to those achieved in the previous year; income results equal to or greater than analysts' expectations.

Instead, it is possible to individuate three typologies of events extraordinary: the Initial Public Offering, the improvement of the capital through the issuance with payment of new shares, the extraordinary operations as hostile takeover and management buy-out.

The empirical analysis

The empirical research consisted in a three-step analysis. First, the variables (dependent, independent, and control) of the proposed analysis model were identified. Secondly, we execute a merely descriptive analysis of the variables identified previously. Finally, to test the relationship between the identified and estimated earnings management variable, multivariate linear regression model was developed and implemented using the ordinary least Squares methodology.

Next, after the variables individuation, we moved to the first observation of our result. In fact, before the main analysis, we observe the result of the descriptive statistic and we commented the most relevant result. Then we focused on the main analysis to test the validation of our hypothesis; to do this we employed a cross sectional analysis to verify properly the association between accounting, legal, finance, supervisory expertise, and earnings management on our sample.

The fact that the discretionary accruals imply higher probability that the management is involved in some earnings management practices deserves a brief comment, hence, a significant positive regression coefficient for any of the background proxies (i.e. ACC, LEG, FIN, SUPER) would advocate lower financial reporting quality for the firm who has among the Audit Committee member the expertise above recalled.

Then the second regression model inspects how much the different mix of expertise among the Audit Committees affects the financial reporting quality, in term of earnings management incurrence.

As in the first regression, the coefficients signal the level of affection of the different mixes of accounting, legal, finance, supervisory, expertise among the Audit Committees of the sample companies.

from our regression analysis legal expertise resulted the less useful for the earnings management inhibition, indeed it was the only variable related to the discretionary accruals level and thus earnings management signals and further the reversal measure of the financial reporting quality. This evidence opens an interesting debate about the need to require mandatory an economical background to be part of the Audit Committee.

Anyway, not all the economical expertise resulted equally able to inhibit the earnings management risk since the regression parameter more relevant resulted the one regarding the accounting members, this result confirmed our first hypothesis per which the professional accounting and auditors hold the perfect combination of knowledge and expertise to disease out the earnings manipulation attempt of the management.

Then, regarding the best mix to avoid the earnings management incurrence. The software tool used to compute the regression outcome required the reduction of variables number. Thus, after the decision to exclude the legal expertise and all its permutation with the other variables we have been able to collect the result and confirm our hypothesis that assumed a mix as much various as possible as the best to warrantee the financial reporting quality.

Anyway, our research has a limit that arise because of the assumption that it is the company to make the choice of a type of AC member exclusively by the company resulting as exogenously given. Thus, we don't consider that it is possible that accounting experts and in general the more qualified for the role of audit committee members do not simply join companies' boards, instead it is more probably that to protect their reputation they choose the companies who judge with the higher integrity under the financial reporting quality.