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Strategic Rethinking and New Perspective of Profit Smoothing. Empirical Evidences from China

Coordinatore:
Ch.mo Prof.
Franco Luciano Tutino

Tutor:
Ch.mo Prof.
Gianluca Vagnani

Candidato:
Dott.ssa Domitilla Magni
Matricola 1316156

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To my family

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INTRODUCTION

授人以鱼不如授人以渔
孔子

Give a Man a Fish, and You Feed Him for a Day.
Teach a Man To fish, and You Feed Him for a Lifetime.
Confucius

The current change in capitalism is marked by a return to strength and a multiplication of forms of the rent that goes hand in hand with a more general overturning the relationship between income, wages and profits. This evolution has given rise to very different interpretations, both theoretical political implications.

In particular, according to a widespread approach in Marxist theories, which was rooted in the Ricardian political economy, the annuity is seen as a pre-capitalistic legacy and an obstacle to the progressive dynamics of capital accumulation. On this basis it was considered that true capitalism, pure capitalism, and effective capitalism would be capitalism without annuity.

Such a vision, replacing the key role of the land's rent with that of the financial one, is now proposed to interpret the crisis of the Fordism adjustment mode and the growth of the European Union since the 1980s. According to this analysis, the sense of the current crisis would be in the conflict between the vocation to the annuity of financial capitalism and the "good" productive capitalism, which is responsible for logic of the accumulation favourable to the growth of production and employment.

From this interpretation, as suggested by the analysis of numerous economists, the proposal is a sort of neo-ricardian compromise between wage earners and productive capital against the power of finance. This compromise should allow to re-establish the hegemony of managerial capitalism of the Fordism era and, hence, the conditions of close to full employment, and all this in a context of substantial continuity with the Fordism organization of work and adjustment of the salary ratio.

This grid of reading seems to be wrong in two terms: it is wrong with the statute of the annuity in capitalism, judging it as an external category in relation to capital dynamics and opposed to the category of profit; the denunciation of the return to the perverse forces and effects of the annuity to be disconnected from any analysis of the underlying

transformations, following the Fordism crisis, intervened in the forms of division of labor and labor-capital relationship.

In relation to this interpretation, the thesis that I intend to pursue in this work can be expressed through two research questions:

1) Is it possible to quantify the allocation of risk sharing among different firm's constituents?

In other words, given a shock to corporate sales, endogenous or exogenous, the undisputed result is that it will affect the annual profit. But is this process always true? Is it true that a decrease in revenue is absorbed, in the same amount, by profit?

2) Supposing there are several channels through which firm risk sharing may occur, which percentage of a demand shock is smoothed by which smoothing channel?

By taking this variable as a starting point, the elaborative objective is to analyze the underlying interrelationships of the most significant items that insist within the company. The ultimate aim of the work is to answer the above questions, to analyze how management actions can avoid an harmonization of profit from one period to another and then study other variables of the income statement might also be affected by a shock or a diminutive variation in the quantum that they represent, which are represented in this way, in the eyes of the managers, as voices that have bearing capabilities for implicating the profit smoothing process.

As a result of the crisis of real subsidence, profit, such as income, tends to represent more and more as a pure dissociated distribution relationship, in most cases, from every positive function in organizing production and growing wealth.

Salary, income and profit are, according to Marx, the three major categories of income distribution that arise from capitalist relations and how these have a historical character. It is in this perspective that I will try to produce conceptual tools to understand the mutation of wage, profit and annuity in the contemporary economy, deepening in particular the category of profit.

Below are the main theories on profit by making an excursus on classical and neoclassical theories, continuing with the analysis of profit in business vision (chapter 1). The study continues with an in-depth study of the annuity, highlighting the three main empirical lines: (a) Entrepreneurial Rents Theory, (b) Managerial Rents Model, and (c) Rent Appropriation Theory.

Also in Chapter 2 I introduce the phenomenon of profit smoothing corporate, accounting and financial level. Earning management policies will also be discussed and how these can

affect the true income statement of the company. It will be seen that the profit smoothing policy is fully in such circumstances and will even be analyzed, as the concept of profit smoothing is also part of Gordon's financial model on dividends.

In Chapter 3, however, an excursus of the financial policies employed by China in recent years will be made in order to fully understand the Stock Market's financial market. In addition, another aspect to not underestimate was to analyze the reasons for China's growth and expansion. Note that the choice to analyze China in my thesis was not casual. First, during my PhD years, I had already assessed the profit smoothing system, in particular by analyzing all listed companies in the London Stock Exchange, assessing that there were indeed high values of companies that used this system. Subsequently, the analysis has expanded to address many of the developed countries of the European Union (Chapter 5). The fundamental question that led me to analyze listed companies in Shanghai and Shenzhen Stock Exchange was whether the profit smoothing phenomenon was of interest to developing countries such as China.

For data collection I experienced a Visiting Exchange semester in China at the Southwestern University of Economics and Finance (SWUFE) in Chengdu, Sichuan, a formative and stimulating experience that allowed me to interface with software such as CSMAR, but also special people and rich in energy that has allowed me to bring my data collection work to China.

The methodology used for the study of profit smoothing is described in Chapter 4. Chapter 4 will also include the research hypotheses and highlight the first results on the general effects of the underlying phenomenon.

Finally, in Chapter 5, the findings are explained, it will tend to give an explanation to the profit smoothing phenomenon and will be input for further research.

CHAPTER 1.
THEORY OF PROFIT

1.1 Profit in traditional argumentation way

Profit can be defined as a form of income that may arise in an economy without a plan or central authority that decides on the production and distribution of the social product. The profit's definition does not end in only one conceptual category; rather it is exposed to a variety of economic, social, cultural and political uses and meanings. Any attempt to clarify the content of this notion removes the character of "absoluteness" and "neutrality" by unifying it uniquely to a particular economic vision.

Economic science offers very different notions of profit, not only in relation to the economic and social relationships to which it refers but also depending on the particular cognitive aim pursued from time to time and the technique of analysis adopted.

Economic profit theory should answer many questions, but the debate on this subject is still lit and this reflects a sense of uncertainty and stalemate that characterizes all the literature on it. Profit has always been a multi-dimensional concept, which does not fall into one economic discipline. Besides having various basic arguments, profit is also a source of numerous studies and business techniques that often are outside from simple accounting rules. Many, from the classical economists, have tried to approach the issue of profit and its assessment; others have governed just the accounted nature and added, in an already busy contest, many theories and definitions on the subject. The evolution of business knowledge, finance and economics' knowledge have allowed an increase in previous studies on the subject of profit. Firm and its management have become, over the years, the main focus of managerial analysis, assuming both relevance increasingly global and interdisciplinary. The rules and economic directives require continuous management apparatus, overwhelmingly, on the ability to persist over time, in conditions of economic and financial equilibrium. Changing the appearance and nature of the firm, changes accordingly the approach of business manager and the role of profit management. Profit has always analyzed as a residual item in the firm but changes its shape, and it is approached by most as a strategic financial variable.

Profit must be closely related to the concept of enterprise, and in that sense, the very determination of profit justifies the existence of all the company's production equipment and is considered indispensable and underlying any business activity. At a company level, profit is considered as a goal to itself or, alternatively, in connection with other goals such as growth or efficiency.[1]

[1] In fact, profit can no longer be considered as a residual variable, that is, defined as the residual amount after

Before analyzing all the literature and theories of economists who have debated the notion of profit,[2] it is necessary to clarify how and through which mechanisms the search for profit can influence the business behaviors and finally it is appropriate to dissolve some inherent nodes both the role of profit as an economic category and its nature.

From these initial considerations, it is understood that, in the first place, the subject or recipients of the profit should be identified and their means to be appropriate to the latter. The need to differentiate, in a theoretically way, the profit from the worker's wage, from the natural resource owner's income, from the interest generated by the liquidity loan, manifests itself at the same time as the historical process of capitalist division of labor.[3] In this case the historical recalls are fundamental: on the one hand the progressive fragmentation of trades into specializations, the fragmentation of craftsmanship and the expansion of the merchant system have prompted the making of entrepreneurs-merchants, concerned about buying the products to bring them to the markets, and to sell raw material to every single producer, gaining a profit. On the other hand, the separation of workers from work tools, the organization of work in the factory, and the continuous technological changes have overwhelmingly overlooked the overproduction of production, creating new problems with regard to its appropriation and its intended use for purpose consumption or accumulation. In parallel, a new social structure emerged, in which a class - that of entrepreneurs-producers - took the power to decide how, what and how many to produce.[4]

The literature clearly dictates the shift from one to another definition of profit: a purely "subjective" and the other "objective". The first trend concerns a vision linked to the primary remuneration of the entrepreneur, in favor of an "objective" view, where profit is the remuneration of the enterprise first.[5]

In order to reasonably interpret the concept of such a profit, it is necessary to clearly distinguish the function and role of the enterprise, always maintaining a vital link with the profit itself.

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[2] In the continuation of the elaborate, we will have an overview of the most important and relevant business and business theories, such as those of Adam Smith, Ricardo, Mill and Karl Marx.

[3] Job division is a key topic in economic theories and generally involves all human organizations, from small communities, such as the family, to the largest multinational corporations. Work is one of the factors of production and its organization plays an essential role in the functioning and evolution of any type of society. In general, job division increases average job productivity, but can only be applied extensively if it is favored by a market expansion.

[4] See also Pesante L.M., *Come servi. Figure del lavoro salariato; dal diritto naturale all'economia politica*. Franco Angelo Edizioni. 2013.

[5] Zappa G., *Le produzioni nell'economia delle imprese*, Giuffrè, 1956.

The function that has always been attributed to the enterprise is that of the transformer and economic generator suitable to increase tangible and intangible assets and monetary wealth. It does not only aim to increase quantitatively the economic wealth, but the broader one to generate wealth in quantity and quality capable of generating consensus on a large number of subjects.[6] The firm's function in the market system is, therefore, to produce goods and services for exchange, in the formation of adequate employment opportunities for system resources, and it concretizes itself in the creation of value under economic conditions.

The role of the firm is the form that historically has responded to the motivations of production: with profit, the enterprise produces wealth, and profit-making parties can achieve greater and/or better satisfaction of the needs.[7]

Historical analysis shows that profit is one of the most powerful reasons for production, and thus one of the most important "endogenous" factors of productivity. Profit, on the one hand, drives individuals to risk their capital, investing them in productive activities; on the other hand, is the strongest motivation for creating new business. Profit becomes both a means to ensure remuneration and capital maintenance as an instrument to increase labor pay and to produce satisfactory interest on the loan capital.

One last point to point out to the profit-enterprise relationship is that the latter, as an institution, presents itself as a historically determined reality, objectively related to its function, its "economically sound".[8] The pursuit of such a model, inspired by specific technical efficiency requirements and valorization of marketed production, allows the regeneration of the means used in the previous production cycles, thus making it possible for the firm to repeat its business. In the instrumental sense, the enterprise, providing a significant contribution to the process of generating economic wealth, gets legitimacy to exist and continue to operate. The growing consensus that the community has attributed to the enterprise has allowed it to be institutionalized, ensuring its stability and permanence within the framework of social institutions. Alongside the function and related objective (technical and economic) conditions of its operation, however, the enterprise is characterized by being a "social system". In it, the subjective element contributes to

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6 Borgonovi E., *Imprenditorialità, consenso sociale e sviluppo dell'impresa*, in *Sinergie*, vol. 70, 2006.

7 Mella P., *Il ruolo dell'impresa nell'economia contemporanea*. 1989.

8 The concept of economy (cost-effectiveness) summarizes the company's long-term ability to efficiently utilize its resources by effectively achieving its goals.

defining the specific, general and partial objectives that guide the evolutionary dynamics, conveying the way in which the instrument is actually used.[9]

Over two centuries of theoretical reflection, economists have kept the focus of attention and study on entrepreneurship, formulating a wide range of responses to the issues mentioned about profit.

The conducted analysis presents some of the most significant theories of profit in their historical succession in order to highlight the progressive refinement of elaborations on the studies and referring them to the conceptions of the economic and social organization to which they are connected.

Profit, as we have seen, is among the most intuitive, and at the same time, controversial notions of economy and enterprise management. The doctrine agrees to re-enter the profit in the general logic category of "income".[10] Historically, the profit is coupled with the entrepreneur's income: it is considered as a real remuneration of the entrepreneur's abilities (organizational, managerial, decision-making, etc.). As we will see later, emerge differences in the articulation of the elements that make up the profit. By briefly reviewing classical economic theory, and then deepening it further into the subsequent paragraphs, it is possible to note that, for Smith, Ricardo and Stuart Mill, profit represents the total amount of remuneration of the capitalist entrepreneur. Neoclassical authors, however, in making the classic concept of profit as a remuneration of the capitalist entrepreneur, identify two distinct components in this remuneration: interests that remunerate the entrepreneur's capital and the salary intended to reward the entrepreneur himself for his work of direction and coordination of production factors. In other words, starting with the income of the entrepreneur, designated as "gross profit", the neoclassical theorists come to isolate a "net profit" after having eliminated from the first the interests of the funds lent and the directional salary.[11] The necessary corollary about the link between risk and profit is then the attribution of profit, understood as "residual", to the subject that endures this kind of risk, namely the entrepreneur. Along the stages of capitalist evolution, above all with the affirmation of the great enterprise, successive authors, both Anglo-Saxon and French, begin to lay the groundwork for moving from a conception of profit as the

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[9] Gatti M., Biferali D., Volpe L., *Il governo dell'impresa tra profitto e creazione di valore* in *Sinergie*, vol 79, 2009.

[10] A conception of profit as the "primary source of savings" is present in Demaria G., *La politica economica dei grandi sistemi coercitivi*, Cedam, Padua, 1969, p.116. Alchian, on the other hand, perceives profit as a factor behind the process of selecting the business environment. See Alchian A., *Uncertainty, Evolution and Economic Theory*, Journal of Political Economy, no. 3, 1950.

[11] That is, the remuneration of the entrepreneur if he takes his job within the firm.

entrepreneur's remuneration (both gross and net) to the remuneration of the corporate firm.[12] Such a move is already anticipated by Zappa, who, considering the profit as a composite entity, states "[...] the profit of the enterprise is not the typical remuneration of the "entrepreneur" but it is a composite income that is compounded by a single and complex set of remuneration of many factors that together in the production of a business contribute to the formation of profits or operating losses."[13]

Re-writing the purely economic theme of the study, as extreme terms, it is possible to propose some opposing views of the economic system: a) the economic system as a market economy; b) the economic system as a capitalist economy, i.e. as a society with a particular organization of work and a specific class structure.

Advocates of the first conception assume that the foundation of inter-individual economic relations is an institution - the market, precisely - that allows the collection and distribution of information deemed useful by each operator to make production decisions and spending. The profit here is fundamentally the income that anyone can perceive whenever others, or rather of others, experience the presence of imperfect market imperfections, take advantage of moments of the instability of a normally stable economic system, react to occasional changes in the economic situation, realize potential but still latent in the economy. In this context lie the theory of profit of Léon Walras[14] and the recent theory of Israel Kirzner.

In the second conception, however, the profit originates from the plus-pledge, from the division of the working day between work required and plus-value. Here I refer mainly to Karl Marx's theory.

1.1.1 Classical economist's thinking

Classic economists identify the primary task of political economy in seeking laws that can regulate the distribution of the social product, in the form of wages, profits, and annuities, to their recipients: wage-earners, entrepreneurs, and landowners.

The analysis of the profit's problem marks a real stage in the wider study of economic dynamics. It contributed to it with a critical work, lasting over a century, the greatest

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[12] See n.11.

[13] Zappa G., *Le produzioni nell'economia delle imprese*, Giuffrè, Milano, 1956, pag. 426. According to the author, the nature of the profit as composite income would reconnect to the disappearance of the figure of the classical entrepreneur following the affirmation of the large corporation.

[14] Considered by Joseph Schumpeter as "the greatest of all economists", Leon Warlas was the father of the first complete wording of the theory of general economic equilibrium.

economists in every school; enormous work that was absolutely necessary given the "diversity" of the various points of view, manifested primarily by the distinctions between short and long periods of time, between statics and dynamics, between generic profits and pure profits, between productive function and distribution function and still, very important, between imputation and distribution. To understand today's problems of profit, it is absolutely necessary to mention the most important phases of this succession of theoretical moments.

According to the classics' thinking, profit was intended as a specific income, which for some (F.A. Walker, W. Bagehot, A. Schäffle) consisted of a pure interest in the invested capital of the entrepreneur, while others also embraced remuneration which goes to work (salary theory of profit) in addition to the risk premium for loss of capital (A. Smith, A. Cherbuliez, R. Malthus, J.R. McCulloch, J. Stuart Mill, and then among the Italians, E. Nazzani and A. Graziani).

The classical economy (in particular, A. Smith, D. Ricardo and K. Marx) defines profit as the difference, in a given productive activity, between the total value of the products and the production costs for raw materials, energy sources, tools production and labor, and attributes to it a residual character and a tendency to decrease over time. On this assumption, Marx founded his theory of exploitation of the working class assuming that the work was the only "enhancing substance" and that therefore the value of economic goods depended only on the amount of work incorporated therein. It follows that profit, or "plus- value", is an income abusively abandoned to wage earners, ultimately a theft.

It is necessary to step back and return, first, to the analysis of Adam Smith's contribution, considered by many as the founder of modern economic theory. In the "*Wealth of Nations*", Smith considers profit as remuneration attributable to the capitalist entrepreneur, reconnecting it to the process of capitalist accumulation and emphasizing the economic benefits deriving from the pursuit of personal interest.[15] Smith distinguishes the profit from interest by assimilating the first to the proceeds derived from the stock of capital to the subject that this capital manages or uses. On the contrary, interest corresponds to the revenue earned by those who offer their capital to third parties.[16]

According to Adam Smith, the market, that is the exchange of goods, was not originally intended for profit that is to earn an amount exceeding the production costs of the product itself. Conversely, whoever exchanged it did, at least, between something that had

15 Smith A., *Wealth of Nations*, 1776.

16 Volpe L., *Il profitto come rendita negoziabile*, Cedam. 2013.

produced in a given time with something that had been produced through a coincidence of working time. Working time, that is the amount of effort needed to create a commodity, is, according to that view, the measurement unit at the base of the exchange or market activity and the right exchange is where a working time is traded at the same time as work, where the product of such work is different and precisely that diversity gives a real sense of exchange. The working time necessary to create a particular commodity is then the economic value, that is, the value-work contained in it, that is, the cost of production. Each commodity exchanges with a commodity with an equal production cost. Real wealth is work, which money represents only in terms of abstract quantity, as a "universal commodity", or universal means of exchange, facilitating the exchange of goods on the basis of their equivalence in terms of their value of the amount of work contained.

Starting from Adam Smith's contribution, the economists' reflection on the role of profit begins, even under the pressure of growing conflict in the relationship between the entrepreneur and the labour factor.[17]

So far it has been considered the possibility that the worker works independently, exchanging his products with other products of value (labour time) that tend to be equivalent to their own. According to Smith, in a modern context, this principle of work-value equivalence is no longer the basis of trade. According to Ricardo, however, it remains valid in this context. However, in it, which is in the modern capitalist system,[18] the worker no longer works for himself but as an employer. Precisely for this reason, the distribution of proceeds deriving from the exchange of goods produced by human labor is here deeply different from the above situation. Since the entrepreneur, exercising a dominant role over the worker, as he provides the tools to the base of his own work, he can claim part of the commercial proceeds from the marketing of the products created by the worker himself.

Continuing therefore with the Smith's line of thought, Ricardo formulates the well-known economic principle that excludes any increase in salary not accompanied by a simultaneous fall in profits. Ricardo thus measures the distribution of income in terms of the amount of

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17 Graziani A., *Teoria Generale del Profitto*, 1887.

18 There are several studies on the origins and interpretations of capitalism. According to some, the historical roots of the capitalist economy are to be found in long-distance business and in the activities of the financial centers of the Middle-Ages and of the European Renaissance, which led to the emergence of capitalism as a dominant system from the sixteenth century. Other interpretations -such as that provided by classical economists- link capitalism to the industrial revolution of the eighteenth century, with the fence of lands, the creation of an independent labor market, the birth of manufactures and a capitalist production, Capable of using the technological change of the era, drastically accelerating growth and consolidating the power of the bourgeoisie.

labor employed, rather than the quantity of physical goods.[19] According to Ricardo, workers do not participate in the distribution of overpayments since the wages they receive tend to settle in the long run, at the subsistence level: it follows that income distribution is characterized by the harsh contrasts between profits and wages and between profits and annuities. In the long run, the overpayment is divided between earnings and profits. Profit is determined, given the subsistence wages, through the concept of differential income.[20] Profit thus assumes a typically residual connotation and is emptied of intrinsic meaning to be considered as all that is produced in excess to the subsistence level of workers.

With reference to the "natural tendency of profit to shrink",[21] Ricardo reconnects to Smith's interpretation of the role of profit as a result of the process of capitalist accumulation. With the shrinking of profits, the motives that induce the entrepreneur-capitalist to accumulate capital will fade in turn as a result of the lack of adequate remuneration for the risk they face in the productive use of capital.[22] And it is in this sense that is necessary to recount Ricardo's analysis, or it can be said that the theory on the role of profit represents the development of Adam Smith's stationary state theory.

Lionel Robbins[23] writes: "Smith thought the profits were determined by demand and supply, and that in the long run, due to this competitive process, the accumulation of capital would lead to a fall in profits. Ricardo questioned it. Ultimately his objection was: if there is a proportional expansion of capital and work, why should there be a drop in the profit rate, given that demand for scarce property is almost insatiable? It must be something that has to do with declining returns, Ricardo thought".

Ricardo stated that the profits were residual, that is, what remained after the payment of wages on the gain realized by the sale. This, however, implied that the profit was not only dependent on salary but also on earnings, and then, the wage would have to depend on this real dynamic, while in reality it was almost always a fixed quota.

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19 Ricardo D., *On the principles of political economy and taxation*, 1817.

20 That is, a sort of price of scarcity due to the limited fertility and better-localized markets than the markets.

21 It is Karl Marx who in the Third Book of *Capital* attributes the crisis of the capitalist system to the law of the tendency of the profit rate, or to the natural tendency of the economic system (based on the exploitation of surplus labor and surplus value) to see the ratio between surplus value and capital, or profit.

22 See n.7.

23 Lionel Robbins was an English economist known for his contributions to economic theories, derived from Marshallian bases. He is considered one of the greatest exponents of Marginalist theory. Robbins became famous in the academic environment for his economics definition: "Economics is the science that studies human behavior when, given a ranking of goals, choices on alternative means of using scarce resources have to be made".

The "*Essays on Some Unsettles Questions of Political Economy*" of 1844, and the "*Principles of Political Economy*" of 1848, summarize, review and develop the achievements of Smith, Malthus, and Ricardo, and together update Mill's ideas. All the studies and writings by Ricardo and Smith led Mill to think as real, at least in accounting terms, the existence of a wage-fund, to be considered as a budget estimate, and this is considered to be one of the few points theoretically firm in an extremely dynamic and uncertain reality. In short, Mill extended to the whole society the concept that total wages come from the existing capital fund as a sum of all the special capital employed in businesses. Individual wage is the product of a division between the total social wage-found and the total of the population that aspires to employment, or which is already occupied. Hence the assertion that wages is paid by capital (considered as wage advance). Capital is about wages, its limitation on the one hand, and its guarantee of existence on the other.

Even for Stuart Mill it is quite natural that man works on the basis of selfish motivation to earn. The production process, even when it comes to organizing itself in the form of manufacture, responds to a natural tendency of man to activity, which is not limited to the necessary and indispensable production to the satisfaction of primary needs but tends to expand. Under a general profile, the problems of social injustice can, according to Stuart Mill, be tackled by simply intervening in the distribution of profits, i.e. by increasing wages and reducing the earnings of entrepreneurs. On the level of profit and salary definition, Mill himself was so brilliant on one side as well as vaguely for another. Its theorization of the wage-fund, that is, of the existence of a wage-fund as part of the initial fixed capital that the capitalist anticipates (and thus does not derive from the profits deriving from the sale), can be used in both reactionary and progressive ways, both to reach compromises and fairer contracts. When Mill realized that the prevalent use was a reactionary mold, he came and retracted it and his self-criticism aroused his suspicions.

Mill, in his "*Principles of Political Economy*", resumed, as I have already said, Ricardo's analysis, trying to adopt it in his time. He then abandons the theory of value-work as Ricardo has formulated and insists on the theory of cost of production, trying to justify the existence of profit. He notes that the theory of value-work in Ricardo's formulation tends to characterize social wealth as a result of the operation of only one factor, the work. He emphasizes, there is "another necessary element besides work". This element is the capital and since capital is the result of "abstinence" or "expectation", i.e. the sacrifice endured by the capitalists who give up immediate consumption, the price of the goods must allow both

the remuneration of the factor work, and the remuneration of abstinence. Consequently, profit is nothing but the "remuneration of abstinence".[24] The theory of production cost so understood is a theory that tends to define the price of goods as a remuneration of the costs borne to produce them, including the remuneration of the capitalist's sacrifice.[25]

To the thesis on the profits expressed by Smith, Ricardo, and Mill, Marx moves articulate criticism. The source of profit, as Smith explains, is due to an act of domination that the wage earner suffers from the capitalist who takes away part of the product of his work and appropriates it in the form of profit. Marx observes, however, that any firms divided into classes legalize phenomena of the appropriation of the work of others. Thus, in the light of Smith's view, the wage earner of capitalist society does not differ from the slave or the worker subjected to any external authority, nor does the capitalist differ from the master or the owner present in any other historical society. Ultimately, Smith fails to explain profit as a form of specifically capitalist income. The same is true for Ricardo's theory, which sets the residual profitability of the other income and appears to be postponed to a specific organization of social work, but ultimately makes it dependent on the profit from the conditions of land cultivation and the survival of workers. These weaknesses found in Smith's and Ricardo's theories of profit are, according to Marx, attributable to the whole of the "classical" political economy: the lack of distinction between the social process of production in general and the process of capitalist production.

In the capitalist economy, Marx observes,[26] it is not produced for use but for capital appreciation, observing the movement of goods can see as. In the capitalism, the purpose of the exchange is not to sell goods against another merchandise that suits different needs, with the intermediation of money that acts solely as a means of circulation (G-M-G), but in the transfer of sum of money or power purchase order to obtain a sum of higher purchase power. Initial money M is valued -that is, becomes M', greater than M- only by purchasing an intermediate form that allows it (M-G-M'). If you stay in the circulation sphere, there is no kind of exchange that will secure this result. The wage earner also freely contracts the remuneration of his/her working capacity, assuming in the exchange a legal position

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[24] Stuart Mill J., *Principles of political economy with some of their applications to social philosophy, abridged with introduction by Stephen Nathanson,* Hackett Publishing Company, 2004.

[25] Gioia V., Perri S., *Corso di istituzioni di economia,* Manni, 2002.

[26] Marx deepens the relationship between exploitation and crisis in his major work, *Capital*, whose goal is not "simply" to explain the functioning mechanisms of capitalism but also to criticize the mystified representations developed by economists (from which the subtitle Criticism of Political Economy).

identical to that of the counterpart or the seller of any goods. The "workforce"[27] which he sells on the basis of a free contract has an exchange value equal to the working time[28] needed to produce what it is necessary to maintain and reproduce, just as a unit of freely traded goods is worth the many units of the other commodities that can be produced in an identical working time. The wage-earned, by surrendering the use of the workforce, has, in fact, made the work of the capitalist available. Thus, a working day of a given length can be divided into two parts: part intended for the reproduction of the workforce and equivalent to the wage, and a part of "plus-work", which translates into "plus-value" when considering the value of the commodity produced by three additions: constant capital or value of the means of production, variable capital or labor force value and plus-value.[29] When the capitalist finally sells the goods and realizes the plus-value, the difference between M' and M, which gets on the basis of the prices that are formed in the markets, breaks down in the annuity for the use of natural resources, interest in the use of liquid funds and the producer's profit. Ultimately, therefore, profit is the income of the capitalist mode of production: it is the source of the plus work,[30] that is, the capitalist organization of labor.

1.1.2 Arguments of the neoclassical economic view

Subsequently of economic analysis and theory began to distinguish within the residual profit of the classical economy different elements that could only appear as one at a time when business management was generally in the hands of those who possessed everything or almost all of the capital invested in them. Later on with the neoclassical school, or marginal school, they tried to assert profitability. Particularly when the entrepreneur's figure detached itself from that of the capitalist -through the spread of societies and the development of credit and the capital market- one realized the previous confusion between interest and profit and how it was necessary to purify the latter's the interest of the venture's capital invested in his enterprise.

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[27] Unlike classical economists, Marx makes a clear distinction between workforce and labor. Workforce is the set of physical and intellectual abilities employed by workers in the production process. It differs from the labor actually delivered because it represents only the ability to work, which results in actual work only when the production process starts.

[28] The workforce is itself a freely available commodity on the market.

[29] Marx K., *Capital*, vol. III. 1894.

[30] "The surplus-value consists of [...] the surplus of the total amount of work incorporated in the commodity with respect to the amount of work paid that the commodity contains" (Capital, Book III, 68).

Neoclassical or marginal school (Walras, Wicksell, Marshall) marks a radical overcoming of Marxist conflict and, abandoning the concept of overweight, proposes instead to consider profit as a mere income, which constitutes the remuneration of the capital productive factor based on its marginal productivity. The element of distinction is precisely considering profit as a kind of opportunity cost that the entrepreneur has to support in choosing to invest capital in his enterprise rather than employing them elsewhere. Sraffa and Robinson, among others, have severely criticized this approach,[31] underlining the erroneousness of the simultaneous determination of wages and profits by the implicit mechanism of the market mechanism. According to them, the theorization of marginal school does not take into account the fact that the amount of capital cannot be regarded as fixed because it is closely related to the performance of the profit rate.[32]

The capital was thus understood by L. Walras and E. Von Böhm-Bawerk[33] as a further factor in production and interest as the cost attributed to it, while the remuneration paid to the entrepreneur for time and work devoted to the firm as if it were of a management wage and not of profit. In open contrast to the residual profit definitions, F.H. Knight (comments on Knight's theory will be discussed in more detail in the following paragraphs) and G.L. Shackle have in turn considered them as the risk premium assumed by the entrepreneur. In the neoclassical theory, the competitive business tends to maximize its profit and the research of the latter is the stimulus to innovations and the spring of economic development. Particularly important has been the performance of the profit rate as the ratio between profit and capital itself. From a macroeconomic point of view, M. Kalecki, N. Kaldor, and L. Pasinetti consider that it is linked to the economic cycle, which determines profit margins in relation to the production level of the entire system. Statistical surveys of the trend of the profit's assay show an uneven trend of variation. While, on the one hand, a long-term increase in the rate of profit does not prove to be a very recent year, on the other hand, it does not appear that some classical economists have predicted that the profit rate would inevitably follow an unstoppable descendant parable (Ricardo, Marx). In developed countries capital growth was indeed higher than the demographic, but the same increase in

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31 Piero Sraffa, *The Laws of Returns under Competitive Conditions*, The Economic Journal, XXXVI, 1926, pp. 535-550 (translated in Italian, *Le leggi della produttività in regime di concorrenza*, in Economia Pura, by G. del Vecchio, Utet, Turin, 1937).

32 Piero Sraffa, *Produzione di merci a mezzo di merci. Premesse ad una critica della teoria economica*, Einaudi, Turin, 1960 (Italian edition curated by Sraffa himself with the help of Raffaele Mattioli); New ed. Edited by Fabio Ranchetti, Einaudi, Turin, 1999.

33 According to Bawerk, capital is not an original factor in production, such as land and work, but it is their backwardness. Its value, however, should not be measured on the basis of work and land used in the past, but rather of the ability to produce goods in the future.

labor costs, the diversification, and expansion of demand for new products has required increasing investments in technologies to increase productivity and boost new productions, which also kept the demand for additional capital high and thus supported the level of the profit rate.

Recently, with the development of entrepreneurial holdings in which there is a split between ownership and firm's control, the maximization goal of profit has been replaced by objectives closer to the managerial direction of maximizing utility and power (R. Marris, R. Cyert, J.B. Baumol, J.K. Galbraith) - a specific paragraph will also be devoted to this aspect.

If we want to draw some conclusions from the above analysis and by making a synthesis of the economics of classical and neoclassical economic approaches, it is plausible to state that the key points of profit theory are the following:

I. Profit is independent of the concrete form of economic organization of society because its essence is not related to what will be of greater income but to dynamic changes. So in the economy, profit would exist (i.e. the production factors would be underpaid) only if dynamic changes took place.

II. Profit is not an element of cost but price. This is explained by the fact that the product has a final and marginal utility greater than those corresponding to the activity of productive services, as a result of the growing needs that is the essence of the dynamic economy. Only if the future production cycles were the same as the previous ones the attribution of the product would only benefit the production factors (through an increase in their price), but then the conditions of the stationary economy would be without profit.

III. Profit comes from progress. Firstly, for the existence of dynamic changes, which are neither strictly periodic nor regularly consistent, appear as uncertain or indefinite. It is this uncertainty that risk theory was closely linked to profit. Uncertain changes occur due to ever-new variables (such as population, tastes, capital, inventions, frictions, etc.) which they constantly transform the cost and demand curves. The only existence of dynamic changes would nevertheless generate profit if the entrepreneur did not reach lower costs than others think. And generally it takes, because there is a profit, a price p far greater than the cost c of "reducing the marginal (and total) usefulness of what the entrepreneur perceives, if any, the profit compared to the marginal (and total) usefulness corresponding

to he would eventually lose if the outcome of the economic operation had not been lucky for him".[34]

From the above three points there are three important consequences:

1. Profit does not exist in a uniformly progressive society because the "uniformity" of the transformations would eliminate any uncertainty and therefore imputation would be mathematically and not economically discounted for the future;

2. Profit is not necessarily a monopoly gain, although monopoly and quasi-monopoly elements are more or less significant gains in earnings; monopoly gain is, from the point of view of productivity, connected with pay less the basic factors of production;

3. The profit of each entrepreneur depends on his ability to predict the indefinite future and this is related to the speed of transformations and their degree of expectation. That is why the State if regulating production and thus reducing risks, could lower the price of entrepreneurship.

The neoclassical view of the economy, as proposed through Marshall, Robbins, and Chamberlin, has undoubtedly played a decisive role in the analysis of the twentieth century, enjoying a nearly unquestioned monopoly situation over the last fifty years. The reasons for this domain are known and largely due to the "perfect"[35] rules that its method prescribes to those who use it. Economists who recognize this approach are required to formalize a problem in terms of an objective function, which must be maximized in respect of a set of constraints (the "model"), exploiting the degrees of freedom available to the decider (the economist). According to the neoclassical view, the firm is in fact composed of a set of factors organized in order to produce and market an asset that can be sold at a price at least equal to the a sum of the remuneration paid to the resources employed. Among the factors involved in the production include the ability to properly organize the resources, as well as any research and development activities, whether it relates to new production processes or to new products. This approach assumes implicit hypotheses and leads to precise conclusions.

In the neoclassical theory, the firm performs the task of producing or transforming goods or services (inputs) into other goods or services (outputs). The production process associated with each good therefore constitutes a self-contained machine, which can modify its operating modes in the face of exogenous variations (such as the price of the

[34] Gustavo Del Vecchio, *Capitale e interesse*, Torino, Einaudi, 1956.

[35] The "perfect" method, described in Ricossa (1986, p.69), implies (1) the definition of an ideal situation (which in the case of these pages is the neoclassical competitive equilibrium), (2) the diagnosis of the separates itself from perfection (usually a market failure), (3) the economic policy intervention.

product or the production factors employed) but which, however, works according to well-known mechanisms or foreseeable.

In the introductory model to the theory of the neoclassical enterprise, it is assumed that:

I. The owner of the business is also the manager of the enterprise;

II. The company's goal is to maximize profits (difference between revenues and costs);

III. The benefits and costs (both social and private) of the firm are fully expressed by revenues and costs.

The theory of the neoclassical enterprise, therefore, studies the choices that the firm needs to maximize profits, under the constraints imposed: (a) by all accessible techniques; (b) by the market structure in which the enterprise operates. The fact that the enterprise, in neoclassical theory, discounts the "perfect" rules does not necessarily mean that it ignores the uncertainty. It should be emphasized that, in this context, uncertainty concerns solely the values assumed by exogenous variables - whether these are prices of goods or factors, whether they are related to technological (exogenous) or institutional (exogenous too) variables. In other words, uncertainty does not affect the operation or efficiency of the machine that transforms input into output. Nor does it concern the entrepreneur's activity, which in fact is considered equivalent to an official organizer-controller, who chooses the most suitable production function according to the objective assigned by the "model" and verifies that the factors are coherently combined with that choice. Certainly, the neoclassical entrepreneur is not an innovator or, more generally, an operator who tries to discover new opportunities, new needs to meet. The "perfection" of the neoclassical view would exclude, at least in potency, the uncertainty and the presence of persistent information asymmetries. Consequently, the presence of better entrepreneurs-organizers than others (entrepreneurs-organizers) would not be eligible for a more efficient production function and thus lower costs than competitors. It follows that the single enterprise, as it operates according to a known production function, can be replicated a large number of times, equal to the number of undertakings for whose aggregate production there is an adequate demand for a price not lower than the average cost. Given the available production factors, this number depends on production technology (machine size that minimizes production costs) and demand characteristics.

1.1.2.1 Alfred Marshall. Short and long-term

Alfred Marshall,[36] the first economist to systematize the theoretical body of the neoclassical doctrine of the enterprise, introduced the idea, widely accepted since then, that the firm's choices could be referred to two distinct moments:

1. Short-term;
2. Long-term.

In the short-term, the capacity of an enterprise to build, that is, the maximum amount of output obtainable over a given period of time, is fixed. In the long-term, however, the entrepreneur is able to change the plant's capacity.

The short-term and long-term distinction can also be made using the concept of the variable factor (input) and fixed factor (input). A factor is variable if its use varies with the amount of product produced. A factor is fixed if the usage does not vary with the amount of product produced. In the long-term all the factors are variable. In the short-term, at least one factor is fixed.

Entrepreneur choices are different whether it's short or whether it's a long-term one. In fact, in the short-term, the neoclassical entrepreneur must decide the amount of output to produce (between zero and plant capacity) with the aim of maximizing profit under the constraint of technique and market structure. We assume, initially, that the market structure in which the company operates is a perfect competition and focus on the bond of the technique. At a given historical moment, the entrepreneur can use a finite set of production techniques (available technology) to get a certain output. Such a set could also consist of a single technique.

In the theory of the neoclassical enterprise, it is assumed that the rational entrepreneur will limit his choice to all the efficient Pareto techniques. A technique is not Pareto efficient if you can get the same amount of output with a lower use of at least one input. The set of efficient Pareto techniques, within which the entrepreneur can operate his short-term choice, is defined by the production function. The short-term production function is the set of efficient techniques to produce the *y*-output quantity in the unit of time considered using the L and RM quantities of variable inputs (labor and raw materials), given the size of the output, implant K.

The short-term production function can be expressed in analytical terms as follows:

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[36] Alfred Marshall wanted to merge theory and historical knowledge to understand the complex causes that work in economic life. He thus designed to bring evolutionary into the economic discourse following the road indicated by Hebert Spencer. This combination of needs represented the peculiar aspect of Marshall's design, which characterized him in the Marginalist revolution.

$$y = f(L,RM,K) \text{ with K as a constant}$$

In the neoclassical theory of the firm, there is a strong logical link between production function, firm costs and the goal of maximizing profit. Consider the case of the short-term production function with only one variable (labor). If the company assumes a new worker, it will face an increase in the cost of the wage. At the same time, considering the curve of the marginal product, it also appears that the amount of product offered by the company increases, and hence revenues. So in the short-term, the entrepreneur will hire a new worker if the additional income that this guarantees (which changes for successive units of engaged worker) is higher than the wage.

Introducing the concepts of *Margin Cost* and *Average Cost* easily evidences the relationship between the production function and the cost of the enterprise:

$$MC = \frac{dTC}{dy} \qquad AC = \frac{TC}{y}$$

Because the costs of an enterprise can be distinguished in *Variable Costs* (associated with variable factors) and *Fixed Costs* (associated with fixed factors), we can write:

$$\text{ATC} = \text{AVC} + \text{AFC} = \frac{VC}{y} + \frac{FC}{y}$$

Consider the case of the production function with only one variable factor (the labor).

$$y = f(L,RM,K) \text{ with RM and K as a constant}$$

$$TC = WL + rM + iK$$

Where W is the salary (wage) while *r* and *i* are the unit costs of M and K.

So, in perfect competition, a short-term entrepreneur will choose to produce *a* quantity of output that will equal the market price at marginal cost when this is higher than the variable average costs.

1.1.2.2 Equilibrium characteristics

These premises allow I to define the characteristics of the neoclassical firm's own equilibrium configurations. In the presence of homogeneous products, there is a perfect competition where prices are near the minimum average cost. With differentiated products,

however, there is a monopoly competition, where the price is higher than the minimum average cost. In both cases the freedom of entry into the industry will tend to cancel the unitary profit of the enterprise, understood as the difference between the price and the average cost. Not always, however, the neoclassical enterprise has near-zero profits. In the light of what has been said in the previous paragraph and contrary to what some of the members of the Austrian School[37] have said, positive profits can also be found in a competitive market, as long as there is uncertainty and entrepreneurs are differentiated between them. In the middle to long-term, however, less efficient operators will be able to reproduce the production methods of the best competitors. The profits will be so erosive, unless exogenous growth opportunities (e.g., opportunities for technological advancement or marketing) do not allow the reproduction of risk situations. In such a case, the typical conditions of the short term would again occur and therefore a new differentiation phenomenon. Of course, this implies that the neoclassical period does not describe a longer time interval rather it describes a sum of short periods in succession. The contest depicted here allows two sets of preliminary conclusions about the neoclassical perspective. On the one hand, the business function runs out almost exclusively in choosing between different production functions. A competitive regime therefore reflects a long-term steady context. Unexpected external shocks and raises regulatory issues solely in the presence of any apparent market failures can only disturb this. As far as business activity is concerned, however, there is no doubt that everyone can be entrepreneurs, because any businessman (Robbinsian) has to follow the track already run by other entrepreneurs, which however, it respects a predetermined pattern, which defines both the objective to be pursued and the method of calculation that allows it to achieve this goal. Finally, and thus the second part of reasoning is reached, even competitive equilibrium would be "perfect", since interaction between neoclassical firms would lead to maximization of social welfare by defining it as a good Pareto's configuration. The issue of income distribution is thus transformed into redistribution.[38]

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[37] The Austrian School argues that the only valid economic theory should derive logically from the basic principles of human action. In addition to its formal approach to theory, often called praxeology, the school has always preached an interpretative approach to history. The praxeological method allows deriving the laws of the economy valid for every human action, while the interpretative approach deals with individual historical events. The major contributions of the Austrian School in Economics are: (a) the theory of price distribution; (b) the emphasis on the convenient nature of each choice; (c) the theory developed by Hayek and von Mises on the economic cycle, also referred to as the Austrian economic cycle, which highlights the expansion of credit due to monetary policy and the fall in interest rates; (d) the hayekian concept of intertemporal equilibrium; (e) the view of Hayek and von Mises of the price as an index of scarcity.

[38] Colombatto E., *Dall'impresa dei neoclassici all'imprenditore di Kirzner*, 2000.

1.2 Economic governance of the firm

The academic debate focuses on a twofold order of issues: the extent to which profit should be pursued and the identification of the subject and subjects to which it should be targeted.

In classical theory, as is well known, the entrepreneur, by virtue of a perfectly rational behavior, acts to maximize his utility function, represented by profit.[39]

1.2.1 Productive and distributive logic

The transition from the entrepreneur to the enterprise qualifies two distinct logics of profit: one of the production matrixes, the other of the distribution matrix. Finding these two logics seems extremely interesting and of great utility: from a practical point of view, a comparison between the two logic allows to capture the implications in terms of divergent corporate governance actions.

Productive logic identifies profit when producing wealth through business activity; distributive logic instead relegates profit when distributing wealth generated by the business activity.

In the first case, the profit coincides with the outcome of the business activity; on the other hand, profit only occurs when the firm's profit (or net product) is distributed.[40]

From a quantitative point of view, profit is what is left of revenues, covered by various management costs, amortization, provisions, and new appropriations. It always includes a definable share as a "restoration contribution", capable of reintegrating the "consumed" economic capital over the period and ensuring the survival capability of the enterprise system. In this regard, profit is part of the firm's gross proceeds, that is, as part of a sum that, before assuming the economic and accounting characteristics of profit, must be reduced by what is needed to bring capital back to the previous measure.[41]

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[39] On the importance of profit as an element that connotes the capitalist economic model, see Sen A., *The Profit Pattern*, Lloyds Bank Review, no. 147, 1983.

[40] In terms of production, profit "is the entity that, over time, increases the company's availability, covered that is all production costs. It stems from an activity of producing only when it is organized in such a way as to be profitable" see Del Punta V., *Profit and Maximization: Closure to a Study Conference*, Economic Policy Review no. 10, 1969.

[41] Production logic appears to be the driving force behind the evolution of the concept of risk from a static field, whereby the risk is present in any economic environment, in a dynamic environment, where the risk tends to assume the meaning of uncertainty of result due to environmental economic mutations. The economic theory of profit is inspired by the criterion for which every factor in production is remunerated for the contribution made. If these contributions are added to the initiative and the organization (which makes it possible to overcome the risk and uncertainty elements) and the costs are attributed to the entrepreneur, the

Productive logic obviously entails a conception of profit as income, residual and non-contracted. The presence of a profit, understood not just as a mere difference between revenues and costs but also as a guarantee of asset recovery, should therefore support the firm's development project over time.[42]

Distributive optics calls into question the ways of distributing profit. Potentially, in fact, a "distributive" problem arises whenever the wealth generated by the enterprise has to be redistributed. Consequently, the distribution optics requires considering the profit by highlighting the position and the role of ownership over other stakeholders. The property, besides giving impetus to business ventures, brings venture capital, taking on its business risk. This risk must correspond, as a counterpart, to the need for adequate remuneration, albeit in a residual form, through appropriate levels of profit.[43] To see, the dichotomy between productive and distributive logic accompanies the evolution of capitalism over time and follows the reflection of the doctrine on the problem of the economic governance of enterprises, aimed at regulating relations between different subjects, bearers of interest in a same common company. Distributive optics is typical of large corporations in which ownership separation and control are determined.

The nineteenth century is marked by the birth of the company as a tool for the realization of the productive function, inseparably linked to the figure of the entrepreneur. With the transition to a "modern" form of capitalism, rooted in the large corporation, states the separation between ownership and control. In the big business, there is no longer a coincidence between those who manage the company's resources, orienting them towards expected levels of expected profitability (in line with risk) and who holds the residual control rights. If classical and neoclassical theories focus on ownership and control in the hands of the individual subject (entrepreneur/capitalist), managerial theories make it distinct attributes, property, and management attributes.

The difference between productive and distributive logic thus incorporates, ultimately, a reflection on the firm's autonomy over ownership. At this point, the reflexes, even and above all in terms of government action, are reflected in the application of a productive or distributive logic to the two aspects initially mentioned, relating to the extent of profit and its destination. Production logic emphasizes the profit in terms of surplus, which is primarily to reintegrate and increase the firm's assets. In that case, profit is the goal of

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latter should also be attributed its benefits in the form of profit. See Ceccherelli A., *Business Economics and Business Administration*, op.

42 Amaduzzi A., *L'azienda nel suo sistema e nell'ordine delle sue rilevazioni*, Utet, Torino, 1966.

43 See Golinelli G.M., *L'approccio sistemico al governo dell'impresa. L'impresa sistema vitale.*

ensuring long-term survival conditions for the enterprise. In the distributive perspective, on the contrary, profit gradually loses the residual character and appears specifically aimed at meeting the expectations of the property. However, a stronger firm's permanence in its own context, namely the increase in probability of its survival over time, appears incompatible with the adoption of merely distributive logic. It not only "profligates" profit as "business income", but it also changes it to the government's action.

Conversely, productive optics is much more in line with the described need for autonomy, and with a systemic logic of corporate governance. It is logical that the subjective rationality of the various participants, in fact, prevails in a systemic rationality, aimed at seeking of the ever-higher probability of survival. It is in this context, typical of the systemic approach that is vital to corporate governance, which points to the inadequacy and dangers of a "global" application of distributive logic, revealing further reflections on the relationship between pursuit and destination of profit, enterprise survival and value creation process.[44]

1.2.2 Governance structure and transaction cost

In 1937 Ronald H. Coase changed the way people saw economic organizations when he published "*The Nature of the Firm*" (1937). Half a century later, Williamson and Winter (1993) published a collection of writings shedding new light on contemporary issues and creating tools that allowed Coasean ideas to be tested. Their discussion focused on the search for economic efficiency. Transaction costs were the explanatory basis for the way in which economic relations were organized. Since then several authors, including Williamson, have reviewed and applied the core concepts of Transaction Cost Economics (TCE). The controversial definition of transaction costs permeates the governance mode among economic actors.[45]

The original model conceived by Williamson (1991) analyzes the governance modes, seen as the results of the search for gains through the choice of cost-minimizing factors, basically as a function of the transaction dimensions (asset specificity, uncertainty, and frequency). Joskow (1993) emphasizes the difficulties in data collection and the problems

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[44] Gatti M., Biferali D., Volpe L., *Il governo dell'impresa tra profitto e creazione di valore,* in Sinergie, vol 79. 2009.

[45] For a sample of approaches to understanding the limits to the firm, see Arrow (1974), Williamson (1985, Chapter 6), and Klein (1996). On the internal organization of the firm – Coase's third question – see Argyres (2009). The economics literature on internal organization has tended to draw primarily on agency theory, not transaction cost economics.

of measurement in empirical research, which caused theoretical testing to progress only very gradually. Empirical evidence allowed Joskow (1993) to restate his proposition that the governance of contractual relations systematically varies according to the degree of asset specificity. However, the author highlights the fact that there are factors that relativize the univocal integration trend directly related to the existence of the high specificity of the assets. In this sense, the cost transaction discussion and its relation to the definition of governance structure are at the core of the Coasean debate. Thus it is relevant to revisit the literature and some empirical proof to assess which factors determine the governance structures.[46]

The coexistence of different structures in the same value chain, whose assets are not different in terms of specificity, is an important issue for Transaction Cost Economics, since it predicts a convergence toward the most efficient structures.

Williamson (1996) associates the concept of institutions with that of governance for microanalyses of the individual transaction. The institutional environment (rules of the game) is taken as granted, and the economic players willfully align transactions with governance structures to optimize revenues. Thus, institutions are governance mechanisms and their study is directly related to the optimum decision regarding lower transaction costs.

Arrow (*apud* Williamson, 1996, p. 5) defines transaction costs as "costs of running the economic system". Based on this concept, Williamson states that the choice of governance mode is made through a comparison of the costs of one governance mode with those of others. In this sense, "the study of governance is concerned with the identification, explanation, and mitigation of all forms of contractual hazards" (Williamson, 1996, p. 5).

The contractual issue is at the core of the debate on the costs of running a transaction (Coase, 1972). Such issue contributes toward the progress of the "*Theory of the Firm*", inasmuch as it points out other relevant determinants of the firm's productive efficiency.

[46] Ronald Coase's landmark 1937 article, *The Nature of the Firm*, framed the study of organizational economics for decades. Coase asked three fundamental questions: Why do firms exist? What determines their boundaries? How should firms be organized internally? To answer the first question, Coase famously appealed to "the costs of using the price mechanism", what we now call transaction costs or contracting costs, a concept that blossomed in the 1970s and 1980s into an elaborate theory of why firms exist (Alchian & Demsetz, 1972; Williamson, 1975, 1979, 1985; Klein, Crawford, & Alchian, 1978; Grossman & Hart, 1986). The second question has generated a huge literature in industrial economics, strategy, corporate finance, and organization theory. "Why", as Coase (1937, pp. 393–394) put it, "does the entrepreneur not organize one less transaction or one more?" In Williamson's (1996, p. 150) words, "Why can't a large firm do everything that a collection of small firms can do and more?" As Coase recognized in 1937, the transaction-cost advantages of internal organization are not unlimited, and firms have a finite "optimum" size and shape.

For Williamson, the contract is a complex institutional arrangement involving the different aspects of an economic transaction (the basic unit of an economic relation), such as planning, promises, competition and governance (Williamson, 1985, p. 30).

The existence of distinct dynamics within the internal logic of the transactions translates into a complex puzzle of theoretical and empirical knowledge. These internal divergences of the transaction are understood through the attributes that lead the economic agents to negotiate. Based on the TCE, Zylbersztajn (1995, p. 137) infers that "the prevailing governance structures are the optimizing result of the alignment of characteristics of the transactions and of the institutional environment. Thus optimization is seen in the neoclassical style, meaning the search for efficiency".

Therefore, it is possible to make a Darwinian assumption that an efficient governance structure should prevail as a winning structure. And it is a fact that there is a process of expelling inefficient structures - which may last until the result is achieved. The path dependence may allow for the persistence of inefficient structures. The necessary time for the most efficient structure to win would depend on a series of factors, among which is asymmetric or incomplete information or even institutional rules - formal or informal - that prioritize certain structures.

Here, we can ask, "How does TCE define the choice of the organizational structure?" According to Williamson (1975) and to Klein, Crawford, and Alchian (1978) different governance structures reflect inherent transaction attributes. Efficient, cost-minimizing structures result from their alignment with the transaction attributes (frequency, uncertainty and asset specificity), considering the agent's behavioral presuppositions (bonding rationality and opportunism).

A degree of asset specificity would be the main attribute of the transaction used to explain a firm's governance strategies. Specific assets are those that are non-utilizable in another activity or by another agent, except with loss of value. The more specific the asset the more the firm will internalize the transaction via vertical integration. Klein, Crawford, and Alchian (1978) argue that whenever the asset becomes more specific, the cost of hiring generally increases more than that of vertical integration. The basic idea is that a firm appears in situations where it is not possible to draw up good contracts and where it is important to allocate power (Hart, 1997).

Therefore, the specificity of the assets is considered as one of the main elements that can explain the transaction costs. The second dimension to be considered in the analysis of the transactions is the frequency, i.e., the repetition of the same kind of transaction, whose

importance is seen in the dilution of costs for the adoption of complex mechanisms throughout several transactions, as well as in the formation of a reciprocal reputation among agents. This concept is also used by Klein, Crawford and Alchian (1978) and Kreps (apud Azevedo, 1996, p. 26) who consider that the cost of an opportunistic action is determined by the present value of the future flow of resources involved in the bilateral relation.

The third dimension is uncertainty, which involves the understanding that it is impossible to foresee future events, i.e., the contractual arrangement cannot *ex-ante* establish price, delivery dates, quality and acceptance of the goods negotiated. Therefore, no contract is complete. Thus an opportunistic action from one of the parties is possible: the costs associated with such an action are the transaction costs.

Most empirical works focusing on transaction costs try to confirm the thesis of the alignment of the governance structures - market, contract and vertical integration - resulting from the intensification of the transaction costs (Joskow, 1993). They also try to demonstrate that asset specificity is one of the most important determinants of the three transaction attributes. This means that whenever the investment in specific assets increases, the cost of performing a market transaction increases more than that of a transaction in more complex structures, thus reaching vertical integration (Willianson, 1985).

1.2.3 Definition model of the governance structure: Williamson's View

Williamson's analysis (1985) departs from the perspective of comparative static by positing a model that relates the degree of asset specificity to the governance mode cost. The author considers that the decision on how to organize production systems is conditioned by a degree variation in the specificity of the asset involved.

The hierarchy is characterized by an internal organization (vertical integration). For Williamson (1985), while incorporating a transaction, the internal organization increases the firm's power to impose itself on the structure of the production system. The adoption of the hierarchy occurs when the costs of this governance structure are inferior to those obtained via the market. The governance structure characterized by vertical integration is mainly determined by the characteristics of the specific assets used in the chain. The higher the asset specificity, the larger the prizes given by the adoption of the hierarchy as a governance mode. The advantage of the latter vis-à-vis market organization lies in its

better capacity to adapt to environmental change conditions.[47]

The type of contract used in this mode is relational, with more flexible transactions and with the possibility of a continuous negotiation, in which adjustments are permanent and *on-line* and, consequently, in which the original contract is no longer an exclusive basis for negotiations (Macneil *apud* Jank, 1996, p. 35). The adoption or intensification of the hierarchical mode requires increased bureaucratic costs and decreased incentives from the market to the agents (Zylbersztajn, 1995, p. 141). If these costs are higher than the benefits arising from the other modes, such a situation enables the adoption of either market or hybrid governance modes.

However, when considering the governance mode as an element that explains the "*Theory of Contracts*", Williamson (1985) accepts that this definition of the optimal structure is not so biased in an economic transaction because contracts thereof tend to be incomplete. Brousseau and Fares (2000, p. 410) state, "agents therefore design incomplete contracts that are not implemented and are ex ante designed as a complete set of (possibly contingent) behavioral rules that will ex post solve all coordination problems. Instead, they design decision-making devices that ex post will indicate the behavior required by contractors to ensure the most efficient coordination and the guarantee the enforcement of mutual commitments".

Thus the decision making process in a transaction will derive from the contractual parties, which can be vertically (hierarchically) integrated, and based either on negotiation (hybrid) or on a third party (market). *Ex ante* a transaction, there is a set of rules and there are authorities established by the governance mechanisms. Brousseau and Fares (2000, p. 410) verify that authority and enforcement belong to the inherent nature of the governance structure, and that its definition is associated with the capacity of the agents that deal with such coercion mechanisms in the transaction. Such arguments call for a new discussion of Williamson's model, and a verification of its methodological limitations to define the governance structure as a tendency to seek efficiency in the transaction.

[47] Whether the firms will integrate thus depends on the comparative costs and benefits of contracting, not on the underlying production technology. Indeed, if contracting costs are low, the related diversifier may actually compete at a disadvantage relative to the single-business firm, because the diversified firm faces the additional bureaucratic costs of low-powered incentives, increased complexity, and so on (Williamson, 1985).

1.2.4 Rediscussing Williamson's Model

Zylbersztain (1995, p. 83) points out an important restriction to Williamson's model when he states that if, in a first moment, scale and scope economies are negligible, there is a limited possibility that other decision elements exist, regarding the integration of a certain production step. In this sense, there are variables only for the costs of production and of organizing the information and the resources required in the process of making the product. There is no alternative for new allocations of resources, since the firm is limited to a non-existence of economies of scope, and since it is based on the definition of already strategically chosen products (beyond the definition of what and for whom to produce; the definition here is only how to produce).

Thus, the total cost is the sum of the production cost and the governance cost, the latter referring to administrative and bureaucratic costs. Initially, the governance cost has to be examined as a variation between the bureaucratic costs associated with the internalized production and the governance mode via market (Equation 1). Within these limits exposed, this cost is only related to the specificity of the assets. For instance, if the specificity is low, the organization will have high adaptability in the social environment. That decreases the costs of managing resources and, consequently, makes the governance cost via market lower than the hierarchic (DG > 0,) cost. As Zylbersztain points out (1995, p. 83), if the hierarchic governance cost (B) is higher than that of the market (M) "this means that with lower degrees of asset specificity the market is more efficient than the firms in terms of transaction costs, since it avoids bureaucratic costs". On the other hand, when the adaptation to the environment becomes more difficult, uncertainty becomes more preeminent and greater adaptation of the firm to external changes is necessary. Here, the governance costs via market (M) become higher than the hierarchic costs (B), because the relative costs to control and adapt the organization to environmental changes become lower than those relative to the free market. There is a limitation regarding the change of the type of governance structure involving the balance between the costs adapting to the environment and to the firm (DG = 0). In this sense, the higher the need to adapt to the organization, the higher the need for controls and bureaucracy and, therefore, DG tends to zero. From this moment on, the more uncertainty becomes preeminent, and the firm demands the more adaptation, the more the option for hierarchical governance is consolidated (bureaucratic and internal control).

$$\Delta DG = B(k) - M(k) \qquad (1)$$

Where:

D*G* = Governance cost variance;

B(k) = governance's hierarchic cost as a function of the specificity of the asset;

M(k) = cost of governance through the market as a function of the specificity of the asset.

Once the constraint to the economy of scale is eliminated, it is necessary to take the production costs into account. At a given moment, it can be advantageous for the firm to have governance via market, but the firm would not profit from scale economies if its processes were hierarchic (or vice-versa). Thus, it is necessary to assess the total cost as the sum of the gains by the production cost (scale) and of the governance (bureaucratic) - Equation 2.

For Williamson (1985), both costs are associated with the type of asset used and, therefore, the decision regarding the best governance structure will rely on the combination of scale and bureaucracy in its evolutionary process. The limit between the definitions of structure will occur when the governance costs and the total costs are null. If such values are inferior to zero, then the prevailing governance structure will be the hierarchic one, due to the higher need for adaptability by internal controls and by scale economies.

$$CT = [Ci(k) - Cm(k)] + [B(k) - M(k)] \qquad (2)$$

Where:

CT = total cost;

Ci(k) = hierarchical cost of production as a function of the specificity of assets;

Cm(k) = cost of production through market as a function of the specificity of assets;

B(k) = hierarchical cost of governance as a function of the specificity of assets;

M(k) = governance cost through market as a function of the specificity of assets.

The Williamson model is strongly criticized for three reasons. The first two come from Demsetz (1993) and Barzel (1997); they include the cost of information as an important element to define the governance structure. North (2005) points out that the persistence of heterogeneous governance structures may be a result of factors such as institutional path dependency.

Demsetz's criticism (1993) is based on the analysis of profit maximization or the efficiency in the replacement of the firm by the market, which occurs if the cost of using the market becomes relatively higher than the cost of the hierarchy. That means that the

extension of the firm will be that one defined by the equality among the marginal values of the transaction costs and those of the hierarchy. According to the author, the cost of information is what will define the governance structure adopted. Thus, to understand its existence it must be recognized that the hierarchy is a resource employed in a world where knowledge is incomplete and obtained at a high cost.

The author contends that internal production does not mean a clear elimination of the transaction cost. Likewise, the purchase of goods from another firm, instead of internal production, implicitly involves another firm's administration costs (of the hierarchy), so that hierarchical costs are not eliminated when goods are purchased through the market. The administration (hierarchy) will be working in a more disperse manner among many firms. Even if each firm is an individual entity, administration costs exist: those of planning and carrying out tasks. Besides, it is not correct to infer that production would become individualized if the transaction cost were zero.

The independent individual or cooperative production through the firm will depend upon on the extension of the economies of scale (scope) and on the hierarchy. The degree of decentralization will not depend only on the transaction cost, because this is not the only cost the firm will take into consideration. There are many other costs, including that of production. Thus, to say that firms produce their own inputs when they are cheaper does not mean that the transaction costs are lower than those of administration (hierarchy). An increase in the transaction cost does not lead to a replacement of the market coordination with the administration (hierarchy), but to a replacement of the hierarchical coordination in small firms (higher quantity) with another type of coordination in larger companies (lower quantity).

For it, the emphasis given to the cost of transaction implicitly assumes that all firms can produce goods with the same facility. The market is seen as a perfect replacement in a firm's production when the transaction cost in the market is compared to that of hierarchy within the firm. This analysis implicitly presupposes that information has no cost for the purpose of production. That means that what a firm can produce another firm also can, so that the decision to buy or to produce depends on the differences in the transaction costs

Demtsez (1993, p. 165) posits, "each firm is a bundle of commitments to technology, personnel, and methods, all contained and constrained by an insulating layer of information that is specific to the firm, and this bundle cannot be altered or imitated easily or quickly. The components of this bundle that are emphasized by transaction cost theory are important, but not exclusively so".

The transaction cost plays an important role determining how the firm is formed, but its vertical limitations depend on the productivity that will be reached according to different arrangements. Particularly important in the determination of the benefits of the cooperative production are the considerations based on knowledge. Continuous association of the same persons facilitates the accumulation of information by the firm (gains of scale) and by the persons (specificity of the human capital). Thus the limitations of the vertical integration of a firm would be determined by the economy of conservation of the expenditures on knowledge. A single firm - vertically integrated- would find it difficult to acquire and keep the necessary knowledge archives to control the cost and the quality to make good managerial decisions if their uses were multiple.

Another line of the analysis focusing on information for the understanding of the firm's configuration is found in evolutionary theory. Winter (1993) holds that the firm in this approach is seen as a repository of productive knowledge, which involves the idiosyncratic characteristics that distinguish it from superficially similar firms in the same line of business.

The evolutionary theory suggests that the concept of asset specificity is important to understand the working of the firm as a repository of knowledge. This theory emphasizes that the firm possessing an established routine has resources that can be used with great profit. Thus, the firm works as a repository of knowledge mainly due to the time necessary to associate the inputs, particularly those regarding human services, with the firm. The costs and benefits arising from the adjustment define a specific mode of governance, which is constantly influenced by the pattern of transaction in force. Thus the process of changing the way things are done in a firm involves incremental adjustments in a complex independent system. Naturally, the market supplies the information that guides the firm's strategy and global profitability.

It is thus necessary to understand the factors favoring firms by opposition, examining others that present lower performance or those that merely copy success. The concept of asset specificity is fundamental to understand the working of the firm as a repository of knowledge and its growth. But it is also necessary to ally such analysis with a wider concept, in which the environments of the transaction must be characterized so that they can give a basis for the analysis of the types of routines of the transactions that are viable in different environments.

The second criticism of the view of Williamson's approach originated in Barzel (1997). The author states that the Williamson's focus is not general, but rather, it is contained

within a wider theoretical model whose information is the general variable that explains the existence of the transaction costs. For the author, transaction costs are costs associated with the transfer, capture and protection (maintenance) of the rights. Given that a transaction involves several dimensions and that for this reason it is complex, there are costs that are hard to measure. Barzel affirms that the concept and measuring of transaction costs are more complex than that proposed by Williamson and the definition of governing structure is dependent on other elements besides the specificity of assets.

Transaction costs will exist when there are information problems, regardless of the existence of specific assets.[48] Thus, even if the degree of asset specificity is very high, there would be no need for vertical integration if the initial rules for contracting were transparent and the distribution of the quasi rent, i.e., of the rights to the property of the income generated, were well defined. However, if there were a large variability in the income generated and difficulty measuring it, one of the parties could capture that income, which would bring high costs for monitoring and protecting rights. This means that when the residual rights to the asset, which is shared by those participating in the relation, are not constant, and then there is a mutual effort to capture the biggest part of this indefinite fraction of the income. Therefore, the maximization of the net value of an asset involves property and the pattern of property. In this way, the pattern of property will be defined by the variability in the assets' value. Thus, integration acquires a relevant role in the definition of the governance structure when there is a situation of high uncertainty of information and prohibitive costs to delineate rights. On the other hand, when the rights are perfectly delineated and there is no cost to obtain information about the product, the relevant transaction cost will be zero.

According to this point of view, Williamson's model only partly explains the real motivation to integrate. It is not difficult to ensure the rights to an asset when the flow of services it generates can be promptly verified, because it is relatively simple to impose a charge commensurate with the level of service transacted. Whenever the flow of service is known and constant, there are no costs to ensure the rights to the assets. If it varies, but is predictable, the rights are also ensured. Naturally, the variability can reduce the value of the assets, but it does not necessarily affect the certainty of the possession of the rights.

[48] The problems and costs of measurement pervade and significantly affect all economic transaction. Errors of measurement are too costly to eliminate entirely. The value of equally priced items will differ, then, and people will spend resources to acquire the difference. Such resource expenditure is wasteful, and it is hypothesized that exchange parties will form such contracts and engage in such activities that reduce this kind of resource use. See Barzel Y., *Measurement Cost and the Organization Markets,* Journal of Law and Economics, vol. 25, n.1 (1982).

However, when the flow of the income of the transacted rights is subject to random fluctuations and both parties can profit from that, then the delineation of the rights is problematic.

Thus, if the degree of asset specificity is the same, Barzel's approach can suggest an important argument for the coexistence of different governance structures in a production chain: the difficulty of measuring information. This means that, in opposition to the Williamson's view, when the same asset specificity is considered in a production chain, the coexistence of governance structures would not be only transitory. Also, it does not mean that we would be at the indifference point between a governance structure and another one. Rather, it means that there would be a region of indifference between one or another situation because of the difficulty measuring information among the different production chains, i.e., despite the same degree of asset specificity, the conditions of uncertainty or of difficulty of measurement would lead to the coexistence of different governance structures.

In his defense of empirical studies focusing on the issue of firm configuration based on the role of specific assets, Joskow (1993) posits that their approach was due to their capacity for instrumentation. However, the author contends that there is no unified theory. Several economic characteristics will thus influence the decision of whether the firms will become integrated or not.

The works of Muris, Scheffman and Spiller (1992) follow this line of thought. They have observed that investments in specific assets in the soft drinks industry in the US were important for the initial configuration of the firm's governance structure. The alteration in the governance structure, from the time the distribution channel was employed to the mode of vertical integration, was caused by changes in the market configuration.

Thus, since there were no changes in the specificity of the asset, the firms adopted the strategy of a more complex governance structure because they needed a higher level of regional information about the demand. The efficiency in Williamson's and Barzel's views must be particularized according to the type of demand the firm meets. Thus it is possible to have the same production system meeting different demands, which makes the existence of more than one type of efficient structure possible.

The last criticism refers to the importance North gives to path dependence to explain the persistence of governance structures. According to the author, economic performance is determined, to a great extent, by the type and quality of the institutions that give support to the markets. North (2000, p. 37) defines institutions as a structure that is imposed by humans upon themselves to facilitate interaction. Corroborating with North, Langolis

states, exemplifies and questions: “But what happened in the century between the railroad and the Internet? Why did high levels of verticalization persist until the late twentieth century, long after the passing of the original entrepreneurial design problem that gave rise to most of these firms? The answer has to do with path dependency and the nature of the selection environment”. (Langlois, 2005, p. 28).

This indicates that the decision may be the technical consistency and efficiency of the chain seeking optimization of resources, but the way humans interact over time and the institutions that permeate and influence them may be decisive in strategic decisions, like the type of governance structure adopted.

Stemming from the criticism, it can be observed that the definition of the governance structure is more complex than if it is considered a function of the specificity of assets. The authors discussed here emphasize that information and the decision-making context may also be important elements to understand the type of governance structure in a chain. These two variables will be amplified to strategies and the influence over the governance structure will be evaluated.

Therefore, it is possible to frame a hypothesis referring to the coexistence of governance structures. This means that the coexistence of distinct governance structures would be centered on the strategic issue of each group of firms meeting different market needs. In order to discuss this hypothesis this study will evaluate: the importance of the strategic axis for the definition of a governance structure starting from the influence of the type of market served (and the coexistence of markets with the same production structure); and the interdependence between the production strategy and commercialization.

1.2.5 Markets Served

The decision concerning the type of governance structure based on Williamson’s approach considers the direct relation between asset specificity and total costs. However, a firm’s economic efficiency must be also determined by the optimization of the use of its resources per market served. In some cases, the same asset can enable the firm to meet different market segments. For instance, the poultry market can meet the demand for whole broiler or broiler cuts using the same production technology.

Such a possibility decreases the asset specificity, but not the firm’s capacity for adaptation and internal control and its control of the environment. In this aspect, this consideration

eliminates the second restriction to the Williamson's model (present in Equations 1 and 2). It also emphasizes the need to evaluate the economy of scope to define the type of governance structure. Therefore, there will be governance costs distributed among the manufactured products. As for the production costs, they can be lower in virtue of the existing economy of scope. Equation 3 shows that the total cost will be distributed among manufactured products. If the total cost is lower than the sum of the costs of each individually manufactured product without the appropriate synergies relative to the economy of scope (*Cta*, *b* < *Cta* + *CTb*), there can be a new configuration of governance.[49]

$$CT_{A,B} = [Ci_A(k) - Cm_A(k) + [Ci_B(k) - Cm_B(k) + B_{A,B}(k) - M_{A,B}(k) \qquad (3)$$

Where: $CT_{A,B}$ = total cost of products *A* and *B* $Ci_A(k)$ = cost of production of product *A* hierarchical as a function of the specificity of the asset. $Cm_A(k)$ = cost of production of product A through the market as a function of the specificity of the asset. $Ci_B(k)$ = cost of production of product B hierarchical as a function of the specificity of the asset. $Cm_B(k)$ = cost of production of product B through the market as a function of the specificity of the asset. $B_{A,B}(k)$ = cost of hierarchical governance as a function of the specificity of the asset. $M_{A,B}(k)$ = cost of governance through the market as a function of the specificity of the asset.

As seen in equation 3, the total cost will be a function of the individual production costs and the governance cost that has synergy (bureaucracy optimized with the increment of new products), as observed in Winter and Demtsez. Each product will have its own basic governance cost, but part of this cost is common to more than one product, which allows for a reduction of the same insofar as it aggregates new products (thus configuring the economy of scope). Thus, the governance cost at a t_1 moment is not a ratio between the governance costs at t_0 because of the amount of product diversification (two products would imply half the governance cost for each one). Part of the governance cost is duplicated and thus the reduction of this cost is not very significant, event though it exists.

With this reduction, the quantity of assets to shift the market governance to the hierarchic mode happens at a previous level of specificity ($k_1 < k_0$). In this sense, it is possible to infer a tendency to change the governance structure based on the existence of the economy of

[49] The served market is that segment of the total market that the firm actively attempts to serve. It is difficult to define, but the concept is essential to the measurement of variables such as relative and absolute market share and growth rate. It is therefore imperative that this task is undertaken creatively before embarking on precise strategy formulation.

scope. The latter can result from a strategic definition of the firm and from the level of information it can obtain from the markets being analyzed. On the other hand, if the total cost of the scope (*CTa,b*) is higher than the sum of the costs of each individual process, it is necessary to decide which market to participate in (loss reduction by scope) or which governance to adopt. Thus, the evaluation of the relation between the choice of the production scope and the type of governance is not so evident because it will depend exclusively on the existence of economies of scope. This tends to happen mainly in processes with significant economies of scope. To evaluate such economies, it is necessary to reanalyze issues such as market functioning, product type, competitors, demand characteristics and market size and to turn all these data into market information. The higher the level of information, the higher the capacity for decision on the most efficient governance structure.

It is important to emphasize that despite the fact that the scale economy is a horizontal relationship (gains stemming from the diversification of production) it may be a source of optimization of governance costs and may alter the vertical relationship (governance structure).[50]

In serving distinct markets with the same production technology, bureaucratic costs are optimized and the total for different products and markets become less than the sum of all individual parts (if the firm served each market separately). This optimization may reduce the governance cost for each product produced below that of a single product. Such a reduction in governance cost may make viable the change in the governance structure from market to hierarchical, increasing the firm's control, reducing risk, without significant changes in costs.

As firms increase their scale of supply there is a tendency to reduce mean bureaucratic costs, which, despite keeping the same technology and specificity of assets, make changes in the type of governance structure viable.

In fact, horizontal decisions, like the increase of supply scale, may have vertical impacts, from the governance structure perspective. For Williamson, this alternative was not considered because it did not contemplate the possibility to increase the potential of scale economies, in other words, producing different products utilizing the same technology. In making this scale economy viable, a productive chain has different commercial ties

[50] This approach defines the firm as a governance structure that is coordinated by a hierarchical authority (Williamson, 2002). Williamson considers authority as the heart of the employment relationship individuals have with the firm.

(serving different markets with the same technological structure) and reduces its mean bureaucratic costs. The larger the variety of production and commercialization utilizing the same production technology, the smaller the mean bureaucratic cost and the larger the incentives for the relationships in the chain to tend towards hierarchical and away from market relationships, seeking to reduce risk at a lower cost (mean bureaucratic cost).

Another aspect referring to the strategic definition of the type of governance derives from the demand side and of the interdependence between production and commercialization.

1.2.6 Interdependence Between Production and Commercialization Strategies

In addition to the economy of scope relative to production costs, it is possible to have an economy based on the capacity to serve different markets, thus reducing risks and maximizing opportunities. In this sense, profitability would be distributed through the different products commercialized, and, as compensation, a differentiated governance structure would be required.

By means of an econometric model, scholars have proven that there is a correlation between the dynamics of the internal and the external market, even though they are distinct, which strongly influence the strategy of the firms. The decision to migrate from one market to another depends on the comparison of different structures between the cost of information (transaction) to carry out that strategy and the revenues received when sales are made in this new market. If the estimated cost were lower than the projected gains, the firm would incur in such costs to enter the national or international market.

The average profit of firms can be expressed through the following relations:

$$L_1 = \frac{(P_{int} \times Q_{int}) - (Cfr_1 + CG_1)}{Q_{int}} \quad (4)$$

$$L_2 = \frac{(P_{int} \times Q_{int}) + P_{ext}(tcam)Q_{ext} - (Cfr_2 + CG_2)}{Q_{int} + Q_{ext}} \quad (5)$$

$$L_3 = \frac{(P_{int} \times Q_{int}) + P_{ext}(tcam)Q_{ext} + P_{proc} \times Q_{proc} - (Cfr_3 + C_{proc} + CG_3)}{Q_{int} + Q_{ext} + Q_{proc}} \quad (6)$$

where: *Pint* = is the price in the domestic market, which is a function of the international price; *Qint* = is the quantity sold in the domestic market; *Pext* = is the price in the external market, which is a function of the currency exchange rate; *Qext* = is the quantity

sold in the external market; *Cfr* = is the production cost; *CG* = is governance cost and; *Cproc* = is the cost of processed product; *Pint* and *Pext* = are market data.

Concerning governance, empirical research has shown that the firms integrated by contract, a trend among all exporting groups, guarantee a less variable price for producers than firms purchasing inputs on the *spot* market (Silva and Saes, 2004). A formal contract with the processing segment and with the distribution channel decreases the level of uncertainty. The offer in the internal market, in turn, depends on international prices that are functions of the exchange rate. Thus, considering a constant demand in the internal market, the profit of the L firms depends on the goods prices in the international market.

Since there is an inter-relation between the national and international market, and considering the price in the international market as given, the firms are also price takers and the demand is inelastic at external market price. However, if this price is inelastic in the international market, any alteration in that market will significantly affect the internal market. Non-exporting firms have their strategies subject to the behavior of the internal market, and, to a certain extent, of the market of processed goods. Thus, this increased complexity and difficulty to access information (please read *markets*) would lead to different governance structures in the chain.

Innovative firms (market leaders) and most imitative exporting firms direct their *in natura* produce to the external market; in the internal market they compete for the processed goods, which have another pattern of competition and a more inelastic demand when compared to the *in natura* produces, and are less dependent on the international price dynamics. This inter-relation among national markets, international markets and different types of products allied to the competitive characteristics of the whole market, enable the continuity of slaughtering firms, in this market, with a smaller scale of production and a less vertical governance structure.

Regarding this aspect, Williamson (1985, p. 125) comments on the influence of the power of the market in the definition of the governance structure. To corroborate his statement, he presents the results of Porter and Livesay's study, in which they observe, "the incidence of oligopoly and large size was much less frequent among manufacturers that did not integrate forward than among those that did".

An example was developed by Muris, Scheffman and Spiller (1992) for the soft drink industry. The governance structures observed in both of the two largest firms, Coca-Cola and Pepsi-Cola, in the North-American market have undergone an important change in the last thirty years. According to the authors, the changes that resulted in vertical integration

with the distributing companies were motivated by strategic considerations, given the significant market changes, particularly regarding the growth in the size of the companies' clients. The efficiency in the geographically dispersed production decreased due to the economic cost associated with the relative concentration of the buyers and the need for a market strategy extrapolating the regional distribution of the bottlers. During the first years of the industry, a centralized control of these operations was impossible due to the difficulty in monitoring and communicating.

In that manner, the interdependency between the form of commercialization and the structure of production makes the governance relationship in the production chain dependent not only on the specificity of assets, but also on the way that production and commercialization are linked.

The efficiency of the firm, throughout its production chain, is linked to the relationship between the productive phase, discussed by Williams, and the way in which the production is commercialized, which is not considered by that author. This peculiarity denotes that besides technology, the governance structure throughout the chain can be defined from the firms' production and commercialization strategies.

In this situation, the economy of scope assumes a determining status, because it develops alternatives for placement of production, reducing mean bureaucratic costs. Horizontal decisions (economy of scope - production mix and/or production channel, as exemplified in the poultry chain), in this situation, assume a determining status in a vertical relationship (definition of the more hierarchical governance structure).

Technology is, therefore, an important decision variable in the governance structure, but not the only one, as Williamson pointed out. Information, institutional path dependency, market and production strategies, are also relevant variables to understand the definitions of governance structures in a chain, allowing for the coexistence of different structures with the same production technology or specificity of assets.

1.3 The concept of profit in business vision

Profit in business vision is the remuneration that the entrepreneur has to do to carry out his business.[51] The income perceived by the entrepreneur in the form of profit can be split into several elements:

I. As remuneration, or remuneration for the active role-played in the production process, similar to what happens to the wage;

II. As an interest, since the entrepreneur invests in the production process own capital that is remunerated in the form of interest;

III. As a premium, for the economic risk associated with the company's management. An important distinction, due to Marshall, is that focused on the difference between the entrepreneur's normal profit and extra-profit.

In the first case, profit is considered as that part of the cost of production that the businessman is responsible for his work in the production process and is, therefore, a non-residual share of the production cost.[52]

In the second case, however, if the additional income that the company derives from the sale of its assets is higher than the cost of production (including normal profit), the entrepreneur perceives an extra profit not justified by any production factor, but merely by specific market conditions (innovative product, increased global demand, etc.). Justifying profit as a remuneration of entrepreneurial work has generated a wide-ranging debate among economists, especially as regards the distribution of national income. As already mentioned above on the subject of profit and to summarize what has been written so far, it is apparent that classical economists, especially Smith and Ricardo, argued that profit constitutes the remuneration of the property of the capital factor and the managerial capacity of the entrepreneur. In this case, profit is the residual part of production, that is, what remains after deducting production costs (essentially wages and raw materials). The analysis of classical economists, however, referred to a capitalist economy in which the distinction between active capitalist and passive capitalist was not yet clearly defined.[53]

Continuing the analysis, it is recalled that, according to Marx, the profit share capitalized by the capitalist is represented by the surplus value or that part of the work of the workers who is not paid through the wage (subsistence) paid by the entrepreneur. Marx claimed

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51 We have already seen, in the preceding paragraphs, how this approach changes from the view of classical economists to neoclassical ones.

52 Already from this first setting it is noticed that profit can only be analyzed as a residual business variable.

53 The first is the one who works directly in the production process, organizing and directing the work of the firm, while the latter provides only the financial capital to start the production process.

that workers produce a quantity of goods that is considerably higher than the wages they perceived; this portion of additional products forms, after being sold, the profit share capitalized by the capitalist who thus exploits labor.

Continuing with the analysis, it is also recalled that according to Marginalist theory, every productive factor receives its specific remuneration; in the case of profit it is the remuneration of the entrepreneurial capacity factor. Accepting neoclassical reasoning is denied the Marxist criticism of the theory of surplus value, as profit is no longer the appropriation by the capitalist of the work of others, but just the reward of his abilities. In Schumpeter's analysis, profit is understood as a dynamic income that derives from innovations under uncertainty in the future and remunerates the uninsured risks of businesses.[54] The introduction of innovation is defined as an entrepreneurial act and entrepreneur who does it: the result of this act is entrepreneurial profit, a phenomenon, according to Schumpeter, typical of the market economy. Whenever an innovation becomes general acquisition, losing its value, the economic development process will introduce another, which will result in new profits. Where there are no innovations, there are no profits.

In the economy and according to a more business view, profit is the income that is derived from an entrepreneurial activity, understood as the surplus of total revenue on total costs, of one or more commercial or financial transactions or the entire management of company. According to the classical economy, as seen above, profit is the difference between revenue and cost and has a residual character. This residue is actually made up of different elements that could only appear as a whole at a time when business management was generally in the hands of those who owned almost or all of the capital invested. If, then, classical economists (especially Smith, Ricardo and K. Marx) for obtain the profit took away production costs only later when the entrepreneur's figure becomes ever more complicated and complete and approaches that of the capitalist, it is intuitive that the above-mentioned calculation for profit is too scarce and does not take account of easily identifiable cases by integrating classical study and observation with a contemporary eyes.

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[54] With the basic *Theory of Economic Development* (1912), Schumpeter added to the "static" approach of the general equilibrium of the economy, a "dynamic" approach, capable of explaining the reality of development. Here is the original definition of development given by Schumpeter: "Each production consists of combining materials and forces that lie within our reach. To produce other things means to combine these things and these forces in a different way".

1.3.1 Profit and profitability

An enterprise's profit is the company's revenue less explicit costs and amortization.

The economic profit of a business is the revenue of the enterprise less the cost-opportunity[55] of its resources. It is often lower than the accounting profit.

The accounting records of companies, in particular the income statement and the balance sheet, are intended to provide information to operators outside the enterprise, such as investors or financial institutions, as well as to the tax office, and must therefore be objective and verifiable.

The costs that appear in the accounting documents are not necessarily appropriate for the decision-making process within the company. Business decisions require measuring economic costs, which are based on the concept of opportunity cost. Economic costs may not coincide with historical accounting costs.[56]

In the formal theories of business conduct, it is preferable to analyze the economic costs compared to the historical accounting costs. This does not mean excluding the accounting costs of business studies; there are many situations, such as the evaluation of past performance of an enterprise or the comparison of two companies in the same industry or the assessment of financial soundness, where the use of documents and accounting reports is enlightening.

The concept of cost opportunity provides the best basis for making good economic decisions, whenever the company has to decide between alternatives. An enterprise that deviated consistently from this cost concept would lose opportunities to earn higher profits; firms that are better able to seize profit opportunities or stay short of capital as investors depress their market price could also ultimately foreclose it.

The difference between economic costs and accounting costs corresponds to that between economic profits and accounting profit.

Accounting Profits = Revenues - Accounting Costs

Economic Profits = Revenues - Economic Costs = Accounts Profits - (No Economic Costs - Accounting Costs).

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55 The cost-opportunity of productive factors is given by their value in the best-paid alternative uses. It may differ from the historical cost, i.e. the sum actually paid for the purchase of the good, service or factor, and depends on the alternative uses for which it is calculated.

56 Balconi M., Fontana R., *I costi nel breve periodo e nel lungo periodo.*

Economists often use the quasi-rent[57] term as synonymous with economic profit.

1.3.2 Profit as a business objective

The prospect of profit should be resumed as a "nervous center" within the enterprise system. Profit maximization is an action line that maximizes the difference between total revenue deriving from the sale of the good or service produced by the company and the total costs incurred for its production. In the prevailing economic theory, profit maximization is assumed to be the fundamental objective of the enterprise. The entrepreneur behaves rationally, hence by *homo oeconomicus*, he tends to maximize profit. The logic that supports this hypothesis is simple and intuitive. Since the entrepreneur aspires to get a profit, through his business, is to believe that he will see his aspirations realized by a great profit rather than by a modest profit. Even with a very big profit, if he discovered that with the same effort and therefore the same costs, it is possible to obtain a larger quantity of product, that is, higher revenues, it would undoubtedly seek to eliminate the waste and continue on this road until no further improvement was possible. By introducing time and risk factors, the company is expected to maximize the long-term management result to the extent of a limited degree of overall risk management.[58] Maximization has been taught by classical economists but, over time, it has also been internalized in neoclassical theory, re-emerging, more recently, within the current of thought based on the coincidence between economic responsibility and corporate social responsibility: the latter, pursuing maximum profit, ensures not only the interests of those who own it, but also general welfare conditions.[59]

We have seen how economic and managerial literature on the concept of profit appears to be aligned in assimilating nature to a form of residual income. However, some authors have tried to interpret the concept of profit in a different way. In particular, it is peculiar, more than anything else, to interpret the profit as a goal to be pursued,[60] a vision that leads to a more general reflection on the "multipurpose" of business behaviors. The most

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[57] Temporary gain, given the positive difference between the average price and the average cost, obtained from the firms that produce at lower costs than their competitors. In a competitive market, companies generally have different average costs, while average revenue is the same.

[58] This theory opposes the theory of business survival, which says that the purpose of the corporate group is to ensure the continuity of the corporate body. Here the profit is used to strengthen the firm and avoid risky activities.

[59] Friedman M., *Capitalism and freedom*, Chicago University Press, 1962.

[60] Rather than simple residual variable.

frequent and intuitive objectives have been described in terms of optimizing multi-variable objective functions, maximizing profits and maximizing profits over the long term, or, on the contrary, renouncing maximizing logic, resulting in a "satisfacentist approach".[61] Where the debate on the nature of profit as a residual income focuses on the identification of the subject to which the profit should be devoted, the maximizing arguments reveal the interest of literature for the right measure in which profit must be pursued. We have already seen how the goal of classical economic theory is to maximize the firm's profit. The search for maximum profit represents, for classical authors, the microeconomic criterion for excellence, capable of giving rationality to entrepreneurial behavior.

The neoclassical thesis of maximizing profit incorporates a vision of the enterprise as a "black box", whereby the pursuit of profit protects the satisfaction of individual needs of all parties involved in business activity. In the basic competitive model or the "Walrasian model", business analysis is only a component of price theory and asset allocation. In fact, the firm is a "black box", which combines production factors to produce the goods, but is not an object of analysis; exclusively the markets drive the entrepreneur's behavior. Markets instantly provide all the economic information that needs to make a decision. As a result, the internal organization has no role in allocating resources.[62]

The maximization hypothesis is actually greatly simplified. In particular, it presupposes that the firm's choices are the unique and coherent expression and that its managers carefully carry out the directive that they have given to them by the owners and that the employees perform as accurately the tasks provided for in their contracts of recruitment.

It should be noted that companies do not all behave according to the same model. Very small businesses, for example, will follow a different approach from the very large ones or still able to enjoy a market power. The great distinction in this regard goes between competing companies and those operating in markets other than competitive ones (oligopoly, monopoly, imperfect competition).

As far as the relationship between profit and entrepreneur is concerned, the business and economic structure that existed at the beginning of the industrial revolution has undergone a slow evolution that has led to different characteristics. The same figure as an innovative

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61 The "satisfactentist" approach finds a significant theoretic antecedent in the work of Herbert Simon, *Administrative behavior*, Macmillan. 1947. Administrative Behavior, Il Mulino. 1967.

62 Hodgson G.M. *Evolutionary and competence-based theories of the firm*, in Journal of Economic Studies, vol. 25, 1998.

entrepreneur,[63] so important in Schumpeter's analysis, has become more difficult to define. More and more often, the individual enterprise has been replaced by firms formed in a corporate form: the executives of these companies, being only a small part of the owners, since share capital is fractionated, have no interest in high profits, but they research a stable trend of the company from which they receive employment and income. As a result of this evolution, businesses often do not seek maximum profit,[64] but a profitable profit. Reflections of this new strategy are:

- The so-called practice of "administered prices", that is, the practice of not changing the selling price of the product to any change in the average unit cost level and any change in demand;
- Excess production capacity: the unused production capacity margin allows the entrepreneur to cope with any increase in demand for the product (e.g.: for a sudden increase in income) or failure of a competing venture and similar phenomena.

There is a change in business goals here. This stimulus to look for new ones ranges from limitations to profit maximization, which mainly concern the behavior of the entrepreneur who cannot be totally free to carry out any kind of action, even to force the difference between cost/revenue. The enterprise lives in an organizational environment with precise features and rules to be respected; moreover, the behavior that the enterprise will take in a long-term perspective produces short-term actions that deviate from the maximization of profit (for example, endure high R&D costs that will yield its returns only in the long period). Finally, an enterprise will not adopt those behaviors that, while maximizing profit, will expose it beyond the risk threshold it is willing to take. In reality, the business group's intention meets the limits above all on a practical level, for example in the event of market crises, in the long-term, the entrepreneur should behave in a way that does not conform to the desired one, reducing the prices of finished products by cutting the cost of research and development indispensable to innovation and reducing investment in attractive development areas.

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[63] The entrepreneur, for Schumpeter, is the innovator: the one who combines the means of production differently "to do something new" and gain a commercial advantage (monopoly yield from innovation): it is the entrepreneurial function to combine, in creative, non-adaptive, plants, skills, materials to create a new product, or experiment with new production methods, or exploit new markets.

[64] From here, the theories that have so far come to the fore, and in particular the maximization of profit, make room for new arguments.

Another limit that the entrepreneur might encounter on a practical level is diversification that, in order to increase profit, he should also transfer his skills and availability to other markets, in order to maximize cash flow or revenue. Sometimes, however, the entrepreneur is blocked in his desire to emerge from the uncertainty of the new markets, from the lack of courage to run a risk.

Other limits of profit maximization, as we have already mentioned, concern the subordination of the social function and therefore the satisfaction of the community: in fact, a businessman concentrating mainly on achieving an ever-increasing profit, little will be done, for example, on the quality of the product that will increasingly tend to be standardized and will have little focus on the specialization of the workforce employed or the assistance offered to consumers right after the sale of the product.

But surely, profit maximization also has several benefits: firstly, it enhances the prestige of the company and the success of the people working and managing the company, so that it can achieve various economies of scale on the market, for example in the bargaining with the suppliers which it will have a greater influence thanks to the increased reputation.

Criticism at the maximization of profit engenders the reflection of economists and business scholars. In particular, Winter points out the following three lines of criticism to maximize profits. Firstly, according to the author, it is sensible that the enterprise may have an objective but this would not be summed up in maximizing profit.[65] On the other hand, affirming that the entrepreneur can maximize variables other than monetary profit obviously refutes the neoclassical theory of maximizing profit as a "criterion of objective rationality".

Secondly, it would not be sensible to speak of the purpose of the enterprise, but only of the goals of the individuals that compose it. Compared to these goals, the maximization of profit does not seem reasonable.[66]

Third, says Winter, maximizing profit would not even be considered a goal, as it is impossible to achieve, given the information and computational boundaries of decision-makers and the complexity of the context in which said decision makers are involved.[67]

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[65] In this regard, Scitovsky believes that the utility of the entrepreneur is sensitive not only to profit but also to leisure. Consequently, maximizing this function would be equivalent to seeking a lower value than the maximum profit. Scitovsky T., *A note on Profit maximizations and its implications*, Review of Economics and Statistics, n. 1, 1943.

[66] A representation of the firm as a coalition is provided by March J.G., Simon H.A., *Organizations*, lackwell, Malden (MA), 1993 (trad. It), *Teoria dell'organizzazione*, Etas, Milan, 1995.

[67] See Winter S., *Economic Natural Selection and theory of the Firm*, Yale Economic Essays, n. 4, 1964, with particular reference to paragraph "A criticism of the assumption of profit maximization". About the

The criticisms mentioned above are added to the other ones highlighted by some managerial and behavioral matrix studies. Synthesizing them is above all Saraceno, which links criticism to profit maximization to the conditions in which business decisions are taken and in particular: i) in the presence of a plurality of organisms and individuals who have varied interests and objectives; ii) existence in the conduct of enterprises of non-income targets, such as income continuity, increase in size, maximization of sales volume; (iii) the nature of the forces which have the power to contribute to determining the management directives and to induce, in view of their expectations and pressures, reasons other than profit.[68]

In essence, according to the aforementioned contributions, the maximization of profit is liable, under uncertain conditions, to provide a realistic explanation of the behavior of both the enterprise and the entrepreneur.[69] This thesis, in fact, shows limits to the emergence of the large enterprise, in which management enjoys wide discretion.

The debate on whether or not to allocate the company to the goal of maximizing profit also associates the theme of its destination. With reference to this latter aspect, there is an even more marked differentiation between the economic-political interpretation of profit and that developed within the business-managerial doctrine. This factor is reflected in a diversity of focus: (i) economists on the role of the entrepreneur and the reasons why the profit should belong to the latter; ii) businessmen, and business scholars in general, on profit as the income of the enterprise/corporate body, which is a source of life and development.

The model of the traditional enterprise replaces a model of managerial enterprise where such problems exist, and in achieving the goals the managers of the government enjoy some discretion. Objective rationality replaces the concept of limited rationality that makes possible behaviors that are as satisfactory or acceptable, other than maximizing. The passage of the command into the hands of the managers introduces, in fact, new motives, which may differ from those of property-oriented maximization of profit. Those who rule

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limits of maximizing settings, see Simon H.A., *Administrative Behavior*, Macmillan, New York, 1957 (ed., Administrative Behavior, Il Mulino, Bologna, 2001); Golinelli G.M., *Economia e finanza nel governo dell'impresa*, Sinergie, no. 61/62, 2003.

68 V. Saraceno P., *Il governo delle aziende*, Libreria Universitaria Venezia, Venezia, 1972.

69 See Enke S., *On maximizing profits: A distinction between Chamberlin and Robinson*, The American Economic Review, n. 4, 1951; Volpi F., *Massimizzazione del profitto e motivazioni dell'imprenditore*, Giornale degli economisti e annali di economia, n. 1/2, 1965.

can be brought to defend their utility function in which they converge a plurality of goals from the earnings, prestige, reputation, and service to others.

Hence the emergence of new theories that can be grouped into three lines:

- Maximizing theories, according to which the firm pursues maximizing behaviors, but relating to functions other than profit;
- Satisfactory theories, according to which the enterprise puts into behavior satisfaction, aiming to reconcile the objectives of the various actors;
- Theories of re-maximizing profit.

1.3.3 Problems in maximizing profit as a business goal

Now, let's go to the analysis, and to try to find a possible solution to the problem of business purpose, which, purified from possible misunderstandings, remains complex and, to some extent, ambiguous. In fact, the problem arises with the emergence of the great managerial business, which, as it is evident, operates in a very different context from perfect competition, and ownership and control are separate. The need to identify the general and ultimate aim of the enterprise arises from the fact that, in order to take decisions and take measures to achieve intermediate objectives, it can not be excluded from checking the exact correspondence between them and the purpose of the business; correspondence that must exist from the determination of goals.

Usually when talking about the firm's general goals, the first word that jumps to the mind is profit. This is because in the classical and neoclassical theoretical framework profit maximization is considered to be a general purpose of the enterprise, that is the ultimate aim of which is to pursue all business, since only with the maximization of profit will it be certain that capital resources and work, by definition "scarce", be employed in the best possible way. In fact, we can no longer share the choice of doing so with the ultimate goal of the enterprise since, in reality, maximization of profit correspond to the best possible use of scarce resources only when it falls within the theoretical framework of perfect competition: the theoretical framework differs in a macroscopic way from the one in which, in the everyday reality, companies find themselves in the business. Obviously, these premises do not find room in the real context in which the large management business has to operate because it operates in a very different way from those for a market that can be defined as perfect competition. The firm is structured in several plants; produces several goods; it has an organization that is constantly changing but has static traits; is

characterized by a clear separation between property and control; responds to a multitude of both internal and external stakeholders, who demonstrate the legitimate expectations of having a high degree of power through their privileged relationships with the firm itself; etc.

From what has been said so far it is obvious that the principle of maximizing profit, while consistent with the assumptions of the classic and neoclassical model, cannot be transferred to a real business management context. As mentioned above, we can add further observations with reference to the impossibility of using the principle of maximizing profit as the ultimate goal of business: in fact, this principle is linked to the possibility of realizing processes of actual maximization, and as such objectively measurable, and to the definition of profit, which is not univocal. In fact, maximization can be intentional when, in other words, the subject in question intends to maximize something or to accomplish when, at the end of the period within which the maximization would have to come, it will be assessed whether the objective function of maximization has been maximized in reality. The intention to maximize something takes on a precise meaning only when it is possible to objectively measure this maximization and to identify a certain specific goal that can be reached to believe that it has maximized the subject in question: in reality it is impossible conduct a fully objective and efficient analysis of the various strategic options, individual operational actions, etc.; with the consequence that it is impossible, in reality, to define *a priori* a certain objectively maximally achievable amount of profit achievable over a period of time, or, as a matter of course, measure whether or not such supposed maximization has been achieved. At this point, there is nothing left to address the last possible objection of who claims that profit maximization can be regarded as the general and ultimate goal of the firm: he could argue that maximizing profit as a general purpose of enterprise, is to be understood as maximizing in the long-run, but that does not make sense since, among other things, it is not possible to define exactly the period of measurement, i.e. the long period of which it is not determined or identifiable and for this, it is impossible, afterwards, to investigate the correct pursuit of this alleged general purpose.

We can say that it is difficult to give a definitive definition of profit as the level of it is the result of managerial decisions that determine it with rules and criteria that reflect the motivations and attitudes of managers themselves: we can therefore have two companies perfectly identical which produce the same goods, which have had the same trend in sales, revenue, turnover and more but have differing profits on the basis of different assessments

of the individual entities that make up the management of the two companies. Also on the basis of this consideration, how can profit be maximized if it is the result of subjective choices? The answer is, of course, that it cannot and therefore cannot be considered that profit is the ultimate goal of business action, since the pursuit of an adequate profit is certainly a fundamental and indispensable condition for achieving any ultimate purpose firm.

1.3.4 Theoretical settings for the purpose of the enterprise

They can be shown, grouping them into three categories,[70] all the numerous theories developed over the last few years with reference to the purpose of business. Within these categories, more or less extreme positions can be found, but in presenting them, they will use the most adherents to the reality of the major managerial business dominating the international markets. In the first category, all theories can be collected which, in one way or another, state how the enterprise has as its purpose the maximization of functions and objectives other than profit. In the second category we can gather the theoretical settings that see, as the purpose of the business, the satisfaction of a multiplicity of goals. In the third category, we can recap the theories that are based on the maximization principle of profit that is revised *ad hoc* to be more fitted to enterprise reality.

Within the three categories we have just given, we can now consider individual theoretical positions, which are worth to exemplify, theoretical positions which, however, do not deviate too much from the reality of large managerial firms. With reference to the first category we have:

1. The model of Baumol and Marris:[71] the first group of theories assumes the interpretation of Baumol (1959), which considering the structure of the managerial enterprise hypothesizes the maximization of turnover as the primary purpose of the enterprise, which in turn other utility functions are linked to the managers.[72] However, the development of revenue is based on the achievement of a minimum level of profit that can silence the expectations of shareholders. A criticism of these models lies in the fact that references to relationships between companies and competitors have been completely forgotten; there is no clear link to specific competitive situations: it is assumed that turnover can be

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[70] Caselli L., *Le parole dell'impresa*, Franco Angeli, 1995.

[71] Marris R., *The Economic Theory of Managerial Capitalism*, MacMillan, London, 1964. (trad. it. "*La teoria economica del capitalismo manageriale*", Einaudi, Torino, 1972).

[72] Baumol W.J., *Business Behavior, Value and Growth*, Macmillan, New York, 1959.

maximized through a policy of reducing the sale price or increasing advertising spending, but the competitors' reactions to such choices are not considered.

This model, taken up by Marris and set in theory in 1964, claims that in the modern enterprise, characterized by a clear separation between ownership and direction, managers, who are responsible for the management, prefer, by personal prestige, power, material well-being, etc., to manage big companies and to have high turnover, which results in their tendency to maximize the growth rate of invested capital. On the other hand, such subjects owe their power and position to ownership, which is usually represented by the shareholders in the managerial business, so they will have to act properly against them so that they do not lose their position. In this trade-off, between the desire for growth and the need for security of its position, existing for managers, according to Marris, profit plays a primary role. In fact, on the one hand, in so far as it is reinvested in the enterprise, finances its development by favoring the pursuit of the managers' objectives, on the other, for the part distributed in the form of dividends, it guarantees the satisfaction of the shareholders to confirm the position of management. The manager could obviously try to privilege a retention and reinvestment policy of the firm's profits, but such behavior would result in lower dividends and a possible dissatisfaction of shareholders who would then sell their shares with the result of a decline in the stock market price and greater risk of hostile escalation in the case of a public company, or, in the event of a more stringent control of the stock company, i.e. when it comes to shareholders with reference or control, would replace the management. According to Marris, therefore, in the big managerial business, it is maximized through a valuation system used by managers, which has two different elements: the growth of the company and the security of its managerial position. Profit, in this perspective, is a mere tool to meet both needs. Maximizing growth and maximizing profit are, however, incompatible, as, beyond a certain growth threshold, profit tends to decrease progressively due to the onset of diseconomies of scale and the excessive risk of a push diversification. It is therefore necessary that managers carefully choose the best balance between business growth and profitability. The maximization of the firm's development rate must be linked to the availability of capital and the willingness of shareholders to finance the size growth of the enterprise pursued through diversification strategies as well. It is the achievement of certain levels of profit guaranteeing the satisfaction of shareholders' expectations regarding dividends and capital gains if the management is only geared to a size-wise growth of the enterprise by applying a policy of non-dividend distribution, shareholders would be forced to sell their participation shares

(danger of hostile climbing). Then, it is necessary to analyze the combination of dimensional growth and the "valuation ratio",[73] a minimum valuation rate equals a value just above the level at which it may take for shareholders the convenience to sell.

A not so dissimilar setting was adopted by Williamson (1964),[74] according to which the management of a big enterprise pursues the maximization of its utility function ("spending preferences": quali-quantitative factors, managerial slacks, that is, staff costs and discretionary powers, access to funds to be used discretionarily), compatible with a minimum profit margin, in order to avoid negative reactions to shareholders and the financial market, which could endanger the security of its work. This utility function is based on three main factors of satisfaction: (a) benefits and number of workers: a large number of people to be coordinated by power and importance to the manager by getting satisfaction; (b) freedom of action: it concerns the possibility for the manager to authorize expenses not strictly necessary with the role it covers. This delights him in personal prestige and sense of power; (c) discretion in making investments: this is the ability for the manager to decide discretionarily, i.e. without addressing higher hierarchical levels, on rather large investments.

The utility function is therefore maximized in accordance with the profit constraint and above-mentioned dividends to meet shareholders' expectations. Williamson also notes that when the business works well all three factors behind the manager's utility function are positive, while, logically, in difficult situations they are absorbed by the need to reduce unnecessary costs. So, when the managerial utility function resets, by resetting the three factors above, it would fall into a maximization model of profit.

Williamson's theory can be seen as a distribution model of profits between shareholders and managers. If we take a perspective of separating between ownership and control, in fact, the distribution of some of the managers' profits can be interpreted as the need to pay in addition to the normal pay, the business function entrusted to non-proprietary subjects. However, the model works only if a minimum acceptable level of profit to the shareholders is ensured.[75]

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[73] The amount of operating income may be affected by the interpretation of the financial statements if this is used as an active asset. Income is normally divided between dividends and self-financing. If the dividends are normal, that is, in line with those that distribute the competition, and usual, that is, in line with those that the company has distributed in the past, the capital market does not react negatively. In this case, it is said that the "valuation ratio" between the stock exchange and the equity is safe, so new shares (capital increase) can be issued without the fear that they will remain unsubstantiated.

[74] Williamson O., *The Economics of Discretionary Behavior*, Prentice Hall, Englewood Cliffs, 1964.

[75] Williamson O.E., *The Economics of Discretionary Behavior: Managerial Objectives in a Theory of the*

2. With regard to the second category we have the following the model of Cyert - March:[76] authors give an application, with reference to the behavior of large corporations, to the theme of limited rationality introduced by Simon. As part of the "satisfactory" scenario, the studies of Cyert and March start from the assertion that the institutions, and therefore the companies have no goals as such, but they are generated by the people that operate in them.[77] The large corporation in particular represents a complex organizational structure in which there is no single decision unit, but a multiplicity of decision-makers each carriers of their own interests. The company can therefore be conceived as a coalition of different groups and people: shareholders, managers, workers, customers, suppliers and financiers with their own needs. Through a bargaining process, which Cyert and March define as "negotiated" among all parties concerned, they define the company's objectives, which should match the satisfaction of the largest number of subjects.

The crux of the theory emerges from the conflict of interests between the various decision-making groups, which, due to the complexity of the businesses and the substantial lack of resources, tend to amplify the conflict by stressing their roles in generating business performance. Conflict management provides for a negotiation of allocation between the different areas and functions of the enterprise and coincides with the budget process; each area presents its proposal of goals and expense that are reviewed by senior management who also compares them to past performance and allocates resources to ensure the highest level of satisfaction within the organization.

Cyert and March also refer to Williamson as a benefit concept that, in their theory, is seen as an additional benefit not only of managers but also of all subjects involved in business activity. The concept of "organizational slacks" can thus be summed up in a benefit that goes beyond what is necessary to have the membership and consent granted to the subjects involved in the business activity. Like the slacks for managers, previously seen in the Williamson model, even in this case, such benefits will increase in business-friendly business times and then, if necessary, decrease in the event of a crisis in order to recover the resources needed for the enterprise, reducing unnecessary costs.

In order to increase internal satisfaction, further payments are made in terms of dividends, capital gains, bonuses, and fringe benefits, bonuses that tend to increase and decrease in relation to the firm's situation.

Firm, Prentice-Hall, Englewood Cliffs, 1967.

[76] Cyert e March, *A Behavioural Theory of the Firm, Prentice Hall*, Englewood Cliffs, 1963. (trad. It. "Teoria del comportamento dell'impresa", Franco Angeli, Milano, 1973.

[77] Cyert R.M., March J.G., *The Theory of Behavior of the Firm*, Prentice-Hall, Englewood Cliffs, 1963.

3. The last current is to re-validate the principle of maximizing profit; in spite of the uncertainty in which companies operate and achieving their objectives with greater difficulty, they are not so different from those that aim at obtaining the highest profit. The firm's survival is the "spring" that drives companies to adapt to the outdoor environment by innovating, increasing their size, seeking alliances, and seeking market niches. The time factor, for example, can be understood by considering the value of expected future profits in a time span by applying an appropriate discount rate that also takes into account risks and uncertainties. With regard to the managers' motivational framework, however, they are not free to deprive shareholders of an adequate dividend, and as far as competition is concerned, this may be particularly high even in a real oligopolistic context. Despite the criticisms, and despite the difficult relationship between theory and the empirical use of the principle of maximizing profit, this is still an ideal to tend and bring down the logic with which to guide behavioral and managerial choices in a rational and efficient manner.

In fact all these theories can be traced back to a single basis, that is, that the general purpose of the enterprise is its survival: enterprise survival is the ultimate universally acknowledged goal to which, however, one can not give up regardless of the theoretical category to which it belongs.

This is because the survival of the enterprise is a symptom and a synthesis of its ability to evolve and adapt to everyday challenges and to the changes in the environment in which it operates, is the expression of the company's ability to last over time, going beyond a static equilibrium, a more or less predictable context, etc. The purpose of business survival is a general and underlying constraint on managers' choices in formulating intermediate objectives: this is a general constraint that, while not satisfying directly any motivation, must be respected by the choices that management will make in considering strategic options for achieving the goals. In the long-term, the overall purpose of the company's survival is to provide a guiding principle for interpreting the policies and strategies put in place by the company; survival therefore assumes a very large meaning to cover all the actions that the enterprise performs, all the responses that it gives to environmental changes, and so on. It is the most general purpose of survival that leads the firm to expand into new markets, grow internally and through acquisitions, diversify, conduct marketing research, seek collaboration and co-operate with other businesses, etc. It can be said that the generic purpose of enterprise to survival is that which better than any other purpose can explain in the short and middle, as in the long-term, the strategic, organizational and

managerial action of the enterprise. We can conclude that digression by saying that the ultimate goal of survival can be better expressed as a tension towards the continuation of the existence of the enterprise through its ability to self-generation and regeneration over time that can only be achieved through a continuous redesign of one's destiny and a constant generation of economic value.[78]

[78] With reference to the necessity/self-generating capacity, we refer to the concept of autopoiesis developed by Vicari S., *L'impresa vivente*, Etas Libri, 1992.

1.4 Profit as a negotiable income

In general economic terms, it is called "income" the total revenue (and benefits) that individuals and families have in a specific time span. Revenues then differ from one another -assuming different denominations- in relation to the productive factor that determines them: in essence, it is defined as wages, labor income; profit, capital income; land income, income derived from the possession of natural goods such as land; economic annuity, measures the economic surplus attributable to a very productive input whose supply is limited.

The analysis of economic and managerial literature reveals the important role played by the profit as the engine for the development of firms operating in capitalist production systems. Literature identifies, besides profit, two additional forms of remuneration for the "factors" of production, in increasing degrees of uncertainty and risk.[79] First, the most reliable, contractually- guaranteed form of remuneration to a given subject, compared to the best alternatives to employment or the holding of an economic activity, is the so-called cost-opportunity. Secondly, the subject's economic income is defined as the contractual predetermined surplus on such cost-opportunity.[80] Lastly, in the presence of uncertainty and imperfect information, the inability to contractually determine the over-opportunity cost opportunity identifies, as is known, the economic category of profit.

At this point, it is appropriate to integrate the study of the profit made in the first chapter with the analysis of the economic outturn, but it is still necessary to make an in-depth study of the annuity in a broader sense.

The concept of revenue is of great theoretical complexity. Three closely interwoven elements allow to simultaneously considering its role in reproduction of production relations and capitalist distribution.

The first element allows characterizing the genesis and essence of capitalist revenue as the result of a process of expropriation of the social conditions of production and reproduction. In this sense, revenue is the other face and denial of the common. The importance of the role of the revenue in the dynamics of capitalism depends in fact, on what Karl Polany's case, can be analyzed as the conflicting succession of historical phases of de-socialization, de-re-socialization and then de-socialization of economy again. The formation of modern landowners revenue coincides with the process of enclosures, with this first expropriation

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[79] Mueller D., *Information, mobility and profit*, in Kyklos, vol 29, 1976.

[80] Schoemarker P.J.H., *Strategy, complexity and economic rent*, in Management Science, vol 36, 1990. See also Volpe L., *Il profitto come rendita negoziabile*, CEDAM, 2013.

of the commune, which was one of the prerequisites for the transformation of land and labor into fake goods. We have here the common trait that encompasses, in one and unique logic, the first enclosures, and the "new enclosures" concerning knowledge or the key role played by the "current privatization of the currency" in the development of financial income and the destabilization of welfare state institutions. Despite these elements of continuity, however, it is important to point out a decisive peculiarity of the current neoliberalism de-socialization process of the economy with respect to other historical phases: the expropriation of the commune not only takes place today on conditions such as earth belonging to a pre-capitalist exterior, in the traditional sense of Rosa Luxemburg. Today's de-socialization of the economy process points above all to the elements of the commune that the struggles have built at the most advanced points of capital development, laying the foundational and structural bases of an economy beyond the logic of capital. This is how we can define, at least potentially, elements of a post-capitalist exterior, as is the case, for example, for the man-made collective guarantee and manpower provided by the welfare state.

The second element, which makes it possible to characterize the revenue, is as follows: the annuity is the income the owner of certain goods perceives as a result of the fact that such assets are scarce (as in the case of natural resources corresponding to the so-called traditional common goods) or especially they are made available in low quantities (as in the case of so-called intangible commodities). In other words, the existence of the sovereign depends of property's form and / or monopoly power positions that benefit from the existence or deliberate creation of an artificial scarcity of resources by imposing higher prices than those justified by their costs of production, as is demonstrated, for example, today by the policy of extending and reinforcing Intellectual Property Rights.

Finally, and it is the third element, the capitalist annuity (as opposed to the feudal one) can be characterized as a pure distribution relationship, since it no longer performs any "function or at least any normal function in the production process".[81]

In short, the annuity is a credit or a property right on tangible or intangible resources, which entitle to a levy on the value created by the work from a position of externality to production.

The economic revenue is equal to the difference between the maximum amount that an enterprise would be willing to pay for input services and the reserve value of the input

[81] Marx K., *Capital*, vol. III.

itself. Economic annuity and economic profit are closely linked. The economic profit of an enterprise depends on the price it pays for the very productive input. If the enterprise acquires the input at a price equal to its reserve value, the enterprise can achieve a positive economic profit, but if it buys it at a price equal to its reserve value plus the economic annuity, as defined above, the company's profit will be zero. So, the economic outturn is the potential increase in the company's economic profit resulting from the use of a very productive input, and the actual economic profit will depend on how much of the rent goes to the enterprise and how much the owner of the input.

1.4.1. Ricardian return, Paretian rent and monopolistic annuities

Retrieving the classification developed by Amit and Schoemaker,[82] it is possible to identify three major earnings-related qualifications.

The first corresponds to the notion of Ricardian return, meant to represent extra profits from available resources in fixed or limited amount.

Ricardo's retirement is the expression of the "avarice" of nature: the obstacles that this opposes to man's efforts cannot be effectively overcome with adequate investment. It is not an absolute gain that is in normal conditions for all landowners; if all the lands were equally fertile, there would be no Ricardian yield: it is a gain of differential character for pros of the more fortunate landowners. It derives from the different cost structure of the various firms or from the cost dynamics of the same firm considered at different times of time (rising costs). It is a price phenomenon in conditions of free competition; in its essence, connected to natural phenomena, is, however, completely independent of the particular features of the juridical structure of society: it would also occur in the absence of an exchange economy. However, for a clear understanding of the phenomenon, consider it in relation to the conditions of such an economy; in this sense are much important the famous Ricardian theses: the annuity, in itself, is not the cause of the price but has an effect; the price of the products determines the annuity and this, in turn, affects the price of land to all, and exclusive, the advantage of landowners whose interests are in conflict with the interests of the other classes and collectivity resulting from their aggregate .

The second qualification expresses the concept of Paretian retirement expressed by neoclassical theorization and identifiable in the difference between the remuneration

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[82] Amit R., Schoemaker P.J.H., *Strategic assets and organizational rent*, in Strategic Management Journal, vol. 14.1, 1993.

deriving from the use of first best and second best of a given resource.[83] Moreover, a concept related to that of Paretian retirement is perceptible in so-called quasi-rent. For quasi-rent, we mean a temporary gain, given the positive difference between the average price and the average cost, obtained from the firms that produce at lower costs than their competitors. In a competitive market, companies generally bear different costs from one another, while average revenue is the same. Those who manage to be productive at lower average costs enjoy a quasi-rent. Generally, it is believed that this type of retirement is generated only in the short term, because in the long-term the inflow of other enterprises, the reorganization of existing ones and the disappearance of those that are in loss, result in a balance in which the price, which has dropped due to competition and increased supply, covers exactly the total costs. However, this situation can only occur in a model of pure competition, and the further away from it, the more it will be possible for companies with lower average costs to obtain quasi-rent even in the long-term.[84] In summary, the notion of quasi-rent is the difference between the value of a resource in the negotiation relationship for which it is specific and the value of the asset in the best alternative use: it is the surplus resulting from increased resource productivity.

The third qualifies for monopoly rents. In fact, this type of annuity can be added to the Ricardian rent, that is, extra-profits due to market power, where companies operate in a sector where competition is limited by small numbers (oligopoly or monopoly) or by differentiation of the product, which generates the existence of niches protected by the action of competitors (monopoly competition). Of course there is the problem of preventing the competitive mechanism from being compromised by the existence of dominant positions or collusive behavior between companies seeking to obtain high profits through agreements and market power rather than through the demonstration by each firm of its own specific capabilities.

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[83] The first best requires the same conditions as the Pareto optimality. The latter, uniquely identified with the vision of social welfare characteristic of traditional economic theory, relate to the production and the exchange of goods (economic efficiency).

[84] Klein B., Crawford R., Alchian A.A., *Vertical integration, appropriable rents, and the competitive contracting process*, in Journal of Law and Economics, vol. 21, 1978. See also Marshall A., *Principles of economics,* Macmillan. 1890.

1.4.2 Entrepreneurial Rents Theory

The complex relationship between entrepreneurial dynamics and its development environment is an ever-evolving research area, despite the fact that it has been and is still very much debated today.[85]

Here, in particular, attention is focused on the forms through which entrepreneurial activity manifests itself, when the entrepreneur finds hostile conditions in the local context of reference. The effectiveness of entrepreneurial activity, in unfavorable contexts, is a crucial area of research between the aspects of management that is widely understood[86] and is indeed one of the major competitive advantage measures (Stevenson and Jarillo, 1990; Lumpkin and Dess, 1996). The performance of a venture depends, in fact, on the "adequately" the entrepreneur (or corporate governance body) -through the guidelines, decisions and capabilities to recognize and decode the signals from the environment- is able to interpret his role.[87] In particular, it is assumed here that, for the purpose of business performance, the conditions of tuning -from a systemic point of view- are fundamental to the environmental condition and the type of behavior adopted by the entrepreneur (Golinelli, 2000).

The theory of entrepreneurial income is rooted in studies of the efficient tool for generating and appropriating economic outlays. Such opportunities, arising from imperfections in product markets, are the result of changes in technology, demand conditions, or other factors. Changes that, as noted, individual subjects or groups can intercept and turn to their own advantage, or attributable to the innovative capabilities of individuals. Entrepreneurial income theory identifies the factor that can trigger the generating process of economic rents in the presence of asymmetries of knowledge about a given entrepreneurial opportunity.

Entrepreneurial rent, therefore, means a level of profitability is higher than "normal", that is, sufficient to make a productive activity worthwhile due to control and the use of appropriate and unique resources, not eroded by reproduction of resources by other firms and by competitive leveling.

More in detail than Paretian tradition, two authors all stand out in that theoretical group: Milgrom and Roberts. They elaborate their own peculiar specification of the concept of rent, introducing precisely the conceptual category of entrepreneurial rent, defined as the

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85 See Golinelli, 1974; Covin e Slevin, 1989; Romanelli, 1989; Buttà, 1991; Baccarani, 1995; Gimeno, 1997.

86 See Gartner, 1985; Low e MacMillan, 1988; Rullani, 1993.

87 Cfr. Lumpkin e Dess, 1996; Golinelli, 2000.

value created when economic actors combine existing resources in different and new ways. Starting from this conceptualization, the theoretical philosophy also marks the difference between entrepreneurial and quasi-rent. The creation of the latter assumes a situation similar to those necessary for the creation of business rents. Nonetheless, the notion of quasi-rent shows a significant distinctiveness: that is, the ability to determine the difference between revenues and costs in a certain or otherwise recognizable way, and hence *ex ante*. By synthesizing, the distinction between the two concepts is linked to the uncertainty surrounding the investment in new resource combinations.

Thus, the first theoretical group emphasizes the role and ability of the entrepreneurial subject in recognizing the opportunities for generating new resource combinations (subjective sense). The key points of this strand can be summarized in three macro-groups: a) the presence of an objective reference to the Paretian tradition in qualifying the concept of quasi-rent; (b) the progressive decline of the margins between profit and economic rent under conditions of uncertainty, with the tendency to assimilate the profit to the category of quasi-rent; (c) the contribution provided to business theory by identifying in the firm the most "institutional mechanism" best suited to achieving it, given the uncertainty, the coordination between generation processes and the appropriation of quasi-rent.

1.4.3 Managerial Rents Model

The managerial rent model has a point of contact and distinction from the previous theoretical theory. Similarly to it, it is worth reading a profit in terms of composite rent. On the contrary, unlike the previous one, this approach has a vision of a contractual rather than an institutional type of enterprise. The most reverent authors of this model were Alchian and Demsetz, not to mention the contributions made by Jensen and Meckling.[88] The authors theorize the concept of firm as a "nexus of contracts" like a set of contracts between several factors of production.

The Property Right Theory (PRT) is essentially due to Alchian and Demsetz (1965). According to Alchian, "property rights are the rights of an individual to use resources; these rights are supported by customs, social customs, ostracism, laws, individual power".

[88] See Alchian A.A., Demsetz H., *Production, information costs, and economic organization*, in American Economic Review, vol 62, 1972. See also Jensen M.C., Meckling W.H., *Theory of the firm: managerial behavior, agency costs and ownership structure*, in Journal of Financial Economics, vol 3, 1973.

Thus a property right is a right to use the resources sanctioned by laws or social conventions and/or behaviors. What is fundamental to the Business Theory is the distinction between the legal concept of ownership law and the economic concept of property law: the legal concept concerns the ownership and use of resources; the economic concept concerns the use of resources in terms of profit and the ability to transfer and/or exchange resources for that purpose.

What is critical in fact in economic terms is the distribution of earnings generated by the joint commitment of different contractual parties. In fact, not only *ex-ante* allocation of residual royalty rights will affect partner engagement, but also the expected profit distribution will affect individuals participating in collective efforts.

Here, from an economic point of view, what defines the property of a firm, and hence the very existence of the firm, is the right to control the result.

In the model, there is a clear reference to Resource-Based Theory and, more generally, to the current thinking that emphasizes the importance of human capital. The key assumption of the model concerns the ability of top management to use its superior skills for decision-making and implementation of operating plans to determine the creation of economic rents. Scholars like Mintzberg emphasized the lack of organizational literature about the characteristics of managerial work. According to the authors, there were no empirical studies that would allow a description of managerial activity, and contributions that provide unitary and comprehensive view of the manager. Most of the authors who first dealt with the theme of managerial skills focused exclusively on one of the many dimensions of the managerial role: principally leadership (Likert, 1961, Fleishman and Harris, 1962) and decision-making (Barnard, 1938 Simon, 1947; March and Simon, 1958; Cyert and March, 1963). Only later, other studies have analyzed the broader spectrum of behaviors adopted by managers. Antonacopolou and Fitgerald (1996) define competences as “the virtues unique to each individual who are expressed in the process of interacting with others in a given social context”. Competences therefore are not limited to knowledge and skills, or to the expected performance standards and expressed behaviors; they also include attitudes, perceptions and emotions and are constantly defined and redefined by the interaction of personal and situational factors (social, political, etc.). Within the context of situational factors, social, formal and informal relations assume of particular importance, established with the members of the management team and the organization itself. The top management skills are the central element on which the model of managerial rents is pivotal, which considers the abovementioned critical skills in order to increase the firm’s

probability of success and thus its survival in a given context.[89] This model identifies the source of top management skills in the tacit measure of the underlying knowledge. It is precisely from the peculiarities of managerial competences that derive an equally peculiar concept of economic rent. The conceptualization of the latter has a strong link with the concept of the Ricardian rent, linked to the differences in productivity between scarce resources. Specifically, this model focuses on income derived from "superior" products and services to other companies or by highly efficient and organizational processes or routines difficult to imitate. The model also qualifies as a management rent the share of the firm's total profits deriving from the top management skills.[90]

To sum up, the qualification of the management rent concept emerges from a further consideration of how profit is understood within the model under consideration. It can be seen that the firm-specific character of such skills appears to stimulate the creation of quasi-rent rather than economic annuities as well.[91] It is inferred that where top management is distinguished for the accumulation of highly firm-specific human capital, its potential for generating income at another enterprise will tend to be lower.[92]

The theme of the appropriation of managerial quasi-rents occupies a very important area within the model precisely because it is necessary to protect these rents through appropriate isolation mechanisms. They are geared to ensuring the appropriation of the rents resulting from the managerial superiority of the executives compared to the attempts of imitation made by competing companies and attempts at expropriation abroad.

By synthesizing, as in the previous model, the distinctive features of managerial rents emerge: a) the treatment of corporate profits as "composite rent", incorporating, in its amount, quasi-rent arising from the exploitation of top management; (b) the close interrelationship between the generative and distributive processes of quasi-rent, so that the creation of the latter contributes to the profits of the enterprise only in the presence of adequate assurances of appropriation by management; c) the mitigation of the conflict between ownership and management in the light of a common tide towards the appropriation of their respective quasi-rent and the consequent emergence of the firm as a

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89 Eliasson G., *The firm as a competent team*, in Journal of Economic Behavior and Organization, vol 13.3, 1990.

90 Castanias R.P., Helfat C.E., 1992.

91 It should be noted that the notion of quasi-rent expresses the difference between the value of a resource in its first better utilization and the value according to the first alternative user.

92 Klein B., Crawford R., Alchian A.A., 1978.

"nexus of contact" capable of guaranteeing a more adequate coordination of the interests of distinct stakeholders.[93]

1.4.4 Rent Appropriation Theory

The theory of *ex ante* negotiation on the rent is a sort of compromise between the first and the second model presented. This theory, on the one hand (as in the model of entrepreneurial income), provides a more complete explanation for the processes leading to the generation of quasi-rent: in fact, the theory of *ex-ante* negotiation emphasizes the opportunities offered by the exploitation of the knowledge resource. On the other hand (with reference to the model of managerial rents) the theory under discussion provides a richer interpretation of the mechanisms of appropriation of quasi-rents.

From the point of view of the qualification of the concept of rent, the theory in question presents many points in contact with the model of managerial rents.[94]

In this latter area, in particular, various contributions demonstrate that the presence of asymmetries of knowledge may give rise to opportunities for *ex ante* negotiation on the retirement of certain categories of stakeholders.[95] Before describing the contents of that theoretical current in more detail, however, it does not seem superfluous to point out that both the "stakeholder" and the "asymmetries of knowledge" are assumed to have a peculiar connotation within it. On one hand, the term "stakeholder" refers to categories of subjects characterized by a strong interest in the development of new capabilities, or which can play a decisive role in this development, as it is triggered by the ability to capture the economic rent. On the other hand, the notion of "asymmetries of knowledge" identifies asymmetry-related conditions not so much of knowledge (know-what), but differences in so-called practical or procedural knowledge (know-how). In particular, according to the approach under consideration, there would be a significant source of negotiating power in the presence of asymmetries of knowledge. In fact, these are asymmetries that allow specific stakeholder categories to have access to a specific knowledge and innovative capabilities, unique and unavailable to other stakeholders. More specifically, the theory of *ex ante* negotiation on rent combines the very understanding of the link between competitive advantage and the generation of profits to the joint analysis of the asymmetries of

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[93] Volpe L., *Il profitto come rendita negoziabile,* CEDAM, 2013.

[94] It is from the model of managerial rents that resumes the Ricardian interpretation and the concept of resource-based of the rent, as well as the implicit vision of the enterprise as a "nexus of contract".

[95] Coff, 2010.

knowledge and the negotiating power expressed by various stakeholders in relation to the firm. Negotiating power, in turn, as a "normal" mechanism for the expression of property rights and, hence, of *ex ante* determination of the profitability attributable to specific stakeholders.

An element of the theoretical current under consideration appears to be particularly significant, namely the identification of profit as a key driver of government choices. Note Child: "it is customary to assume that a certain level of profit represents a return deemed at least sufficient to ensure the availability of the resources needed to implement present and future development plans."

To this purpose, it emphasizes the centrality of the processes that determine the appropriation of profit by distinct bearers of interest towards the firm, highlighting the influence they have on the process of generating profit. This theoretical line implies a conception of profit as a rent not only "composite" but also negotiable. The theory of *ex ante* negotiation on rent provides a more complex theoretical justification for the generative processes of quasi-rents linked to human capital of top management. This theory seems to integrate and extend the theoretical lens on property.[96] In order to fully understand how the firm's competitive advantage is reflected through profits, the theory of *ex ante* negotiation considers it inadequate to ascertain the existence of rent generation opportunities, in turn resulting from asymmetries of knowledge among different stakeholders. In conjunction with these asymmetries, this theory poses the need to analyze the negotiating power[97] of the various bearers of interest in the enterprise.[98]

Again, we can outline the fundamental points of the theory, among which: a) the peculiar nature attributed to profit as a "composite and negotiable" rent; (b) the relevance of the negotiating power of internal stakeholders (top-management) in determining the size of the "cake" generally appropriate by the firm, subject to the outcome of the *ex ante* negotiation processes on quasi-rent originating from asymmetries of knowledge for the benefit of top management; c) the emergence of a new concept of the enterprise as a "nexus of stakeholder", which integrates and extends the traditional contractual vision of the firm through the crossing of two commonly separate approaches: resource theory and Property Right Theory.

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96 Demsetz H., *Toward a theory of a property rights*, in American Economic Review, vol. 57, 1967.

97 It is understood as a "normal" mechanism for the expression of property rights and, consequently, for *ex-ante* determination of the appropriate share of profitable interest by specific stakeholders.

98 Milgrom P., Roberts J., 1992. See also Holmstrom B., Milgrom P., *The firm as an incentive system*, in American Economic Review, vol 84, 1994.

1.5 From profit to value creation and sharing

The awareness of the objective value of the enterprise, about the contribution to collective well being, is such as to overcome the most brilliant ideological dilemmas on the distribution of the wealth produced. In the concept that Amaduzzi provides for the production firms, the company's finalism is "clearly on the achievement of income in the economic sense of profit."

Profit gives meaning and measure to the value of the business; is the recognition of entrepreneurship, risk, success, even if determined with the competition of fortune. The value of the enterprise cannot be separated from that of profit; the correlation between the two sizes is certainly fascinating to convince a certain school of managerial thought to wager all corporate policy on the exasperated search for maximum profitability. The question that arises is yet another; are the reasons of the very essence of profit that must be pursued, beyond the objective conditions of economic equilibrium, in dual relativity, tendency in durable time and relational with respect to a compatible environment. The profit-generating function can not therefore be left out of a wider context of equilibrium conditions that also contemplates the assimilation of the system of risks, constraints and degrees of freedom to the business of the enterprise; conditions from which verification depends ultimately on the soundness of the judgment of economic value. Even this more advanced and in any case less simplistic approach to so many empirical or pseudo-rational formulations does not seem to make justice to the thousands of inconsistencies, contradictions and even abuse of evaluation. The transition to the analysis of the financial value of the firm's capital further entails the introduction of other variables relating to both the peculiarities of the trading and equity markets, and the strategic governance framework of equilibrium and conflict of interest. The result is particularly complex and it is difficult to think of formulating a value strategy based on a single proposition mission, goals and choices. It is therefore possible to approach an enterprise strategy approach and SBA (strategic business area) aimed at optimizing the objective conditions of the firm's economic equilibrium through research, achievement and exploitation of competitive advantage. Economic analysis through a "value matrix" obtained by crossing "business activities" with "business areas" can certainly favor the intelligence of selectively targeted interventions on the "value chain" and the "competitive differential". After that, the financial analysis goes through the formulation of a corporate strategy or group holding, through which the focus of the mission objectives moves to another order of business

profiles that, in addition to the value distribution, governance and, last but not least, conflicts and balance of interests in corporate governance.

The firm's economic value basically provides the ability to generate new wealth through the organization and management of integrated processes of production and exchange of goods and/or services.

There is thus an instrumentality link between the generating function of the wealth value expressed by the corporate system and the value of the enterprise itself.[99] One could say, emblematically: "the firm is worth because it creates value".

Prophetically to a proper strategic analysis of the value processes that concatenate the enterprise's economy, it is good to bring clarity to three essential points.

At the first point we note that if there is a logical correlation between the economic value generated by the firm, as a vital sign of its durable existence, and the value of the enterprise as such it, is equally true that the respective conceptual categories, as the "value generated by the firm" and "the value of the firm" must be kept separate, even though they are close to each other. Different is, in fact, the order of magnitude that characterizes them because different is the economic attribution and, likewise, the very purpose of their measurement, representation and interpretation. Is not questioned the interaction between the economic and accounting categories that respectively form the income and working capital on the one hand and, on the other, the firm's value.

However, even if we intended to commensurate the economic capital of the firm by abstracting the book value matrix, it would still be indispensable to surpass analogous or simulated processes, perhaps not entirely useless, empirically, albeit scientifically inaccurate. A "value accounting" set up to meet the need to determine the firm's economic capital can, in fact, be related to the connection with the accounting information system from which derive the original value generated by the firm. Quantities that proceed, as far as the flows, progressively configurable, from the market value of the product, to the added value, to the operating income, to the net income of the year. For capital, apart from the distinction between invested capital and risk capital, it is also possible to have interim situations (possibly three or four) to significantly influence the level of availability of resources. But, ultimately, it is on the fundamental relationship between operating income

[99] Amaduzzi argues that "the firm's function is to generate and auto-generate production processes and to achieve equilibrium conditions for an indefinite period" further observed that "even the problem discussed in theory of the firm's assessment as an economic complex can be better solved, if add the consideration of the degree of self-generating power of the enterprise to be evaluated". See A. Amaduzzi, Self-Regenerating Function of the Enterprise and Evolution of Principles, RIREA, no. 1-2, 1989.

and the average invested capital that, suitably "normalized", involves the further methodological development aimed at extrapolating and elaborating, directly or indirectly, the configurable firm's value as economic capital. It is, however, good to emphasize the different conceptuality between the classical accounting representation of "equity capital" or equity (understood as an abstract fund of values against which the profit for the year is compared) and that of "economic capital", quantitative expression of the firm's value. Diversity of the configuration and purpose of the equity capital and economic capital, which is reflected in their respective evaluations dictated by equally different principles, criteria and methods.

The second point to consider is that the financial statement is, in any case, an indispensable aid for the assessment of economic capital, and this is because of its congenital signposting behavior in revealing trends and situations, both and perhaps above all, high semiology induction that can be retracted by the skillful ones as experienced "financial analysts"; induction that can certainly benefit in assessing the compatibility of the firm's development plans with respect to the conditions in place of the firm's economic equilibrium. Conversely, it would be unwise to overestimate the chances of knowledge that the financial statement can offer, because the congenital limits are well known. One of the major constraints, perhaps the largest one, in the accounting and, in reflection, of the financial statement concerns the inadequate measurement and representation of the value of so-called intangible assets (patents, trademarks, technological know-how, intellectual skills, etc.) that even feed the value process as critical factors of success and, in any case, of competitive advantage. The so-called "intangible assets", although not detectable (unless explicitly disclosed in its cost) is a determining factor for the company's economic value and cannot therefore be ignored in any way. Moreover, it is also important to consider that accounting outweighs those exogenous circumstances to the enterprise and that, moreover, they are, in fact, true variables that complement the "combinatorial value calculation". We intend to refer to the various weighted "interest rates" on invested capital and corporate, market and environmental risk systems, the extent of which depends on the size of the economic capital. It is well known, in fact, as in increasing interest and risk wise, it corresponds, inversely, to the generalized decline in the firm's value.

The third point, certainly not least, concerns the analysis of the value for those firms that are in the company's possession and, in particular, those with quoted shares on the stock exchange. For such firms, the value of "stock market capitalization", as well as depend on the company's economic outcomes, the economic situation, and market trends in general,

is influenced by further multiplicity of circumstances to which attention should be paid. Of particular importance and consideration here are the firm's structural, corporate and financial evolutionary dynamics, which correspond to decisions of extraordinary or exceptionally intense strategic value. Nevertheless, the same corporate governance profiles for inherent expectations, interests, and consequent interventions can significantly affect, if not entirely, altering or disrupting the stock market trend, even in open contradiction with the "key indicators" of business economy.

Ultimately, the economic value of the enterprise, as a vital phenomenon, is the expression of the prospective conditions of equilibrium and development, both organic and functional, of the corporate system. As a magnitude, value commensurability requires more advanced tools than traditional accounting, while providing (in particular, the financial statement) indispensable basic information. Nor, on the other hand, as mentioned above, can rely on so-called "empirical methods" adopted by financial analysts, methods that, too often, have turned out to be clamorously fallacious; as well as mathematical-predictive models whose validity, though relative, if acceptable for large generalizations, is not at all demonstrable for individual cases. The answer that, more rationally, can enlighten the knowledge about the firm's value of the economic capital can only come from an unspecified "value accounting": an accounting, obviously, in the elliptical sense, that knows to conjugate the derivatives of the system of corporate training (statements and development plans) from which to portray the basic value's matrix, with further determinants (immateriality, interest rates and risk profiles) that complement the calculation of the enterprise's value.[100]

1.5.1 Stakeholder views

The seventies and eighties of the last century are characterized by a heated debate on business goals. Scholars led by Freeman (1984)[101] support the stakeholder theory,[102] which derives from the systemic matrix theories, then from those on "open systems", which currently convey the debates between enterprise and the context of reference. This highlights the simultaneous possibility of action and reaction between the enterprise and

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[100] See G. Bruni, *Contabilità del valore per aree strategiche d'affari*, Giappichelli, Torino, 1999.

[101] See R.E. Freeman, *Strategic Management. A Stakeholder Approach*, Pitman,Boston, 1984.

[102] Stakeholder theory consists in extending the mission of the enterprise to the pursuit of social instances; firm no longer focuses exclusively on generating profits to satisfy shareholders but is also geared towards promoting the well-being of society through the interplay of each interlocutor with whom it interacts.

the reference environment,[103] which refers to the complex interactions between the behaviors of the various third parties involved, which for various reasons have interest, condition or are conditioned by the choices of the organization. The latter is nothing more than a description of business reality that emphasizes the effects that productive activities generate on all involved parties, both internal and external. Therefore, the business, to achieve and maintain its own success, needs to have established relationships with the bearers of interest. It is necessarily to meet the expectations of those people whose behaviors can affect into the business success. "Relational" resources, though not intended as inputs in business processes, act and result in competitive advantage over competitors. This approach implies that not only the company, for its own success, needs support from bearers of interest but also that business success coincides with meeting the expectations of third parties involved. The firm therefore must not only act with the goal of maximizing profit but also with the aim of achieving the interests of all stakeholders[104] by distributing the wealth produced in a homogeneous way.[105] The stakeholder theory highlights how the company needs explicit and lasting commitment to the stakeholders,[106] far beyond the statutory obligations. From the experience, it is deductible that generating wealth for shareholders is facilitated by the presence of harmonic relationships with the surrounding environment and with the subjects involved: good levels of reputation[107] can facilitate value creation.[108] The stakeholder theory can be considered as "a genuine theory though a perfectible one".[109] The visual power of the model stakeholder and its simplicity has contributed to the success of the stakeholder concept. By doing this, stakeholder management, understood as a process through which managers manage to reconcile their

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103 See G.M. Golinelli, M. Gatti, *L'impresa sistema vitale. Il governo dei rapporti inter-sistemici*, in Symphonya. Emerging Issues in Management (www.unimib.it/symphonya), n. 2, 2000-2001.

104 Stakeholder's term originates from corporate strategy studies and is first published in a *memorandum* of the STANFORD RESEARCH INSTITUTE of 1963. Stakeholders are considered those groups without which an organization does not survive; see G. Rusconi, The Social Enterprise Budget. Problems and Perspectives, Giuffrè, 1988.

105 The other group of scholars argued that a firm that engages in social objectives to the detriment of earnings would only hurt society instead of helping it.

106 See A. Marra, *L'etica aziendale come motore di progresso e di successo. Modelli di organizzazione, gestione e controllo: verso la responsabilità sociale delle imprese*, Franco Angeli, Milano, 2002.

107 The image of a company with a good socio-ecological reputation is crucial to establishing loyalty relationships between consumers, workers, shareholders and the organization, for more in-depth information, cf. J.J.Lambin, *Changing Market Relationships in the Internet Age*, UCL Press Universitaires De Louvain, 2008.

108 See S.Pivato, N. Misani, A. Organini, F. Perrini, *Economia e gestione delle imprese*, Egea, 2008.

109 See F. Lèpineux, *Stakeholder Theory, Society and Social Cohesion*, Corporate Governance, n.5, 2005.

goals with the demands and expectations of different stakeholders,[110] has become an important tool for transforming ethical aspects into management practices and strategies.
We saw how Freeman published in 1984 the contribution entitled "Strategic Management. A Stakeholder Approach", which illustrates the plurality of third parties involved in business management and, moreover, "re-conceptualize the nature of the firm to encourage consideration of new external stakeholders beyond the traditional pool shakeholders, customers, employees and suppliers, legitimizing in turn new forms of managerial understanding and action".[111] The stakeholder theory[112] is certainly included in theories on open systems and is inclined to a balance between systemic rationality and subjective behavior. This theory provides a "new way to organize thinking about organizational responsibility. By suggesting that the needs of shareholder can not be met without satisfying to some degree the needs of other stakeholders".[113] The term "stakeholder" refers to a person or group of persons involved in the business activity or of which the enterprise is concerned: the biunique nature of the internal/external relationship between the enterprise and the context of reference is expressed. The firm can be considered as a system that involves all stakeholders and, therefore, attention is drawn to the network of relationships between the various subjects, both internal and external, which may have implications for the dynamics of the whole organization. Stakeholder management requires the identification of efficient methods of coordinating relationships with the many involved people interacting with the company and trying to match the often-diverging expectations of stakeholders with business. Instrumental vision means stakeholder management as a viable way to achieve business success; whatever is the purpose, stakeholder management fosters the achievement of the goal successfully.[114] The descriptive approach aims to represent the various third parties and their interactions, in fact, the enterprise is considered

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110 See A.B. Carrol, *The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders*, Business Horizons, July/August 1991; S. Sciarelli, Etica *e Responsabilità Sociale nell'Impresa*, Giuffrè Editore, 2007.

111 See J.Jonker, D.Foster, *Stakeholder Excellence: framing the evolution and complexity of a stakeholder perspective of the firm*, Corporate Social Responsibility and Environmental Management, 9, 2002.

112 Stakeholder Theory finds its moral foundation in the Kantian principle of respect for people, the principle that these subjects must be treated as fine in themselves and not merely as means for some end; see N.Bowie, *Management Ethics*, Blackwell Publishers, Oxford, 2005.

113 See D. Foster, J. Jonker, *Stakeholder Relationships: The Dialogue of Engagement*, Corporate Governance, 5, 2005; see also: D. Hawkins, *Corporate Social Responsibility: Balancing Tomorrow's Sustainability and Today's Profitability*, Palgrave Macmillan, New York, 2006.

114 Garriga e Mele say, "*Instrumental stakeholder theory assumes that the corporation is an instrument for wealth creation with CSR conceived as a strategic tool to promote economic objectives*", see E. Garriga, D.Mele, *Corporation Social Responsibility Theories: Mapping the Territory*, Journal of Business ethics, vol. 53, 2004.

a constellation of shared and conflicting interests among the various stakeholders; finally, the normative assumes that the firm must consider all stakeholders, respecting moral values or principles of a philosophical nature. Regulatory theory, as stated, requires that management in compliance with certain moral principles treat all stakeholders. Donaldson and Preston (1995) state that the normative value depends on two significant theses: the first implies that the stakeholders identify themselves because of their interest in the enterprise, irrespective of whether or not there is a functional interest of the enterprise towards them; the second assumes that the interests of all the different stakeholders are intrinsic value and deserve consideration for themselves in the managerial decision-making process, regardless of the ability of a particular stakeholder group to promote the interests of another group. These interests have intrinsic value, and then deserve consideration and respect, not just in the instrumental sense of other purposes.[115]

This theory contrasts with the argument supported by Clarkson, who classifies stakeholders in primary and secondary.[116] The company fails to survive without the constant participation within the corporate life of the main stakeholder group. The stakeholders are shareholders, investors, workers, consumers, suppliers and all identifiable stakeholders as public stakeholders, governments and communities that provide infrastructure and markets. Strong is the interdependence between the enterprise and those subjects. If stakeholders from the main stakeholder group, such as consumers and suppliers, become dissatisfied and move away from the enterprise system, even if only partially, would make the same vulnerable and weakened, unable to continue their business. Primary stakeholders, defined as "risk-bearers", are those who have an economic interest in the company that bear a risk. It is stated that the enterprise can be defined as a system of major stakeholder groups, such as a series of intimate relationships with the interests of the groups, although characterized by different goals, rights, implications and responsibilities. Business survival and continuous success depend on the ability of its managers to be able to create enough wealth, value and satisfaction for the stakeholders belonging to the different stakeholder groups to ensure that every single group is feeling part of the stakeholder system company. Excluding the participation of third parties is the cause of business system failures.

The secondary stakeholder group is comprised of those who influence or are influenced by the firm's business but are not considered fundamental to business transactions and are not

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115 See E. D'Orazio, *Verso una teoria normative degli stakeholder*, notizie di OLITEIA, XXII, vol. 82, 2006.

116 Cfr. M.B.E. Clarkson, *A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance.*

essential to the survival of the organization. This category includes media and groups with special interests.

Subjects included in this category have the ability to mobilize public opinion in a favorable way or contrary to company performance. The fact is that the company does not depend on its survival by the secondary stakeholders, although the latter may, by their behavior, cause considerable damage.

Management, though thought to be an employee of the company, is considered a bearer of interest in itself in relation to the important role-played. The position of management as stakeholder of the firm depends on the following factors: size and degree of company complexity, in fact, in large companies managerial delegation is more articulate and covers many aspects; the proprietary structure, as in the case of an unimpaired stock, facilitates the management's position; the implementation of incentive mechanisms, such as aligning management's retribution with the results achieved, thus balancing property expectations with those of managers, and finally the presence of an efficient financial market, which can affect the firm's choices as it allows the property to control the work.

1.5.2 Shareholder views

In the literature on business, the concept of value creation has long ago been recalled. The same companies have incorporated this concept into their vocabulary and use it often by identifying it with the goal of ordinary management and extraordinary interventions. Businesses must create value for their stakeholders.

Who are the business stakeholders? They are a plurality of subjects: they are clients, they are workers, the territory, and they are the creditors. A special stakeholder category is shareholders, then, risk capital providers.

There is a natural conflict between the interests of stakeholders, or at least some stakeholder categories, and those of shareholders. Here the role of financial markets comes into play. Creating value for shareholders means with a certain approximation to generate income, and thus, second, profit. Financial markets, more generally, are available to provide resources to businesses provided they create value. The rules of finance, as well as those of economic theory, are fair: those who create wealth gain further funding and ensure the prospect of growth. Financial markets tend to favor the shareholders' logic. It is to be said that the approach to the issue of value creation allows highlighting a European-Continental tradition to some extent opposed to Anglo-Saxon.

While the first tends to attribute equal importance to all stakeholders and to emphasize in this sense the need for moral behavior of companies, the second tends to attribute prevalence to the figure of the shareholder, or the bearer of capital. This leads to enhancing the relevance of the rules of finance and, from this point of view, to accepting severe rules of judgment by the market.

While it is now possible to highlight the continuation of the first dotted counterpoint, it is undeniable that the globalization process that has affected the markets in general and the financial markets in particular has led to an increasing homogenization of the firm's objective functions towards the Anglo-Saxon scheme. The recent events, all known, clearly show how the interests of the market (of shareholders) prevail over those of other stakeholders. It must be ethical behavior, understood as behavior that tends to a composition of the interests of the various stakeholders, to avoid a degeneration of market laws. The role of regulation that imposes these minimal rules is important, and needs to acts as a discipline and sanction element, but it is also necessary that internal forces be created for firms that address them towards moral behavior. From this point of view, a literature on intangibles in businesses should be reported, which are factors that affect the value of businesses in a way complementing their ability to create wealth and which can be synthesized in the culture and the business climate, managerial skills and ultimately, in the broad sense of morality that informs the management.

In the notion that the company is nothing more than a set of contracts, signed by a number of subjects, each in search of maximizing their utility, it is a commodity, bought and sold on a market at a certain price. In perspective of the shareholder view, corporate finance provides the methodologies for valuing the invested capital in the company and the decisions of the directors that influence its value. The assessments concern the estimate of costs, benefits, and inherent risks and consequent decisions on capital utilization.

CHAPTER 2
TOWARDS A DEFINITION OF PROFIT SMOOTHING

2.1 Smoothing

An earnings management strategy that has survived the test of time is smoothing (Buckmaster, 2001).[117] Smoothing is the dampening of fluctuations in the series of reported earnings. There are two types of smoothing: real and artificial.[118] Real smoothing involves making production and in- vestment decisions that reduce the variability of earnings. Artificial or cosmetic smoothing is achieved through accounting choices.

There are a number of differences between the two types. First, because earnings are a random variable that depends on past production and investment decisions, real smoothing is likely to precede artificial smoothing. Second, real smoothing involves decisions that reduce the volatility of economic earnings. In contrast, artificial smoothing involves both over-statement and understatement of economic earnings: It overstates low earnings and understates high earnings. In that way, the series of reported earnings has the same average as the series of economic incomes, but with lower variability.

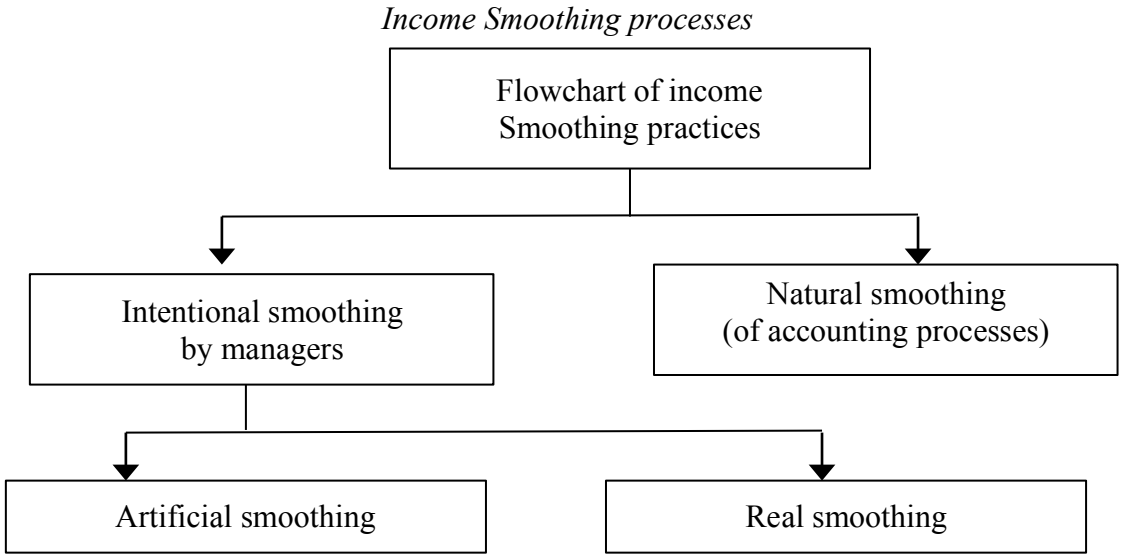

Figura 1. Income Smoothing process. Source: adapted from Eckel (1981, p.29).

[117] Smoothing has been studied extensively. For a survey of research before 1980, consult Ronen, Sadan, and Snow (1977); Ronen and Sadan (1981). An incomplete list of later studies includes the following: Belkaoui and Picur (1984), Moses (1987), Booth, Kallunki, and Martikainen (1996), Hunt, Moyer, and Shevlin (1996), Saudagaran and Sepe (1996), Subramanyam (1996), Carlson and Bathala (1997), DeFond and Park (1997), Chaney and Lewis (1998), Chaney, Coleman, and Lewis (1998), Oyer (1998), Barth, Elliott and Finn (1999), Godfrey and Jones (1999), Barth, Elliott, and Finn (1999), Hallock and Oyer (1999), Hwang and Ryan (2000), Payne and Robb (2000), Kanagaretnam, Lobo, and Yang (2004), Cheng and Warfield (2005), Abdel- Khalik (2006), Myers, Myers, and Skinner (2006), Tan and Jamal (2006), Tucker and Zarowin (2006), and Grant, Markarian, and Parbonetti (2007). See Buckmaster (2001).

[118] According to Ronen and Yaari (2007), there are two types of smoothing: real and artificial. Real smoothing involves making production and investment decisions that reduce income variability. In contrast, artificial smoothing is achieved through accounting practices.

Smoothing can also be pernicious; in that reported earnings are made to be close to an earnings trend line that differs from what management truly believes it to be. To the extent that smoothing is pernicious, the Sarbanes-Oxley Act (SOX) is likely to affect the relative occurrence of real and artificial smoothing. Intuitively, accruals management seems more appealing than real smoothing because it does not reduce the firm's value as much. On the other hand, real smoothing has the added benefit that it is less transparent and thus much harder to detect and deter (Ewert and Wagenhofer, 2005).

Now we try to understand the motivations to smooth along the two dimensions of capital markets and governance. The capital-market-oriented motivation centers on the informational value of smoothing and the demand for consumption smoothing. The governance motivation centers on the smoothing incentives of an agent in multi-period principal–agent relationships.

2.1.1 Capital Market

The capital-market incentives for smoothing can be divided into two categories. The first concerns the stock market; the second concerns the banking system, which allows individuals to borrow and save funds in order to finance private consumption.

2.1.1.1 Stock Market

The first question to be addressed is whether smoothing affects valuation. Practitioners seem to think that it does. Graham, Harvey, and Rajgopal (2005), surveyed chief financial officers (and officers with similar financial reporting tasks but different titles, such as controllers, vice presidents, etc.). [119]

Smoothing is beneficial when it conveys valuable information on future results. As Ronen and Sadan (1981) Chapter 3, Suh (1990), Sankar and Subramanyam (2001) have noted, smoothing can be beneficial by reducing distortions in market prices. To illustrate, suppose that the firm lasts two more periods. At the beginning of the first period, its books value is €10,000. By the end of the first period, it generates profits of €50,000. It is known that the second-period earnings are either €140,000 or zero with equal probabilities. The firm alone learns the true second-period earnings before it reports the first-period financials. Suppose that the second-period earnings are €140,000. The valuation of a firm that reports the truth is €130,000, which is the total of its first-period book value, €10,000, the first-period

[119] They report that 96.9% of their respondents preferred a smooth earnings path.

reported earnings of €50,000, and the expected second-period report (=1⁄2 x 140,000 + 1⁄2 x 0). Since the second-period outcome is €140.000, this firm's value is €200.000, so its value is underestimated by €70,000. In contrast, a firm which smooths the first-period report by reporting half of its total reported earnings at the end of the first period, €95.000 (=1⁄2 x (€50,000 + €140,000)), is correctly valued at €200.000 (=10,000 + 95,000 x 2). Smoothing, then, improves the information content of its reports.[120]

In this example, smoothing is accomplished by reporting the average earnings, which reduces the variability of reported earnings to zero. Yet any first-period report between €50.000 and €95.000 dollars would reduce the variability of earnings! This raises a question regarding the optimal degree of smoothing.

Chaney and Lewis (1995), and John, John, and Ronen (1996), provide answers that rely on the costliness of signaling value through smoothing. Chaney and Lewis analyze a two-period reporting model with two types of firms: high value, h, and low value, l, h > l, where the market cannot distinguish between the two. Since the first-period managed earnings must reverse in the second period, the reports of the two types in each period are as follows:

$$\tilde{R}_{J1} = \tilde{X}_{j1} + \gamma_j\left(\mu_j - \tilde{X}_{j1}\right) + \delta_j \qquad j = h, l \qquad (7)$$

$$\tilde{R}_{J2} = \tilde{X}_{j2} - \gamma_j\left(\mu_j - \tilde{X}_{j2}\right) - \delta_j \qquad j = h, l \qquad (8)$$

$\tilde{R}_{jt}$ is the report of a type j, j=h, l, in period t, t=1,2; $\tilde{X}_{jt}$ is the economic earnings, generated by a mean-reverting process, $\tilde{X}_{jt} = \mu_j + \varepsilon_j, \mu_j$ are the means, and ε_j are white noise terms with known variance. The reporting strategy is made up of two variables, the first-period smoothing variable, $\gamma_j, 0 < \gamma_j < 1$ and the first-period bias variable, δ_j.

Clearly, if the market cannot distinguish between the two types, it understates the value of a type-h firm and overestimates the value of a type-l firm. The type-h firm therefore has incentives to choose a report that separates it from the type-l. Chaney and Lewis prove that in a separating equilibrium, type-l firms report the truth, and the type-h firms combine smoothing with a positive bias that is costly because it increases taxes. Although this study

[120] Under uncertainty, beneficial smoothing can backfire when management's expectations are not realistic. In that case, smoothing increases the prediction error of the value of the firm (Hoogendoorn, 1985). To illustrate, suppose that the managers of both firms in our example erroneously assume that the second- period cash flows will be zero. Hence, to smooth, the firm reports €25,000 ((50,000+0)/2). The market's valuation now is €60,000, which underestimates the firm by €140,000, in contrast to the valuation of the truth-telling firm, €130,000, which is only €70.000 short.

calculates the optimal bias in the first period, clearly, there are many profiles of γ and δ that yield the same report. The equilibrium therefore is not unique.

In John, John, and Ronen (1996), smoothing results from signaling value to investors because of the tax implication of reporting profits earlier. The point is that a signal is valuable only if it is costly enough to deter low-value firms from mimicking high-value firms. Taxation provides such a signal, where shifting taxable income to an earlier period causes the series of reported numbers to exhibit a smoother path than the series of economic earnings.

Earnings management is neutral when it has no effect on cash flows. Goel and Thakor (2003), describe neutral smoothing. They analyze stylized rational expectations equilibrium. The firm's shareholders are principally uninformed traders, who, for liquidity reasons, must sell their shares after the publication of the accounting reports. They sell to informed traders, who acquire costly value-relevant information that can neither be communicated by the firm nor publicly observed without cost. The informed traders recoup the cost of the signal by trading with the uninformed traders, and the higher the variance of the firm's income, the greater the informed traders' profits and the higher the incumbent share- holders' losses. Hence, a firm's stock price is negatively correlated with its volatility. This provides the firm with incentives to smooth to reduce volatility. There are four possibilities along two dimensions: the firm smooths or does not smooth, and the market expect or do not expect smoothing. Clearly, in equilibrium, either the firm smooths and the market correctly expect it to smooth, or the firm does not smooth and the market does not expect it to do so. The latter profile cannot be an equilibrium be- cause if the market does not expect the smoothing, the firm can increase its price by reducing the volatility of the series of reported earnings. Hence, the only equilibrium profile is the former: (a) the firm smooths and (b) the market expects it to smooth.

Smoothing is neutral because the market undoes the smoothed report to learn the truth. In other words, the payoffs to all players are the same as the payoffs had the firm reported the truth and the market believed the report. The reason that truth-telling equilibrium is not feasible is that the dynamics are those of the "signal-jamming" equilibrium in sender–receiver games: If a deviant firm (the signal's sender) does not smooth, it is punished be- cause the ignorant market (the receiver) evaluates its income stream at a lower price to "correct" for smoothing. (These dynamics also drive Dye, 1988, discussed in Chap. 8; Stein, 1988; and Elitzur, 1995, discussed in Chap. 2).

Another study with neutral smoothing is Elitzur and Yaari (1995). The authors analyze

multi-period decision making by a manager who times ac- counting accruals and his trading strategy in the firm's shares during his tenure with the firm (his compensation package comprises a base salary, a bonus based on accounting earnings, and stock). Lifetime consumption considerations yield a smoothed series of reports. Smoothing is neutral if the market is perfectly rational with sufficient information to know the truth.[121]

Firms may have incentives to smooth without signaling management's true expectations of future earnings because they perceive that a lower variance in the series of reported earnings affects valuation favorably. (For an empirical documentation of the link between variance and the valuations based on reported accounting earnings, see, e.g., Bitner and Dolan, 1996; Hunt, Moyer, and Shevlin, 1996; Subramanyam, 1996; Hann, Lu, and Subramanyam, 2007.) The question is under what circumstances a firm can perniciously smooth in a rational market.

Pernicious smoothing can occur if the market lacks sufficient information (see the discussion in Elitzur and Yaari, 1995). It involves pooling equilibrium in signaling games, where pernicious smoothers mimic firms with a genuinely smoother earnings series. Trueman and Titman (1988), analyze the case in which firms take a loan. Because of the risk of bankruptcy, debt-holders require a higher rate of return for firms with more variable income. The fact that some firms cannot smooth gives sufficient credibility to the smoothed reports of firms that can to make it worthwhile to smooth. As Newman (1988), and others argue, it is not clear why firms with stable earnings will not take measures to distinguish themselves from those that try to pool with them to reduce their cost of capital.

Yaari (2005) shows that when firms wish to beat a target in future periods, the firm hoards reserves of reported earnings to beat the target. When current earnings are high, the firm understates earnings, which is consistent with smoothing. However, when, earnings are low, the understatement of earnings increases earnings variability (the opposite of smoothing).

2.1.1.2 The Banking System

Consumption smoothing can motivate smoothing of reports (e.g., Monsen and Downs, 1965; Dye, 1988; Suh, 1990; Christensen and Feltham, 1993; Sivaramakrishnan, 1994; Boylan and Villadsen, 1998; Haas, 2000; Sankar and Subramanyam, 2001; Srinidhi, Ronen, and Maindiratta, 2001).

[121] Smoothing is not innocuous when the market is unable to filter the noise in the report to learn the truth.

To illustrate the argument, assume that the firm lasts two periods, stochastically generating earnings of x_t, t=1,2, in each period. Because economic earnings are unobservable, the manager's compensation in period t, S_t, is based on the accounting report, m_t:

$$S_1 = S(m_1),\ \ S_2 = S(m_2)$$

The only restriction on reported earnings, m, is that in the long run they equal the truth; that is, given the firm's internal rate of discount, r,

$$(1 + r)m_1 + m_2 = y$$

Where

$$y = (1 + r)x_1 + x_2$$

Suppose that the manager alone has perfect knowledge of the second-period earnings, x_2, when the firm issues the first-period report, m_1. The decision on m_1 affects the timing of the recognition of the firm's value, y, between the two periods, because once m_1 is disclosed, m_2 is determined: $m_2 = y - (1 + r)m_1$.

If the manager's goal is to obtain a perfect consumption-smoothing path, $c_1 = c_2$, then if $S_1 = S_2$, perfect smoothing of the reports ensues, $(1 + r)m_1 = m_2 = y/2$.

The argument that consumption smoothing yields smoothed reports is based on two assumptions: first, it is presumed that the capital market is imperfect, so smoothing the reports is the only vehicle to achieve consumption smoothing. If the capital market were perfect, the reporting strategy would maximize total compensation, and the manager would achieve his optimal consumption path through transactions in the capital market.

Second, the argument assumes away the hoarding of compensation, which might affect the reporting strategy (Yaari, 1991). In other words, what prevents the manager from reporting y and earning S(y) in the first period and zero in the second period, and dividing consumption between the two periods by hoarding a portion of S(y) in the first period? Hoarding is optimal if the compensation is a sufficiently convex function of the report.

2.1.2 Governance

The relationships between smoothing and governance are captured by the principal–agent relationships between owners and managers. Owners face the challenge of designing a mechanism—a compensation contract—that induces the manager to make the "right

decisions."

A clue regarding the effect of moral hazard on smoothing is provided by the finite-horizon principal–agent literature, which documents that the cur- rent-period compensation must be conditioned on the history of outcomes (Lambert, 1983; Rogerson, 1985a; Christensen and Feltham, 1993, 2005). If the agent has the option to choose the timing of the report that is the basis of the contract, he is likely to smooth the stream of reports when the total of the reported numbers and the sum of the outcomes are equal. The question is whether the owners allow it. Allen (1985b) proves that a long-term contract dominates a series of short-term contracts because it allows inter temporal risk sharing and provides additional information. This result suggests that smoothing is likely to be desirable to the principal. On the other extreme, in the perfect capital market framework of Holmström and Milgrom (1987), for example, there is no difference between a contract that pays the manager periodically and a contract that pays the agent just once at the end of the contract's period; in such a framework, artificial smoothing is valueless, since the timing of reported earnings is unimportant.[122]

Admitting the manager's actions into the analysis leads to dividing our discussion between real smoothing—actions that produce smoother accounting reports—and artificial smoothing—smoothing merely the series of reported outcomes.

Real smoothing involves production and investment decisions. Oyer (1998), who studies smoothing by salespeople, explains how it is done:

> Consider a company that sells parts to car manufacturers. Car manufacturers are concerned with inventory costs and want to avoid buying materials they never use. Also, they are likely to purchase parts at a contracted price, so threats of future price increases are not an effective way to rush orders. Now consider a company selling complex and expensive computer systems to corporations. The sales-person may be in a position to share or hide information about price and technology changes. Similarly, the executives of the computer company can share or hide information from the public and sometimes even from the salesperson. In this way, unlike agents at the parts company, the computer salesperson and the executives for

[122] Additional studies that have dealt with a multi-period contract versus a series of short-term contracts include Townsend (1982), Fellingham, Newman, and Suh (1985), Fudenberg, Holmström, and Milgrom (1990), and Spear and Srivastava (1987), Malcomson and Spinnewyn (1988).

> whom he works can influence the date a computer is purchased and shipped. The computer salesperson has more opportunity to attain quota in current and future years, while computer executives can move sales to the year where they have the most impact on their own compensation.
>
> This timing influence, which I will call "timing gaming", can take two forms. The salesperson can "pull in" potential business from the next fiscal year to make quota this year, or the salesperson, knowing he has achieved quota or giving up for the current year, can "push out" business to the next year. Without knowing salesperson turnover rates and the form of the sales distribution, it is not possible to determine for sure whether the pull-in or push-out effect dominates. (p. 156).

Although the literature on the finite-horizon repeated principal–agent game had detected inter temporal links in the choice of actions (Lambert, 1983; Rogerson, 1985a), the first study that analyzes the connection be- tween moral hazard and real smoothing is that of Lambert (1984).

The analytical literature offers insights into the incidence of artificial smoothing in principal–agent relationships. The mechanics are similar to those presented in our discussion of smoothing under limited borrowing conditions (Penno, 1987; Sivaramakrishnan, 1994). When the agent knows current earnings and has an imperfect signal on future earnings, the agent smooths the first-period report around the future signal when he is restricted to communicating only the current period's outcome. Hence, although the current report is not truthful, it is forward-looking.[123]

Fudenberg and Tirole (1995), examine the reporting strategy of an incumbent manager who is anxious to keep his job. The manager has to cope with the reality of information decay, which implies that being successful one period ago is less meaningful than being successful today. They prove that the agent smooths the report: If it is very good news, deflating it by deferring reporting to the future "saves" it from the information decay. If the information is bad news, inflating the report ensures continuous employment.[124]

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[123] Artificial Smoothing.

[124] The importance of future earnings, emphasized by this model, motivates the empirical tests in DeFond and Park (1997), Elgers, Pfeiffer, and Porter (2000), and Payne and Robb (2000). For recent corroboration of the theory, consult Ahmed, Lobo, and Zhou (2006).

One question that has plagued the principal–agent works on smoothing is whether it is beneficial or pernicious to the principal. Demski (1998) formulates conditions for each case. The harmful case is obvious, in that artificial smoothing reduces the quality of the accounting message in its role as a monitor of the agent's effort because it garbles the message. Even here, however, there are different shades of gray, as, in some in- stances, the principal (weakly) tolerates smoothing. The beneficial case obtains when the opportunity for smoothing arises only if the agent exerts the high, desired level of effort.[125] Arya, Glover, and Sunder (1998), prove that smoothing can improve the welfare of a principal who cannot commit not to fire his manager in response to poor short-run performance. The threat of early termination of employment is costly because the requirement that the contract guarantee the agent his reservation utility level can only be met with a higher compensation cost. (This result depends on the parameters of the problem because earnings management is also costly; inflating the first-period report to cover up for poor performance delays the principal's ability to infer that the incumbent manager is inefficient and should have been replaced by a more efficient manager sooner.) Similar to Ronen and Sadan (1981), Suh (1990), and Sankar and Subramanyam (2001), show that the informativeness of smoothing is valuable, albeit costly, too. The former notes that the cost of smoothing is that earnings are a less informative signal on the agent's effort, and the latter observe that the cost arises from providing the privately informed, utility maximizing manager with more discretion over the choice of accounting treatment. Srinidhi, Ronen, and Maindiratta (2001), study the optimal reporting strategy of a manager who cannot access the capital market, but who can use his private knowledge of future outcomes to smooth his consumption stream in an infinite horizon model, through the smoothed stream of reports. They show that the manager smooths and that smoothing is a policy that satisfies the GAAP requirements of consistency, un-biasedness, and cash-flow convergence.

[125] This issue applies to the single-period case as well. Verrecchia (1986), analyzes the one-shot principal-agent game in which the principal does not observe economic earnings but knows that the agent can acquire at a cost a signal that improves the financial reporting so that it coincides with the economic earnings. Verrecchia shows that the principal may prefer to allow the manager to manipulate the report in order to obtain a better signal to monitor the agent's unobservable effort.

2.2 Real earnings management policies

Real earnings management policies consist of manipulating the firm's result through "*ad hoc* operations",[126] which also reflect on real activities and not solely on their accounting. In fact, in order to put in place such policies, it is necessary to actually execute transactions and enter into contracts with counterparties outside the company or group. Such actions are not accomplished in order to achieve the economic advantage that is usually associated with them, but "to obtain benefits that are not proper to that particular economic operation":[127] in fact, the will is to arrive at a desired representation financial statement, functional to the pursuit of further objectives, and real operations are a mere tool for achieving set goals. For example, if they consider it convenient to maximize their operating result, directors may decide to postpone the no-capital cost of research or development expenditures in order to avoid charging these costs in the income statement and thus not depressing the profitability of the period; in this way, management prefers the effects associated with short representation,[128] even at the cost of losing the opportunities and benefits associated with such discretionary expenses.

By way of example, with regard to transactions concluded with entities outside the company, managers may anticipate or delay discretionary costs, among which, in addition to research and development costs, even advertising or staff training, may modify ordinary maintenance on the assets, can act on sales prices or choose which asset to sell the instrumental assets (with the provision of plus/minus values).[129]

Intragroup transactions undertaken with the aim of achieving precise budgetary targets, such as trade in goods or services, are easier to achieve in order to allow for the accounting of the related costs or revenues in the financial statement of the companies belonging to the same group;[130] or, equally, easy to implement are the budget policies that are achieved through transactions between a single company and majority shareholders, such as formal

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126 The expression is made by Verona (2006, p.71): "In ad hoc operations, accountancy technique is not used to modify the interpretation, classification or valuation of management operations. In this class of budget policies, some of the operations are sometimes carried out, sometimes only formally, not in order to achieve their natural economic result, but to achieve the goal of being represented in the budget, giving the impression that they have been put into practice to achieve other ends".

127 See Verona (2006, p. 72).

128 Short-term.

129 See Florio (2011, p.21).

130 Severino (1992, p. 66) in his contribution refers to the case of *ad hoc* operations occurring within corporate groups, in which "an intercompany commercial or financial transaction may allow to conceal losses or perhaps reduce the pressure taxation, offset the positive performance of some companies with negative performance of others".

indebtedness towards third parties, which in fact represents an increase in risk capital by the shareholders.[131] All these *ad hoc* operations are characterized by greater feasibility because they are supported by the collaboration and trust between the various companies of the group or between a single company and members.

Returning to transactions with non-inside counterparts, according to Roychowdhury, in order to avoid any losses in the balance sheet, administrators may grant price discounts at the end of the financial year and thus temporarily increase sales, delay research and development costs, produce more than they plan to sell for the purpose of reversing part of fixed costs through inventory of finished products. In the opinion of the author, shared here, these decisions may, however, have a negative impact on the firm's value: for example, aggressive price policies to increase short-term profitability will potentially lead consumers to expect discounts in the future (with resulting in greater difficulty selling at the price list), while overproduction entails increased inventory management costs and generates excess inventories to be placed on the market in subsequent years.[132]

Conversely, if the purpose is to minimize the operating result, research and development costs or advertising costs are anticipated, the organization of personnel training courses is anticipated, or assets that are deemed to generate capital losses are anticipated too.

From the above, it is concluded that real earnings management policies are based on the management discretion of the directors and affect the time distribution or the amount of costs and/or revenues; these policies affect the normal business practices of the firm, deviating from the ordinary way of doing business:[133] "In order for this form of earnings management to manifest itself concretely, there is a need for differences in the ways and/or the times when an operation would was completed in the normal course of the operation and the manner and/or the times with which the transaction was carried out in order to achieve the target set.[134] However, real budget policies generally lead to a "purely formal result" from a middle to long-term perspective:[135] the configuration or timing of management operations is changed in order to achieve predefined revenue targets for the

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131 In this regard, Verona (2006, p. 73) writes: "Formal indebtedness towards third parties, which essentially hides an increase in risk capital, could be identified as a fictitious operation. This is, in practice, a real risk capital increase made in the company by the shareholders and masked by a formal subscription of "loan to third parties"".

132 Verona (2006, p.75).

133 Roychowdhury S. (2006), *Earnings management through real activities manipulation*, Journal of Accounting and Economics, vol. 42, n. 3, p. 338.

134 Florio (2011, p.22).

135 Verona (2006, p.72).

period but this entails adjustments in the opposite direction in the coming years, in fact with a neutralization of the total real effects. For example, if the company reduces R&D or advertising spending in the current year, it is presumed to be forced to increase these expenses in subsequent periods in order to support growth and image not adequately sustained in the past; or where the company has given customers favorable discounts or favorable terms of payment to speed up sales at the end of the year, they may encounter more difficulties in the future to market the product under the standard conditions and will therefore face a contraction in demand.

An element that unites all real earnings management policies and distinguishes them from those of accounting profit management is that "the use of management discretion affects the real economic and financial situation of the firm and not just the representation of that is given in external information":[136] such policies, in addition to having a real (and not merely appraisal) impact on the result of the period, also reflect the actual cash availability of the firm or its debit and credit standing.

However, these are operations whose concrete instrumentation is difficult to recognize as they fall within the usual commercial operations, which are solely attributed to the discretion of the directors in the management of the company: it is not possible to distinguish with absolute certainty which of these are implemented solely for reasons of economic convenience, present or prospective, and which ones are performed on the basis of the achievement of a predefined earnings-related earnings in the financial year.[137]

2.2.1 Earnings management policies based on end-of-period valuations

On the other hand, it is more significant for the purposes of the subsequent development of the work to focus on the earnings management policies that take place through accounting maneuvers when preparing the financial statements or already during the year. These budgetary policies are based on the technical discretion available to those who are in charge of these tasks, or with decision-making functions for the purpose. Unlike the real earnings management policies do not affect the firm's reality, but affect only the economic-financial representation that is being made.

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136 Mattei M. M. (2006), *Dalle politiche di bilancio all'earnings management,* d.u.press, Bologna, p. 113.

137 See also Schipper (1989), in *Commentary on Earnings Management*, Accounting Horizons, vol.3, p.92: "*It might be difficult to distinguish empirically between investment or production decisions (such as choosing the level of expenditures on research and development or on advertising, adding or dropping a product line, or acquiring another firm) that are undertaken purely to maximize share values and those undertaken purely to manage earnings*".

Accounting earnings management policies may, in turn, be distinguished depending on whether the margin of maneuver affects the classification of the values in the financial statements or concerns the valuation of accounting positions at the end of the financial year. In this work, policies of the first type are omitted and this second subset, which is known in the literature with the term accrual earnings management.

This denomination derives from the term "accruals", which refers to those non-monetary income components (including the devaluation of goodwill) or that during the year they did not have a monetary manifestation because they refer to non-monetary processes still terminated at the end of the financial statements. These components originate from the assumption that the financial statements have to be drawn up in accordance with the principle of economic competence (at international accounting standards it is referred to as accrual basis), which requires the recognition of costs and revenues at the time of their economic maturity regardless of their monetary manifestation. These are unreliable values, which can not be determined in a unique and absolute way, and therefore require an inevitable assessment of management at the end of the term: it results in estimated and conjectured values, which are easy to implement budget policies,[138] or to provide a distorted and trendy representation of reality.[139]

The need for knowledge and decision making to reach a result of the period cannot therefore be ignored by the technical discretion implied in the assignment of a value to posts reflecting transactions that are still ongoing at the end of the financial year. International accounting standards take note of, for example, leaving various options in the valuation of an accounting item (such as the FIFO method or the weighted average cost of valuation of inventories), requiring the budget drafters to estimate the presumable recoverable amount of a immobilization in order to make any impairment at the end of the period, require management to allocate common costs over several years and, more generally, to grant valuation benefits that enable the implementation of earnings management policies.

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[138] Coronella (1997, pg. 48), referring explicitly to accrual earnings management, defines fiscal policies as "*attitudes to the instrumental use of valuations, in order to show an inconsistent economic, financial and asset situation, more or less distant from reality*".

[139] Ronen e Yaari (2008, pag. 371-372): "*Accruals arise when there is a discrepancy between the timing of cash flows and the timing of the accounting recognition of the transaction*". The authors then distinguish between accruals normally related to the level of activity of the enterprise and the accruals that derive from the exercise of a certain discretion by the directors: "*Non-discretionary accruals are accruals that arise from transactions made in the current period that are normal for the firm given its performance level and business strategy, industry conventions, macro-economic events, and other economic factors. Discretionary accruals are accruals that arise from transactions made or accounting treatments chosen in order to manage earnings*".

The presence of accruals therefore results in an in-eliminable discretion, which, however, "must not be used instrumentally to eliminate the impartiality of the budget, should not be used by the directors as a pretext to take advantage of the option of arbitration".[140] In fact, the presence of potentially manipulable values does not in itself lead to information that is certainly untrustworthy, but simply facilitates any opportunistic behavior of the budget editors. It is desirable, however, that directors are not instrumental in end-of-term valuations to pursue corporate or personal goals but rather take advantage of the discretion granted to provide a true representation of the firm's financial position and financial performance.

Accounting earnings management policies may affect the most varied accounting positions and the maneuver spaces in the determination of these values are used to alter the quantitative size of the economic results in both directions:

- for example, they can help to improve a disappointing operating result both over valuation of stock inventories and alignment of asset value at the higher current fair value;
- by way of example, in order to reduce the profit, discretionary charges can be used, such as higher amortization or provisioning provisions, or can avoid capitalizing on costs that could be deferred in future years.

The areas of discretionary valuation afforded by the international accounting standards also allow a considerable variation in the value attributed to the financial statements and therefore may have, individually or cumulatively, a significant impact on the result of the individual financial year. However, Mohanram (2003) points out that accounting policies implemented through accounting maneuvers can be considered inter-temporal transfers between administrative periods and are usually neutral in a long-term perspective:[141] firms can have the convenience of "taking loan" or to "save" income shares from or for future years by anticipating or deferring income and expense, but such valuation choices generally have no impact on the total income recorded by the firm over its life. In fact, "the fiscal policies that rely on estimated and conjectured income components (…) do not exhaust their effects in the implementation exercise, but have an opposite effect on the

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[140] See Verona (2006, p. 29).

[141] Mohanram P.S. (2003), *How to manage earnings management*? Accounting World, p. 6: "Earnings management can be considered an "inter-temporal" transfer of income between periods. If a firm is aggressive with its accounting, it is in a sense borrowing from the future. If a firm is conservative, it is saving up for the future. None of this matter is in steady state, because of the natural reversal in accruals".
Similarly, with regard to income minimization and income maximization policies carried out through accounting manipulations, Ronen and Yaari (2008, page 342) write: "Since the total reported earnings and total cash flows are equal, the present minimization will lead To future maximization, and *vice versa*".

performance of one or more subsequent years".[142] By way of example, if the budget drafters assign a high value to finished product inventories in order to increase the positive income components and inflow the balance sheet assets, in the following year this will automatically result in a negative component of equal amount, with a counterpart impact in the profit statement.

In the following, considering only earnings management policies based on end-of-period evaluations, an analysis of the various implementing modalities with which these practices can be carried out is carried out. In particular, one can face a policy of income smoothing where the goal is to stabilize incomes during the financial years, to minimize income strategy or, if necessary, to big bath earnings management if the directors tend to break the result of period, to income maximization practices where management is acting in view of achieving the highest achievable profit. These cases do not exhaust the many behaviors that may be related to budget policies, but represent the most widespread and most popular forms of earnings management in the literature.

2.2.2 Income smoothing policies

The income smoothing policies consist of an attempt to level the incomes, possibly along a growing trend: the will is to provide a stable business image of the income earned, avoiding large fluctuations in the level of profits that could perceive the firm as the most risky. Therefore, through taxation equalization policies, administrators mask the variability of operating results, trying to make a non-existent earnings-related equilibrium appear over time.

The target threshold to be reached, in the perspective of income smoothing, is identified in the result of the previous year, which "must be at least reconfirmed and possibly improved",[143] albeit with low increases, compatible with further slight gains in the coming periods. Stability maneuvers are therefore long-term policies that require monitoring and ongoing intervention by the directors, in order to allow "coordination" with the income results of contiguous exercises: "It is necessary, in fact, that the compressions and expansions of accounting income are carried out systematically with the relative increases and reductions in actual income. It is therefore not a matter of increasing or decreasing the

[142] Florio (2011, p.26).

[143] See Florio (2011, p. 50).

accounting income for contingent reasons and irrespective of the outcome of previous or subsequent years".[144]

Consequently, if the result for the period does not reach or exceed the target value represented by the economic result of the previous financial year, the directors take corrective action to increase or reduce profit appropriately: in favorable terms they make provisions or charge higher discretionary costs, in the adverse periods they use funds, turn to the future negative income components, or try to anticipate revenue. Therefore, unlike the earnings management forms, in this case the direction of manipulations is not univocal, but varies according to how the result before the accounting maneuver is compared to the result of the previous year.[145] With particular reference to goodwill, income smoothing policies can be achieved by affecting, on the basis of the need for representation, the impairment loss recognized as a result of impairment tests: specifically, if pre-policy earnings management profit exceeds the target income to be achieved, management should intervene accounting for a goodwill devaluation for a higher amount than that resulting from a neutral valuation in impairment testing; conversely, in the event that the result *ante* budget policies is lower than the result of the previous year, the directors should manipulate the test results in order to avoid entering a goodwill impairment value or otherwise to detect it for an amount lower than that actually due.

Management takes such policies because that stable results are desirable both at the time the company presents itself and is involved with the capital market and in dealing with other corporate realities. Considering the firm least risky in terms of earnings strength, shareholders should be willing to receive a lower remuneration from the invested capital; similarly, considering the most reliable solvency business, external lenders should be more inclined to grant more favorable credit rates: all this would result in lower capital cost for the firm, with safe benefits in terms of capacity self-financing. At the same time, suppliers and customers, relying on the firm's ability to continue over time due to its stable profitability, may want to start with this long-lasting business relationship, also by offering better terms about offered services or payment terms.

Always with regard to the stakeholder-to-business ratio, the stabilization of distributable profits is very often effective in ensuring the stabilization of dividends, and thus allowing a

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144 See Verona (2006, p.171-172).

145 Ronen and Yaari (2008, p.383), with regard to income smoothing policies implemented through accounting choices, thus expressing "artificial smoothing involves both overstatement and under statement of economic earnings: it overstates low earnings and understates high earnings. In that way, the series of reported earnings has the same average as the series of economic incomes but with lower variability".

constant remuneration of the shareholders. In addition, stable or slightly increased dividends, due to their financial and economic strength, usually have positive effects on the corporate image: the ability to generate a constant cash flow is positively perceived by the market and can have a positive impact even on stock capitalization.

2.2.3 Big bath earnings management

A behavioral manipulation of the alternative economic result compared to the one described above falls under the name "big bath earnings management".

Big bath earnings management is concerned when, in a year already characterized by losses or inadequate performance compared to market expectations, budget drafters are working to further decrease this result by overestimating the costs of expertise. In essence, it is considered that managers take advantage of an already negative result to record even heavier losses.[146]

To account for additional budget costs, management may especially focus on estimated and conjectured amounts: fund provisions, high depreciation of assets, under-valuation of stock inventories, heavy devaluation asset due to impairment tests. In particular, with regard to goodwill presented in the balance sheet, it may be expedient to record a significant "*una tantum*" devaluation in an already negative exercise, perhaps avoiding further value reductions in near future financial years.

The underlying reason for adopting these policies is as follows: in the impossibility of achieving the goal result -or zero, the income of the previous year, the expected profit from shareholders or analysts- overestimates the discretionary costs and exceptionally devaluate assets in order to reduce costs (including depreciation) and impairment losses that will occur in the following years. The attempt is to create the "prerequisites for improving the firm's future performance"[147] by anticipating accounting positions that could have a negative impact on the result of subsequent periods.

The underlying expectation is that "the achievement of a non-recurring loss of budget is somewhat "offset" by the market, as financial analysts and investors tend to focus on future income"[148] expectations rather than on income in the final balance. In addition, investors' reactions to the announcement of non-achievement of the expected outcome

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[146] The expression "to take a bath" means, in fact, to suffer a major financial loss.

[147] See Florio (2011, p. 56).

[148] Florio C. (2007), *Impairment test dell'avviamento e big bath earnings management: alcuni riscontri empirici,* in Rivista dei Dottori Commercialisti, vol. 6, p.1201.

should not differ in proportion to the recorded gap: less than target results are perceived in the same way as the market. Therefore, the firm should not be strongly affected by the further worsening of operational performance driven by earnings management practices.
In addition, Tokuga and Yamashita (2011) observe that the likelihood of big bath policies is very high in the face of a change in management. According to the authors, firms seek to use the upgrading to the vertices as an opportunity to remove those elements that may put pressure on future performance. In particular, newly appointed management could experience heavy losses in the first year of office and try to take responsibility for the management that preceded it. The two authors then report the case of a "friendly change"[149] between predecessors and successors: in this case, large devaluation and other discretionary costs are accounted for by the management outgoing at the same time as the resignation, so that the new summit to achieve a satisfactory income as a result of its establishment at the top of the company.

2.2.4 Income minimization and income maximization policies

The other two forms with which earnings management can be presented are income minimization and income maximization. As we can easily deduce, it is about income minimization or income maximization if the behavior of the directors is oriented, respectively, to the reduction or maximization of the operating result. The two policies are in the opposite direction; in fact, as has already been observed, the intervention of the directors is not always aimed at improving the performance of the income but depending on the needs of representation and the objectives pursued, may have a different impact on the budget of the manipulative policies put in place.
In the policy of income minimization, in fact, the due prudential appreciation of the firm's facts when drafting the financial statements (which involves "reasonable underestimation of the firm's assets")[150] is shifted from the deliberate and tendency to minimize the profits of the directors, but the distinction between these two attitudes is not easily

[149] Tokuga Y., Yamashita T. (2011, page 2) divide managerial changes into hostile and friendly depending on the relationship between outgoing and incoming directors: "*Changes of management can be divided into "hostile changes" and "amicable changes" according to the relationship between the predecessors and successors. Hostile management changes involve hostile relationships and amicable management changes involve amicable relationships*".
[150] The expression is making by Severino (1992, p. 61). In preparing the financial statements, the IAS / IFRS principles require a prudent appreciation of company facts in order to secure third parties that have business relations.

recognizable:[151] there are in the case of earnings management practices where in the assessment freedom there is no limitation to prudence so to say "rational", but tend to exceed in the cautionary assessment of some economic values in order to voluntarily cut the income to achieve a predetermined goal.[152]

The income minimization policies can be implemented by underestimating positive components of income or by overestimating the negative components: as an example, possible ways of implementing are the underestimation of inventories of finished products, excessive provisions for future expenses or losses, the recording of substantial devaluation of tangible and intangible assets (including goodwill). Such manipulative operations correspond to undervalued assets or over-valued items: assets recorded at a book value lower than the real value, less inventories in state assets capital, funds constituted in a deliberately excessive amount compared to the actual needs.[153]

Minimizing policies, underestimating invested capital or overestimating passive assets, originate in hidden reserves,[154] which in turn are a source of self-financing unclear. In fact, the negative components of income that are charged to the income statement (such as higher amortization, devaluation asset, fund provisions) do not result in a related cash outflow, while reducing the result for the period. This prevents the release of financial resources in the form of taxes or any dividends and these resources remain in the company's willingness to proceed potentially to further investments or the financing of current management activities (unless the resources are absorbed from commercial credits or have not already been invested in other assets): non-disbursement is, in fact, a source to

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151 Pini (1991, pp. 90-91), with reference to budgeting policies aimed at minimizing income, he comments: "*It is not always easy for the expert budget user, or for the social control bodies, to understand if the outcome of the evaluations expressed is the result of an estimation reasoning in which the reference to the prudence mask, at least in part, is the voluntary nature of the error which results in deliberate underestimation of the asset or over valuation of the liability of the balance sheet* (...)".

152 Courses (2013) stresses that, in the context of international accounting standards, prudence "*is cautious in exercising the judgments necessary to carry out the required estimates in uncertainty so that the activities or Revenues are not overstated and liabilities and costs are not underestimated"*. The author continues to point out "*improper and excessive application of this principle* (...) *would lead to the creation of occult reserves, thus affecting the reliability of the budget to which the same prudence is subordinated"*.

153 Verona (2006, p. 222) notes that some funds, which are allegedly in nature, may voluntarily be set-aside for an excessive amount. It also adds that "the provision of the" credit risk provision "is one of the transactions with the highest degree of subjectivity between the various liabilities of the liability: it is difficult for the directors to carefully determine the degree of solvency of the loans, often in their own Valuations are affected by the incidence that these provisions may have on the result of the exercise. "

154 The term "hidden reserve" also refers to those funds that are improperly constituted by provisions exceeding the economic needs, which, as they are inflated into the balance sheet, increase the liability, and at the same time reduce the profitability and consistency of the company's assets.

enable greater autonomy of the enterprise from a financial and asset point of view.[155] In addition, the lower net profitability is only temporary and allows subsequent earnings to record higher results thanks to the reduced or absent amortization of fixed assets, the utilization of the provisioned funds, and the lower negative components due to initial inventories: the income reduction measures in the exercise affected by income minimization policies, it is precisely the creation of hidden reserves to which they draw in subsequent periods.

Going to consider the reasons for implementing such policies, it should be noted that the reduction in the period's result is usually aimed to bring the profit back to a qualified level as satisfactory, that is to say that it reaches the target but does not distance itself excessively upwards. This will arise from the consideration that there are few benefits from the wide over-targeting of earnings, and investors and financial analysts are likely to revise their forecasts for future performance, resulting in greater difficulty for the company to reach them and therefore more likely that expectations are easily overlooked in the coming years.[156] Any disappointment in expectations in subsequent periods, on the contrary, may result in disinvestment by shareholders and a fall in stock prices.

This form of earnings management can also be used in order to depress the share price before buying a treasury stock from the company or corporate tops. In this case, the reduction in the result of the period is functional to bring out lower distributable profits and presumably reduced dividends;[157] Such circumstances may be perceived by the market as a negative sign and, consequently, may result in a downturn in the share price that facilitates buy-back transactions by the firm or a possible increase in the management concerned to acquire control (the so-called management buyout operations): the firm or the directors are facilitated in their intent since they can guarantee the purchase of the securities at an "subsidized" price. Administrators could also resort to income minimization policies and thus cause a temporary reduction in stock price quotations simply for speculative purposes:

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155 Severino (1992, p. 59) makes reference to this aspect of income minimization policies: "*By controlling the budgetary values in a restrictive sense, a consolidation of the company can be achieved in terms of financial autonomy and capital. In this way, the available profit is reduced as dividends payable to shareholders and thus reduces the possible flow of company's "forces" to the outside*".

156 Mohanram (2003, p. 3): "*When firms are way above their targets, they may again have an incentive to reduce earnings. Typically, there is little benefit in going way above a benchmark.* (...) *Further, reducing the extent of over-performance prevents the ratchet effect. The ratchet effect is when expectations are adjusted upwards when performance is strong. If firms do too well, expectations for the future are adjusted accordingly making future targets more difficult to attain*".

157 In the absence of adequate reserves of distributable earnings, a reduced operating result has a direct impact on the dividend policy.

this is a phenomenon known as insider trading. In this case, managers take advantage of the private information they have (unlike the market) to obtain personal benefits that, in the present case, consist of acquiring stock of the company they administer at a price that they know they are underestimated and therefore profitable, and then proceed to a sale of the package when quotes are regenerated, in line with the true economic value of the business.[158]

Finally, the policies under consideration are also often implemented to reduce the excessive tax burden that would otherwise entail on operating income prior to manipulation. For this purpose, however, the devaluation of tangible and intangible fixed assets is not possible. In fact, if the firms, following impairment tests, align the carrying amount of asset to the less recoverable amount, this devaluation does not account for taxation and therefore does not allow cutting the taxable income.[159]

However, at the end of the financial year, which is affected by the implementation of income minimization policies, the firm's economic situation is worse than the actual one. Generally speaking, the effect is a minor or a lack of dividend distribution (which is equivalent to greater financial holdings retained within the enterprise), and a related occult strengthening of the assets. At the same time, however, the corporate image may be affected, and therefore, may be negative financially: debt service providers could experience a higher risk of insolvency and thus increase the rate of interest on loans; for their part, shareholders, considering the low level of dividend pay, may be more reluctant to invest further in the company in the event of a rise in share capital or even may be induced to divest the shares already held. Therefore, if the management decides to implement such budget policies, it must also consider carefully the possible counter-effects that could counterbalance the results that they are aiming to achieve.

Conversely, income maximization maneuvers have a counterproductive purpose compared to those of the newly treated policies, that is to say the outcome of business management is better than it really is. In order to maximize the operating profit, administrators can

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158 In theory, the quotation price of the shares should reflect the present value of the future dividends to be distributed by the company, which in turn represent the economic value of the company. However, at any time, stock prices may not be perfectly aligned with that economic value because of the lesser information available to market participants: in particular, prices may be affected by the manipulation of the financial results executed by managers who, not being caught as such by the market, entail a misguided revision of expectations (up or down) about future dividends and a consequent adjustment in investment decisions by shareholders. Faced with these situations, directors can take advantage of mispricing to purchase/sell securities depending on whether the shares are undervalued or overvalued, respectively, over the firm's economic value.

159 Cipriani V. (2013), *Ias/Ifrs, dal bilancio a Unico: immobili, impianti e macchinari*, Fisco Oggi Rivista Telematica, 2013.

overestimate the positive income components or underestimate the negative components. Amongst the multiple maneuvers to which leverage can be made include over-valuation of inventories, postponing future assets recognition of asset value losses (including devaluation of goodwill), depreciation of reduced amortization or non-provisioning to funds. The above-mentioned manipulations, therefore, aim to provide a better representation of the firm's financial and capital situation than the actual one and, if necessary, allow for no losses already occurring. Generally, they can bring benefits in terms of corporate image perceived by stakeholders and consequently allow for easier access to finance or subscription capital increases. In the latter case, among other things, due to the tendency of an increase in share price due to good performance, the company is guaranteed greater financial income when placing new shares in circulation: in fact, with the same share capital increase, the company has a higher price than the nominal value of the shares, and this difference consolidates the firm's assets as a share premium reserve. Moreover, interventions aimed at maximizing the result of the period are often explained by the need not to violate the clauses contained in the financing contracts and thus prevent the occurrence of a re-negotiation of the loan on more difficult conditions for the enterprise or with the will to temporarily support stock market quotation, particularly in the context of extraordinary transactions or capital increases. In addition, management may use such accounting maneuvers for strictly personal purposes, such as receiving a higher remuneration, where this is partly variable and depends on achieving certain income levels or in order to obtain the re-appointment of the assignment. In the present case, in the case of the renewal of the Directors' duties, income maximization policies can be found to mask poor income performance and thus avoid being foreclosed or obtaining a higher benefit allowance in the event of a failure reconfirms or, alternatively, to occupy better occupation, as a role in the direction of society, following the turnover.[160] Finally, as regards income minimization policies, management may be induced to inflate the firm's share price through manipulation of rising earnings, in order to take advantage of over-valuation of the securities to sell at a reasonable price the shares in its possession.

However, at the same time, income maximization policies determine the unfavorable impact on the enterprise. First, the company has to sustain a higher tax burden than what it would have on real income, with no ups and downs. That is, unless the positive components of income recognized in the financial statements are fiscally irrelevant or the

[160] Ronen e Yaari (2008, p. 93).

deferred costs for future periods are not in any case unjustifiable.[161] Another negative aspect of the policy of income maximization is the fact that as accounting manipulations aim to inflow the profit leads to a progressive redemption of the capital, i.e. there is a dummy increase in the net equity because it does not correspond to an actual value of assets or other assets, net of liabilities: Florio points out that the value shown in the financial statements "is more than the capital actually available to the business and economic reality".[162] This situation leads to a potential injury for creditors and members who, on the basis of the financial statements, are led to trust in a wealth that is probably only apparent. This may also be reflected in the potential distribution of profit (dividends) not actually earned, with relative depletion of the firm's assets: dividends distributed possibly are in part without an economic foundation and, more importantly, weaken the enterprise from a financial point of view. Even in the case of income maximization policies, management must evaluate and weigh the benefits and risks that arise from the implementation of such budget maneuvers: in particular, it must be aware that, in the event that the shareholders' meeting decide on a distribution of dividends, in the face of profitable distributions only fictitious, there is an actual liquidity subtraction to future business management and this could seriously damage the enterprise.

2.2.5 Underlying reasons for the implementation of financial statement policies

At the conclusion of the paragraph and this brief overview of the main aspects of earnings management policies, it is appropriate to systematically present the various incentives underlying the impairment of the economic result for the year and, more generally, the statement of financial position presented in the financial statements. In fact, in presenting the conceptual definition of earnings management policies, it has been observed that, in order to be in the presence of such practices, there must be a potential purpose underlying the accounting or management maneuvers.[163] It is now time to go for the "real cause" that drives management to implement financial statement policies, the ultimate goal that is to

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[161] What is meant here is that inflating the positive components of income or avoiding the inclusion of negative components, the company goes to higher taxation. However, if these factors are of no relevance to the tax discipline, even the misalignment between the tax load before and after manipulations does not occur.

[162] See Florio, (2011, p. 54).

[163] With regard to this aspect of budgetary policies, Severino (1992, p. 81) in his contribution thus states, "*in order to arrive at the budget maneuver, it is necessary to pursue certain objectives which are not aligned with the faithful representation of the economic situation, capital and financial assets of the company".*

be achieved. The reasons why, in part, have already been mentioned in the course of the discussion are explained and argued.

Firstly, it is important to say that businesses and groups are not self-contained, but interact with stakeholders in various ways that make up the surrounding environment. As they are embedded in such a wider context, their operation is affected by constraints and interactions with the external environment, and administrators, aware of this, may have the convenience of providing non-neutral information on the economic and financial situation to influence third party investment or financing decisions. In essence, management takes advantage of information asymmetry about business performance, which characterizes the relationship between both external and internal stakeholders, and exposes a not entirely faithful contest to affect the convergent interests of the company in various ways and to make sure that an image is found in favor of the achievement of the goals pursued by the directors. Management therefore resorts to financial statement policies to generate positive (or sometimes even negative[164]) opinion about the firm's economic and financial dynamics in interest bearers and thus to avoid adverse reactions to the external environment which otherwise are feared could arise where it comes exposing the actual business situation or actively influencing and activating stakeholder attitudes in order to reach well-defined goals.[165]

Ultimately, with a capacious representation of business management and conscientious dissimulations of the firm's real income, financial and equity position, the directors seek to direct third parties to behaving in a manner consistent with the particular purposes they intend to achieve. In this aim of creating false expectations in the economic operators outside the firm or in any case in the subjects not directly involved in the management activity, the administrators can leverage the least degree of knowledge of the firm's real estate owned by external stakeholders and minority shareholders compared to those who work within the firm.

Going more specifically, but without any claim of exhaustiveness, the most important motives underlying the budget policies are now being analyzed.

In general, the reasons behind the implementation of budgetary policies can be distinguished in market incentives and contractual incentives, depending on whether the

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164 See about the big bath income minimization policies.

165 Pini (1991, p. 53-54). Among the styles of implementation of the fiscal policies, the author distinguishes the consequentialist style (which is characterized by the fact that the possible negative reactions of the third parties are taken into account in the drafting of the budget) and persuasive style (which is distinguished by the willingness to create certain consequences in the external environment).

purpose is to influence the stock exchange or, more closely, to influence specific contracts entered into by the company. The incentives underpinning the implementation of financial statement policies may then be either business or private, depending on whether the aim is to take advantage of the company or to achieve personal goals of managers, sometimes at odds with the interests of the company. Indeed, if the administrators provide a financial or economic image of the firm or group different from the real one, benefiting from it can be both the firm as well as indirectly the management.

Considering market incentives first, these are linked to the trend of stock market quotations on the market and can act both in terms of price increases and decreases, depending on the circumstances. As previously mentioned, it is common practice for financial analysts to prepare forecasts about the performance of listed companies. The company may, therefore, have the specific objective of not denying the expectations expressed by analysts and hence reaching or possibly overcoming the expected earnings outcome. In fact, a company that achieves or even exceeds the financial analyst's expected result generally benefits from an increase in the price of its shares.[166] Conversely, firms with disappointing results compared to the expected target often severely affect this negative outlook and may see their stock prices falling. Ronen and Yaari (2008) also point out that analysts' forecasts represent, in fact, market expectations and that the first rule for a listed company is not to disappoint expectations of the market.[167] The administrators could therefore adjust some accounting positions in order to bring an outcome in line with analysts' expectations and, on the other hand, to ensure a favorable trend in equity securities.

Also considered crucial are the two thresholds represented by the overrun of the accounting balance and the achievement of a result at least equal to that of the previous financial year. In particular, on the basis of purely psychological arguments, a profit, albeit low, is welcomed by the market in a very positive way compared to a modest loss, rather than rationally justifiable.[168] Therefore, it is plausible that companies avoid exposing mild losses and "if the result is not too far from zero, adopt accounting policies to make it

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166 Ronen and Yaari (2008, page 209) note that the market rewards companies that reach or beat the expectations of analysts: it was noted, in fact, that "*a significant stock price premium for meeting or beating (missing) analysts earnings forecasts*". Florio (2011, p.73) writes: "*Companies that reach or exceed the performance level expected by financial analysts get a significantly higher listing than companies that do not reach the performance level expected by analysts*".

167 Ronen and Yaari (2008, p.137).

168 See Mattei (2006, p. 197-198).

positive, believing that market reaction is disproportionately more negative where instead of just a positive result the company has a slightly negative income".[169]

As for the other critical threshold, i.e. achieving an equal or slightly higher result than that of the previous year, Mattei observes that "interrupting a continuous series of improvement in net operating results significantly penalizes the performance of the shares of companies in financial markets".[170] Consequently, management is expected to manipulate accounting positions at least in order to achieve, if not exceed, the income level achieved in the previous period.

Firms therefore pay attention to possible unfavorable market reactions in the face of failing to meet the three critical thresholds[171] and administrators could implement upward fiscal policies by intervening on various income components. With reference to goodwill, it is conceivable that the administrators "scrap" the impacts of the impairment test to avoid having to account for devaluation when this implies the impossibility of achieving the target result. Consistently with this hypothesis, it is believed that companies with good earnings performance and a solid financial situation have less incentive to conceal any loss of goodwill that, in this context, the listing should not be strongly affected by the devaluation: the negative sign that the market is expected to show that the expected lower benefits appear to be weaker when the target threshold is still reached (in spite of the devaluation) compared to the case of firms already in financial and economic difficulties.[172]

In addition, with regard to market incentives, financial statement policies could be put in place with the intention of improving profitability and thus supporting the share price close to an acquisition (where, of course, the firm represents the target) or other operations of an extraordinary nature. In this case, the rising values are altered and the negative components of income are dissipated in the periods immediately preceding the acquisition, mergers, divisions, and divestments of the firm branches, so that subsequent transactions may take place under more favorable conditions for the company and its members. However,

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169 Prencipe A. (2006), *Earnings quality. Analisi della qualità degli earnings in una prospettiva internazionale*, Pearson Education Italia, Milano, pag. 127.

170 See n.168.

171 In their contribution, Degeorge, Patel and Zeckhauser (1999) argue that there is a priority order as well as the threshold values to reach: the three authors find it more important for firms to avoid losing than to deliver a result in improvement compared to the next exercise; the last in the scale of the goals is the will to reach the result provided by the analysts.

172 In their contribution, Verriest and Gaeremynck (2009) suggest that better performing companies are more likely to recognize a possible reduction in the value of goodwill since a devaluation is not particularly neglected by the market in a context that is still characterized for good profitability and financial solidity.

administrators may have an interest in downtime manipulation if they themselves intend to acquire the company in order to refine the management buy out transaction at a cheaper price. In addition, even where the extraordinary operation is set up between companies belonging to the same group, management can be encouraged to implement accounting policies that are likely to depress income performance: for example, in the case of intergroup mergers, the embedded administrators to respond at group-level strategies, may be worsened by the operating income of their company in order to establish a coupon relationship for the benefit of the merging company.

Lastly, market incentives to manipulate rising earnings are in line with other non-recurring transactions involving the sale of the firm's equities on the market. In particular, such incentives can be found in proximity of share capital increases with the issue of new paid shares -where, as has been seen, the improvement in earnings performance is aimed at raising stock quotation and thus raising more financial resources with the parity of nominal capital issued- or by an initial public offering (IPO), i.e. the initial listing of the company's securities on a regulated market; in the latter case, income maximization policies are implemented on the assumption that better financial statement outcomes in the periods preceding the quotation often mean the initial bid price of the highest shares and thus still greater incoming financial resources.[173]

Given the other category of incentives, or contractual incentives, these are mostly linked to clauses contained in financing contracts or are related to management remuneration.

In the case of issue of bonds or in bank financing contracts, so-called debt covenants or loan covenants are often introduced, which impose financial or management constraints and investments and are designed to secure the creditor against the risk of default of the debtor in repaying the loan.[174] Failure to comply with the covenant involves the creditor's ability to renegotiate the terms of the loan (e.g. increase in the rate applied or expiry review) or even termination of the contract and withdrawal of the loan. Therefore, in the presence of such clauses, administrators implement earnings management policies in order not to violate the constraints contained therein. In particular, where the covenants provide

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[173] Florio (2011, pp. 60-61), Ronen and Yaari (2008, pp. 145 et seq.). On this point, Prencipe (2006, p. 32) states: "*As a general rule, companies that are less well-known than those already listed, accounting results in the periods immediately preceding the acquisition date are of particular relevance to the market valuations*".

[174] Clauses may include, for example, achieving minimum income levels, dividend distributions limits, the obligation not to exceed a certain debt ratio, or the commitment not to sell certain fixed assets or to not proceed with further investments.

for a minimum income level, the incentive cannot be to detect impairment losses on goodwill or other assets in order to preserve the profitability of the period.

Finally, there are incentives more strictly managerial, that is, they concern the compensation due to the managers or their stay in office. Management remuneration plans are often divided into a fixed part and a variable part, referring to the achievement of predefined income levels: no premium is recognized where the operating result is below the minimum income threshold, a pro-rated bonus is expected if this is between the lower limit and the upper limit in the plan and if the result exceeds the upper limit, marginal remuneration increases tend to be nil.[175] Therefore, Mattei (2006) believes that administrators are likely to put in place financial statement policies aimed at maximizing the result of the period (i.e. income maximization policies) in the presence of a useful *ante* manipulation of just below the threshold value that allows the bonus to be obtained. If profits are extremely high, in addition to the higher level included in the incentive plan, managers are supposedly an incentive to implement accounting maneuvers aimed at reducing profit (the so-called income minimization policies) and thus create hidden reserves from which draw in future exercises with disappointing results. Finally, if the result deviates excessively from the minimum payout threshold, it is plausible that administrators, while unable to receive a bonus during the financial year, further reduce income by imputing discretionary costs (policy called big bath earnings management): in this way, they create the conditions for achieving a positive result more easily in the coming years, with a view to obtaining prizes at least in subsequent periods.

In line with these considerations, Francis, Hanna and Vincent (1996) report two possible arguments about the correlation between income performance before accounting manipulations and timing of devaluation's asset. On the one hand, if the bonuses of the directors are recognized on the basis of the company's economic result and the latter is much lower than the target threshold, management is encouraged to anticipate the

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[175] Healy P.M. (1985), *The Effect of Bonus Schemes on Accounting Decisions*, Journal of Accounting and Economics, vol. 7, n. 1-3, 85-107. Regarding the remuneration of managers, in addition to this approach proposed by Healy, there are other contributions in the literature, which include additional contractual incentives that may lead to the implementation of budgetary policies. In particular, Ronen and Yaari (2008) point out how management's remuneration can comprise, in addition to cash components (bonus plus wages), shares or options (stock options) to which manipulative behavior of directors can be reconnected to raise the course of the shares and thus increase their overall remuneration. In this regard, Mohanram (2003, pg. 4) identifies among the various reasons behind the acquisition of the title of "learning resources", "*the incentive to get options at as low a strike price as possible and the incentive to exercise them at as high a price as possible.* (...) *Managers are more likely to postpone disclosure of good news and accelerate negative disclosures in the time periods just prior to option grant awards. As options are typically given at the money, this allows them to get options at a potentially lower strike price making them more valuable*".

recognition of asset loss losses. On the other hand, according to the smoothing earnings policies, companies that have an unusually positive result tend to show impairment's devaluation, probably because the operating result exceeds the upper limit provided by the remuneration plans.[176]

Ultimately, where remuneration is partly variable, managers may put their personal interest in perceiving higher remuneration and may, in doing so, pursue a financial statement objective that is not necessarily in line with what would be the other internal stakeholders and the firm as a whole. Mattei believes that managers are "rational and self-interested subjects, and therefore exercise discretion in their role in maximizing their utility".[177] Usually the interests of the administrators coincide with those of the firm, so pursuing their personal goals also benefit the enterprise at the same time. However, in some circumstances -and this is the case for managerial remuneration- the two interests may not be aligned and the work of the managers will only benefit those, at the expense of all other stakeholders, including minority shareholders. In view of the fact that "minority shareholders of listed companies possess virtually the same informational possibilities as non-internal stakeholder",[178] administrators can, in fact, put into practice faulty behaviors that also weaken this category.

The administrative body, however, may be expedient in the near future of the mandate to make a greater profit than the actual one in order to obtain the renewal of the mandate from the shareholders' meeting. On the other hand, as before, a change in the top of the company can undergo big bath policies by management just settled -linked to the desire to record losses to be attributed to the previous administration and thus to clear the field from futile unsatisfactory results- and by the outgoing directors, where the replacement at the top of the company is defined as "friendly".

Summarizing, internal and external stakeholders react differently to the publication of the financial statement and the data contained therein. Therefore, in drafting this document, the administrative body takes into account the foreseeable reactions of third parties and seeks to guide their decision-making processes by leveraging on a deliberately distorted and tendentious representation of business events. By implementing profit management policies, administrators adjust the content of the financial statement in accordance with the

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176 Francis J., Hanna J. D., Vincent L. (1996), *Causes and Effects of Discretionary Asset Write-Offs,* Journal of Accounting Research, vol. 34 Supplement, p. 123.

177 Mattei (2006, p. 112-113).

178 Verona (2006, p.52-53).

objective that, from time to time, is influenced by and influencing the financing, investment or commercial choices of the various stakeholders. Through accounting manipulation and consequent alteration of disclosure to third parties, the firm may, for example, have access to grants that otherwise would not have access to,[179] it may acquire new capital from investors not directly involved in management choices such as shareholders minority or small savers, can guarantee a better stock quotation. Managers can also show the firm financial and financial standing to maintain close relationships with suppliers and customers, who are reassured, respectively, about the solvency of the buyer' firm and about the guarantees from this promise. Finally, a better representation of the firm's reality, managements can lead to more personal benefits, such as higher remuneration or renewal of office.

[179] Verona (2006, p. 237) states in this regard: "*It is undeniable that by showing a better financial situation than the actual one, it could allow the company to exploit more market opportunities (credit opening, rates more advantageous funding) and, consequently, to improve the prospects for future income, in the same way as other conditions*".

2.3 Income Smoothing

Income smoothing has been defined as "the deliberate dampening of fluctuations about some level of earnings which is considered to be normal for the firm" (Barnea, Ronen and Sadan, 1976, p. 110). The practice is conjectured to be widespread (Worthy, 1984; Foster, 1986; and Ronen and Sadan, 1981), but evidence in support of deliberate smoothing is not convincing. Accordingly, the objective of this study is to determine the pervasiveness of smoothing in accounting practice, and to describe the type of companies that smooth income.

Income smoothing has received much research attention.[180] Early empirical researchers in accounting examined *ex post* data to determine the existence of smoothing behavior.[181] The general premise was that if smooth earnings resulted from the choice of a smoothing variable (such as choice of depreciation method, pension cost amortization, intangible asset amortization, extraordinary charges and credits, investment tax credit, purchase versus pooling, inventory method, and dividend income under the cost method of reporting a subsidiary) then income smoothing behavior must have occurred. Most of the researchers found evidence to conclude that firms choose accounting policies in a fashion that smooths reported income over time (Ronen and Sadan, 1981).

There are two different types of smooth income streams: those that are naturally smooth and those that are intentionally smoothed by management (Eckel, 1981).[182] A naturally smooth income stream results from an income generating process that produces a smooth income stream. An intentionally smoothed income stream can be the result of real smoothing or artificial smoothing techniques. Real smoothing occurs when management takes actions to structure the economic (revenue generating) events of the organization to produce a smooth income stream. Artificial smoothing occurs when management manipulates the timing of accounting entries to produce smooth income streams.

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180 See Morduch, J. (1995). *Income smoothing and consumption smoothing*. The journal of economic perspectives, *9*(3), 103-114. Trueman, B., & Titman, S. (1988). *An explanation for accounting income smoothing*. Journal of accounting research, 127-139. Fudenberg, D., & Tirole, J. (1995). *A theory of income and dividend smoothing based on incumbency rents*. Journal of Political economy, 103(1), 75-93. Tucker, J. W., & Zarowin, P. A. (2006). *Does income smoothing improve earnings informativeness?* The Accounting Review, 81(1), 251-270. Beidleman, C. R. (1973). *Income smoothing: The role of management*. The Accounting Review, *48*(4), 653-667.

181 For a review of research, see Ronen ans Sadan (1981) and Imhoff (1981).

182 Figure the previous paragraphs (especially §2.1).

2.3.1 Approaches to the study of income smoothing

2.3.1.1 The Classical Approach

The classical approach to studying income smoothing involves an examination of the relation between choice of smoothing variable and its effect on reported income. Unfortunately, this approach does not study the existence of artificial smoothing because of shortcomings in the research design, which may be criticized as follows (Eckel, 1981). First, the studies typically utilize an expectancy model of "normalized" income that may not have adequately described the underlying earnings process.[183] Second, the concentration on one smoothing variable may result in biased results. Some companies that smooth may use that variable alone or in combination with others. Other companies that smooth may not use that variable. Third, some studies considered the effects of smoothing variables on one period only, ignoring the inter-temporal effects. Ronen and Sadan (1981) also criticize the early studies; their criticism is that the studies lack a behavioral model to explain why smoothing behavior occurs and predict when it might take place.

2.3.1.2 The Income Variability Approach

Imhoff (1977) was the first researcher to attempt to separate management's artificial smoothing behavior from the confounding effects of real smoothing actions or naturally smooth income streams. Imhoff asserts that sales revenue represents the results of the real economic actions of a firm, and would therefore incorporate real smoothing activities if they exist. The existence of artificial smoothing behavior can thus be studied by comparing the variance of ordinary income to the variance of sales. No comparisons from his sample of 94 Compustat industrial firms met his smoothing criteria.

A second researcher who investigated the existence of artificial smoothing behavior is Eckel (1981). His efforts were directed at separating the results of artificial smoothing from the real smoothing that management might take. Eckel's research differed from Imhoff's in that Eckel did not exclude firms that exhibited low variability of sales from this sample. Imhoff, implicitly assuming that artificial smoothing and real smoothing were mutually exclusive, investigated the effects of smoothing on only those companies that exhibited high sales variability. Eckel examined the financial statements for 62 industrial

[183] Various expectancy models used have been exponential, such as linear, time-series, semilogarithmic time trend, first difference market income index, and Box-Jenkins. (See Ronen and Sadan, 1981; or Imhoff, 1981, for a review).

firms in four industries[184] from 1951 to 1970 using Compustat data. Using net income as the measure of income, two firms (3%) were classified as artificial income smoothers.

The Imhoff (1977) and Eckel (l981) studies do not show the degree of artificial income smoothing that Worthy (1984) suggests. One reason for this is that their results are influenced by the choice of firms selected for their studies. Imhoff only selected companies that had a high variability of sales, which indicates that the firms were experiencing a large amount of economic uncertainty. Eckel studied only four industries out of the entire economy. It is very possible that a cross-sectional study examining all strata of the economy would show different results.

2.3.1.3 The Dual Economy Approach

One means of studying firms in an organized manner is through a dual economy perspective. Averitt (1968, pp. 6-7) describes American capitalism as "a composite of two business systems" that have come to be called the core and the periphery. Bluestone, Murphy, and Stevenson [BMS](1973, pp. 29-30) provide a good description of these two economic sectors:

> The core economy includes those industries that comprise the muscle of American economic and political power. The core economy is by far the largest sector (…) in terms of financial resources. Entrenched in durable manufacturing, the construction trades and, to a lesser extent, the extraction industries, the firms in the core economy are noted for high productivity, high profits, intensive utilization of capital, high incidence of monopoly elements, and a high degree of unionization.
>
> Beyond the fringes of the core economy lies a set of industries that lack almost all of the advantages normally found in [core] firms. Concentrated in agriculture, nondurable manufacturing, retail trade, and sub-professional services, the peripheral industries are noted for their small firm size, labor intensity, low profits, low productivity, intensive product market competition, lack of unionization, and low wages. Unlike core sector industries, the periphery lacks the assets, size, and political power to take advantage of economies of scale or to spend large sums on research and development.

[184] The four industries are pulp and paper, chemical, air transport, and rubber. All four of these can be classified as core firms.

Beck, Horan and Tolbert (1978) operationally tested the BMS[185] definitions of the core and periphery sectors by classifying companies as core or peripheral on the basis of their two-digit SIC codes, and examining company labor characteristics within each sector.[186] They found that core-firm labor characteristics in fact differ from periphery-firm characteristics.
Using this classification scheme, Belkaoui and Picur (1984) separated 171 companies from 42 industries into 114 core sector firms and 57 periphery sector firms. They hypothesized that companies in the core sector of the economy would exhibit a lesser degree of smoothing behavior than would companies in the periphery sector because "firms in the periphery sector have more opportunity and more predisposition to smooth both their operating flows (for example, through their labor management) and reported income measures, than firms in the core sector" (p. 530). Their method was to compare the change in operating income and the change in ordinary income to the change in expenses.[187] Their findings give evidence that firms in the periphery sector indeed show a greater depth of smoothing behavior than do firms in the core sector for both measures of income.

2.3.2 When Insiders Know more than Outsiders

The practice of income smoothing has a long tradition in corporate finance. For example, Harold Geneen ran ITT for eighteen years (1959-77), during which the company reported earnings increases for fifty-eight consecutive quarters. It was widely assumed that this streak depended on a certain amount of gray-area fiddling with the numbers, but it was also accepted that investors were not being misled about the big picture. ITT was in fact growing steadily during his tenure and the figures were, on average, a fair reflection of the company's performance. More recently, Microsoft, General Electric, and American Express have all been labeled as "smoothers."
Why do firms smooth income?[188] We argue that a primary reason for income smoothing is the pressure imposed on managers to meet the market's (i.e., analysts') earnings

185 Bluestone, Murphy, and Stevenson.

186 The industry dichotomy is represented by *Core Sector* (mining, construction, transportation, metal industries etc.) and *Periphery Sector* (agriculture, furniture and fixtures, retail trade, personal services etc.).

187 See Kamin and Ronen (1979) for a description of the method.

188 Companies indulge in this practice because investors are generally willing to pay a premium for stocks with steady and predictable earnings streams, compared with stocks whose earnings are subject to wild fluctuations. Related reasons often cited for income smoothing are: risk-averse insiders with limited access to external markets trying to insure themselves (Lambert 1984, Dye 1988), managers aiming to maximize their tenure (Fudenberg and Tirole 1995) or to minimize taxes (Graham 2003). Income smoothing can signal good prospects (Ronen and Sadan 1981) or low volatility to reduce the cost of debt (Trueman and Titman 1988). Income smoothing can also encourage liquidity trading by uninformed investors (Goel and Thakor 2003).

expectations. Although shuffling cash flows backward and forward ("financial smoothing") to level out income fluctuations may be harmless, income smoothing has a darker side.[189] First, managers who are at risk of missing the earnings target may cut investment expenditure and in doing so destroy value. Second, in an attempt to meet market expectations, managers proactively manage expectations by distorting real decisions by doing things like smoothing sales.

In a survey by Graham, Harvey, and Rajgopal (2005) among more than 400 executives, 80% of survey participants report that they would decrease discretionary spending on R&D, advertising, and maintenance to meet an earnings target.[190] More than half (55,3%) state that they would delay starting a new project to meet an earnings target, even if such a delay entailed a small sacrifice in value (Graham, Harvey, and Rajgopal 2005, 30-31). Their survey results are supported by a series of empirical studies that show that managers are prepared to destroy value in order to meet the market's expectations.[191] There is also evidence that managers proactively manage expectations. Bouwens and Kroos (2011) examine how retail store managers reduce their sales activity in response to target ratcheting. They find that managers with favorable sales performance in the first three quarters reduce their sales activity in the final quarter in an attempt to mitigate the increase in the next year's sales target (see Indjejikian, Matejka, and Schloetzer (2014) for a review on target ratcheting and incentives). Proactive expectations management also arises endogenously in our model.

Although this interplay between market expectations and managerial incentives is widely acknowledged, it begs the question as to how it is possible that in equilibrium firms can keep managing earnings and expectations, and get away with it -in many cases indefinitely. Why do investors not intervene, or why does the smoothing equilibrium not unravel? If income and expectation management lead to value destruction, why then do insiders and outsiders engage in this game in the first place? Our theory answers these questions by

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189 Jensen (2005, 8) notes: "*Indeed, earnings management has been considered an integral part of every top manager's job for at least the last two decades. But when managers smooth earnings to meet market projections, they are not creating value for the firm; they are both lying and making poor decisions that destroy value...when numbers are manipulated to tell the markets what they want to hear (or what managers want them to hear) rather than the true status of the firm it is lying, and when real operating decisions that would maximize value are compromised to meet market expectations real long-term value is being destroyed*".

190 Related theories that explain income manipulation (but not smoothing) are linked to insiders' myopia (Stein 1989, Bebchuk and Stole 1993) or career concerns (Gibbons and Murphy 1992, Holmström 1999).

191 See, e.g., Baber et al. (1991), Perry and Grinaker (1994), Bange and DeBondt (1998), Bushee (1998), Cheng (2004) and Gunny (2010), among others.

providing a rational expectations equilibrium featuring income smoothing and expectations management that are driven by the pressure imposed on managers to meet income expectations.

We consider a neoclassical firm in which insiders set output on the basis of marginal revenues and marginal costs. Each period, outsiders demand their share of the income that they believe has been generated. Marginal costs are latent and observed by insiders only. Outsiders observe sales, a measure of the firm's output level. Because sales are a monotonically decreasing function of marginal costs, outsiders can perfectly infer the corresponding level of the latent marginal cost variable, and therefore also the level of income. Outsiders' indirect inference of income through sales creates, however, an incentive for insiders to distort production: insiders under produce in an attempt to downplay the firm's fundamentals and to lower outsiders' income expectations. Outsiders rationally anticipate what insiders are up to, but nevertheless this type of value- destroying manipulation persists in this signal-jamming equilibrium because both parties are "trapped" in a type of prisoners' dilemma. Conditional on outsiders believing that insiders will "behave" it is optimal for insiders to manipulate (i.e., under produce). As a result, underinvestment and expectations management always prevail in equilibrium. Outsiders infer the correct value of the firm's income, and payout moves in lockstep with realized income (i.e., there is no financial smoothing). Underproduction causes both parties to be worse off than under a first-best policy. Furthermore, the absolute amount of lost output is higher in economic booms than in recessions. This reduces the output variance, a phenomenon we refer to as real smoothing. In our model, underproduction and real smoothing are two sides of the same coin. This direct link between underproduction and real smoothing is not an obvious one. If, for example, insiders were to reduce output at all times by a constant absolute amount, then underproduction would not coincide with real smoothing.

Next, we consider the case where outsiders observe sales with measurement error or "noise." This noise is value-irrelevant, transitory, normally distributed, and independent and identically distributed (i.i.d.) over time. When observing an increase in noisy sales, outsiders cannot distinguish whether the increase is due to a reduction in marginal costs (and therefore represents a real increase in income), or whether the increase is due to value-irrelevant measurement error. Because measurement errors are transitory and shocks to costs persistent, the underlying source of change becomes clear only as time passes by. Therefore, outsiders calculate their best estimate of income on the basis of not only current

sales but also past sales, by solving a Kalman filtering problem.

Then, in rational expectations equilibrium, outsiders form their expectation of actual income on the basis of the complete history of sales and of what they believe insiders' optimal output policy to be. Conversely, in each period, insiders determine their optimal output policy given outsiders' beliefs. We obtain a perfect Bayesian equilibrium in which insiders' actions are consistent with outsiders' beliefs, and outsiders' expectations are unbiased conditional on the information available. Each period, outsiders receive a payout that equals their share of what they expect income to be. Insiders also get a payout, but they have to soak up any under- (over-) payment to outsiders as some kind of discretionary remuneration (charge): if actual income is higher (lower) than outsiders' estimate, then insiders cash in (make up for) the difference in outsiders' payout.

Consequently, income and payout are smooth compared with actual income not because insiders want to smooth income, but because insiders have to meet outsiders' expectations to avoid intervention. With imperfect inference, two types of smoothing take place simultaneously: "payout" (or "financial") smoothing and "real" smoothing.[192] The former is value-neutral and merely alters the time pattern of payout to outsiders without changing the firm's underlying cash flows as determined by insiders' production decision. Insiders also engage in real smoothing by manipulating production in an attempt to manage outsiders' expectations. However, because outsiders' income estimate is now based on the complete history of sales, the instantaneous effect of sales on outsiders' beliefs is weakened. Measurement error and the resulting asymmetry information therefore mitigate the effect of indirect inference on production and real smoothing.

Importantly, real smoothing also has a lagged effect. With imperfect inference, the current output decision affects not only current sales levels but also outsiders' expectations of current and future income. This exacerbates the previously discussed underinvestment problem for insiders because bumping up sales now means the outsiders will expect higher income and payout not only now but also in future. The instantaneous effect of measurement error dominates, however, the lagged effect so that, on balance, measurement error and asymmetric information mitigate underinvestment and reduce real smoothing. However, in the presence of measurement error, outsiders' estimate of the firm's income, although unbiased, is not exact. Payout no longer moves in lockstep with realized income but is smooth relative to income.

[192] In Ronen and Sadan (1981), various smoothing mechanisms are discussed and illustrated in great detail.

2.3.3 Income Smoothing Attributes

Earnings management has been defined as an attempt by the managers to mislead some stakeholders about the economic performance of the company or to influence the outcomes of contracts that may affect their compensation (Healy and Wahlen, 1999).

Academic research, however, has not found pervasive earnings management practices among US firms (Dechow and Skinner, 2000). Theoretically, earnings management may not be problematic for three major reasons. First, earnings management is a process of estimating accruals, and estimation of accruals is the heart of financial reporting (Beaver, 2002). Systematic accrual accounting choices made within GAAP should be differentiated from fraudulent reporting.[193] Second, accrual management is problematic only if the motive is opportunistic (Beaver, 2000).[194] Third, earnings management does not matter under the efficient market hypothesis.[195] Empirically, earnings management has not been found problematic mainly because current research methodology is not good at identifying firms that manage earnings (Dechow and Skinner, 2000).[196]

Academic research also has not found a large effect of earnings management on financial reporting. Dechow and Skinner (2000) argue that earnings management relates to managerial incentive and managerial incentive, in turn, has been linked increasingly to stock price performance. Research in earnings management, therefore, should be more fruitful if the focus is on firm valuation.

One form of earnings management is income smoothing (Dechow and Skinner, 2000). The study of income smoothing in general has been more successful than the study of other forms of earnings management for two reasons. First, income smoothing has been defined more precisely. For example, Fudenberg and Tirole (1995) defined income smoothing as:

> The process of manipulating the time profile of earnings or earnings reports to make the reported income stream less variable, while not increasing reported earnings over the long run (p. 75).

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193 The purpose of estimating accruals is to record the financial effects of transactions, rather than to just report the cash effects of transactions. The problem, therefore, is not accrual accounting choices per se, but the appropriateness of the choices (Dechow and Skinner, 2000).

194 Motives for accrual management are either opportunistic or signaling. Beaver (2000) argues that the former is problematic because the managerial intent is to mislead and influence while the latter is not because the managerial intent is to inform.

195 Academics may argue that under the efficient market hypothesis earnings management does not matter as long as it is fully disclosed or the cost of obtaining the information and observing the managerial intent is low (Dechow and Skinner, 2000).

196 The main difficulties are the measurement of managerial intent, the determination of the appropriateness of accrual accounting choices, the operationalization of the definition of earnings management, and the differentiation among different forms of earnings management.

Managers will take actions to increase earnings when earnings are relatively low and to decrease earnings when earnings are relatively high.[197] Second, the differentiation between smoothers and non-smoothers has been operationalized successfully in numerous studies (e.g., Belkaoui and Picur, 1984; and Michelson et al., 1995 and 2000). There are several income smoothing descriptors, although the basic idea of those descriptors is to compare the variability of earnings with the variability of sales.[198] The variability of earnings is smaller than the variability of sales for a smoother.[199]

Income smoothing has been examined in the setting of different economic sectors. Belkaoui and Picur (1984) and Albrecht and Richardson (1990) compare the income smoothing behavior of companies in the core sector with those in the periphery sector.[200] Albrecht and Richardson (1990) also study the size effect on smoothing behavior. Companies in the core sector and larger companies exhibit a lesser degree of smoothing behavior.

Income smoothing has also been examined in the setting of different countries with diverse results. Gray (1988) argues that accounting follows different patterns in different parts of the world because of the differences in culture, societal value, and accounting sub-culture. Accountants in Anglo countries (such as Canada, the UK and the US) and Nordic countries (such as Finland, the Netherlands and Sweden) are independent professionals. They focus on presenting a true and fair view of a company's financial position, instead of implementing detailed legal requirements. They are more concerned with consistency and comparability subject to the need for flexibility instead of uniformity. Their practices are more transparent and optimistic. Accountants in Germany, Belgium, and France focus more on uniformity.[201] Their practices are less transparent and more conservative. Accountants in Japan and less developed Asian countries (such as Malaysia) focus more on uniformity and statutory control. Their practices are also less transparent and more

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[197] The latter is an important characteristic of income smoothing since the mangers' actions are not always to exaggerate earnings.

[198] Imhoff (1981) claims that generating sales is a real economic activity of firms. Real income smoothing, therefore, is reflected in sales revenue. Artificial income smoothing, on the other hand, is not reflected in sales revenue. The detection of artificial income smoothing, therefore, can be achieved by comparison of the variability of earnings with the variability of sales. The variability of earnings is smaller than the variability of sales for an artificial income smoother. It should be noted that both real smoothing and artificial smoothing are intentional smoothing, not natural smoothing.

[199] The comparison of the variability of earnings and the variability of sales has been the most widely used descriptor of smoothing behavior. It, however, can be argued as suggested by the referee that managers can also manipulate the timing and recording of sales.

[200] Albrecht and Richardson (1990) listed industries in the core sector and industries in the periphery sector in their Table 1 (p. 716).

[201] Belgium and France are classified as more developed Latin countries by Gray (1988) in his Figure 1.

conservative.

Income smoothing studies on Japanese companies have found that (1) managers incline more to use R&D investments to smooth net income than their US counterparts (Nagy and Neal, 2001), and (2) managers engage in smoothing behavior even though management bonuses are not significantly affected by earnings (Hermann and Inoue, 1996). The smoothing behavior is caused by the less transparent practices and the pressure to signal growth and stability to shareholders (Nagy and Neal, 2001). Income smoothing studies on Malaysian companies, however, have not found smoothing behavior of managing discretionary accruals (Roubi and Richardson, 1998).

Companies in Germany do engage in smoothing behavior. Good or bad performance in a particular year is not necessarily considered as a representation of what a company ordinarily achieves. Smoothing, therefore, is needed for obtaining economic reality (Oliverio and Newman, 1997). Belgium companies also engage in smoothing behavior. One of the attributing factors is the lack of auditor litigation (Vander Bauwhede et al., 2003).

Companies in Anglo countries and Nordic countries engage in smoothing behavior too (e.g., Beattie et al., 1994; and Michelson et al., 1995 and 2000). Although classified as similar in accounting characteristics by Gray (1988), they engage in smoothing behavior for different reasons and with different degrees.[202] For example, Swedish companies are allowed to create untaxed reserves to serve as buffers for future losses (Sunden and Jansson, 1999). Forty percent of Finnish firms in a sample have smoothed their income (Booth et al., 1996).[203] In Canada, a variation in one quarterly net income is generally followed by a reverse in the next three quarters. This phenomenon is interpreted as the evidence of income smoothing (Fortin et al., 1997).

Given the voluminous international evidence, one can conclude that managers' income smoothing behavior may be considered legal and normal (e.g., Oliverio and Newman, 1997; and Sunden and Jansson, 1999), and may not significantly affect managers' bonuses (e.g., Hermann and Inoue, 1996). Culture, societal value, and accounting sub-culture are attributing factors. An important question, however, can be raised: What is the effect of income smoothing on stock price if it is observed in a country that has transparent and

[202] In a related study, Weetman and Gray (1991) have found that UK GAAP and Dutch GAAP are less conservative than US GAAP while Swedish GAAP is more conservative than US GAAP.

[203] The sample consists of 31 Finish firms listed in the Helsinki Stock Exchange from 1989 to 1993. The coefficient of variation of change in sales is compared with the coefficient of variation of change in income for the sample firms. Natural income smoothing is reported in 40% of the cases.

optimistic accounting practices?

Income smoothing indeed has been studied in the context of firm valuation as suggested by Dechow and Skinner (2000). Results, however, are mixed. For example, Michelson et al. (1995) have found that US smoothers have a lower ten-year annualized return than non-smoothers while Michelson et al. (2000) have found that US smoothers have a higher cumulative average abnormal return than non-smoothers.

Beaver (2002) argues that any form of earnings management can improve or impair the quality of financial statements and earnings. Income smoothing, therefore, can also improve or impair the quality of earnings. This study is an extension of previous income smoothing studies. Following Beaver (2002), it argues that although the variability of earnings is smaller, smoothers' earnings quality is not guaranteed, i.e., a smaller variability of earnings does not guarantee a higher firm value. Instead, reported earnings of smoothers are hypothesized to be more value-relevant (consistent with the results of Michelson et al., 2000) if the reported earnings are of high quality. Reported earnings of smoothers are less value-relevant (consistent with the results of Michelson et al., 1995) if the reported earnings are of low quality.

This study first classifies sample firms along two dimensions: smoothers versus non-smoothers (Michelson et al., 1995 and 2000), and quality earnings firms versus non-quality earnings firms (Sloan, 1996). Sample firms are then divided into four groups: quality earnings smoothers, quality earnings non- smoothers, non-quality earnings smoothers, and non-quality earnings non-smoothers. Value relevance of reported earnings (between the smoothers and the non-smoothers, between the quality earnings firms and the non-quality earnings firms, and among the four groups) is examined using both the levels and the changes approaches (Kothari, 1992). Indicator variables (Barth et al., 1999) are incorporated into the levels and the changes regressions to compare the significance of price-earnings and price change-earnings change multiples.[204] Results show that (1) the multiples are not significantly different between smoothers and non-smoothers when quality of earnings is not explicitly considered, (2) quality earnings firms' multiples are significantly higher than non-quality earnings firms' multiples when smoothing behavior is not explicitly considered, (3) quality earnings smoothers have a higher price change-

[204] The price-earnings multiple is the regression coefficient when regressing price on earnings. A higher price-earnings multiple indicates a higher association between price level and earnings level. The price change-earnings change multiple is the regression coefficient when regressing price change on earnings change. A high price change- earnings change multiple indicates a higher association between price change and earnings change.

earnings change multiple and a lower price-earnings multiple than quality earnings non-smoothers, and (4) non-quality earnings smoothers have a higher price-earnings multiple and a higher price change-earnings change multiple than non-quality earnings non-smoothers. The practical implication is that analysts and investors should consider smoothing behavior and earnings quality for firm valuation.

Income smoothing involves the repetitive selection of account measurement or reporting rules in a particular pattern, the effect that is to report a stream of income with a smaller variation from trend than would otherwise have appeared.[205] An accounting practice measurement rule must possess certain properties before it may used as a manipulative smoothing device. Of all available account alternatives (rules, practices), some will always have smoothing potential while others will only smooth under special circumstances never at all. A perfect smoothing device must possess all of the follow characteristics:

A. Once used, it must not commit the firm to any particular future action.

B. It must be based upon the exercise of professional judgment be considered within the domain of "generally accepted accounting principles".

C. It must lead to material shifts relative to year-to-year differences in income.

D. It must not require a "real" transaction with second parties, only a reclassification of internal account balances.

E. It must be used, singularly or in conjunction with other practices over consecutive periods of time.

Effective smoothing devices should not establish a precedent to which the "principle" of consistency may apply. Practices, which, once used, commit the firm to report particular amounts in the future, may smooth current income; however, use of them may cause anti-smoothing in the future. Future freedom of action is vital for long-run smoothing. For example, the inter-period income tax allocation procedure has often been called a smoothing device.[206] However, when a firm adopts inter-period allocation in one year, it commits itself to use the same procedure in future periods, and future allocation may have undesired effects.

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[205] An operational test of smoothing was suggested by Gordon, as follows: for each firm fit a curve to a stream of income calculated two ways, (a) excluding the manipulative variable, and (b) including it. "*If the variation of the observations around the curve are smaller in the latter case, income smoothing has been the consequence of transactions in the account*". M.J.Gordon, *Discussion of the Effect of Alternative Rules for Non-subsidiary Investments,* Empirical Research in Accounting: Selected Studies, 1966, sup. Vol.4, Journal of Accounting Research, p. 223.

[206] See T. F. Keller, *Accounting for Corporate Income Taxes* (Bureau of Business Research, University of Michigan, 1961), p.48.

The term "smoothing" implies adjustments to income in two or more consecutive periods and detection thereof requires analysis of data for at least three periods. While a two-year comparison may indicate that the second year's income had increased or decreased, it is not sufficient for determining a pattern of behavior in any one firm.

2.3.4 Classification of Firms into Smoothers Categories

Albrecht and Richardson (1990) claim that there are two types of income smoothing: natural smoothing and intentional smoothing.[207] A natural smoothing is the result from an income generating process that produces a smooth stream of income, i.e., there is no manipulation by the managers. Following Fudenberg and Tirole (1995), this type of smoothing is not earnings management since there is no manipulation. Intentional smoothing can either be a real smoothing or an artificial smoothing. A real smoothing is the result from managers' change of the economic (revenue generating) events while an artificial smoothing is the result from managers' change of the timing of accounting entries (Albrecht and Richardson, 1990). The type of intentional income smoothing, therefore, depends on managerial intent.

Managers' income smoothing behavior whether real or artificial, like any other forms of earnings management, cannot be observed directly. Classification of firms into the smoothers and the non-smoothers categories, therefore, has to be inferred using descriptors. The most widely used income smoothing descriptor is the comparison of the coefficient of variation of one period change in earnings with the coefficient of variation of one period change in sales (Albrecht and Richardson, 1990; Booth et al., 1996; and Michelson et al., 1995 and 2000). This idea originates from Imhoff (1981) who argues that (1) generating sales is a real economic activity of a firm, (2) real income smoothing is reflected in sales revenue (because managers change revenue generating economic events) while artificial income smoothing is not reflected in sales revenue, and (3) the variability of earnings, therefore, is smaller than the variability of sales for an artificial income smoother. A firm is classified as a smoother if the former is smaller than the latter. Different definitions of earnings, such as operating income after depreciation, pre-tax income, income before extraordinary items, and net income are used. Empirical results based on different earnings definitions generally are consistent (Michelson et al., 1995 and 2000).

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[207] We have already seen the definitions in the previous paragraphs.

Income smoothing behavior is inferred from the variability of earnings since managers' smoothing behavior cannot be observed directly. The critical question is whether a firm with a smaller variability in earnings always generates a higher firm value. Empirical results are mixed. The results of several studies indicate that a smaller variability of earnings means a lower risk, and a lower risk leads to a lower firm value (e.g., Beidleman, 1973; Lev and Kunitzky, 1974; and Michelson et al., 1995). Empirical evidence from event studies also documents this significant relation between stock price and variability-reducing events.

The results of several studies, on the other hand, indicate a smaller variability of earnings leads to a higher firm value. Several studies suggest that institutional investors generally avoid firms showing large variability of earnings, and investors generally are not attracted to firms with fluctuating earnings, i.e., the consequence, therefore, is that prices of those stocks are reduced (Badrinath et al., 1989; and Michelson et al., 2000). Several other studies show that decrease in variability of earnings improves earnings persistence, and therefore stock prices (e.g., DeFond and Park, 1997; and Hand, 1989).

The results of prior studies indicate that using variability of earnings as income smoothing descriptor perhaps cannot provide a definitive answer to the question of its effect on firm value. A possible remedy is to also consider the quality of the reported earnings.

The concept of earnings quality has been widely used without a uniform definition. The US Securities and Exchange Commission, for example, has referred to the importance of this concept in its *Accounting Series Release No. 159* as:

> The purpose of the explanation of the Summary of Earnings is to enable investors to assess the source and probability of recurrence of net income, and thus of earnings quality.

Beaver (2002) suggests that earnings management can improve or impair the quality of earnings. Income smoothing, therefore, can also improve or impair the quality of earnings since it is a form of earnings management. Theoretically, if quality of earnings is improved, then the association between firm values and reported earnings should also be improved. If quality of earnings is impaired, then the association between firm value and reported earnings should also be impaired. Prior empirical results do show that smoothers sometimes have higher returns than non-smoothers (e.g., Michelson et al., 2000), and sometimes have lower returns than non-smoothers (e.g., Michelson et al., 1995). A plausible explanation is that smoothers have higher returns when they are quality earnings firms, and have lower returns when they are non-quality earnings firms. The critical

question then is how to measure quality of earnings of a firm.

2.3.5 Accounting techniques for smoothing

Probably the most fundamental point to be made in these years is the distinction between monetary and real income. Current accounting practice is almost exclusively concerned with the measurement of the difference between monetary costs consumed or expired and monetary proceeds realized in connection therewith. This may be described as a purely monetary conception of income. If, on the other hand, we consider income to represent an increase in command over goods or services, an entirely different result may emerge.

Consideration of income in the real sense embraces numerous problems typically identified with stabilized accounting. Hence, income will be considered from a strictly monetary point of view, although little thought is necessary to visualize the shortcomings of such a position.

We may consider the term income to be indicative of the "normal earning power" of a business enterprise. This is the usual connotation of the term "operating income" or "operating profit", as employed by accountants, and is generally measured by the difference between gross revenue from the major activity of the enterprise and applicable costs of a regular or recurring nature, but exclusive of "abnormal" or non-recurring items. From this point of view, it is apparent that considerable "juggling" of income may be accomplished by management decision as to the normality or abnormality of an item of revenue or expense, and the resulting statement classification.

2.3.5.1 Motivation of income smoothing

From a practical point of view, there is little doubt but what the most compelling motivation for income smoothing is the existence of tax levies, based upon income. Even with the existence of a non-progressive corporate income tax (except for the smallest concerns) and the availability of the carry-forward or carry-back provisions relating to operating losses, there may be distinct tax advantages to income shifting or smoothing. This is most apparent in the case of changes in tax rates or the addition or removal of types of income taxation.

A less tangible, but perhaps more fundamentally important type of advantage of a relatively stable level of periodic income lies in the area of management relations with investors and workers. Certainly the owners and creditors of an enterprise will feel more

confident toward a corporate management which is able to report stable earnings than if considerable fluctuation of reported earnings exists. The stable dividend policy which level earnings facilitate does nothing to lessen satisfactory stockholder relations. The absence of peaks and valleys in the earnings record of an enterprise may do much to maintain continuing satisfactory industrial relations. A sharp increase in reported profits is very likely to produce the feeling in the minds of the members of the working force that they should participate to a greater extent in such profits, with resulting demands for wage increases, strikes and general industrial unrest. Finally, in the case where a considerable amount of the fluctuation in income may be attributed to changing price levels, the recognition of this cause may be vitally significant to corporate management as a guide to dividend policy, in order to assure preservation of corporate capital.[208]

The above factors are significant from the point of view of an individual firm.

It seems essential to mention a further point incident to the smoothing of income fluctuations that may well be of considerable importance to an entire economy. It is reasonably well recognized by economists that psychological factors, particularly in the area of producers' expectations, are an important factor in the determination of economic activity. By the same token, changes in such psychological attitudes or expectations are significant in the explanation of cyclical upswings and downswings in business activity. Since, in the formulation of expectations, prediction of future events and conditions is an extremely hazardous process current conditions have a very important influence upon future expectations. Hence, a current condition of declining business income may cause expectation of further decline, bringing upon actions, which make these expectations a reality, and a cumulative process is initiated resulting in substantial stagnation of business activity, employment, etc. The opposite process may occur in the other direction when rising income appears. It would seem that the maintenance of a relatively stable level of periodic income might do much to reduce the effect of "waves of optimism and pessimism" on the level of business activity. It should be emphasized that the author is not subscribing exclusively to a completely psychological theory of business cycles, but is merely indicating that psychological expectations, motivated by fluctuations in income, are of some significance in this connection.

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[208] As illustrated by an analysis of the effect of price level changes on nine major steel companies. See *Effect of Inflation on Capital and Profits: The Record of Nine Steel Companies*, Ralph C. Jones, The Journal of Accountancy, January, 1949, pp. 9-27.

2.3.5.2 Gross Revenue Manipulation

A rather direct approach to the objective of income smoothing may be made through the process of inter-period shifting of gross revenue. Given actual knowledge of or expectations about the operating results of two accounting periods, speeding or delaying the shipment of and billing for product and hence the recognition of revenue, may accomplish some degree of leveling of the income of the two periods. The effect of shifting gross revenue may be particularly significant in service rendering enterprises where the amount of direct costs related to such revenue would be relatively much smaller than in a manufacturing or merchandising enterprise. In many concerns the magnitude of the effect upon periodic income from this source would be minor, since only transactions occurring relatively near the closing date would be susceptible to such shifting. How- ever, in an enterprise, which has a relatively small number of revenue transactions, each involving a sizable money amount, the effect of such inter-period shifting on period revenue could well be substantial. Similarly, the use of production as a criterion for revenue recognition by a concern engaged in a small number of large and extended construction or manufacturing contracts, would tend to produce a more stable level of periodic income that would strict application of the conventional accrual basis. However, it is hardly appropriate to consider this as a method of artificially smoothing income, but rather as the use of a realistic and logical method of gross revenue booking.

2.3.5.3 Inventory Accounting

Alternative techniques of inventory valuation may provide a very significant method of income smoothing. This has become particularly true with the emergence and wide adoption of the last-in, first-out method of inventory pricing. The effect of the use of LIFO may be described, in summary form, as causing the matching of sales revenue expressed in terms of the current period price level with cost of merchandise or product expressed in similar terms. This is accomplished by valuing the inventory of unused material or unsold product substantially in terms of a fixed base price, the aggregate thereof being changed only to the extent of changes in physical inventory quantities. It is apparent that this matching of “current cost with current revenue” will have a decidedly stabilizing effect on income, as compared with the results of the more traditional first-in, first-out assumption. This will be particularly true in the case of an enterprise with a lengthy manufacturing process, using substantial quantities of raw materials subject to fluctuating supply prices

and, in particular, during a period of rapid price level changes. It seems appropriate to remark that the recent extension of last-in, first-out to such concerns as department stores can be defended by few of the theoretical arguments, which may be applied in the case of certain types of manufacturing enterprises. It would appear that smoothing of income, particularly due to the income tax effects thereof, represents the principal motivation for the use of LIFO in many (if not most) cases. Other pricing techniques, more recently suggested, which will produce the same general effect are next-in, first-out; highest-in, first-out; and, more-in than-out. Since no general use of these methods exists, it seems adequate to merely indicate their existence, without attempting detailed discussion thereof.

Less fundamental methods of income smoothing through the inventory valuation process are also available. These arise through the subjective decisions made by management relative to reduction of inventory value for unsalable, obsolete, or damaged material or merchandise. The timing of adjustments for these conditions may well produce a smoothing effect on periodic income.

2.4 Profit smoothing and corporate finance

The issue of financial manipulation and accounting fraud has long been felt in the public opinion for some years, following the known financial scandals that have occurred indiscriminately throughout the Western world. What is not always clear is that such events are the tip of the iceberg of a certain business management style that, driven by a perverse system of economic incentives for managers, has the dominant goal of maximizing value for shareholders in the short term. The financial statements, which should be a faithful mirror of business activity and a transparent guide to investors' use, are so often the instruments to positively impact the markets to the detriment of true and trustworthy markets.

Before analyzing quantitatively the concept of profit smoothing, it is appropriate to make an excursus on other fundamental concepts that insist on the company's corporate profile. One of these, from a business point of view, is the phenomenon of earning management.[209]

It is necessary to state that accounting is not a precise science, so it does not exactly describe the facts. Accounting, and consequently the measurement of financial results and the state of the firm's resources, is based on conventions and a series of estimates that can be more or less made for their own interest. To counter this possibility, reference is made to accounting principles that must be respected by companies that make use of it, punishable by penalties and, where appropriate, in the most extreme cases, exclusion from the market. It is not always easy to understand when a manipulation or accounting fraud occurs. Business managers have the ability to manipulate market-driven information, artificially increasing profits, even without violating accounting rules and therefore without risking being punished. To describe this practice of changing budget data commonly used are terms such as manipulation, correction, adjustment, attenuation, etc. The most common term in specialist literature is "earnings management". It is a neutral expression that does not intend to suggest moral judgments.

For Schipper (1989), earnings management is the strategic intervention by managers in the process of reporting financial data to the outside public with the aim of gaining personal gain. The basis for this behavior is the availability of data managers who are not accessible by external stakeholders: in other words there is an information asymmetry that allows the earnings management practice. The concept of information asymmetry is therefore fundamental in the analysis of earning management. Information asymmetry occurs when

[209] As we see, also cites the previous paragraphs.

in a relationship or a commercial transaction one of the parties involved has an informative advantage over the other or on the other. According to Schipper, such asymmetry exists in the relationship between managers and other interest groups and cannot be completely eliminated by changing contractual arrangements.

Davidson, Stickney and Weil (1987) say that earnings management is the process by which managers, while remaining within the accepted accounting principles, try to reach a desired level of useful returns back to the outside.[210] This optics focuses on the issue of managers' judgment in defining financial data. There are several ways in which it can exercise its own judgment to influence financial relationships. For example, estimates that relate to the final value and duration of a certain asset, or about possible future expenses that have not yet occurred.

Beneish (2001) analyzes different earnings management definitions and notes that while the opportunistic perspective has been well studied, little relevance in the literature has been given to the information perspective, for which managerial arbitration is a means for managers to reveal to investors their expectations regarding the future cash flows of the company. However, he believes that the informational approach does not it has always been positive: in fact the signals that managers throw on the firm's prospects and which should help investors choose between good and bad companies can also be deceptive. For example, a manager can deceive stakeholders by hiding gains in positive moments (for example by overestimating lending losses or infrastructure obsolescence) and "using them" to improve results when needed.

Technically, earnings management includes a spectrum of actions ranging from conservative accounting to fraud through aggressive and neutral accounting through a wide range of accounting choices.[211] In other words, such choices can be applied to each of the accounting entries and, with the exception of fraudulent accounting that is obviously manipulative.

Bhattacharya, Daouk and Welker (2002) speak of "opacity" of profits as a result of earnings management. Three are the opacity measures identified:

• earnings aggressiveness, that is, how much profits are the result of risky accounting choices and too optimistic estimates by executives;

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[210] This is the definition of Healy and Wahlen (1999): "*Earnings management is needed when managers use their judgment in reporting financial data and structuring transactions with the aim of altering financial relationships to deceive interest in the company's core business performance or to influence the consequences of contracts that depend on the reported data".*

[211] Giroux 2004.

• loss avoidance, that is, the incentives to communicate positive benefits disturb the relationship between profits and economic performance and thus harm the informative nature of the returns reported;
• earnings smoothing, that is, how much information profitability are corrupted by the activity of artificially lowering earnings and then using them later.

Literature has given great emphasis on verifying the presence in the contemporary economic system of earnings management and later on profit smoothing. Despite the common sense that earnings management and the profit smoothing phenomenon actually exist, it has not always been easy for researchers to confirm this hypothesis with concrete evidence. Recently, numerous studies have been able to show that this activity actually takes place in a widespread manner.[212]

Healy and Wahlen (1999) examine the evidence of earnings management, profit smoothing, and implications for updating accounting standards. The authors conclude that the general evidence states that companies "maneuver" the profits in line with a next public offering of shares. Teoh, Wong and Rao (1998) go into more detail and report that approximately 62% of companies making a public purchase offer have unexpected higher accruals than a sample-control of similar companies. This is considered to be a signal of earnings management.

Degeorge, Patel and Zeckhauser (1999), instead, introduce a model based on the thresholds of profits. Considering that executives maneuver their profits with the aim of influencing the perception of outsiders and since they judge the activities of managers precisely on the basis of certain earnings targets, the authors assume that executives focus their attention on the thresholds to be taken in consideration to assess the firm's performance. Degeorge, Patel and Zeckhauser identify three thresholds that would be kept in mind by executives when they convey the profits:
• communicate positive profits, that is, profits greater than 0;
• support recent performance, that is to do at least the same benefits as the previous year;
• to meet the expectations of analysts, in particular to focus on the consensual forecast of earnings.

Analyzing a series of corporate results from 1974 to 1996, the authors come to the conclusion that when managers are motivated to reach these thresholds, the distribution of reported returns becomes abnormal: historically there are too many companies that exceed

[212] Also cites the previous and the following paragraphs.

the thresholds of profits compared to those Which do not exceed them. For example, with regard to the "support for recent performance" threshold, there is a big leap in the distribution of profits around the value 0. The value in this case refers to the difference in earnings per share between one year and the other (EPS = EPSt - EPSt-1).[213] In other words, in the region of small negative EPS changes the distribution seems to have been "limed": part of the density that would normally be between -1 and 0 of EPS in normal distribution seems to have moved to the area slightly higher than 0. Declining falls, though for an inertia, for a manager is a problem especially at the image level: it is easier then, in these limiting situations, to artificially increase the profits of that minimum amount that will allow you to match or slightly improve the results of the previous period so as not to alarm the investors. This phenomenon is proof of the existence of earnings management. Moreover, according to the authors, a hierarchy of thresholds emerges: the most important goal for managers is the threshold of positive profits, which prevails indifferently from the other thresholds; once this is achieved first threshold is trying to improve profits from the past; the last in the order of importance is instead the threshold of analysts' expectation.[214]
Concerning the results that often appear to be better than they actually should be before offering new shares in the financial markets, Beneish (2001) recalls that, despite the certification bodies and the rules prohibiting fraudulent communications, the information asymmetry remains and consequently there is the potential to deceive potential investors.
A search by Myers, Myers and Skinner (2005) that analyzes a set of companies with positive earnings per share (EPS) for at least 20 consecutive quarters shows that the number of companies that are part of this group between 1963 and 2004 is greater than you would expect. This phenomenon is de finite earnings momentum, or "the ability to report quarterly positive earnings per share for several consecutive years", and is a proof of earnings management. To succeed in this business, the managers of the companies under review would act to increase the EPSs reported when they were declining and, conversely, to decrease them when they would otherwise be growing more than needed. More in detail, managers would tend to bring positive or negative items into account to mitigate profits.

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213 EPS: Earning per share, also called net income per share, is a market prospect ratio that measures the amount of net income earned per share of stock outstanding. In other words, this is the amount of money each share of stock would receive if all of the profits were distributed to the outstanding shares at the end of the year.

214 Degeorge, Patel & Zeckhauser, *Earnings management to exceed thresholds*, 1999; see also Kellog, I. & L.B. Kellog, *Fraud, window dressing and negligence in financial statements*, 1991, McGraw Hill.

Beneish (2001) concludes that the set of evidence suggests that earnings management tend to increase earnings is more rampant than that with the aim of decreasing them. Obviously, situations where a company goes too well with expectations and goals, and therefore profits can be "put in safe" for worse times, are less frequent than when each extra income has a positive effect on the manager utility function.

2.4.1 Profit's strategic reasons

The complexity of the phenomenon of the economic value of the firm as such and the high difficulty of its measurement, representation, analysis and interpretation is certainly not inferior to the extraordinary interest that arouses the subject for the scholar as for those, entrepreneurs, executives, shareholders, stakeholders and professional analysts who, in their respective roles, have to evaluate, decide and behave accordingly.

The analysis of value, even before its strategic proposition, can be suitably conducted on two distinct levels: one, in a conception, exquisitely economic-business, enterprise strategy, the other according to a vision of corporate and financial, of corporate strategy,[215] obviously not leaving the interdependencies between the two plans of study and analysis.

As a business strategy, value is primarily the economic determinants of value that contribute to its profitability and profitability, given the pseudo-axiom "more profit more value". The strategic economic determinants of value are therefore identified in the structure of the firm in its organizational and functional system and in the consequent processes of production, distribution and sale of the products. Auxiliary and administrative processes, albeit indirectly, contribute to the formation of value to the extent that they effectively support economic and financial processes; it goes without saying that, in any case, operating efficiency and cost-effectiveness contribute directly to increasing the profitability of the firm.

The proposed analytical model involves the construction of an original "matrix value" that features, on the one hand, the "strategic business units (product/market - SBU)" previously selected and, on the other, the development of value, distinctly, for "activities" that are

[215] From Andrew to Porter, and in a generalized orientation, agrees to put the business strategy (the competitive) and the corporate strategy (of value) approaches but different. Andrew writes: "*Corporate strategy is an organization process, in many ways inseparable from the structure behavior and culture of the company in which it takes place. However, we can abstract from the process two important aspects, interrelated in real life but separable for the purposes of analysis. The first of these we may call formulation, the second implementation*". See K. Andrew, *The Concept of Corporate Strategy*, Homewood, 1987 and M. Porter, *From Competitive Advantage to Corporate Strategy*, Harvard Business Review, May-June, 1987.

functional to production processes. Obviously, the more numerous the SBUs, the more complex the value breaks down on the matrix, while in the case of a company that produces only one product for a single market, everything would be simplified in the strategic analysis of the "value chain" (see the "Porter" sense),[216] for traditional processes and/or business activities. Within each functional process sequence (from production to distribution, to sales), they can then find evidence (if one can have an appropriate managerial accounting progress) matrix data of the further disaggregated value for both "by activity" and "for strategic business areas". By way of example only, could a number of "value options" be highlighted far beyond the classic *make or buy?* dilemma. This may be the case for a whole range of arbitrations between outsourcing, processing for or on behalf of third parties, decentralization of production in developing countries, complete automation of plant and machinery, reformulation of firm logistics, from that in production support to sales distribution and so on. It should be noted in this regard that the strategic orientation towards excessive "outsourcing" or other formulas that would otherwise lead to the abolition of increasingly important value-added quotas could lead to the gradual de-structuring of the firm, the loss of skills in human resources, know-how and, ultimately, loss of value, not to mention social and territorial reflections.

At the level of product and market policies, the value strategy could go further by searching for an optimal combination of earnings leverage. We remember how, by acting on sales revenues and/or the contribution margin, the "leverage effect" (equal to the ratio between the contribution margin and operating income) would lead to a more than proportional increase in the income that can be achieved. Conversely, acting on fixed costs, a similar structural leverage effect (equal to the ratio between fixed costs and operating income) would be obtained but inversely proportional. Clearly, the complexity of the determinants at stake and the close ties between them do not make the leverage maneuver easy with the risk of modifying the income equilibrium formula without a clear strategic design to be achieved; a design that, in order not to end itself, should be framed within the firm's competitive strategy (with particular emphasis on SBUs) where they enhance those entrepreneurial and managerial skills that are a highly critical factor in the process of creating value.[217]

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[216] A value chain is a model that allows describing the structure of an organization as a limited set of processes. Michael Porter theorized this model in 1985 in his best seller *Competitive Advantage: Creating and Sustaining Superior Performance.* According to this model, an organization is seen as a set of nine processes, of which five primary and four supporters.

[217] According to the authors of "*A new management philosophy*", managers demand that their business be

However, the value strategy does not exhaust its mission by optimizing operating income, on the one hand, and by affirming the firm on the market, both in terms of strategic positioning and the acquired competitive advantage, on the other.

Ultimately, but not least, the financial value of the value process remains to analyze. The firm's economic activity requires capital investments, both fixed and current, that determine the financial needs to which it is covered by self-financing, capital and financial indebtedness. When self-financing for indivisible dividend consolidates together with equity, it constitutes the equity or venture capital of the enterprise, which, in turn, together with the financial indebtedness (net of any financial assets), expresses the total of the sources of invested capital in the firm. This is due to the fact that the financial debts are, by definition, for an expense, the interest expense paid (net of any assets that may have been received) to absorb part of the value generated by the economic operation in relation to the net financial exposure, the technical nature of the financial transactions carried out and, of course, the essays of interest and, ultimately, the weighted average effective test. If financial management is essentially irrelevant to the value generated, it is true that in the transfiguration from operating income to gross tax revenue, the financial charges incurred can absorb a portion more or less significant up to the limit of zeroing the economic result, or even, make it a negative sign.

The targeted value strategy for corporate finance must therefore carefully consider opportunity-options to reduce capital requirements by "differentiating" or "disposing" non-strategic or unproductive investments, "accelerating" the rotation of working capital, or "de-structuring" some auxiliary activities opting for outsourcing or other tactical strategies.

Emphasizing the value strategy on the containment of invested capital or emptying the industrial content of a company may, however, prove to be detrimental to its equilibrium over the middle to long term. The exasperation of the managerial doctrine implicated in the known formula called Economic Value Added -EVA can induce high-risk business policies, such as postpone renewal or technological upgrading of plants or disincentive investment in research and development. Of course, the intent -indeed very little strategic-

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considered as "value creators" rather than as "value-appropriators" -and consequently: "*the shift of emphasis is a great inside firms. In the logic of a turbulent organizational economy, competitive advantage is anchored in the company's ability to innovate its way temporarily out of frelentless market pressures. As companies change focus from value appropriation to value creation, facilitating cooperation between people takes precedence over enforcingcompliance, andinitiative becomes more valued than obedience. The manager's primary task is refined from institutionalizing control to embedding trust, from main taining the status quo to leading change"*. See S. Ghoshal - C. A. Bartlett - P. Morgan, Strategy and Value Creation in Strategic Thinking, MIT-SLOAN. Jossey Bass, San Francisco, 2001.

to highlight short-term profitability indicators on ROI and ROE respectively. Moving from the sources of invested capital, one sees how the value strategy can leverage several levers, including, first of all, the classic, financial, which is capable of acting as a leverage to increase net profitability compared to operating profitability (ROE>ROI) to the condition that the "weighted average interest rate" corresponding to the financial indebtedness, is lower (with a reasonable margin of security) than ROI. The imprudent use of the leverage without a clear strategic view of induced and collateral effects can seriously compromise the structural balance of assets where, for example, a company should be excessively undercapitalized with respect to the value of immovable or inalienable investments, just as be strategic.

Still others can be business finance interventions, with the aim of maximizing profitable strategy. Among the most commonly used, we note the buy-back transactions, i.e. the purchase of stock shares by a company with the dual effect of supporting the stock market value and, on the other hand, reducing the net capital, thereby raising the profitability of the enterprise to its level of profitability. Always in consistency with the aim of accentuating the profitability of the enterprise and, in its reflection, its economic value is recalled by the discontinuing operations through which it is possible to contract, even very significantly, the invested capital by shedding down branches of business or assets considered not strategic or, in any case, not adequately contributing to the process of value. And yet, for the same purpose, a further hypothesis of reduced invested capital could be represented by a significant excess of liquidity (free-capital) if these were disbursed in the form of extraordinary dividends to be allocated to shareholders (more rarely below form of reduction of share capital). Lastly, it could be noted that limiting the self-financing policy to a high return on equities through a high payout of dividends compared to net profit as well as meeting the financial market appreciation would in turn, to contain risk capital and, on the other hand, to further increase its level of profitability.

The second moment of the strategy of value -a strategy, however, formulated on the search for the economic equilibrium conditions of the firm over time or, more explicitly, of "lasting profitability"- concerns the very value of the firm, as already initially laid down. There is no doubt about the fundamental correspondence between the value of profit and that of economic capital as it is the "expected gradient of profitability" to offer the merit of investing in a firm for the commitments to be taken, for the uncertainty of the future and the consequent risks. If the fundamental determinant of its economic value can be well recognized in the profitability of the firm, so that a company strategy aimed at maximizing

profit is a priority, it is true that there are still other conditions and circumstances that influence the valuation of the firm's economic capital. The first of these conditions lies in the value risk, more precisely as a system of risks, endogenous and exogenous, to the enterprise that is reflected in its ability to generate profits. Profit risk is an integral part of the economic value of the enterprise but, due to its difficult, if not impossible, safe weighting, without prejudice to the decisive weight of the balance of the corporate system, the appreciation it takes may be, objectively, changing in the relativity of space and time, as well as subjective is propensity, no less than individual expectation. This explains how, while having the same data, the valuation theorem of the enterprise's economic capital can find the most contradictory solutions, even by a same subject in the short-term. The value strategy, as a business strategy, is thus defined by the enhancement of the economic capital derived from prospective profitability (possibly integrated with intangible values).

The awareness of the economic value of the company is a major component of strategic control over mission objectives pursued. In the individual, family or personalized business, the firm is the dominant economic entity, factor and arbitrator of the company, in his own, prevailing, if not exclusive, personal interest; interest that, in the background, collides with the company's vital life. Equally, it cannot claim to be in capitalist firms, in the form of equity firms and, more specifically, for those listed on a widely traded stock exchange. For the latter, and for so-called public companies in particular, the economic entity assumes a much more complex connotation. Even the economic value of the firm, sought and achieved through profitability, can no longer be considered an end to gender as an extreme indicator of the effectiveness of entrepreneurial skills, useful in verifying and comparing strategic profit choices.

2.4.2 Gordon's model related to managerial goals

The time has come to introduce the concept of dividends and equity stocks into the analysis, including in the broader model defined by Gordon.[218] Equity stock should be valued with the same logic as for bonds. The difference is the greater difficulty in estimating the cash flows that can be obtained from them. Several equity-rating models have been presented, depending on the type of growth that firms anticipate. All models

[218] Gordon M. (1962). *The Investment, Financing and Valuation of the Corporation*, Homewood Illinois: Irwin.

have their intrinsic validity, provided that the implicit hypotheses are taken into account in the application. This paragraph highlights how the price of the shares can be divided into two parts: one linked to the current yield (dividend yield) and one linked to growth opportunities. A proper valuation of value must allow understanding the possible rebalance between the two components of value. For the shares, the general principle is that the value depends on the future cash flows that they will produce. For an investor with a one-year time horizon, the cash flows generated by an action are:

- dividends (if paid by the firm);
- the price after one year (in case of perfect liquidity of the investment).

The price of the stock will be equal to the present value of those two flows on the basis of an "r" rate appropriate to the risk.

Then:

$$P_0 = \frac{Div_1}{1+r} + \frac{P_1}{1+r}$$

The same applies to the stock valuation at the following time:

$$P_1 = \frac{Div_2}{1+r} + \frac{P_2}{1+r}$$

By proceeding with the appropriate substitutions then you will come up with a general formula:

$$P_0 = \sum_{t=1}^{\infty} \frac{Div_t}{(1+r)^t}$$

It is deduced from the fact that if the financial market is properly applied to whether to choose a dividend distribution or to take the road to capital gain, the answer is "indifferent".[219]

The newly viewed formula poses the problem of defining the dynamics of dividend flow produced by a firm. The analytical forecast of all streams appears to be an abstract exercise compared to the actual achievability. On the other hand, it is more realistic to hypothesize

[219] The dividend is the share recognized to the shareholder. Its amount depends on the management decisions of the firm and is influenced by the economic and financial results achieved during the year. Sometimes listed firms decide to distribute extraordinary dividends by drawing on the provisions set aside in previous years.
Capital gains, on the other hand, represent the positive difference between the sale and purchase value of equity (investments, warrants, convertible bonds and options).

some middle or long-term dividend trends and to look for appropriate valuation models. The trends considered are usually the growth that dividend flows can have in the future.

The first example is the simplest case: with zero growth the share becomes a sort of life annuity (risky) and as such is evaluated.

The case analyzed[220] is where the company still carries out the activities (including investments) necessary to maintain the ability to compete (e.g., replacement investments). It should be noted that the dividend flow that is discounted is uncertain: in the formula, an expected dividend value is entered.

Therefore in the formula:

- the dividend entered will be the one expected;
- the rate to be applied must include a risk premium.

In the case of constantly growth, it is assumed that dividends can grow on a perpetual "g" rate. The "g" growth rate of dividends is the result of a similar growth of the enterprise in all its components (profits, assets, debts, cash flows, etc.). It would therefore be more appropriate to talk about "company expansion". Consequently, the dividends obtainable by the firm may be represented by a geometric progression where the growth factor is expressed by the quotient between:

- 1+ g, expression of corporate growth;
- 1+ r, expression of the cost of risk capital.

By solving geometric progression, we get the "Gordon's" formula (from the name of the scholar who first dealt with this problem).

$$P_0 = \frac{DIV_1}{r - g}$$

This is a very used formula in professional practice as a result of it simplicity. It is necessary to know only three elements:

- *DIV*, i.e. dividends expected at the end of the year in which analysis is carried out;
- *g*, i.e. growth's rate;
- *r*, i.e. the cost of the venture capital.

We will also see that this simplicity can be a trap in which it is easy to underestimate the importance of certain implicit hypotheses to the formula.

One of the limits of Gordon's formula is to hypothesize a single "g" growth rate. More often than not, companies with different growth periods are observed:

[220] With zero growth.

- higher in a first phase (e.g. exploiting the innovative aspects of a new product);
- constrained (and coupled to an average of the economic system) in longer periods. Hence the need for a formula capable of capturing these two moments of growth:

$$P_0 = \sum_{t=1}^{T} \frac{DIV_0(1+g_1)^t}{(1+r)^t} + \frac{\frac{DIV_{T+1}}{r-g_2}}{(1+r)^T}$$

Growth in earnings (and dividends) basically depends on two factors:
- amount of profits made available;
- rate of return obtainable on such provisions.

$$1 + g = 1 + [(\% \text{ useful retention}) \times (\text{yield})]$$

For example, a 10% growth rate can be obtained:
- holding 50% of the profits to reinvest them to 20%;
- holding 80% of the profits to reinvest them to 12,5%.

Historical ROE values can be good starting points to estimate the yield rate obtainable. It should also be recalled that the significance of the firm's historical data depends on its degree of commitment.

As for the second variable, the market based on the implied risk on the company should fix the "r" rate. This assumes the ability to properly interpret the financial market equilibrium. Alternatively we can get "r" through the following expression:

$$r = \left(DIV/_{P_0}\right) + g$$

Where:
- the first part of the formula represents the immediate yield of the title (dividend yield);
- the second part expresses the growth rate.

The formula highlights an important relationship: increasing the "growth" component of expected performance can reduce the "immediate" component. Finally, estimating the level of dividends would seem to be the most "simple" component. For this reason, it often triggers gross errors. In the formula we must enter always the value of dividends expected for the period. Gordon's formula imagines that the retention rate of earnings is perpetually constant. If this varies, it is necessary to make analytical estimates of the value. The formulas considered are net of all tax effects. Sometimes, however, dividend policies can

be affected by the tax treatment of non-distributed profits compared to those reserved for dividends. This helps explain why there are good-value companies in the financial markets, despite low paybacks.[221]

The general model allows some reflections: a) growth of profits does not generate a secure growth of the value of the company: the former grows if the reinvestment profits are positive, the second grows only if reinvestment creates value (makes more than "r"); b) there is no difference between analyzing profits and dividends only in the case of companies that do not grow. In other cases there is a clearing between increased value driven by growth and lower value as a result of incomplete distribution of profits in the short-term; c) there may be firms that do not distribute dividends provided that promises of growth (equivalent to future dividend promises) are probable.

The basic model for assessing the intrinsic value of an stock -also from the chronological point of view, as developed as the first model of stock valuation- is that based on the discounting of dividends. According to this model, the value of a stock is given by the present value of the dividends it expects from it. In an infinite valuation horizon, the book value is a perpetual dividend annuity, where the discount rate is the cost of equity (determined using CAPM, for example). The *Dividend Discount Model* (DDM), which is based on the same logic of bond rating, works properly for investments with a defined time horizon. One of the fundamental features of the stock is the indeterminacy of their expiration. For this reason, in order to calculate the value of a stock over a time horizon defined with DDM, it is necessary to estimate the expected price of the stock at the end of the period. In this regard, the main theoretical limit of DDM emerges immediately: the current intrinsic value of the share is based on a forward price estimate, which is, moreover, the value that is sought to estimate. Although the value of a stock is based on dividends, the estimated dividend time horizon does not provide an adequate intrinsic value. Indeed, firms that cannot generate value can in the middle term distribute dividends using debt, while companies with good profitability may decide not to distribute any dividends. A solution to solve this problem is to assume that the dividend paid in the last year of the explicit estimate period will be kept forever. In such a case, the expiring price will be equal to the capitalization of a perpetual annuity at constant rates (obtained by dividing the dividend at the cost of equity).

[221] It should also be recalled that the risk of the two components is not always comparable.

An alternative is to assume that the perceived dividend at the end of the explicit forecast period will continue to grow indefinitely at a steady growth rate (known as "g"). In this case, the value of the forward price is obtained by capitalizing on a perpetual rent with increasing rates = DIV/(Equity cost - g). This model, as we have seen before, is known as *Gordon Growth Method*. The main limit of the *Dividend Discount Method* is that dividends do not represent a value creation measure over a defined time horizon, despite the value of a stock being determined by the same dividends. A firm that does not create value can in fact be indebted to distribute dividends, while highly profitable firm may decide not to distribute any dividends. One way to overcome the DDM limits, while adopting the same focus on cash flows, is the *Discounted Cash Flow Method* (DCF).

The *Gordon Growth Model* (GGM) links the value of the share to the expected dividends in the following period, the rate of return required by the share (expressed by equity cost) and the expected growth rate of dividends. As emerged from the application of the *Dividend Discount Model*, a solution used to estimate the forward price to be used in calculating the intrinsic value of a share is to assume that the dividend received in the last year of the explicit forecast period will continue to grow to a constant rate "g" to infinity. If it is assumed that growth does not begin at the end of the forecast period but immediately (i.e. in the first year after the estimate), the intrinsic value of the share is given by the capitalization of a perpetual rent with increasing rates:

= DIV_1((Equity Cost - g). This method is known as the *Gordon Growth Model*. The *Gordon Growth Model* can be used to evaluate a firm that is in a stable growth phase that is when its dividends grow at a constant rate. If is true that *Gordon's Growth Model* is a simple and powerful approach to evaluating stocks, it is also true that its use is limited to firms that are in a steady growth phase.

Profit smoothing insists on the dividends' phenomenon. It should be noted how profit smoothing is used to keep shareholders' expectations on profits[222] constant from one period to another.

[222] As dividend.

2.4.3 Culture of extra profit as a threat to the shareholder value

The value created is the result of appropriate managerial choices. The management choices that have the greatest effect on the value of the business are those that relate to the complexity of the business formula, are mainly strategic, long-term choices. The choices that induce the most incisive growth in value in the middle to long term are almost always those that are linked to innovation. There is, unfortunately, no effective and direct instrumentation for measuring the link between these choices and the value created. Choices about technological investments, for example, are very difficult to judge; the evaluation tools are almost always of a qualitative and unstructured type. There are no convincing and effective quantitative tools that can allow us to evaluate a technological strategy in the effects on the value created. Very often, value orientation is not taken for long-term choices -because of the difficulty of verifying a useful link- but has a precise and constant application for short-term choices simply because they have a much faster and safer impact on business results. By acting on variables that can be maneuvered in the short term, the value maximization for shareholders passes through three master classes: a) growth in profits; b) growth in the level of indebtedness whenever the return on the resources used exceeds the cost of the financial charges, c) rationalization of invested capital. There are several short-term mechanisms along the aforementioned guidelines that improve performance even at a very rapid pace. These mechanisms are widely and progressively widespread. All these roads mean, however, that if they are not embedded in a wider logical framework, they are also possible perverse, dangerous, sometimes fatal operative events. Growth of profits can be forced simply by alleviating the investments needed to support subsequent strategic cycles. Investment in R&D is likely to be attenuated, as they have a reduced effect on the value created in the near future and an incremental, otherwise uncertain, effect for the farthest exercises. Beside investment in R&D, there are several other cost cuts that amplify, but only in the very short period, the value created. There are a lot of cost items that lend themselves to a “harvest” strategy. Creating value, with a strategy of this class, means “squeeze” everything achievable in the shortest time possible. It is clear that such a strategy, if implemented with measure, corresponds to the implementation of an appropriate efficiency recovery plan. However, the value model does not stop at achieving a good level of efficiency, but continues to point out the convenience of further cost cuts in addition to the actually appropriate level. Profitability recovery is done to the detriment of customers, or suppliers, or employees, or those shareholders who are interested in a long-term growth profile, or the environment.

The exasperation of the level of indebtedness is entirely consistent with the culture of value, but it undermines the firm's financial prospects and makes it more vulnerable in difficult times. The optimal level of indebtedness, according to the logic of value, is consistently higher than the level that would be termed more traditional logical follow-up, especially for successful businesses. On this point there is a wide empirical anedoptics. Managing invested capital for value creation is often carried out by the sale of "non-strategic" assets or the spin-off of real estate or intangible assets (trademarks and patents). These transactions impoverish creditors and shareholders of tomorrow, anticipating the value of today's shareholders, and considerably increase the prospective risk of the company. A stock option incentive system impoverishes the same shareholders today. This is a mechanism that pushes toward short-term strategies for recovering value. In addition, the risk of opportunistic behavior or market abuse is extremely high. Empirical evidence largely confirms this fear.[223]

Value culture hampers therefore the pursuit of middle to long-term goals and undermines the survival of the enterprise in an intergenerational perspective. The pervasiveness of short-term goals is counterproductive, as is clear in the literature and found in business practice. The cases of companies managed with a strict logic of value are very frequent and formally adopted the models that some years later faced important moments of crisis. Value growth for shareholders can therefore be virtually based on short-term opportunities, the above-mentioned behavior has provided some specification, or virtuously based on innovation paths. Frequently, value growth can occur, in the context of opportunistic opportunities, without any virtue, at the expense of customers, suppliers, employees, communities, and the environment with which the business interacts.

Corporate Social Responsibility or codes of conduct and ethics are just about to put a brake on extra-profit situations. These are measures of "self-limitation" in the path to value.[224] However, recent studies (Omran, Atrill and Pointon 2002) demonstrate that stakeholder-view business management does not necessarily result in lower stock returns than the returns offered by managed businesses in shareholder-view logic.

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223 See Johnson, S. A., & Tian, Y. S. (2000). *The value and incentive effects of nontraditional executive stock option plans*. Journal of Financial Economics, *57*(1), 3-34.
Core, J. E., & Guay, W. R. (2001). *Stock option plans for non-executive employees*. Journal of financial economics, 61(2), 253-287.
Core, J., & Guay, W. (2002). *Estimating the value of employee stock option portfolios and their sensitivities to price and volatility*. Journal of Accounting research, 40(3), 613-630.

224 See M. Onado, *Azionisti, clienti e valori d'impresa*, Il sole 24 Ore, 26 Marzo 2006.

The culture of value is, in effect, a culture of extra profit. The fair profit is that measure of income that remunerates the risk of firm (endorsed by the shareholders) and which allows a reinvestment rate necessary and sufficient to preserve the prospective profitability of the enterprise. In a free competition market, it is not possible to generate and defend long extra profits. But this is just a logical reference model; reality often differs. Value culture does not recognize merit in achieving a profit, but only in achieving something more. Value culture strongly pushes businesses towards creating rents and the abuse of acquired dominant positions. The verbal expression “extra-profit” evokes an idea of danger for the community, abuse, short-term, undeserved outcome; the expression “created value”, which has the same intrinsic meaning, evokes managerial foresight.

CHAPTER 3.
WHY CHINA

3.1 Introduction

The development of corporate governance[225] in China is entering a new phase in which effective governance mechanisms and practices have become the necessary prerequisite for seeking lasting prosperity through an open, open market economy that can compete globally. While Chinese corporate governance could have been considered an obscure topic and in the hands of a few academics and practitioners, it is now a very important part of financial language for various stakeholder groups, including investors, managers, corporate directors, as well as government organizations and non-governmental. China cannot go further, this is the time to support its momentum of growth, develop credibility and the various forms of business organizations that implement their corporate governance. In order for the Chinese model of corporate governance, adapted from the Anglo-American version, actually functions, it is necessary that the formal and substantial market as well as the social institutions actually develop and work[226]. While we have continued to introduce and use an impressive number of corporate governance practices and mechanisms, there are some systematic and related issues that require the introduction of a fully effective corporate governance system.

Among these issues, for example, there are: the current family problem of the management implications for domain ownership by state-owned companies in listed firms, in major banks and in unlisted companies; insider control; publicity and information reporting system, as well as poor monitoring; the actual exercise of the rights and the stakeholders' protection; the effectiveness of the board; and the applicant's weakness as well as the uneven application of laws and regulations. There are also major struggles such as the corporate governance role of the Communist Party organization, overlapping regulatory issues, transparency, administrator remuneration, and the development of a functioning market and social institutions, as well as a corporate culture compatible with a modern corporate governance system that the Chinese government is trying to build. The development of the corporate governance in China can serve in many ways of linking and guiding to develop other key areas in the economic and regulatory context. For example, in recent years the listing of major state-owned and foreign-owned companies in foreign

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[225] Cook J., Deakin S., *Stakeholding and corporate governance: theory and evidence on economic performance*, Research center for business research, University of Cambridge, 1999.
Keasey K., Thompson S., Wright M., *Corporate Governance: Economic Management and Financial Issues*, in Oxford University Press, Oxford, 1997.

[226] KIT T.O., *The development of Corporate Governance in China*, Cheltenham, Northampton, MA, USA, Edward Elgar, 1999.

equity markets has provided the necessary boost to ensure governance and governance change that Chinese authorities would find fit for their benefit because foreign investors and lawmakers they will demand compliance with international standards.

At this stage China is moving from a generic introductory framework of formal norms and regulations to the creation of comprehensible institutions to run the system in the interest of all stakeholder categories. The initial development of corporate governance has been limited to setting what is needed in a formal context for listed firms. After about twenty years of development, there is now an urgent need to reform the country's financial system and respond to the growing demand of domestic and corporate sectors to access the capital market and invest more effectively, as well as providing answers to the public sector which needs to be equipped with institutions and tools that make it possible to exercise indirect control over the economy. The Chinese government has decided to change its line of business, ranging from the usual routine management of state-owned enterprises to the control and guidance of industries that are thought to be strategic at national level by promoting a select group of large-scale, directly owned businesses From the central government, to make it the industry leader, both in size and in the position of natural or regulated monopoly. To achieve these goals, state-owned banks will be a key strategic key to allow the government to exercise discretionary macroeconomic initiatives to guide the growth path of the Chinese economy. The massive expansion of bank lending in the short term as a Chinese response to the global financial crisis in 2009 was a clear confirmation of the Chinese government's modus operandi. This, the experience of financial scandals and the restructuring of state-owned Chinese banks in separating outstanding loans[227], highlighted the importance of good corporate governance to ensure that the banking industry can deliver results.

[227] Non-performing loans.

3.2 China's development: a powerful imperialist pole emerges

The last twenty years of the life of capitalism are characterized by strong changes in the international scene. Alongside the US as the only gendarmes in the world, the consequence of the fall of the Soviet empire, the European attempt to start the process of establishing a new imperialist pole able to cope with the American side and alongside Japan, the economic colossus of the extreme east, sustained by a persistent stagnation that seems only for one year being overtaken, the East is experiencing a period of great economic viability, characterized by rates of development far superior to those of the Western world, which starts to impose a decisive change to the world economic equilibrium. While on the one hand there is the tedious and cramped progression of American and European capitalism, characterized by a structural crisis, on the other hand, the unprecedented development and the swirling growth of the Asian area, an area that could soon assume a decisive global weight. India and China, but especially the latter, are the engines of this development that will soon bring new problems to the whole world. This is undoubtedly a very important phenomenon that cannot be neglected because it will lead to major changes in the coming years. China, with the impressive strength of the vastness of its territory and its population, is trying to become an economic power capable of returning to the world scene with renewed vigor and credentials of true imperialistic power endowed with all the numbers to treat par with the American and European giants. This is an epochal change that also deserves our attention in the effort to understand the future imperialistic dynamics.

3.2.1 Chinese development

China has been expanding for about twenty years at an average annual rate of 9%.[228] The World Bank forecasts that China's gross domestic product surpassed the US in 2014, bringing the country to the top spot in the world. Another indicator confirms it: the per capita GDP has risen from 248 renminbi in 1970 to 1,633 in 1990 to 6,648 in 1999 to 54,003 renmibi in 2016 and continues to grow.

Synthesizing the internal components of development, we see that the weight of the industrial and service sector is constantly growing (+9.9% between 1979 and 1991) while agriculture is declining steadily (+5.3% average in the same period). However, China continues to be one of the largest agricultural producers in the world (it has a cultivated

[228] See China a boom of clay feet reported on Prometheus No. 7 of 2003. In particular see also Chapter 4 of *The Miracle of China* by Maria Weber, edited by Il Mulino, 2003.

area of only 10% of the total). This is the result of the de-cultivation process of agricultural enterprises started in 1974 which fragmented the distribution of land, thereby reducing labor productivity and has produced the phenomenon of peasant escape in the cities due to their increasing economic difficulties (today peasants and their families still account for 870 million people on a total of about 1 billion to three hundred thousand men). In the last decade, the peasant farmers' urbanization process was such that the ninth five-year plan (1996-2000), fully grasping the gravity of the problem, paid particular attention to the issue of re-launching agriculture through the introduction of technologies and more advanced work organizations.

The industrial sector has been reformed since 1979 (with a decisive acceleration in 1984 when foreign investment was strongly encouraged), the year in which the process of economic liberalization that has progressively led the state to lose ownership of the 50% of the industries. In about twenty years, state-owned, large-scale, state-of-the-art economy has dropped considerably, thus generating 77.6% of the total gross industrial product at about 25%. In the same period, small and low-tech companies, economically free from the plan's economy and managed in function of the local market, increased from 22.4% to 35-40%. Considerable is the development of private and foreign-owned enterprises since the nineties, which, of course, have settled in the most innovative and technologically advanced sectors of the market. These ranged from a modest 4.4% in 1990 to a more robust 17.9% in 1997 (we do not have the latest data available) but it is reasonable to assume that later this sector has recorded a real boom given the inflow huge foreign capital of recent years. The significant figure is that, in addition to traditional manufacturing sectors (especially textiles where there is the largest world production), China is developing considerably in the fields of mechanics, transportation, chemicals and food. If the silk, cotton and wool industry are in trouble due to product quality still lower than that of the most advanced countries and the lack of the centrally administered price regime (in September 1999 the government abolished the price guaranteed for cotton production), high tech industry marks important developments giving a particular connotation to the growth of the economy by the fact that beside the traditional sectors of capitalist development, with low organic composition of capital, coexist technologically advanced sectors who can compete well on the international market. While the former bases the success of their exports basically on lower production costs due to wages significantly

lower than those of competitors, the latter may also have a much higher product quality.[229] Consumption development also highlights the peculiarities of Chinese development; for example, in the country there is a progressive diffusion of fixed telephony (still limited to high-income consumers, mostly resident in cities), alongside the mobile one, based on the use of the most advanced mobile phones. Consumption today, especially in cities, is a good indicator of this phenomenon: the so-called four luxuries of the Maoist period (watch, bicycle, radio, and sewing machine) replaced the current seven televisions by color television, video recorder, refrigerator, washing machine, phone, camera and cell phone. So, alongside a backward, low-consumption, low-value economy, especially in rural areas, there is an ever-growing economy in cities that is more like the Western economy.

3.2.2 Development's reasons

First of all, economic reforms. In 1978 Deng Xiaoping's reform plan was announced. It is a program run from above, by the Communist Party, to introduce the free market into the Chinese economy. In practice, this is to reduce the economic area managed by the plan and controlled by the state that holds it fully, to progressively increase the free market and businesses held by collective, individual and strong foreign capital. The program is started starting from the rural areas where the de-collectivization of agricultural enterprises is realized, returning to the family as the core of production. Alongside this, three special economic zones (Sez) are created in Guangdong (Shenzen, near Hong Kong, Zhuhai, near Macao and Shantou) and one in Fujian (Xiamen, near Taiwan). This is the open door policy that wants to make the country available for foreign capital investment, a policy that is articulated at various points and that it intends to engage in intense commercial, financial and industrial relations with the major powers of the world. The project envisages the experimentation of these relationships in the Sez and then progressively extends them to wide areas throughout the country. Of course, many facilities are granted to foreign capitals, including the main taxation, which provides for corporate taxation reduced to 10% at the same time as the government's absolute commitment to not proceed to any confiscation and intrusion into corporate management. Subsequently, in 1992, the agreement on the annulment of the expiry date of joint ventures (which after a certain number of years the Chinese state could become the owner of the company) and the right

[229] See the interesting article on Xian's Technology Park on Il Sole24Ore of November 18th, 2004.

to appoint the presidency of the board of administration by the government. To other companies, they agreed to accept the rules of the market, with a tax rate of 15%.

Sez' economic success drives the extension and intensification of the liberalization program. The second phase of the reforms takes place starting in 1984 and involves urban areas: the inhabitants of the cities are granted what they had been given to peasants in 1978, namely the freedom to engage in commercial activities and to start up a family business. In state companies, however, attempts to introduce the principle of managerial responsibility by introducing the figure of the professional manager who would have to replace the centrally appointed bureaucrat in different business directions. Only a decade later, the reform of state-owned enterprises becomes more pronounced. In 1993, the Constitution was amended. The concept of free-marketed socialism is officially introduced, which mulled the planned socialist economy. In practice, economic categories, typical of liberal capitalism, are declared socialist, which have been adopted by the reform program justifying them with the necessity of developing the country and constitutionally affirms the principle of the responsibility of management of enterprises and farms to link the income individual to the company's economic results. In the same year, tax reform began to adapt the taxation system to the spirit of deregulation. The fiscal disbursement, which is no longer rigidly centralized, is divided into three levels of competence: central, regional and local. In spite of this, and this evidence shows that behind the reforms there is a bit of interdependent contention for the appropriation of wealth, the central government, in exchange for greater tax autonomy of the periphery, reserves with a special measure 60% of the tax revenue overall rising from the previous 38%. At the same time, the VAT is raised from 9 to 17%.

The results of the reforms are surprising; China's trade flows with the rest of the world are rising dramatically, recording a surplus of $16.7 billion in 1995, 12.3 billion in 1996, 40.3 billion in 1997 (the year in which the Asian financial crisis exploded), 42,8 billion in 1998 and only 29.16 billion in 1999, an abnormal year in which imports (+18.2%) increase in exports (+6.1%) due to a sharp increase in high-consumption goods tech market in the domestic market. In summary, the share of Chinese exports in the world has risen from 1% in 1950 to 5% in 2002. In the same year, if trade flows between China, the USA, Japan and Europe are considered, the country has in any case a surplus, particularly marked with the US, with which, as a result of imports for 22 billions of dollars, has exports worth $ 134 billion. More balanced the relationship with Japan from which it imports for 53 billion and

exports it to 62. From Europe, however, China imports 32 billion dollars but exports 77 billion.

The second reason for the Chinese boom is foreign financial investment. Open door policy has led to a huge influx of capital around twenty years, equivalent to about a third of foreign investment worldwide (approximately $40 billion annually on average), two-thirds of which come from Asia. They are enormous figures that no country in the world has enjoyed to finance their own economy.

The third reason for the development is the enormous availability of raw materials of all kinds and of low-cost labor. China is a very large country whose subsoil is rich in raw materials of all kinds, including oil, coal and natural gas, which guarantee energy supplies, even though, at this moment, it does not disdain to even supply it on the market international. Even more important is the overabundance of arms working in factories under inhumane exploitation with massive working hours and with wages far lower than those of the most advanced capitalist countries. This means a company's ability to have large amounts of surplus value to be reinvested at each production cycle. Here we do not have the space to deal with the subject in detail, but we only point to the conditions of intense exploitation of the forced labor force at shifts and defamation times, accidents at work that often ripen hundreds of lives whenever they happen, to the harm caused by the use of deadly pollutants used indiscriminately in production processes. This is a phenomenon that even remembers the wage and living conditions of that unfortunate working class of the first British industrial development.

China, especially in its eastern part, today is a huge open landfill that, with its poisons, is poisoning the surrounding environment by even polluting the skies of the neighboring states. In these inhumane conditions, the Chinese proletariat leads its laborious existence into a state of slavery that guarantees the Chinese bourgeoisie an enormous competitive advantage over international competition. In the countryside it is even worse: the conditions of wage earners are simply extreme poverty, a poverty that deny access to the most elementary products of the so-called industrial economy.

3.2.3 China in the world market

It has already been mentioned that China is a net importer of capital from the rest of the world as a country in which foreign investments are in a good position to be valued. We now see the trade flows between China and the most important economic areas. It is interesting to analyze the 2002 data, which is quite recent, broken down by the three main economic areas, North America, Western Europe and Japan (we do not have data for Asia as a whole). In North America (mainly US), China exports $134 billion and imports for just $22 billion; in Europe it exports for 77 billion and imports for 32, in Japan it exports for 62 billion and imports for 53 billion dollars. As you can see, almost 50% of Chinese exports are directed to the US, while the remaining 50% is divided between Japan and Europe with a certain prevalence of the latter. For imports, however, there is a certain balance with Japan, there is a marked imbalance with Europe and very sharp with the US (here for every dollar of imports there are 6 exports). So China, at least in traditional manufacturing sectors, is a real threat to the American industry, which is taking away ever-larger market shares (another sign of US decline) and is equally dangerous for the European one. Charging the price of Chinese competition is the most backward sectors of the respective industrial equipment, those with lower organic capital composition. China in this case is unsurpassed given the wage levels of its workforce, which are, for example, 3% of the US.

If we look at a longer period, the years ranging from 1990 to 2002, we see that China has continued, continuing the trend in place since the fifties, to take on more and more importance on the world market; its exports went from just under $800 billion annually in 1990 to about 1700 billion in 2002 with steady growth. Imports also followed, with lower values, the same trend, however, growing gradually less in exports, indicating how China goes progressively to occupy an increasingly important position on the world market as an exporter with economic relations that develop intensively in several continents. We can conclude that, with current growth rates, its weight in the world economy is bound to grow a lot.

Even from a financial point of view it is necessary to find out how China is now a giant; we mention only a couple of situations that confirm what they said even if the

topic deserves a thorough discussion. At present, Japan holds about one-third (between 850 and 900 billion) of all dollar-denominated world currency reserves; China holds nearly a sixth (about 400 billion); together they account for the largest share of US government securities that are the countries that mainly finance and support, with significant daily purchases of Treasuries, the US public debt. China, at the end of November 2004, signed an agreement with Brazil for $100 billion in ten years. It is a huge figure that it will deliver to a Latin American country belonging to that geographic area considered by the US as its "backyard". This is a demonstration of how China is able to export its financial capital in open competition with the American superpower and the rest of the world.[230]

3.2.4 Economic and global issues

First aspect: State-controlled state companies (still around 118,000 that absorb two-thirds of the total workforce, producing only about 27% of total industrial production) are not at all competitive and are very indebted. The government estimates that at least 30% of workers are in excess. This is a huge problem, which would require drastic corporate restructuring and massive redundancies.

Secondly, the banking system is exposed, with rates comparable to those of other Southeast Asian countries, to bad debts owed by financing to state-run chronically-owned enterprises. At the end of 2003, the total non-performing loans (recoverable loans) of the banking system amounted to 17.8% of the loans granted (to understand the importance of the data it is known that in Italy the same period amounted to about 2%). Therefore, China has the problem of urgently reforming the banking system, which is easier said than done, as this would entail a drastic cut in funding to the state industrial sector with all the consequences that one can easily imagine (even if some credit limitations imposed by the financial authorities reduced the bad debt to 13.3% in the second quarter of 2004).

Third appearance. The dependence of the Chinese economic system on exports to international markets. China, so as not to explode the problem of unemployment, both in cities and in the countryside, must maintain, if not increase, the current (already high) pace of development and therefore continue to export intensely. This means that it is

[230] Baldesserini, F. (2016). Lo sviluppo dell'economia cinese e la recente crisi.

dangerously exposed to the slowdown in the international economy and the internal social consequences that this could entail.

Fourth appearance. The dangerous habitat that is being created between cities and countryside. Rural income is extremely lower than those of cities, especially coastal, which have been invested by the phenomenon of economic development. This means that every year millions of poor peasants, literally hungry and lacking in any assistance, pour into the metropolis looking for a job, aggravating the problem of unemployment (official government statistics now account for it at 8%). This, as we said before, requires that development rates should not diminish the burden of the social issue.

Fifth appearance. The condition of the urban and peasant proletariat is at the limits of tolerance. The repudiation, with liberal economic reforms, of any form of welfares has eliminated virtually every social expense from the state. Everything has been privatized and, consequently, the essential health services (in the countryside the state has reduced to 1 euro per capita per capita spending), social security (63% of the population, the total number of proletarian peasants, is not entitled to the retirement) and school are paid with the result that today the majority of the population, the urban and peasantry proletariat, can not access it. Certainly economic development has allowed the formation of a small wealthy bourgeoisie in the cities where private initiatives have developed, but in the face of this phenomenon, the condition of the proletariat as a whole has significantly worsened. In summary, social inequalities have been dramatically sharpened. This is a potentially very dangerous situation according to the same Academy of Sciences, which with its recent report titled “Opulent society, a new problem for China”, warned the government to pay attention to the problem.

3.2.5 Political implications of Chinese development

After this brief overview I want to highlight the main political conclusions of my analysis.

China is becoming an economic giant able to compete increasingly on world commodity and capital markets and this process is likely to progress in the coming years; as a result, it seeks to widen its sphere of commercial and political influence in the world and first of all in Asia, rivaling directly with Japan; its imperialist role is destined to become more important and will be a problem for the US. China’s development, its transformation into imperialistic power able to compete with the other imperialist world poles, the US and Europe in the head, is part of the process of rewriting the frontiers and international

alliances launched in the last period, a process not yet concluded and that it still has to define future alliances among nations. It is another element of the threat to the US world domination and its international position, along with the outcome of the process of establishing the European imperialist pole, the international political position of Russia and the outcome of the destabilization process of the Middle East, is a determining factor for understanding the future structure of the imperialist clash. China, but we could extend the same speech to united Europe, is not a factor of international stabilization and pacification, but an element of further destabilization of the current situation, which is already characterized by accentuated tensions and precarious balances of traditional political alliances.

China is not such a development area to reverse the economic cycle of capitalism marked by the structural crisis, a crisis destined to aggravate and produce its most devastating effects. That is, one cannot argue that capitalism finds outlets in the Chinese market to start a new expansion phase capable of inverting the cycle of accumulation and overcoming the current crisis. In fact, western capital investment is primarily investment for productions that are substitute for the same mother-of-mother's, productions that in China enjoy the great privilege of a significantly lower labor cost. In a word, what capital is going to produce in China, almost always the same capital stops producing it in its own country, giving rise to the so-called phenomenon of re-location. Therefore, the Chinese market, as the outlet of commodities and capital, is only one element of counter-tendency to the fall of the average profit rate, a counter-tendency that can only slow down this fall but not stop it. This is confirmed by the fact that over the last twenty years, despite the sustained growth of China and its openness to foreign capital, the causes of international tension and instability have increased and not decreased.

China is not going to retrace the same steps as the western capitalist development through three industrial revolutions. In particular, its domestic market will not be characterized by a high-consumption economy capable of raising the Chinese proletariat’s living standards to the standard of the US or Europe. Its economy is predominantly exported and its ability to compete on international markets is based on an accentuated differential in the cost of its workforce; consequently, it cannot afford a marked rise in wage levels. Moreover, the change of the Chinese state’s role in the economy, with the consequent restructuring of public spending, will not only not allow the Chinese proletariat to receive the social services offered by Western capitalist states since the mid-twentieth century, but it will impose a precarious condition on it even more pronounced than it had when the economy

was totally centered in the hands of the state. China will increasingly be a country characterized by intense contradictions, first of all that of a powerful and rich bourgeoisie opposed to a proletariat reduced to a condition of semi-slavery.

Chinese development is not a stimulus factor of "collaboration between peoples and nations". Its exported products are substitutes for those made in other economic areas at higher costs and hence the Chinese economy is a threat to the economy of its importing countries. Thus, it compels Chinese workers with those of other nations. The export of financial capital follows the same laws as the western one, and consequently China, with the false and usual ideology of aid to arrears and international cooperation, lends money simply for the purpose of obtaining a financial annuity and widening the its own political influence. With this, it contributes to the robbery carried out by large banks and financial institutions to the detriment of the proletarians of the backward countries who thus have to produce with their work the surplus value needed to remunerate in the form of interest the capital lent to their states. In summary, China contributes to developing nationalism, a powerful ideological weapon to counter the proletarians of the various countries and bring them to the general disaster caused by economic competition and ultimately military clashes.[231]

[231] Caccavaio, M. (2009). The Effects of the Reform of the Chinese Financial System. *Equilibri*, *13*(2), 185-192.

3.3 China and the responsibility of power

Realists believe that liberal arguments for engaging China are based on shaky ground. It is true that economic interdependence between China and the world economy is intensifying. Economic interdependence alone, however, is insufficient to change Chinese behavior decisively and is at the mercy of Chinese leadership's cold calculation of cost and benefit. It is also true that China's participation in regional and global international institutions is growing. Regional international institutions in East Asia, in contrast to Europe, are, however, too weak to exert any real influence in modifying China's security policy and behavior in the region. While engagement policy may encourage the Chinese government to liberalize internally, other domestic variables such as succession politics and the vulnerability of the political system are more decisive of the future of China's democratization.

The contributors share many common concerns with the current debates. We also believe that the rise of China is central to the future shape of the regional and global international order and China's international behavior will change as its power grows. Further, China's growing power needs to be managed carefully to minimize its disruptive effect on the international system. We differ, however, on the assessment that the rising Chinese power is necessarily and inevitably destabilizing and threatening. A crucial variable here is China's attitudes towards the responsibility of its rising power in international relations. Does China view power as a means or an end, and a means to what end? What is the conception among Chinese elites of China's responsible role in international relations? As a rising power, does China share with other Great Powers similar understanding of their responsibility for managing the international system? Where is the gap? How can international society induce a rising China to play an increasingly responsible part in the emerging international order? Answers to these questions, we argue, have important bearings on our understanding of the implications of an ascendant China for the future international order.

We seek therefore to join the debate by investigating this missing dimension in the current discourse on the rise of China and to invigorate the debate by taking us beyond the sterile discussions of a rising power *vis-a-vis* a pre-eminent power. Regardless of one's theoretical preferences, the role of theory is to aid in understanding and explaining. There are two additional reasons why this line of enquiry should be pursued. First, China has

often been stigmatized as an irresponsible power and a "rogue state"[232].

Evidence drawn from, for example, China's evolving arms control policy and its policies towards North Korean nuclear and missile programs, as well as its behavior during the Asian financial crisis in 1997-98 and its missile exercise in the Taiwan Strait in 1996 is, however, inconclusive and contradictory at best. Such contradictions need to be analyzed carefully. Second, unique among Great Powers, China has developed a set of uneasy and unusual social relations with global international society. Our investigations must be embedded in that social context and are to contribute to our understanding of that social context.

Power exacts responsibility. Even in the anarchical and hierarchical world of international relations, this conventional wisdom remains unpalatably true.[233] Hedley Bull[234] once explicitly argued that it is precisely because of the embedded inequality of states in terms of power in international society that Great Powers enjoy special rights and privileges at the same time when they assume duties and managerial responsibilities for maintaining and sustaining international order. Great Powers also have a greater stake in the existing international order.[235] Bull argues more specifically that Great Powers contribute to international order by managing their relations with each other; and by exploiting their preponderance in such a way as to impart a degree of central direction to the affairs of international society as a whole. The persistent vitality of G7 (now G8), the uncompromising privileged status of the exclusive nuclear powers club, and recent debates over the reform of the United Nations Security Council are testimony of the continued relevance of Bull's arguments after the end of the Cold War. Two points need to be made here, though. First, the concept of the responsibility of Great Powers is fundamentally different from that of the state responsibility. Whereas state responsibility is legally and explicitly defined in international law (for example the responsibility to protect aliens and their property),[236] Great Power responsibility is politically as well as morally postulated

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232 For a caricature of different perceptions of China, see David Lampton, *China*, Foreign Policy, no.l I0 (Spring 1998), 13-27.

233 For the most recent debate, see Alberto R. Coli, *Introduction: American power and responsibility in a new century*, Ethics and International Affairs, 14, (2000), 3-1 0; and Tony Smith, *Morality and the use of force in a unipolar world: the "Wilsonian moment"?* Ethics and International Affairs, 14, (2000), 11-22.

234 Was Professor of International Relations at the Australian National University, the London School of Economics and the University of Oxford.

235 See Hedley Bull, *The Anarchical Society: a study of order in world politics* (London: Macmillan, 1977), 200-29.

236 For state responsibility in international law, see, among others, lan Brownlie, *System of the Law of Nations: state responsibility* (Oxford: Clarendon Press, 1983).

implicitly rather than explicitly. It rests on shared understanding principally among Great Powers. Collective expectations of international society therefore underlie the conceptualization of the responsibility of power. Second, in his discourse on the duties and stake of Great Powers in international order (largely conducted in the 1970s), Bull dearly privileges order over justice in world politics, although he is not entirely comfortable, and is sometimes ambivalent, as to where he situates justice *vis-a-vis* order. As Ian Harris has noted, Bull's ambiguity in his treatment of justice results from lack of an enquiry into international ethics.[237] Further, Bull's discussions suggest that the rights and duties of Great Powers are mostly, if not exclusively, structurally determined. There is little elaboration in Bull's discussions about how the domestic constitutions of individual states shape their attitudes towards power and their understanding of the responsibility associated with it. Discourse on the responsibility of power, which is deprived of normative content and blind to the role of domestic institutions and ideas can no longer be either justified or left unchallenged.

The responsibility of power, arguably one of the most fundamental concepts in international relations, remains one of the most underexplored in international relations theory. We are not here, however, to launch a study of the ethics of power and responsibility in international relations. Important as it is, it belongs to an entirely different enquiry.[238] Our purpose here is simply to highlight how notoriously difficult ethical considerations of power and responsibility can be and why they are likely to remain contentious and controversial. Ethical judgment of how and whether a power fulfills its responsibility is ultimately subjective. Difficulties in investigating Chinese behavior in this kind of analytical construct are further amplified by the differences in Chinese philosophical tradition and political culture that sustain China's historical assumptions about power and responsibility.[239] Whereas a system of legal and institutional checks on the exercise of political power has been developed in the Western political tradition, the Chinese political tradition has relied more on the ethical and moral character of rulers to

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[237] Ian Harris, *Order and Justice* in The Anarchical Society, International Affairs, 69, no.4 (October 1993), 725-41.

[238] See for example, Daniel Warner, An *Ethic of Responsibility in International Relations* (Boulder, Colorado: Lynne Rienner, 1991); and Stanley Hoffmann, *Political ethics of international relations*, Seventh Morgenthau Memorial Lecture on Ethics and Foreign Policy (New York: Carnegie Council on Ethics and Foreign Affairs, 1988).

[239] For a succinct and vigorous discussion of historical assumptions of power and responsibility in the Western political thought, see Leonard Krieger, *Power and Responsibility: historical assumptions*, in Leonard Krieger and Fritz Stern (eds), The Responsibility of Power: historical essays (London: Macmillan, 1967), 3-33.

restrain the abuse of power.

This is not in the least the only complexity to consider. Chinese revolutions in the twentieth century and China's turbulent relations with other Great Powers have also conditioned its understanding of the responsibility of power. In particular, China's unique experience of socialization into international life in the second half of the twentieth century has helped produce a special set of social relations between China and the changing international society. As Yongjin Zhang argued, Revolutionary China's relationship with international society in the 1950s and the 1960s is best characterized as alienation rather than isolation.[240] It is not hard to imagine why Revolutionary China did not feel obliged to take any social responsibility to an international society of which it was not regarded part and in which its legitimacy was tenaciously denied. In this context, it also makes perfect sense to talk about how and whether China is (re) joining the world.[241]

Yet, China's position in international society remains a curious one. China has been a declared nuclear power for almost forty years and has been one of the Permanent 5 in the United Nations Security Council for more than thirty years. It is now universally regarded as a rising power. Its membership in the Great Power club is nevertheless at best contentious. In the post Cold War international society, inference more often than direct reference is made to China being a "rogue state". China's full membership in international society continues to be questioned, but from a different angle. Human rights and democratization are now the litmus test, as Rosemary Foot argues in her chapter.[242] As the lingering Westphalia system becomes less tolerant of political heterogeneity,[243] the nature of the domestic political system, democratic process and institutional set-up become increasingly significant in defining not only the domestic legitimacy but also the

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240 See Yongjin Zhang, *China in International Society since 1949: alienation and beyond* (Basingstoke: Macmillan, 1998).

241 Oksenberg and Economy, *China Joins the World,* is the most recent example.

242 This follows a similar line of arguments by Andrew Nathan and Strobe Talbott, among others. Andrew Nathan, for example, argues that China should "behave in a way [in terms of human rights] that does not offend the conscience of that [international] community" in return for the benefits of full membership. Andrew Nathan, *Influencing human rights in China*, in James R. Lilley and W L. Willkie (eds.), *Beyond MFN: trade with China and American interests,* 80. Strobe Talbott, Deputy Secretary of State of the first Clinton Administration was more explicit, stating, "We believe China cannot be a full partner in the world community until it respects international obligations and agreements on human rights, free and fair trading practices, and strict controls on the export of destabilizing weapons and military technology". Strobe Talbott, "US Deputy Secretary of State Strobe Talbott's speech to the Japan National Press Club on 25 January 1995" (Washington, DC: US Department of State, 1995). For theoretical arguments on human rights as legitimizing norms, see Jack Donnelly, *Human rights: the new standard of civilization?* International Affairs*,* 74, no. I January 1998), 1-23.

243 See K.J. Holsti, *Dealing with dictators: Westphalia and American strategies*, International Relations of the Asia-Pacific*,* I (200 I), 51-65.

international legitimacy of a particular regime.

3.3.1 Responsibility: an evolving concept and a moving goalpost

The idea of "responsible power" began to take hold in Chinese thinking roughly in the mid-1990s, and Chinese scholars seem to agree that it became China's national self-identification in 1997.[244] Scholars have emphasized that certain ideas acquire their appeal because of their utility as "road maps" in guiding policy.[245] But sometimes ambiguity explains their attractiveness as well. In the case of "responsible power", its meaning was never officially spelled out. U.S. politicians never clarified specific yardsticks on specific issues, although this did not prevent academics from trying to make explicit the U.S. conditions on its China policy.[246] In fact, demand on Chinese responsibility marked a retreat from Clinton's earlier linkage policy, explicitly listing concrete Chinese concessions for renewal of its most-favored nation (MFN) status. Apart from academic exercises in clarifying what China had to do, the United States never specified a set of *a priori* obligations expected of China.

Its ambiguity notwithstanding, expectations, both domestic and international, for self-change in Chinese foreign policy in line with international standards were loud and clear. For instance, domestic institutional reforms were a requirement for membership in the World Trade Organization (WTO). Reformist leaders led by Premier Zhu Rongji had to restructure China's state-owned enterprises, many functions of the state, and the domestic legal framework in order to both comply with the international trade regime and compete in the global marketplace. Improving China's image as a trusted regional player in Asia and as an international citizen was imperative if China was to shed some of the fear and suspicion gathering toward it from the outside world. To credibly project a peaceful and constructive image, as Harvard professor Iain Johnston argues, China needed to show it cared about its international standing and played by the rules. Thus, "the 'responsible major power' identity discourse has had a distinctively multilaterals and status quo content to it." [247] Indeed, the most visible manifestation lay in China's attitude toward

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[244] Li Nan, Summary of the *China's International Responsibility Concept* Seminar, Dangdai Yatai, November 20, 2008, pp. 150–155. Open Source Center.

[245] Judith Goldstein and Robert O. Keohane, eds. *Ideas and Foreign Policy: Beliefs, Institutions, and Political Change* (Ithaca: Cornell University Press, 1993).

[246] James Shinn, ed., *Weaving the Net: Conditional Engagement with China* (New York: Council on Foreign Relations, 1996).

[247] Alastair Iain Johnston, *Social States: China in International Institutions*, *1980–2000* (Princeton:

multilateralism -the swift turnabout from anti- to pro-multilateralism in the late 1990s was one of the few radical shifts in contemporary Chinese foreign policy.

The 1997–98 Asian financial crisis became a seminal event. It crystallized for the Chinese leadership what responsibility meant in terms of expectations and benefits. Amidst extreme volatility in currency values in East Asia, the right thing for Beijing to do was to not devalue the Renminbi (RMB), even if this meant acting against its own immediate interest in keeping its export sectors competitive. And it did exactly that -did not devalue the RMB- thereby helping stabilize the regional economy. Moreover, unprecedentedly, China offered its share of financial support for struggling neighboring countries in tandem with international rescue efforts. Because the crisis concerned neighboring economies, the idea of responsibility became more real and pertinent to China than other seemingly remote global concerns. The fact that Chinese acts were a response to its distressed neighbors also internationalized "responsibility" beyond a call from the United States. In this case, responsibility ultimately served China's interest, earned it praise, and enhanced its regional influence. As a result, the idea spawned a whole spate of concepts and refrains reflecting not only a fresh spirit of multilateralism but also a new worldview befitting its deepening globalization.[248]

So, the Chinese did not just passively accept a role assigned by the reigning Western powers. Instead, China took "responsible power" as a calling to act as an active participant in world affairs, challenging the long-standing self-portrayal as a victim of the strong. The idea also suggested that the threats to China transcended nation-states, and so did solutions to them. This effectively eroded its traditional notion of rigid sovereignty. Reflecting the tremendous inroads the idea had made into China's worldview, the liberal scholar Wang Yizhou openly advocated that China's national interest should include attentiveness to international responsibilities, in addition to domestic self-strengthening reforms and defense of territorial integrity.[249]

Around the mid-1990s, China officially identified itself as a "responsible power" because of U.S. power and pressure. When Europe, Japan, and the rest of Asia immediately joined the call in their engagement policies toward China, it effectively turned the U.S. objective

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Princeton University Press, 2008), p. 148.

[248] Pang Zhongying, *Zhongguo De Yazhou Zhanlue: Linghuo De Duobian Zhuyi* [China's Asia Strategy: Flexible Multilateralism], in Niu Jun, ed., Zhongguo Waijiao Juan [China's Foreign Affairs] (Beijing: New World Press, 2007), pp. 132–42; Avery Goldstein, *Rising to the Challenge: China's Grand Strategy and International Security* (Stanford: Stanford University Press, 2005), pp. 119–128.

[249] Wang Yizhou, *Tanxun Quanqiu Zhuyi Guoji Guanxi* [Exploring International Relations from a Globalist Perspective] (Beijing: Beijing University Press, 2005), pp. 340–357.

into a collectivized international demand. The Asian financial crisis and the requirements for China's impending WTO membership, which it eventually obtained in 2001, crystallized for the Chinese leadership that China's domestic fate was deeply tied to the world.

China's self-identification as a "responsible power" was, ironically, simultaneously clear and ambiguous. It was clear in the sense that China had to make changes in order to clean up its tarnished international image after the bloody Tiananmen Square crackdown in 1989, and reforms in line with international expectations represented the best opportunity to do that. Domestically, people like Premier Zhu Rongji leveraged China's bid for WTO membership in order to push for painful economic restructuring and institutional reforms. But the "responsibility" moniker also left much room for the Chinese leadership to interpret the concept to suit its own agenda, thus the ambiguity.

In dealing with the outside world, leaders separated "responsibility" from domestic politics. Acting as a "responsible power" gave no license for international interferences on China's human rights practice, nor did it suggest the Chinese government's tolerance with the slightest inkling of a color revolution in the country. It contained no risk of jeopardizing the legitimacy of the Communist Party-state. Rather, international responsibility could potentially compensate for political differences with the West, differences that historically were a major source of strategic fissure between great powers.[250] To the extent that responsibility involved China's restraint and compliance within the international status quo, it became both a credible signal and a new launch pad for China's "peaceful rise." All in all, during the first phase from about 1989-1998, Chinese conception of national interest turned open and porous enough to seamlessly incorporate "international responsibility" as its new identity. Responsibility facilitated China's ascent in status. It suited the reformist leadership's agenda of reforms and economic globalization. Striving to become a "responsible power" helped deepen China's globalization, reduce fear of Chinese power, and steer active participation in the existing world order as the overriding objective in Chinese foreign policy. "International responsibility" might have started out as a foreign import. Established powers or the Chinese never spelled out the terms of "responsibility". As Yongjin Zhang and Greg Austin point out, "Great Power responsibility is politically as well as morally postulated

[250] Mark Haas, *The Ideological Origins of Great Power Politics*, 1789–1989 (Ithaca: Cornell University Press, 2005).

implicitly rather than explicitly."[251] Through political acumen and internalization, reformist Chinese leaders were able to adapt the "international responsibility" idea to serve Chinese needs and help navigate the significant confusion and uncertainty it faced in both domestic and international politics during this tumultuous time.

As such, it became self-identification and a choice rather than surrendering to foreign demands. But, to the extent that the idea put a premium on compliance with international norms, embracing it did represent arguably the most "liberal" moment in Chinese foreign policy. Chinese officials took for granted that prevailing global institutions and norms were a critical part of the frame of reference, if not the guide, for Chinese domestic reform and its ongoing transition. Chinese leaders and analysts, conversely, often openly resented and resisted the unfairness of the Western-dominated international hierarchy. But they also believed a "multipolar world" could only slowly evolve from the existing order. And for the foreseeable future at the turn of the century, being a better citizen of the international society served its agenda at home and abroad.

[251] Yongjin Zhang and Greg Austin, *Introduction*, in Yongjin Zhang and Greg Austin, eds., Power and Responsibility in Chinese Foreign Policy (Asia Pacific Press, 2001), p. 5.

3.4 Chinese Financial System

The strong economic growth of China, which began with the implementation of the first reforms in 1979 and still in progress, is attracting increasing interest from both scholars and policy makers. Numerous works are concerned with the analysis of "takeoff" and the development of the Asian colossus (see Sachs-Woo, 1997). However, in the face of this impressive literature that has focused mainly on the "real sphere", the contributions that investigated the "financial sphere" and especially the structure of its financial system are still relatively scarce (see Boyreau-Debray and Jin-Wei, 2005). Recent contributions by Allen et al. (2002; 2005; 2007) are therefore particularly important and constitute, to date, a benchmark for analyzing the financial system in China. According to the analysis carried out in these works, the Chinese economy would be a real puzzle: even though it has a financial system that is still not very developed and poorly market-oriented, it has recorded very impressive growth rates.[252] More specifically, Allen and his associates correctly emphasize the role played by informal funding channels -which would have been partially replaced by traditional ones in favoring the strong development of companies belonging to the so-called hybrid sector[253] (non-state, non-listed firms).

Taking these observations, I try to show how China has significant specificities also for the step-by-step approach that has followed in the implementation of the reforms that have invested its financial system.[254] This contrasts with traditional shock or "big bang" therapy (see McMillan-Naughton, 1992; Chen-Jefferson-Singh, 1992; McMillan, 1994; Stiglitz, 2002), adopted by other emerging or transition countries,[255] based on principles inspired by the so-called Washington Consensus, which, as we know, prescribe the immediate and indiscriminate introduction of market-oriented systems through massive liberalizations and privatizations.

The gradual analysis, in the implementation of the financial structure reforms, highlights the evolution and development of the latter over the years, and compares China with the so-called "bank-based systems" and "market-based". As I will try to demonstrate, although it has guaranteed a certain macroeconomic stability so far, the reform process of the

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252 See Yueh, *China Statistical Yearbook*.

253 This is a very varied sector, consisting of (see Allen et al., 2007): 1) private non-listed companies controlled by both Chinese citizens and investors from Taiwan or Hong Kong and foreign companies or citizens; 2) collective companies, where property is often a mix between public (government and local institutions) and private.

254 As is well known, "gradualism" has characterized most of the reforms that have undergone the Chinese economic system (see McMillan-Naughton, 1992).

255 As Russia and the ex-socialist countries of Central and Eastern Europe.

Chinese financial system has not prevented problems of financial fragility in the banking sector and corporate governance for businesses that could threaten, in the absence of appropriate interventions, the sustainability of growth in the future (see OECD 09/2005, Yueh, 2004).

3.4.1 Importance of the financial structure

The financial structure is traditionally a mix of tools, institutions and markets that characterize the country's financial system.[256] The consideration of the latter becomes crucial as it moves away from the "ideal world" of Arrow-Debreu[257] to analyze a concrete economy characterized by incomplete markets, the presence of large transaction costs and imperfect and asymmetric information between insiders and outsiders enterprise: all aspects particularly evident when considering an emerging and transition country like China.[258] In order to limit the problems mentioned above, the financial system performs, as is well known, several functions (Levine, 1997): saves money; permits diversification and risk sharing; produces and disseminates information; enables managers to monitor and improve corporate governance; facilitates investment and innovation. From the structure of the financial system, therefore, both the efficiency of resource allocation and the stability of the economic system depend (see Allen et al., 2004) and hence the growth of an economy.[259]

As is well known, the literature on comparative financial systems is still characterized by the presence of the classic dichotomy (see Allen-Gale, 1999; Levine, 2002), which contrasts the bank-based view to the market-based view. The two types of financial structure referred to above would in fact be alternatives having applied in very different economic systems, such as Germany and Japan (bank-based systems), and the United States and the United Kingdom (market-based systems) other.

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256 This is still true despite the process of strong globalization that has occurred in recent years: in fact, many countries still face substantial differences from the point of view of the structure of the financial system (see Allen et al., 2004).

257 In a perfect capital market, the financial structure is irrelevant to actual decisions -as Modigliani and Miller show in their famous theorem of 1958- furthermore, in this context, the role of the financial system would be suppressed by the actions of the same investors (cf. Campbell-Cracaw, 1980; Fazzari-Papadimitriou, 1992).

258 The degree of uncertainty and the "imperfections" within the economic system obviously characterize both developed and developing countries. However, as I will try to show by referring to China, in the case of emerging countries these aspects are particularly relevant especially during early stages of development (see Mishkin, 1996; Sau, 2003).

259 Indeed, there are models of "endogenous" growth that consider the role of the financial system (see Pagano, 1993).

Bank-based viewers emphasize, in particular, how a monetary economy[260] develops thanks mainly to the coordination action guaranteed by the presence of institutions, among which credit firms play a decisive role. In fact, banks play a very special and central information role (Stiglitz, 1985): they are "social accountants"; carry out the activity of "screening" of potential customers and that of "monitoring" towards those who obtain credit; finally, they not only acquire but also produce information.[261] Banks would therefore be the most efficient resource allocation intermediaries because, better than others, they minimize costs due to the presence of asymmetric information (i.e., the standard debt contract is optimal, see Diamond, 1991).[262]

Market-based viewers, however, emphasize the virtues of particularly wide, widespread financial markets (equity, bonds and private equity) (Boot-Thakor, 1997; Allen-Gale, 1999). In fact, they favor the financing and the creation of new businesses and hence the most innovative projects (Holmstrom and Tirole, 1993); improve corporate control by creating, through the possibility of takeovers, disincentives to the opportunistic action of managers (Jensen-Murphy, 1990); finally, they can avoid many of the problems related to the relationship-based relationship that exists between banks and businesses and which can generate collusive behaviors that can damage other creditors and prevent efficient corporate governance (Wenger- Kaserer, 1998).

Most recent "financial services views", however, tend to show that both systems (bank-based or market-based) have both advantages and disadvantages and therefore cannot be asserted (see Levine, 2002)) that a system universally better than another.[263] According to the "financial service view" (Merton and Bodie, 1995; Levine, 1997), bank-based and market-based systems would be complementary rather than alternative in favor of efficient resource allocation and economic growth. In this way, the clear contrast between the two

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260 That is, it is based on a complex network of financial and debt interrelations in a context characterized by imperfect and asymmetric information.

261 The opening up of credit to an entrepreneur is in fact a "signal" given to the firm of trustworthiness of the same, which promotes the emergence of long-term relationships between the firm itself, its customers and its suppliers (Boot et al. 1993, Boot-Thakor, 1997). The bank-based view specifically states that these functions can not be carried out by "securities" markets due to the occurrence of the "free rider" phenomenon (cf. Stiglitz, 1985): the acquisition and sale of information would in fact to be prevented by the possibility that someone may appropriate information without any cost. This means that the two phenomena of moral hazard and adverse selection are difficult to eliminate.

262 The analysis of the "information" role of banks has tried to give endogenous foundations to the presence of these intermediaries. Their function would not give rise to the "free rider" phenomenon because they provide for internal debt contracts, which provide that the creditor can access or even participate in the decision-making process, but that these activities cannot be negotiable.

263 Both bank-based systems (Germany and Japan) and market-based ones (USA and UK) recorded fairly moderate growth rates.

approaches is overcome and the role of financial markets and banks is emphasized in limiting the imperfections and coordination problems present in a given economic system.
In this regard, Tadesse (2002, 2005) shows how the optimal financial structure should not be considered statically as it depends on a set of factors specific to the country over a given period such as:

a) The development of institutions and the legal system within which banks and markets operate (see La Porta et al., 2002, Rajan-Zingales, 1998);

b) Incompleteness and imperfections in the economic system (see Boot-Thakor, 1997);

c) The "technological" characteristics of enterprises that need to be funded, that is, the structure of its industrial system (i.e. traditional firms versus innovative companies, see

Market Oriented System

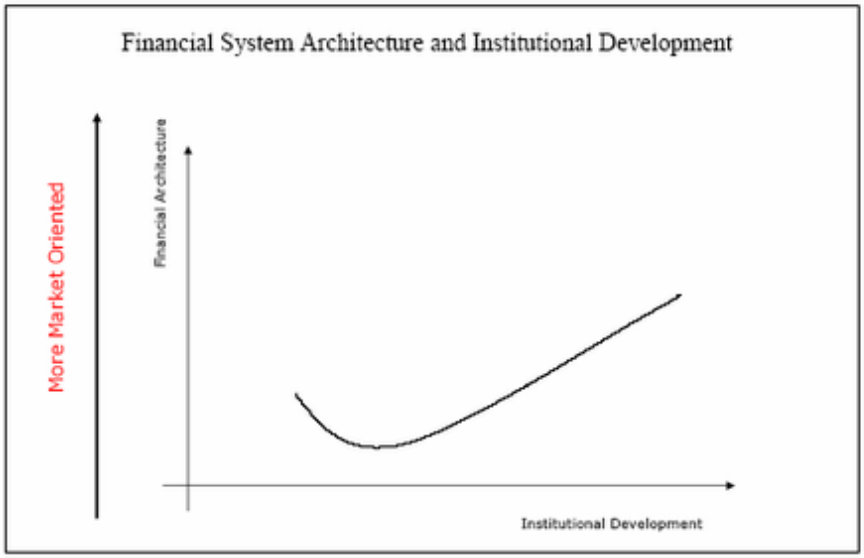

Figure 2. Sourch: Tadesse (2005).

Allen-Gale, 1999, Rajan-Zingales, 2001).

Taking this perspective into account, during the transition phase from planning to the market economy, China is in a critical situation, both in terms of the first aspect and the second (see McMillan-Naughton, 1992). But instead of the structure of its industrial system, it was mainly characterized by manufacturing firms. According to the analysis of Tadesse (2002) above, if a country has these characteristics it would be preferable to first

strengthen a bank-based system[264] and only when the specific factors mentioned above have improved and/or changed, point towards a market-based financial system (see Figure 2).

This approach is, in my view, particularly significant as it allows us to understand why China has a still rather bank-based financial system and moves only gradually towards effective strengthening of national financial markets and an opening to international ones.

3.4.2 Gradual reform of Chinese financial system

This paragraph focuses on the origins and development of the complex of intermediaries and markets that characterize the Chinese financial system. As I will try to show, this is an evolution that is still in place and that has been initiated by the implementation of gradual reforms since the end of the 1970s to the present.

With regard to the banking system, it is necessary to take a step backwards and recall how the advent of the People's Republic of China (1949)[265] resulted in the entire nationalization of firms and financial institutions, in a single year. For this reason, almost thirty years (1950-1978), the financial system of this country has been anchored to one and only bank: the People's Bank of China. The latter was entirely state-owned and was, until 1978, directly controlled by the Ministry of Finance. By acting as a central bank and commercial bank, the People's Bank of China was in the privileged position of controlling almost all the financial transactions that took place in the country.

Thus, 1978 is a kind of "watershed" for the analysis of China's financial structure, on the one hand, it coincides with the "divorce" between the People's Bank of China and the Ministry of Finance (which made the former an entity partially autonomous being kept under government supervision); on the other hand, the period after 1978 is important for the transformations in the credit system because it was the birth of three new state-owned banks that had been abandoned by the People's Bank of China, many of its commercial banking functions. The three new state-owned banks were: the Agricultural Bank of China, which would direct its activities to support agricultural and rural areas; the Bank of China,

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[264] The analysis carried out by Tadesse (2002) considers 36 countries, distinct according to the development of their respective financial and legal systems. He shows that if specific factors are characterized by a low development of these indicators and by highly accentuated agency issues (typical features of emerging countries), it is preferable to first strengthen a bank-based system.

[265] Before 1949 China had a rather developed financial system that revolved around Shanghai.

which would specialize in currency transactions; the People's Construction Bank of China, which would resort to the financing of real estate investments.

These three major banks joined a fourth only in 1984: the Industrial and Commercial Bank of China, which completely eliminated the business activities that still depended on the People's Bank of China, making it a full-fledged Central Bank and giving rise to the so-called "Big Four" state-owned credit bloc, which, as will be shown, is the core of China's banking system (see Chiarlone-Amighini, 2007).

During the second half of the eighties, new local financial intermediaries such as Regional Banks (partly owned by the local government) began to develop; the Rural Credit Cooperatives network under the supervision of Agricultural Bank, and finally Urban Credit Cooperatives; even the first non-bank intermediaries and the first foreign financial institutions began to emerge in recent years but their function was rather limited.

Considering the period (2000-05), it can be seen how the so-called Big-Fours dominated[266] within the Chinese banking system, both for the volume of total assets (RMB 16,932 billion in 2004, of which 10,086 billion), which in terms of deposits (14,412 billion RMB in 2004) having recorded higher values than other types of private, foreign and local commercial banks. This fact has, for a long time, led to the presence of a low degree of competition within the banking system. Comparative analysis carried out by Demirguc-Levine (2001) for China, Japan, South Korea and Taiwan shows that, for the majority of the 1990s, the Big Four concentration index -assets on the total- proved to be around 91% and was the highest compared to the Asian countries considered.

However, the entry of new private banks and new intermediaries has gradually pushed for greater competition since 1997 (see Allen et al. 2007). Banking reform, implemented under the supervision of the China Banking Regulatory Commission (CBRC), then followed a mixed strategy[267] between the so-called "rehabilitation approach" and "new entry approach" (cf. Claessens, 1996), preferring, however, between the two, the first. China has, as seen above, primarily aimed at strengthening the state-owned banking sector (i.e. rehabilitation approach for the big four) before enabling new national and foreign banks (i.e. new-entry approach) and thus increasing the degree of competition in the intermediary sector.

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[266] The fact that the Big-Fours have had an almost exclusive weight in lending and collecting deposits does not mean that they have been also efficient in allocating resources.

[267] In this sense, the reform of the Chinese banking system is very different from that adopted in Russia and Estonia, and is more similar to that implemented in Hungary and Poland.

The capital market has only begun to be operational since the 1990s, even if the launch as the second "pillar" of the financial system, distinct from the credit market, can also be traced back to 1978 (cf. Gordon-Wei Li, 1999). Before that, the small savings[268] were deposited at the People's Bank of China. The elimination of part of the constraints on private property, resulting in numerous private or quasi-private companies, has allowed the savings to gradually find an alternative use to deposit with the only bank.

As has been mentioned the official activation of the two "national" stock market, the Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE) took place in the early 1990s, respectively in 1990 and 1991. They will then be joined by Hong Kong[269] Stock Exchange (HKSE), where larger firms are listed and more innovative.

During the 1990s, however, the Chinese capital market developed rapidly, but from the comparison with the most important world equity markets (see Allen et al., 2005), in terms of total capitalization at the end of 2002, it was only eleventh (Mainland China: SHSE and SZSE); while it was tenth with regard to HKSE. However, the two Chinese stock markets were considered jointly and already in 2002, fifth, preceded by the United States, Japan, the United Kingdom and France.[270] In terms of the concentration index (fraction of the stock market capitalization of larger firms), China had fairly low values of 29.4%, i.e. less than half of Japan; while the turnover index is the highest (224%)[271] compared to other developed countries, demonstrating that stock market trading was very frequent.

As is well known, one of the peculiar characteristics of the Chinese stock market, when faced with other international financial markets, is the high segmentation: there are indeed many types of actions (see Gordon-Li, 1999; Beltratti-Caccavaio, 2006; Allen et al. 2005). A first method of classification, which is particularly useful for the comments that will be made about the impact of this market within the financial system, concerns the distinction between tradable shares (TS) and non-tradable shares (NTS). While the first can be traded freely, NTSs (State Shares and Restricted Institutional Shares) can only be sold privately and are therefore not subject to public bargaining on the market. The latter were issued in favor of the founders and employees of a state-owned company and have the dual function of preventing the State from being removed and maximizing the subsequent listing through

[268] In 1978, roughly 6% of GDP (State Statistical Bureau, 1997).

[269] Hong Kong has remained a special status region and is considered separately from the so-called "Mainland China" in many of the countries and international official statistics (see International Financial Statistics).

[270] By calculating capitalization taking into account the PPA, China is ranked first (see Allen et al., 2005).

[271] Since at the end of 2002 many of the shares were still non-tradable, such a large turnover index is significant due to the high speculation on the stock market.

IPO. Green and Black (2003) observe that the first aspect is related to the government's attempt to prevent "wild privatizations" during the restructuring of public enterprises. At the beginning of 2005, non-tradable shares were still about two-thirds of all outstanding shares (see Beltratti-Bortolotti, 2006).

Regarding tradable shares, they can be classified into domestic shares (i.e. A Shares) as they are held and traded only by domestic investors and foreign shares (i.e. B and H shares)[272] denominated in foreign currencies and reserved to foreign investors.[273]

As of April 29th, 2005, the China Securities Regulatory Commission (CSRC) has given rise to an important reform project that should have effects very important on the future structure of the structure of the Chinese financial system. It foresees the gradual reduction of non-tradable shares. More in in particular, this reform has affected the period from April 2005 to September 2006 and foresees that NTS holders have to pay TS holders in various forms (cash, bonus shares, warrants) to have the right to sell their shares (see Beltratti-Caccavaio, 2006; Beltratti-Bortolotti, 2006).

The reform process consists of two phases: in the first phase, every firm concerned announces the sale; however, before the transaction can be performed, clearing methods are established. In this way, the shock associated with the increase in the stock price bid should be slower.

At the end of 2006 in terms of total capitalization, HKSE alone, sixth, with an increase over 2005 of 62.6%; SHSE and SZSE are still eleventh, but show a variation, compared to the previous year, respectively by 220.6% and 97.1% respectively. By comparing this data, with those previously seen and analyzed by Allen and his associates relative to 2002, it can be seen how the stock market is gaining an increasing weight within the structure of the Chinese financial system.

Concentration index has also improved for the two mainland stock markets being respectively 71.2% for Shanghai and 37.7% for Shenzen; turnover index in 2006 is still quite high, indicating the presence of high exchanges, and stands at around 153.8% for Shanghai and for Shenzen around 251.7, instead of 62.1% for Hong Kong. As a result of stock market reform, non-tradable shares declined from 66% (of total shares) to 23.66% in February 2006 and reached 57% in June of the same year, resulting in the tradable share

[272] H-shares differ from B-shares as they are listed on the Hong Kong Stock Exchange.

[273] Another feature of the Chinese stock market is the fact that the price of domestic shares is generally higher than that of the shares subscribed by foreign investors. Gordon-Li (1999) observe how this is due to the government's decision to act as a sort of discriminating monopoly on the financial market while maintaining a lower internal interest rate in order to favor the financing of the state deficit.

from 34% to 43% (of which 35% is A-shares). Additionally, the change in% of the float in 2006 was, compared to 2005, 208.7% for SHSE and 174% for SZSE (see world-exchanges.org, 2006).

As for the Chinese bond market it can be seen as the most significant increase in new bond issues mainly concerned the state sector: treasury bonds with a 32.8% increase over the period (1990-2002), and bonds issued by state-owned banks that recorded an increase in 38% over the same period. Bonds issued by private firms, in comparison with the previous ones, almost nonexistent 8.2% (see Stastistical Yearbook of China 1990-2002). The next period (2002-2006) marks a slow improvement in the issuance of corporate bonds, recording an increase of 20.4% (see Statistical Yearbook of China, 1990-05).

The end of the 1990s marked the rise of institutional investors even though their role in the economic system was still low. The first two Chinese mutual funds were set up in 1998 (Guo Tai and Nan Fang), and nowadays 46 out of them also have 13 foreigners (Qualified Foreign Institutional Investors or Joint Ventures). There is no evidence of hedge funds as short or short term financial transactions are still prohibited within the country;[274] it should be added that pension funds are stalling to take off (see Allen et al 2005, 2007). The OECD report on China (09/05) highlights that, just as the small institutional investors' weight is one of the major shortcomings of the Chinese financial system, it must be tackled as soon as possible.

3.4.3 Evolution of the financial structure in China

After describing the main reforms that have undergone the Chinese financial system, this section will look at the structure of this system, trying to show the evolution of the relative importance of the various forms of funding. In this regard, reconsider the repeatedly quoted contributions of Allen et. alt. (2002, 2005, 2007), taking into account the effects on the Chinese financial system caused by the most recent reforms.[275] The comparative analysis of China with that of other countries is based on structural indicators computed by

[274] Since summer 2007, the Government has allowed Chinese residents in the Mainland to purchase any amount of shares traded in Hong Kong; this shows the tendency to gradually reduce control over short-term capital movements (see The Economist, 25/8/2007).

[275] The analysis of Allen et al. (2005, 2007) mainly refers to 2002, therefore, at an earlier date than the stock market reform.

the method proposed by Levine (2002) and Demirguç-Kunt and Levine (2001), relative to the sample studied and classified by La Porta et al. (1997, 1998).[276]

Following the approach of Allen and his associates (2005; 2007), I first consider a size that provides information on the size of the bank credit market with respect to the stock market from a macroeconomic point of view and relative to 2002.

To this end, the total bank credit[277] in relation to the bank credit ratio (GDP) allows to state without any doubt that the incidence of the banking system within the Chinese financial structure is very significant, even being greater than the unit (1.11). But the surprising thing and that it is superior to what in the sample considered by La Porta et al. is calculated for the "Germanic countries"[278] (0.99), and should be emblematic for so-called bank-based systems. However, when the data on credit extended to the so-called hybrid sector is observed, the fall in value (0.24) shows that the majority of bank loans granted by Chinese banks favored state-owned enterprises (SOEs) or listed firms.

As far as the capital market is concerned, the situation prevails: China only records a ratio of 0.32 (32%) (Total stock market capitalization/GDP or market capitalization ratio). It is in fact among the lowest and well below the average considered to be 47%. The result then falls to 11% if the floating or floating supply of the market should be considered in relation to GDP (i.e. Float supply ratio or total value traded ratio). This latter figure is particularly significant as, unlike total capitalization, the float is equal to the value of the shares traded on the market. Allen et. to the. (2002, 2007) are aware that the mere comparison between the data that considers the volume of total credit granted and the total stock capitalization (in relation to GDP) is not sufficient to draw conclusions on the relative importance of banks compared to the capital market within the Chinese financial system; that is, the structure is bank-based rather than market-based.

In this regard, the analysis is extended to consider the so-called "structural indices". In this regard, if I consider the structural measure or structural activity index obtained by considering the log (float supply ratio/bank credit ratio) and the index that measures the structural dimension or "structure size" in turn, by making the log (market capitalization

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276 La Porta et al. (1997, 1998), consider 49 countries, both developed and emerging, with the exception of China.

277 In the calculation of bank credit Levine (2002) excludes all loans deposited by banks for the public sector and local public bodies. However, in the case of China, these loans are, for the reasons that we see, very important and therefore cannot be overlooked.

278 This is a sample of countries that, by legal and financial system, are very similar to those of Germany (i.e., the Rhineland capitalism); including Japan.

ratio/bank credit ratio), China is among the countries with the lowest indices compared to the sample considered by La Porta et al. they are in fact equal to: (-1.07) and (-1.24).

This makes it possible to draw significant conclusions about the predominance of the banking sector with respect to the stock market. Indeed, as seen in both volume and index terms, the structure of the Chinese financial system was dominated by the role of banks and, especially from public ones (i.e. SOB).

If we then consider some of the efficiency measures in the banking credit market, we can see that it is quite disappointing: general overhead costs, relative to the total of banking assets, compared with those of the other sample countries, are in fact among the highest (0.12). Also, the index that measures the relative efficiency of the financial market with respect to banking, the so-called Structure Efficiency Index obtained by making the Log ((capitalization ratio) x (overhead cost ratio)) provides a very high value (-1.48) compared to the same indexes of other sample countries, demonstrating that the financial market is more efficient than the banking credit market[279] in allocating resources due to the high cost of brokering in China.

From the analysis of Allen and his collaborators (2005; 2007), therefore, it is clear that the Chinese financial system has been centered on the banking market but that this has been inefficient. On the other hand, the stock market is still very small, but in terms of efficiency, by the best results.

As the "financial service view" approach has been seen, it prefers to take into account the role played by the entire financial system rather than that of the banking and financial markets, taken separately. For this reason, Allen et al. (2005) obtained indices using the method of Levine (2002) related to the overall development of the financial system (i.e. financial development indices). They are essentially of three types, depending on their size, development and efficiency.

The finance-activity index is obtained by making the Log (float supply ratio x private credit ratio); as far as the bank credit is concerned, only the companies belonging to the Hybrid Sector are eligible for financing.

The finance-size index will be obtained by considering the Log of the total market capitalization ratio x private credit ratio. The two indexes are rather low compared to the average, especially with regard to finance size (-1.02). In terms of efficiency of the entire financial system, the finance efficiency index is the Log of (floating supply ratio/overhead

[279] See also Boyreau-Debray-Jin Wei (2005) regarding the distorting effects of the Chinese financial system for allocating resources.

cost ratio) is also rather low, indicating that the Chinese financial system is still not very developed in relation to other countries.

Based on the above-mentioned indices, I am now able to show the evolution of the structure of the Chinese financial system taking into account the period following the stock market reform. As already mentioned, in 2006, in terms of total capitalization, HKSE alone, was sixth with an increase of 62.6%; SHSE and SZSE are still at the bottom of the list but mark a change (%) over 2005, respectively, by 220.6% and 97.1% respectively.

As in the previous section, in June 2006, the -Tradable shares/Total- mark a good increase of 43%. By comparing stock market data (2002 vs. 2006), we see how the latter are taking on a growing weight within the Chinese financial structure. As a result of the stock market reform, it can be seen that, both in absolute terms and taking into account the indices, the Chinese financial structure is evolving vs. a more market-oriented system.[280]

Macroeconomic observations can be further strengthened if data on the financial structure of Chinese firms are observed, that is, the use of the various sources of funding. As I have in part anticipated, Chinese firms can be distinguished in: state sector firms; listed sector firms; unlisted private companies (hybrid sector firms). For the first two types of business, the most commonly used sources of funding for fixed capital investments are: bank lending, direct funding of funds (internal financing or self-financing), direct issuance of shares and bonds and local government funding (excluding the state budget). The importance of state funding has been decreasing over the last few years due to the privatization process in progress by many firms. Their relative weight is, to this day, comparable to that of the state sector, although in perspective it should increase, given that China, following its accession to the WTO in 2001, is becoming an increasingly open economy. The incidence of bank credit is particularly significant for companies belonging to the state sector and the listed sector but not for hybrid sector companies (see China Statistical Yearbook).

The direct collection of funds by issuing shares and bonds it is mainly characterized by state sector firms and listed sectors firms, even though for small amounts compared to bank financing (as we have seen by analyzing macroeconomic data). Obviously, internal finance is particularly significant for businesses in the hybrid sector. This is not surprising as the latter are rationalized both in the credit market and in the equity and bond market; internal sources often come from direct financing of the firm's founders or their family

[280] This process is in tune with Tadesse's approach (see Figure 2).

members. To be more precise, however, in the hybrid sector of seed phase, the informal financing takes the form of "angel finance" by relatives and friends, then an important role is played by the cash flow (i.e. internal finance), financial support networks between enterprises, but also forms of illegal fundraising such as *hehui*, *biaohui*, *taihui* (see Allen et al 2005; OECD Report 9/05). These so-called "informal" funding channels are key to the survival and development of this type of business.

3.4.4 Problems with the structure of the Chinese financial system

As previously explained in the preceding paragraphs, China's financial system is still fragile. The gradual reforms that invested the financial system did not prevent problems such as financial turmoil in the banking sector, poor transparency in financial markets and insufficient corporate governance for businesses.

With regard to the first aspect, the most significant problem is certainly the presence of a large amount of non-performing loans (NPLs) as well as a low capitalization of the major banks (see Chiarlone-Ferri, 2005). The high amount of non-performing loans mainly concerns the grants granted by Big Four to state-owned enterprises. The latter have often been granted for political reasons rather than economic ones and have accumulated over the years. At the base of this process, there has certainly been the fact that many public banks have found themselves lending to public companies that often were their shareholders, creating a sort of "Siamese brotherhood" that prevented the implementation of an adapted screening and monitoring of the debtor requesting the funds.

Allen et al. (2006), based on the data of the Asian Banker database, shows that, both in relation to the total amount of new loans and in relation to GDP, China has the highest ratios especially in the period 2000-02. This result is even more significant if we take into account the fact that Japan was faced with one of the most serious banking system crises in the period under review. Even in terms of profitability (calculated in both ROE and ROA) China, there are some indicators that are among the lowest if compared to those of other Asian countries. Slowly improving thanks to massive bank recapitalization efforts but remains a major concern by many international observers (see OECD, 09/2005).

As far as the financial markets and, in particular, the so-called Mainland stock markets are concerned, as they have been trying to show in this work, they are gaining an increasing weight within the structure of the financial system but still have too low concentration indexes and turnover too high, indicating that there are still a few big companies and a high

speculation on the stock market. Additionally, stock prices do not properly reflect core values of listed companies due to the lack of or ineffective regulation. There are problems related to both *ex-ante* (adverse selection) and *ex-post* (moral-hazard) asymmetries information. With regard to the first aspect, non-governmental corporations belonging to the hybrid sector seeking to be listed often find it much more difficult than state enterprises. The process leading to the stock market share is, in fact, the first, particularly long, expensive and carried out by an auditor little independent of political pressures. These aspects lead to a genuine adverse selection against firms and its equity-rationing phenomenon, which prevents many firms that are profitable to get quoted. Even with regard to the problems of moral hazard by public managers, the lack of transparency and the almost total impossibility of takeovers by potential competitors favor the possibility of recurring opportunistic phenomena by the same managers, with distorting effects in terms of economic efficiency. These last comments allow us to connect to another major issue within the Chinese financial system: corporate governance. Regarding listed firms, the traditional mechanisms are rather weak and limited; listed companies are governed by an organizational system that is based on two levels: the Board of Directors and the Board of Supervisors. The most significant issue is that the members of these Boards rather than being elected by the shareholders are public officials elected by the government following a once unpopular process. The government in China plays the role of regulator and shareholder of many listed firms, of many banks and financial institutions, creating obvious conflicts of interest that go once again at the expense of economic efficiency. Even on the legislative front, corporate and bankruptcy law has been and still remains very weak. In fact, despite the bankruptcy law being passed in 1986, the first law governing company law came into force only in 1999.

3.5 Corporate governance and development of Chinese Financial Economy

Since 2009, 60 years after the establishment of the People's Republic of China, China has begun to become a world-class economy in size, for its continued growth, and for its strongest exporting country in the world. These results are clearly the product of the country's success in economic reform and openness to world markets. Nevertheless, serious problems remain that may threaten the stability and sustainability of these outstanding results if they are not fully addressed and resolved. One of the major battles is the rhythm and quality of the country's financial development. It is a widespread belief that a properly functioning capital market and effective corporate governance at an industrial level are mutually reinforcing. Looking at macroeconomic perspectives at the current stage of China's reform and modernization, it is believed that the implementation of the economic system can push the improvement of the corporate governance system. For a long time, the pace and scope of the reforms of the Chinese financial system have fallen behind other sectors of the economy. With the rapid transformation into a market-oriented economic system with a very high level of investment and trade, the need to speed up financial development is urgent because China can not afford to be a simple attendant in the globalization process where massive volumes of trans-frontier economic flows, goods, services and investment funds must be efficient and orderly. From the Chinese national economic outlook, the reasons for a faster pace of growth in financial development are increasingly pressing. Despite household savings remain significant, they have been overtaken by corporate savings. Household savings have traditionally been a cheap and simple resource for Chinese banks, in the form of low-interest bank deposits, which in turn has allowed Chinese banks to rely on interest rate differentials as an additional form of entry. It has been noted that there is a need to address the lack of alternative financial investment channels for most households, other than low-performing bank deposits or investments in the most volatile capital market. Increasing business savings, principally in the form of unallocated profits, provided a further boost to a broad and profound reform of the Chinese financial system and the creation of a variety of financial products and services for firms and families that would yield better returns their investments. Financial development can be defined as the set of factors, policies and institutions that enable effective financial intermediation, the functioning of financial markets, and broad access to

the capital market and financial services.[281] In an attempt to measure the country's financial development, the World Economic Forum identifies key criteria for the necessary institutional and commercial context, which are:

- Liberalization of capital;
- Liberalization of the national financial sector;
- Amount of incentive-based remuneration;
- Efficiency of the board of directors;
- Trust in professional administrators;
- Robustness of control and monitoring measures;
- Protection of the interests of minorities;
- Regulation of exchanges of financial instruments;
- Property rights;
- Independence of judgment.

Most of these elements also belong to the series of essential internal and external governance mechanisms required for an effective corporate governance system. Of course, since a country's financial system needs to provide more and more specialized services for investors and savers to manage their capital more efficiently and optimize their economic positions, the development of these essential elements equates to the development of an effective corporate governance system. While various advances have been made in enhancing proprietary rights, establishing rules for securities exchange, and strengthening disclosure in listed firms, much remains to be done in these and other key areas. The Chinese banking system, dominated by state property, has traditionally been designed to serve the state industry, resulting in a number of related issues that are well known. Corporate governance practices in Chinese financial institutions have not kept pace with the rich industry of management techniques and tools that have been introduced in recent years. Given the overwhelming majority share of the state in the four major Chinese banks, it is not surprising that most of China's corporate governance issues concern the banking sector. In any case, given the central role of the banking sector, and the potential systemic risk that bank failures may bring to the economy, the importance of having effective corporate governance is increasingly urgent and relevant. With the fixed rate trading system and the growing foreign exchange system, the resulting monetary expansion certainly requires prudent monetary management based on an efficient banking and

[281] World Economic Forum, *The Financial Development Report 2009*, 2009.

financial system. The continued liquidity injection created by the growing foreign exchange reserve can fuel inflation in property and stock market prices, causing a serious distortion in the composition of bank credit and the allocation of resources in general. Unfortunately, given the state of financial development in China, the possibility for central bank intervention to sterilize such a liquidity expansion is quite limited.[282] The need for the Chinese financial system to increase the ability to handle these systemic solicitations properly is urgent. There is another factor that is pressing for a progress in the development of corporate governance.

The second most important pillar in the development of a modern financial system in China is the stock market, through which state-owned enterprises have undergone a transformation from open public listing to a partial privatization, initially to increase financing capital and revitalize investment capability, but more recently and more significantly as a means of establishing a corporate governance reform. Capitalization of the Chinese equity market as a percentage of GDP has experienced significant volatility over the last twenty years. Particularly noteworthy is that the proportion of negotiable shares remains about one-third of equity capitalization for most years until 2009 when the share ownership reform started in 2006 slowly began to trade in the other two-thirds of issued shares who were formally non-negotiable and held by state and other state organizations in the form of "legal person" actions. The non-negotiable dominant state holding was one of the major issues highlighted in the development of corporate governance in the most modern forms of business organizations in China, listed companies. The predominance of the state as a direct or indirect owner of two-thirds of shares issued in over 80% of listed firms in the country has aggravated the governance issues a joint stock company has to face. The fact that state-owned and state-owned shares could not be negotiated, along with the widely recognized problem of internal controls in many of these firms,[283] have ended up generating a number of practices and results that can be assimilated specifically to corporate issues governance in China. In recent years, a rich corpus of literature has been developed based on empirical studies that tested and tested the characteristics of corporate governance and ownership, and their possible impacts on the

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[282] Wu X., *Deputy Governor, People's Bank of China*, 2007, Conversation notes by the author (Tam) with Mdm Wu in Beijing, 26 September 2007.

[283] Shanghai Stock Exchange (SSE) 2006, *Corporate Governance Annual Report*, available at www.sse.com.cn.

firm's results of Chinese companies.[284] In 2009, China had more than 1.700 listed firms in the two stock exchanges, with 120 million shareholders. These two markets have experienced several corporate governance scandals and failures in large and small companies over the years. These problems were the weakest link in the Chinese financial system, whose efficient corporate governance would provide vitality and robustness.

The future of China's capital market development is moving beyond opening to the world, as its dimensions have quickly reached a level appropriate to China's overall economic position. In this context, the Chinese authorities now clear that their main task is to integrate into the Chinese capital market and the business environment the most advanced forms of financial institutions, products and market mechanisms in the world to improve the effectiveness and operational criteria of the country's capital market system.[285] In China's economic reform environment, where market institutions and law enforcement practices are still under varying degrees, the effectiveness of the financial system is inseparable from the progress in other key areas, including the reforms in finance public and corporate law, the legal system and the rules governing the entry into the market and the operations of both internal and external participants. Both in direct financing and in financial intermediation, the effectiveness of the state-dominated financial system in China was considered unsatisfactory. Regardless of the pace at which the Chinese government will liberalize currency controls on its capital accounts, there is no doubt that to fully develop the banking system, stock markets and listed companies, standards and performance of corporate agreements and practices governance must be raised.

3.5.1 The "public-private" business structure in China

In the last fifty years, the liberalization of the Chinese market and corporate governance reforms have triggered start-ups of privatization and stunning economic growth. China is increasingly moving towards a complete privatization through the use and adaptation of

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[284] Xu X.N. and Wang Y., *Ownership structure and corporate governance in Chinese stock companies*, China Economic Review, 1999, 10(1), pp. 75-98; Qi D., Wu W. e Zhang H., *Shareholding structure and corporate performance of partially privatized firms: evidence from listed Chinese companies*, Pacific-Basin Finance Journal, 2000, 8(5), pp. 587-610; Sun Q., Tong J. et al., *How does government ownership affect firm performance? Evidence from China's privatization experience*, Journal of Business Finance & Accounting, 2002, 29, pp. 1-27; Wei Z. and Varela O., *State equity ownership and firm market performance: evidence from China's newly privatized firms*, Global Finance Journal, 2003, 14(1), pp. 65- 82; Chong V.K. and Eagleton I.R.C., *The impact of reliance on incentive-based compensation schemes, information asymmetry and organizational commitment on managerial performance*, Management Accounting Research, 2007, 18(3), pp. 312-342.

[285] Qi B., *Report on China's capital market*, 21th Century Business Herald, November 13th 2009.

foreign models of the most industrialized countries. However, the characteristic that still today distinguishes Chinese firms is the proprietary structure, especially in large companies, that is to safeguard the connection between public and private. These are firms mainly financed by private capital, but whose management is actually under the supervision of the public. Chinese institutions therefore essentially seek to imitate the Western corporate governance model without adopting it in all its features,[286] as ownership and control are not shifted from managers to shareholders and no real market for corporate governance is created.

I then analyze the evolution of the governance in China.

Prior to the introduction of the first corporate law in 1904, during the imperial period, both in the Ming Dynasty (1368-1644) and in the Qing Dynasty (1644-1911), there were large family businesses in China, producing and distributing local products, even in long distance trade, and whose success was largely due to state support.[287] The strong presence on the international market of Chinese firms led China to imitate[288] Western corporate governance to adapt to the development of the international economy. They thus began to highlight the weaknesses of the State in addressing foreign policy and economic aggression.[289] The first industrial establishments were undertaken with the aim of regaining military strength and defending national pride, without challenging the status quo of government and society,[290] rather than triggering economic development. This led to the absence of an industrial revolution and modernization of the economy. The domestic capital market, created following the distribution of capital on the market for obtaining

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286 "*Although China's first corporate code contained many elements of the modern formula for privatization – including some requirements for transparency, separation of ownership and control, and annual auditing and reporting requirements – it ultimately failed to effectively transform Chinese business enterprises into full-blown corporate institutions."* Goetzmann W., Koll E., The History of Corporate Ownership in China. State Patronage, Company Legislation, and the Issue of Control, in Morck R. K., A History of Corporate Governance around the World. Family Business Groups to Professional Managers, The University of Chicago and London, Chicago and London, 2005, p. 150.

287 The state financed the firms in return for contributions to military companies and high donations in favor of public or imperial projects.

288 The process was rather driven by a sense of competition against the West.

289 "*In the so-called Self-Strenghthening Movement during the Tongzhi Restoration period between 1862 and 1874, reform-minded government officials – mostly politically powerful provincial governor-generals – attempted to revive the national economy and military after the devastating Taiping Rebellion.*" Goetzmann W., Koll E., *The History of Corporate Ownership in China. State Patronage, Company Legislation, and the Issue of Control*, in Morck R. K., *A History of Corporate Governance around the World. Family Business Groups to Professional Managers*, The University of Chicago and London, Chicago and London, 2005, p. 153.

290 General Governor Li Hongzhang (1823-1901) demanded that the Chinese government should fight to improve its technology and military equipment to defend itself from the Western power that had shown its military superiority at the expense of China.

funding from small investors, even foreign, fell in 1883 due to strong speculations. Thus, a new form of enterprise based on government support (*gaundu shangban*) was established: private people were providing capital and managing the enterprise, while the state was in control of production.[291] However, when the state was no longer in a position to carry out effective business control because of corruption phenomena, financial problems were again posed to businesses, and as the firm's risk fell again only on private investors, who did not have the power to control the management, they got low profits and consequently invested less and less in the firms. To overcome this new wave of problems, *guanshang heban* was set up, a more attractive type of corporation in which the management function and the allocation of invested capital was partly transferred to the same private investors. From 1895 onwards, a privatization process began and began to set up the first foreign companies in China. Still, the stock market was still very weak and businesses were mostly family-friendly.

In 1904, the first law on corporations (*Gongsi Lü*) was finally introduced,[292] which was based on legislative orientation in Japan and England, but in a shorter form. The goal was to meet the popular demand for change and modernization of the economy by creating legal protection for the best investors, so as to encourage private investment leading to national prosperity. Many firms listed on the market becoming limited liability companies, however, the internal business organization did not change radically, as the hierarchical line remained unchanged.[293] The novelty arising from the legal transformation of companies into private companies was the introduction of an annual meeting for shareholders, as they increased the weight of their consultations. In addition, under the legislation of 1904, it became mandatory to appoint two auditors responsible for examining the financial positions, but nothing was specified about the principle of independence, as a result, auditors often belonged to management and did not undertake their role of representatives of the interests of the shareholders.[294] Strong changes were introduced in

[291] These were quasi-monopoly situations.

[292] Goingsi Lü was the latest reform of the Qing monarchy to meet the desire to introduce legal, institutional, and reformative reforms to modernize the Chinese economy, trying to maintain the conservative political status quo of imperial monarchy.

[293] In particular, there is strong collusion between majority shareholders and managers in China at the expense of minority shareholders.

[294] In general, the new legislation did not bring any real improvements to the protection of shareholders' rights and the control of managerial power.

terms of financial control and transparency: companies were obliged to produce annually a report[295] on their economic, financial and commercial situation.

In essence, the hope was to create a capital market that could support the development of the national economy in relation to world growth, but the effects were limited due to cultural factors. The importance of personal relationships has brought about conflicts of interest within corporate organizations and institutional factors due to the lack of effective market regulation for corporate control and the development of the Chinese domestic market has been stymied by a series of crises involving a substantial mistrust of the exchange of actions.

Currently, China, in a situation of vigorous economic development, is focusing on the importance of protection and rights of shareholders by developing a new corporate governance regulation aimed at eliminating persistent problems in companies and the market national equity.[296]

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295 The annual report did not provide for a uniform standard compilation system for all businesses. "*Modern, Western-style bookkeeping methods found their way into China only in the 1930s, and to judge from archival evidence, most companies officially started using standardized, modernized accounting systems only in the 1940s*". Goetzmann W., Koll E., *The History of Corporate Ownership in China. State Patronage, Company Legislation, and the Issue of Control*, in Mork, R.K., *A History of Corporate Governance around the World. Family Business Groups to Professional Managers*, The University of Chicago and London, Chicago and London, 2005, p. 170.

296 "*Our results also provide some insights for policy makers. We suggest that policymakers pay particular attention to the collusion between tunneling participants rather than merely prohibiting certain tunneling tactics. As long as the separation of control and cash flow rights triggers tunneling motives and controlling shareholders can smoothly establish collusion with managers, controlling shareholders can develop more subtle and more invisible ways to tunnel. We also recommend that regulators strengthen corporate governance norms, improve the corporate governance environment, and enhance shareholder protection.*" AA.VV. Controlling Shareholder-Manager Collusion and Tunnelling: Evidence from China, in "Corporate Governance. An International Review", Vol. 22, Issue 6, 28 August 2014, p. 456.

3.6 Institutional framework and challenges

At the beginning of the process, the Chinese government adopted a top-down approach to develop corporate governance.[297] Last decade has shown that the operation of regulation and government agencies such as China Securities Regulatory Commission (CSRC) and State-owned Assets Supervision and Administration (SASAC) has been instrumental in promoting the development of effective corporate governance practices between Chinese firms and state-owned enterprises. Indeed, without the push for regulation, the considerable progress in creating many of the conditions necessary for such work practices would be untenable.

A considerable part of literature based of the agency theory has examined a multitude of problems stemming from the conflict of interests between shareholders and corporate directors, although the dominant agency theory in corporate governance research has always been questioned.[298] With blockholder prevalence in Europe and Asia, the issue of protecting minority interests has attracted more attention from researchers.[299] Recent financial theory[300] has shifted and expanded the analysis perspective from the theory of the dominant agent based on the conflict between shareholders and managers to the increasing concern about the decline and subtraction of the interests of minority shareholders in favor of controlling shareholders in large corporations. For countries with poor investor protection, ownership concentration is seen as an internal governance mechanism to replace the inadequacy of external governance of institutions.

In East Asia, where protection of investors is generally recognized as weak, the concentration of family property is supported in various ways by cross-ownership of shares, corporate pyramids and financial companies, and is a common strategy adopted by the founders of a company in replacing the legal protection of investors.[301] In China, where

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297 Tam O.K., *The development of Corporate Governance in China*, Cheltenham, UK and Northampton, MA, USA, Edward Elgar, 1999.

298 Judge W.Q., *Thomas Kuhn and corporate governance research*, Corporate Governance: An International Review, 2009, 18(2), pp. 85-86.

299 Shleifer A. and Vishny R., *A survey of Corporate Governance*, Journal of Finance, 1997, 52, pp. 737-783.

300 La Porta R., Lopez-De-Silanes F. and Shleifer A., *Corporate ownership around the world*, Journal of Finance, 1999, 54, pp. 471-517; La Porta R., Lopez-De-Silanes F., Shleifer A. and Vishny R., *Investor protection and corporate governance*, Journal of Financial Economics, 2000, 58, pp. 3-28.

301 Bebchuck L.A., Kraakman R.H. and Triantis G., *Stock pyramids, cross-ownership and dual class equity: the mechanisms and agency costs of separating control from cash-flow rights*, 2000, in Morck R., Concentrated Corporate Ownership, Chicago: University of Chicago Press; Claessens S., Djankov S. and Lang L. H. P., *The separation of ownership and control in East Asian Corporation*, Journal of Financial Economics, 2000, 58 (1-2), pp. 81-112.

there is a high concentration of state property, major governance issues generally revolve around the issue of state property, internal members' control, and lack of law enforcement. In fact, the ownership of the Chinese state of affairs and the related governance issues have increasingly attracted the attention of scholars for some years.[302] The Chinese government has transformed thousands of state-owned firms over the last twenty years, with the privatization. However, it is unanimously recognized that the reform did not lead to the desired results. Building on an international OECD study of corporate governance in state-owned enterprises, two common problems are identified for the State in the performance of its responsibilities due to property: undue intrusions and political interference; or totally passive or confidential properties. The demonstrations given in the literature show that China particularly suffers from the first problem. For example, it was found that more than a quarter of the delegated directors in a sample of 790 recently privatized companies are former or current government bureaucrats.[303] However, with the pervasive problem of insider control[304] that is often interwoven with the collusion of government officials, the second problem manifested itself in the form of the absence of the state as a true owner, a phenomenon widely discussed in China in the nineties.

In order to better understand the significance of the milestones in the development of Chinese corporate governance, the logic and implications of key governance issues involved must be illustrated. And to understand the relevance of some of these issues it is also necessary to discuss the challenges for state-owned commercial banks.

By adopting modern corporate governance as a means of improving the performance of state-owned enterprises, the Chinese authorities therefore reaffirm their conviction that state-owned enterprises can operate effectively and remain competitive.[305] In any case,

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302 Jefferson W., Hu A., Guan X. e Yu X., *Ownership, performance and innovation in China's large -and medium- size industrial enterprise sector*, China Economic Review, 2003, 10(1), pp. 75-89; Han D., Wang F. e Yue H., *Board structure, political influence and firm performance: an empirical study on publicly listed firms in China*, Asia-Pacific Journal of Accounting and Economics, 2004, 11(1); Bai C., Liu Q., Lu J., Song F. e Zhang J., *Corporate governance and market valuation in China*, Journal of Comparative Economics, 2004, 32(4), pp. 519-616; Tian L. e Estrin S., *Retained state share holding in Chinese PLCs: does government ownership always reduce corporate value?*, Journal of Comparative Economics, 2008, 36(1), pp. 74-89.

303 Fan J. P. H., Wong T. J. and Zhang T., *Politically connected CEOs, corporate governance and post- IPO performance of China's newly partially privatized firms,* Journal of Financial Economics, 2007, 84, pp. 330-357.

304 Qian Y., *Reforming corporate governance and finance in China,* 1995, in M. Aoki e H. Kim, *Corporate Governance in Transition Economies: Insider Control and the Role of Banks,* Washington, DC: The World Bank; Lee K. e Hahn D., *From insider-outsider collusion to insider control in China's SOE's*, Working Paper Series n. 44, 2001, Institute of Economic Research, Seoul National University.

305 Li Y., Feng Y. and Liu Y., *An empirical study of SOE's market orientation in transitional China*, Asia Pacific Journal of Management, 2006, 23(1), pp. 93-113.

several scholars argue that only the complete restructuring of state property and privatization can really transform state-owned enterprises into efficient business entities because state property dilution has been judged to limit impact.[306] Recent literature shows that the performance of partially privatized Chinese companies has worsened in the years following privatization and poor governance is the most decisive factor.[307] An alternative theory suggests that state-owned enterprises can achieve effective performance as long as modern corporate governance and modern management procedures are adopted and effectively implemented.[308] It has been argued[309] that the effect of state property on corporate value is U-shaped so that beyond a certain threshold, the government can actually improve corporate value. This result has been attributed to the consequences of ownership concentration and preference for government. Despite corporatization and privatization in the reform of Chinese companies, the Chinese Government clearly believes that the state still has a role in maintaining state ownership of enterprises. In fact, in a new political move, since 2002, the Chinese government has begun to consolidate and merge the nation's largest state-owned enterprises into large-scale central enterprise groups and in designated industrial sectors. At the same time, the government has also decided to impose modern corporate governance mechanisms in these companies to exercise state ownership rights more effectively and achieve better business performance. The Chairman of the State-owned Assets Supervision and Administration, Li Rongrong, said the improvement of corporate governance was the core and the most difficult problem in reforming the state-owned enterprise system.[310]

3.6.1 Institutions and regulatory sources in corporate governance

When CSRC was founded in 1992 and the National People's Congress approved corporate law in 1993, most state-owned enterprises in China were still at the beginning of the firm's work and the long process of modernization and partial privatization. Both theories and

306 Tenev S., Zhang C. and Brefort L., *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets*, 2002, Washington DC: World Bank.

307 Allen F., Qian J. and Qian M., *Law, finance and economic growth in China*, Journal of Financial Economics, 2005, 77(1), pp. 56-116.

308 Liu G. S. and Sun P., *The class of shareholdings and its impacts on corporate performance: a case of state shareholding composition in Chinese public corporations,* Corporate Governance: An International Review, 2005, 13(1), pp. 46-59.

309 Tian L. and Estrin S., *Retained state share holding in Chinese PLCs: does government ownership always reduce corporate value*?, Journal of Comparative Economics, 2008, 36(1), pp. 74-89.

310 Rongrong L., *State owned asset supervision and administration commission*, Shanghai Securities Daily, December 19th, 2009.

corporate governance practices were quite unknown to the new and emerging corporate sector. The nod of political debate and academic discussion in China was at the same time the problem of withdrawing businesses from the social welfare responsibilities inherited from the expected socialist model, and clarifying the ownership rights and responsibilities between business management, and ministers of government. At the same time, a growing number of empirical studies began to study the possible links between property types, in particular property in the hands of the state, and business performance.[311] Suffice it to recall that the gradual approach to a market-oriented reform based on the opening up of the Chinese economy continued to be the guiding principle. In terms of corporate governance development, the Chinese government has maintained its proactive and top-down approach to introducing formal governance rules and structures and increasing its use.

The end of the nineties led to a wave of new regulatory measures and major laws (1998) and accounting (1999) that provided and formalized some key components of the legal foundations for the development of a corporate sector and a modern financial market. The rules on the Shanghai Stock Market are clearly an important part of building effective corporate governance. In fact, Shanghai's Stock Exchange has also taken an active part in promoting better corporate governance by publishing an annual Corporate Governance Report from 2002.

Another often overlooked administrative measure that had had a significant impact on the way China's corporate governance is conducted is constituted by the "Administrative Rules for Registering the Company's Legal Representative" promulgated by the State Bureau of Industry and Commerce Administration In 1998. These rules established that the position of the chairman of the board is a legal representative of the company, thus unintentionally creating the status of a powerful corporate leader with the potential to intervene in corporate governance. It is commonly acknowledged in China that board chairpersons often use that capacity. However, we do not know much about the scope and impact of this, and there is little academic research on this important area of the dynamics and processes of corporate management.

New regulatory measures aimed specifically at the development of corporate governance were introduced by CSRC between 2000 and 2002. The most significant in this context were the Corporate Governance Code for listed companies introduced jointly by CSRC and the SETC (State Economic and Trade Commission) in 2002 and the requirement

[311] Wei Z. B., Varela O., D'Souza J. e Hassan M. K., *The financial and operating performance of China's newly privatized firms*, Financial Management, 2003, 32(2), pp. 107-126.

introduced by CSRC since 2001 for listed companies to have independent directors in the board of one-third of members of the board of directors by the year 2003. Together, these two initiatives set a more systematic procedure course integrated to bring about effective corporate governance reform for Chinese companies.

The CRSC has also launched two other measures to strengthen and support such changes: "Opinions on strengthening the work of monitoring and regulation of listed companies" (2000) and, given the important role of board chairmen in the structure China's corporate practice and government practices, the document on "Implementation of the Discussion/Interview System with Presidents of Board of Directors of Listed Companies" (2001). In fact, the interest of the research on the various relationships and the impact of independent directors and the structure of the board of directors have grown with the release of several studies, both inside and outside the Chinese context.[312] In 2002, the China Banking Regulatory Commission (CBRC) also published two similar documents on corporate governance lines and independent bank-owned administrators, thus expanding its attention to the major banking sector. In 2005, the CBRC also announced line guidance for board administrators and a Code of Conduct for commercial banks. A year later, CSRC announced the Corporate Governance Code for investment fund management companies alongside changes to the Securities Act.

3.6.2 SASAC (State-owned Assets Supervision and Administration) and Central Bank Governance

During this period, another important institution, SASAC, was founded in 2000. It is entrusted with the responsibility to exercise the property rights on behalf of the State, the firms owned by the country's largest state, the central enterprise groups. The first predecessor of SASAC was initially founded as a Bureau of State Assets Administration under the Finance Minister in 1998 with a limited supervisory power. Since 2004, SASAC has begun its strategic adaptation of central companies through breaks and bouts to speed up the creation, desired by the government, the profile and the structure of the national

312 Chen G., Firth M., Gao D. N. and Riu O. M., *Ownership structure, corporate governance, and fraud: evidence from China*, Journal of Corporate Finance, 2006, 12, pp. 424-448; Clarke D. C., *The independent director in Chinese corporate governance*, Delaware Journal of Corporate Law, 2006, 31(1), 125-228; Lin X. e Zhang Y., *Bank ownership reform and bank performance in China*, Journal of Banking & Finance, 2009, 33(1), pp.20-29; Lo W. C. and Ng M. C. M., *Banking reform and corporate governance*, Chinese Economy, 2009, 42(5), pp. 21-39.

economy through the strengthening of influence and control over central companies. With a significant but largely neglected move at the same time, in 2004 SASAC announced its first list of business centers for 49 central companies in November. Defining a core business is important because it is necessary to ensure that these strategic businesses provide market outcomes to help achieve national development goals. Equally important is the government's concern about the tendency of many central firms to divide into profitable property development business, which differs from their mission of becoming efficient and globally competitive in the designated business sectors. Building on risky but highly profitable property developments, along with the benefits of easy access to bank credit, state-owned enterprises will not only distort the allocation of resources but may hide poor performance in strategic sectors for which they receive considerable resources and regulatory support. From a corporate governance perspective, easy profits can disguise government failures. However, the definition of strategic sectors for these huge groups has been highly controversial and political because of the multitude of stakeholder interests. One of the most powerful "stakeholders" in this context, besides the firms concerned, is the local level of government, which receives a substantial part of its income from property development activities within its jurisdiction.

It is interesting to note that only two central firms have been authorized in the property development list as strategic sectors in the first list of 49 central companies. In any case, within a year, SASAC's list of companies having a proprietary development as a strategic sector grew rapidly up to 13. At the end of 2009, the number grew up to 16 out of a total of 128 core businesses. It can be assumed that SASAC has been put under pressure by a variety of stakeholders and this has made its task difficult to accomplish. This is because SASAC is actually one of the many government ministerial agencies, and the economic logic of producing state-owned enterprises' profits, as a commercial entity was, after all, not in contrast to official rhetoric, although it was certainly put questioning that so many subsidiary firms and state-sponsored companies should all be competing in this area. The formal designation of strategic sectors, however, does not mean that businesses that do not have property development in their strategic sectors will not engage in it. In its latest attempt, SASAC announced on March 23rd, 2010 that those companies that have not listed ownership development in their strategic areas would have to plan to withdraw from these activities.

Traditional agency theory requires remuneration for performance-based directors to better align the interests of managers and shareholders. After a mixed debate over policy makers

and academics in China in the mid-1990s, CSRC in 2005 was able to announce measures that would allow the use of stock or stock options as incensed for major administrators (i.e. "Administrative rules on equity incentives in listed companies" in a non-definitive version). For central firms, SASAC first introduced in 2004 temporary calculation methods to safeguard the state's wealth and growth in these large groups. Five years later, in 2009, SASAC announced the "Transactional Rules for the Performance Evaluation of People Responsible for Central Businesses", with performance evaluations based solely on strategic business matters, using a method of computing performance indicators more sophisticated. From the perspective of corporate governance development, this represents a significant step in the improvement of the SASAC transition methods adopted in 2000 and 2004, since it for the first time connects incentives and benefits to a set of performance indicators determined more objectively and to accurately identified responsibilities. This also strengthens the political intent of encouraging directors to focus on strategic business objectives.

3.6.3 Challenges of administration regulation

In China, there are several overlapping governmental organizations that directly and indirectly exercise regulatory and administrative powers over firms, particularly state ones. The following key national organizations have different objectives and degrees of responsibility on listed companies, government companies and financial institutions in determining corporate governance rules, procedures, and practices:

- *China Securities Regulatory Commission* (CSRC)
- *China Banking Regulatory Commission* (CBRC)
- *China Insurance Regulatory Commission* (CIRC)
- *State-owned Assets Supervision and Administration Commission* (SASAC)
- *Central Huijin Holding Ltd*.
- Communist Party of China
- People's Bank of China
- Ministry of Commerce
- *State Administration for Industry and Commerce*
- Ministry of Finance
- Shanghai Stock Exchange and Shenzhen Stock Exchange.

Among these national organizations, most have some of the branches of local government that are delegated to implement and enforce monitoring and control functions often with different degrees of rigor and ability. There is a need to clarify, streamline and reconfigure the roles and responsibilities of various government agencies and ministries so that clear responsibilities can be established and implementation of standards enforced.

For example, if SASAC acted as the owner of state-owned enterprises, would the Chinese government allow it to exercise the common stockholders' rights, including the ability to have a proper power in appointing the chief executive officer and councilors? Should the various forms of monitoring and the supervisory power of state-owned enterprises be streamlined and managed by a major organization? Or as suggested an OECD Survey on State Enterprise Governance in 2005, how could SASAC be "the body acting as a fiduciary of the Chinese people" and is committed to achieving priorities that include difficult challenges such as "limiting behaviors Irregular state as a shareholder"?

In fact, the current role of SASAC is quite different from what one might ideally seek to have or how the government initially understood it. With regard to one of the major governmental roles in the appointment, remuneration and dismissal of top managers, directors and directors of central firms and their subsidiaries, including listed companies, the final decisions on these matters remain firmly in the organization of the Chinese Communist Party. The Party should have over 90 million members that include most of the elite, so much so that it can assume that it is capable of creating a group of talents that are broad enough to presumably imitate a form of internal market competition to produce qualified subjects in the best possible way for any position. However, without really open and competitive markets for managerial talents, it will be difficult for the type of corporate governance model China is building to operate effectively. In the context of Chinese firms, in addition to the role of the Chinese Communist Party, the supervisory board since its inception in the early 1990s has also increased the complex duplicity of less transparent government agreements. The supervisory board has, however, been generally ineffective[313] although some ways have been suggested to improve its transparency governance function.[314]

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313 Tam O. K. and Hu H.W., *Supervisory board in Chinese corporate governance*, in R. Ash e L.S. Ho, China, Hong Kong and the World Economy, 2006, London, Palgrave Macmillan.

314 Tam O. K., *The development of Corporate Governance in China*, Cheltenham, UK and Northampton, MA, USA, Edward Elgar, 1999.

3.6.4 Conclusion on the Chinese system

As in other areas of economic reform in China, the development of corporate governance has been a gradual development, research and experimentation of ideas and modalities from abroad and within to create its own system and useful to the national aspiration of economic growth and modernization. While rural reforms and the liberalization of centralized production quotas and prices are often driven by the logical appearance of market forces, for example, China's approach to this important area of corporate governance development is led primarily by policy makers and regulators to wait for the construction of modern corporate and financial sectors. Since the Chinese government started its approach from the top down to the development of corporate governance in the early 1990s, there has been considerable progress in creating the many key elements and mechanisms it needs. The wave of laws and regulations introduced in the mid-1990s will play the role of establishing effective corporate governance devices while the country undergoing further reforms to create more of the economic and social institutions and business culture to effectively operate such devices. Government's attempts to remove some of the obstacles as the initiative to allow most non-negotiable state-owned shares to become negotiable is a recognition by the Chinese authorities of the importance of developing a corporate governance and a position signal more active in making the corporate governance platform that has already been established work better. Clearly, there are still great challenges to building a truly functioning corporate governance system in China. In addition to rapid and steady economic growth in China, recent news reports of corporate scandals and crimes have also become commonplace in particularly recent years. Some of these scandals have involved the leaders of the largest business firms in the country, including the major state-owned banks. These are certainly symptoms of inadequacy and failures of national corporate governance devices. As noted in the 2005 IFC[315] report, part of the problem is that, even with companies involved in good governance, the outcomes are often bankrupt or unsatisfactory with respect to the best practices that are expected to be implemented due to the lack of deeply rooted business traditions and corporate culture in China. In addition, the effectiveness and professionalism of the multitude of regulators is questionable,[316] and the traditional problem of controlling

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315 International Finance Corporation (IFC), *Step-by-Step Corporate Governance Models in China: the Experience of the International Finance Corporation*, 2005, Washington, DC: International Finance Corporation.

316 Cai H. W., *Bonding, law enforcement and corporate governance in China*, Stanford Journal of Law, Business and Finance, 2007, 13, pp. 82-120.

controllers must be addressed. However, China has not shown the phenomenon found in other developing countries where formal governance mechanisms are only foreseen for external electoral constituencies to achieve legitimacy and not being implemented.[317] Indeed, given that corporate governance could be a specific institution,[318] its development in China will require continued vigilance and perseverance by all stakeholders to shape and operate the system. From the perspective of research that can offer new ways of thinking and insights into theoretical and empirical problems of corporate governance in general and China's development experience in particular, there are excellent opportunities. For example, while state-owned enterprises still dominate the leverage of strategic industrial sectors in China, the private business sector, which is ninety percent of households' ownership,[319] is gaining momentum in China's economic growth. In 2009, private businesses created 11.4 million new jobs, contributing over ninety percent of the whole new urban use. In fact, private companies took more than 72 million people in 2007, exceeding the 61 million assumed by state-owned enterprises. At the end of 2008, households accounted for 31 percent of China's listed companies.[320] Family businesses are prevalent not only in Asia but also in rivals to widespread businesses and other non-family businesses in Europe, the Middle East and America.[321] While family businesses are gaining increasing importance in the Chinese economy, the development of their corporate governance is often overlooked and not well understood or deepened. Given China's potential growth, it will be very important to study what would be the best corporate governance in the world's largest and rapidly expanding economy.

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317 Wanyama S., Burton B. and Helliar C., *Frameworks underpinning corporate governance: evidence on Ugandan perceptions*, Corporate Governance: An International Review, 2009, 17(2), pp. 159-175.

318 Yoshikawa T. and Rasheed A. A., *Convergence of corporate governance: critical review and future directions*, Corporate Governance: An International Review, 2009, 17(3), pp. 388-404.

319 Zhang H. Y., Ming L. Z. e Liang C. Y., *Development Report of Chinese Private Enterprises 2001*, Beijing: Chinese Academy of Social Sciences Press, 2002.

320 Zhou J., Tam O. K. and Zhao C., *Do family managers outperform non-family managers? Evidence from Chinese public family firms*, 2010, paper presented at the Corporate Governance and the Global Financial Crisis Conference, Wharton Business School, September 23rd 2010.

321 Claessens S., Djankov S. and Lang L. H. P., *The separation of ownership and control in East Asian Corporation*, Journal of Financial Economics, 2000, 58 (1-2), pp. 81-112; Faccio M. e Lang L. H. P., *The ultimate ownership of Western European corporations*, Journal of Financial Economics, 2002, 65(3), pp. 365-395; La Porta R., Lopez-De-Silanes F. e Shleifer A., *Corporate Ownership around the world*, Journal of Finance, 54(2), pp. 471-517, 1999.

CHAPTER 4.
EMPIRICAL ANALYSIS OF PROFIT SMOOTHING

4.1 Empirical study on accounting and financial data

The study that is addressed in the following chapters has the purpose of understanding, through empirical analysis, the phenomenon of profit smoothing.

With the definition of "data analysis", a set of statistical methods is used to study a plurality of quantitative/qualitative variables detected on multiple units. The fundamental objective is to search for a pattern in the data, which, in the first approximation, can be considered to be the establishment of relationships between variables and the identification of similarities between the units.

The analysis of the data is therefore the modern revision and extension of the part of the traditionally defined "descriptive" statistic. But the emphasis is on the joint treatment of multiple variables, and this aspect is often underlined by the specification: multidimensional data analysis.

The novelties of the data mining[322] are mainly due to the ability to process sets with a very high number of observations, in the order of hundreds of thousands of statistical units, but also millions, and the integration and harmonization of the various techniques in the field of a single procedure, in such a way as to offer a guided and facilitated path in the interpretation of the results. The enormous amount of data poses in the first place computer problems, both for the limitations of statistical software in the number of variables and units that they are able to handle, with dilations even in computing time, and because the data of nature corporate or administrative information are often stored in the data warehouse or in the banks in formats that are not immediately usable for statistical processing, so laborious conversion operations need to be done. New methodological approaches are becoming increasingly frequent, as pre-processing is essential to "clean up" the data set, eliminating errors, inconsistencies, abnormal values, and establishing appropriate treatments for missing data. This phase, in the presence of millions of units, is very long and complex and often requires *ad hoc* procedures.

Data mining broadly considers information types that are not the subject of traditional data analysis methods, focused on quantitative and qualitative variables. The most important types of interest are the following:

[322] Data mining is the set of techniques and methodologies that have the object of extracting a knowledge or knowledge from large amounts of data (via automatic or semi-automatic methods) and scientific, industrial or operational use of this knowledge.

- Text mining, which examines statistical methods of words (newspaper articles, advertising messages) in order to locate recurring expressions more frequently and to group documents by topic, based on the words contained in them;[323]
- Web mining, which takes into account the characteristics of visitors to a website (number of visits within a certain time frame, sequence of page views, duration of stay);
- Data stream, i.e. information generated continuously in time or at very close time intervals, such as the electricity consumption continuously detected for different users, the levels of pollution measured by monitoring stations of a city, transactions on stock exchanges made by telematics;
- Symbolic data, meaning those that do not translate into individual values, but are represented by lists, intervals, and distributions.[324]

Often in data mining, data collection is performed automatically by means of computer tools.

It is to be emphasized that the coordinated, but also mechanical, application of various statistical techniques of data mining, on the one hand, provides a guide to research, but on the other hand it risks neglecting the logical premises of each methodology and its limitations of applicability. The inexperienced researcher can see the results to which it can be obtained as the product of a black box, which ignores the effects and actions. The researcher should, however, always ask "why the phenomena" and deepen the meaning of every step of the analysis.

For this reason, in the chapter presented, the various methods of analyzing multidimensional data will be described in detail, trying to explain and clarify the underlying ratio, the advantages and limits, the scope of application in the business field.

The financial statement indices that are analyzed in the following paragraphs are generally the ratio between the economic, capital and financial amounts contained in the balance sheet and the income statement reclassified. Recurring analysis scheme is: (a) reclassification of the income statement and balance sheet; (b) identification and calculation of the most significant quotients; (c) comparison with reference values. At this

323 See Bolasco, 1999; Weiss, 2005; Feldman and Singer, 2007.

324 See Liu, 2007.

point, the analysis stops to determine and verify the possible signals that are found and then further deepen through coordination systems.[325]

The index classes considered are:

1. Profitability;
2. Productivity;
3. Liquidity and working capital;
4. Financial structure;
5. Development.

Profitability indices illustrate the level of profitability of the firm and the contribution of the various areas of management.

$$ROE\% = \frac{Net\ Income}{Shareholder'sEquity}$$

ROE (Return on Equity) represents the overall profitability of its own funds and is an index that approximates the level of self-financing that is intended to earn income.

For a first estimate of the investment in the firm, a comparison is made with expected returns and with alternative investment returns.

It is an indicator of the profitability actually obtained by the enterprise and hence the degree of risk remuneration sustained by the entrepreneur and associates. This index refers to all business management: feature, accessory, financial and extraordinary management. In other words, it can be summed up as the overall profitability of its own resources and approximate the level of self-financing (understood in the income statement).

$$ROI\% = \frac{Operative\ Income}{Cost\ of\ Investment}$$

ROI is an index that expresses the remuneration that management can produce for the financial resources collected. It is an indicator that measures the company's income potential, regardless of extracurricular events, financial events, and the tax burden on

[325] The co-ordination system is a set of techniques that foster the harmonization of many corporate functions in order to achieve the set goals.
The main coordination tools are:
- Determining the goals by which the various actions of the organizational units are directed towards a specific outcome;
- Formulation of plans and programs;
- Determination of rules to be followed by different organizational units;
- Hierarchical determination.

which enterprise income is being met. Assess therefore, as mentioned above, the efficiency of the characteristic management.[326]

$$ROA\% = \frac{Operative\ Income}{Total\ Asset}$$

It expresses the economical nature of its management. It is influenced by the growth rate of new investments and by the degree of amortization, in fact, by entering only the operating activities in the denominator, a more specific indication of the profitability of the asset management is obtained.

$$ROS\% = \frac{Net\ Income\ (before\ Interest\ and\ Tax)}{Sales}$$

The ROS% index highlights the profitability of sales as a direct expression of the link between selling prices, volumes and operating costs, given the net revenue generated. It also contributes to determining the level of ROA and tends to vary considerably depending on the sector of affiliation.

The firm's income capability is directly related to the productivity of invested capital and labor productivity. The higher the productivity of the factors employed, the higher the company's earnings.

Productivity indices express the amount of output obtained in relation to the resources used to obtain it. They are also defined as efficiency indicators for the use of production factors and are more significant when compared to the values of other companies in the same sector.

$$Turnover = \frac{Net\ Income}{Total\ Asset}$$ [327]

This index identifies the number of times the invested capital returns in liquid form as a result of sales revenues.

[326] Capital Invested, net of non-typical management components, which are hard to find in the reclassified balance sheet, should represent ROI denominator.

[327] Mutual (Total Assets/Net Income) expresses the intensity of capital: the volume of investments made to produce a sales unit.

$$Gross\ Fixed\ Asset\ Turnover = \frac{Net\ Income}{Gross\ Fixed\ Asset}$$

It is an indication of the efficiency in the use of capital permanently invested in the company. Gross denominator values facilitate comparison with other firms.

Liquidity and working capital indices put the financial risk at the center of the analysis. It can be measured by short-term solvency (liquidity) or through medium to long-term solvency (asset strength). Solvency affects the ability of creditors to renew their outstanding loans and the granting of new loans.

The structure and financial performance indices measure medium to long-term solvency, or capital strength, which depends on the coherence between stable funding sources and durable loans and the degree of indebtedness, that is, dependence on third-party lenders.

$$Leverage = \frac{Total\ Asset}{Shareholder's\ Equity}$$ [328]

$$Financial\ Debt's\ Incidence = \frac{Net\ Financial\ Position\ (NFP)}{Total\ Asset}$$

The net financial position (NFP) indicates the difference between financial payables, regardless of maturity, and financial assets (immediate liquidity) excluding equity investments.

This is a more restrictive indicator on the financial coverage of financial charges.

EBIT/FC = (EBIT/NI x NI/NFP) / (FC/NFP)

This indicator allows you to simultaneously analyze the financial profile with the firm's financial and economic size.

In finance the result before financial charges or even operating income is the expression of the firm's result before taxes and financial charges. The acronym EBIT is also widely used, which is derived from the Earnings Before Interests and Taxes expression. EBIT expresses the income that the firm can generate before the remuneration of the capital, including with this term both the capital of third parties (indebtedness) and equity (equity). In the

[328] Degree of capitalization or equity participation in business risks.

formulation of the financial statement indices, it is used to obtain ROI (Return on Investment, EBIT/Net Capital Investment), which is the expression of the total return on capital invested in the firm, irrespective of their origin.[329]

"Earnings Before Interest, Taxes, Depreciation and Amortization" represents the profit before interest expense, taxes and depreciation on tangible and intangible assets.

This indicator, EBITDA, is useful for comparing the results of several firms operating in the same sector through comparative multiples (useful when price decisions are made in an initial public offering). Because EBITDA is a quick approximation of the value of cash flows produced by a company, it is often used, together with other more accurate and reliable methods, to approximate the value of a business. EBITDA can also be used to calculate the operating result of a firm, starting from gross profit, removing the company's taxes, depreciation and interest. If costs will be higher than revenues, you will have a loss, respectively, if you will have higher cost revenues, you will have a profit.

Among the indices that will be used in the following analysis is the gross profit. It is a term used in the economic and corporate sectors to define gross profit, i.e. the difference between revenues and costs incurred. This financial statement indicator represents the firm's profit without going to consider extraordinary costs, taxes and any other items to be deducted from gross profit to get the firm's net profit. The market usually rewards a listed company that reports a growth in gross profit with an increase in the value of the shares on the list or on the price lists where it is traded. A growing gross profit company often falls well within the orbits of fund managers who buy shares on the market.

Finally, the last fundamental variable to be categorized and analyzed is the wage. Wages, like all remuneration for individual production factors, are a price but a price that does not follow the general market laws, as labor is not comparable to any commodity. In fact, work is inseparable from the worker's person and therefore cannot be conveyed as capital or land; the market cannot withdraw it for a long time and its offer has a very particular trend, while job application obeys the usual laws of the application. In the context of free competition where the determination of the wage is left to the market and the individual workers contract individually with the employer outside any agreement between them, where there is a large number of workforce and limited employment opportunities, it is

[329] EBIT is often associated with the Net Operating Margin (or NOM) but does not coincide conceptually with it: in addition to the operating income components, EBIT includes the charges and income from ancillary management (e.g. real estate management for civilian use for a manufacturing company), as well as financial income from so-called active financial management.

fatally forced to go down to minimum levels. This is the situation that took place at the time of the Industrial Revolution, when the use of machines initially reduced demand for labor (while the influx of labor from the campaigns increased the supply) and workers, shrinking corporations, they found themselves without defense. It was precisely on the basis of the experience of that period class economists formulated their pessimistic theories of wages and that Marx elaborated his theory of surplus value. The natural wage, for Smith and Ricardo,[330] is in fact the minimum sufficient to ensure the existence of the working class, which always ends up matching current or marketing wages.

Economic reality has denied such pessimism and, as a result of both technical progress and reduced production costs, and the rise and strengthening of trade union organizations and social legislation, wages have progressively increased, regardless of monetary causes, and the working class's living standards are largely favorably altered. The labor market is not taking place today in conditions of competition but in bilateral monopoly, and collective bargaining, backed by the weapon of the strike, has changed the strengths between the contractors. The wage, defined in the collective agreements between the employers' organization and the corresponding organization of workers, is the result of a comparison of forces, while being naturally contained within the two extreme limits acceptable to the parties, employers are willing to pay, taking into account the marginal productivity of workers and without it being necessary to reduce the number of employees, and the minimum that workers are willing to accept in relation to the cost of living without a contraction of production. In such circumstances, it is not possible to say beforehand what the wage equilibrium is, but only what is the bargaining zone within which it will be determined peacefully or as a result of conflicts and possible interventions of the authority (conciliation attempts, arbitration, etc.).

[330] Or also wage necessary, according to J.S. Mill.

4.2. Empirical Review

Several studies have been undertaken to study Profit alterations by Managers (Nonari, 2002; Burgstahler & Dichev, 1997; Degeorge, Zeckhauser & Patel, 1999). To accomplish this, managers can either alter the earnings number via accounting manipulations or changes to real operations. There is a vast body of literature that investigates the management of earnings through accounting manipulations designed to meet a variety of incentives (Healy, 1985; McNichols & Wilson, 1988; DeAngelo, 1994; Teoh, Welch & Wong, 1998; Kasznik, 1999).

There is the belief that managers engage in profit smoothening taking actions that will reduce fluctuations in firm's reported earnings. Ronen & Sadan (1981) found that managers engage in profit leveling with belief that investors prefer firms with smoother income. Lambert (1984) and Dye (1988) showed that a risk adverse manager who is precluded from borrowing and lending in the capital market has the incentive to smooth firms reported earnings. Trueman & Tiwan (1988) contrast from Dye & Lambert (1988) that within a market setting an incentive exists for a manager to smooth profit that is independent of either risk aversion or restricted access to capital markets. Graham et al (2005) report "an overwhelming percentage of respondents indicate that they prefer a smooth earning path".

Contemporary research has shown that managers used reporting discretion, which are categorized into garbing or efficient communication of private information. Managers may smooth reported earnings to meet bonus target (Hearly, 1985) or to protect the job (Fuderberg & Tirrole, 1995; Arya et al, 1988). The contracting theory argues that profit garbling is an equilibrium solution because the principal would otherwise pay a high premium to compensate the agent, who has information advantage for taking additional risk (Lambert 1984; Demski & Frimor 1999). Under this scenario even under efficient contract the communication has been garble and therefore the reported earnings is less informative about a firm's profit and cash flows.

In contrast, other studies show that managers use profit smoothing to bring to the fore private information and future earnings (Kirscheneiter & Melumad, 2002; Ronen & Sandan, 1981; Demski, 1988; Sankar & Subramaanyan, 2001). The reported communication can be either active or passive. According to Kirschenheister & Melumadd (2002) the level of reported earnings permit investors to predict level of permanent future cash flows. Fluctuation of earning increases uncertainty and reduces ability of investors to

predict permanent cash flows. The dual role motivates managers to smooth earnings. Ronen & Sadan (1981) argues that it is only firms with good future prospects that smooth earnings as borrowing from the future could have negative consequences on poorly performing firm. Michelson et al. (2000) smoother firms report higher abnormal return mean compared to non-smoother firms. Norani (2002) profit smoothing had no significant effect on the return of firms. Furthermore, the study found nature of industry firm belongs and size of the firm can influence abnormal accruals. Bao & Bao (2004) investigated effect of profit smoothing and earnings quality and concluded that no significant differences exist between earnings per share and share price of smoother and non-smoother firms.

Despite rich literature on profit smoothing, few studies have been carried out in developing countries especially in China about effect of smoothing on performance of firms. This paper attempts to fill this gap and study the effect of smoothing and quality of earnings of firms quoted on Shanghai Stock Exchange and Shenzhen Stock Exchange.

4.2.1 Profit Smoothing Hypothesis

Profit smoothing is the leveling or averaging of profit generated by entities to smooth the income from fluctuations from period to period.[331] It is aimed at approximating reported income over the reporting period to create impression of stability of entities earnings. This is based on assumption that buyers of shares are willing to invest in entities with stable earnings. It is assumed that the preferences by investors of firms with stable earnings motivate some firms to indulge in creative accounting. Gordon (1964) suggested that managers could smooth income (or security) with assumption that stable income growth rate will be favored ahead of higher average income flows with more variations.

The following prepositions were made. First, managers will aim to maximize utility. Secondly, utility increase with job security, growth and level of manager's income and firm size. Thirdly, the satisfaction of shareholders motive of increasing income determines job security. Fourthly, shareholders satisfaction depends on increases with the average rate of growth in the firms' income (or the average rate of return on its capital) and the stability of its income. It follows therefore that if the assumptions above are justified management within the latitude provided by accounting rules will smooth reported income as well as the rate of growth in income.

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[331] The definition of "profit smoothing" has been widely debated in the previous chapters.

Underlying the profit smoothing hypothesis there are two research questions:

1. Whether among various firms' components the apportionment of risk sharing can be quantified?
2. If the risk can be diversified through different smoothing channels, which percentage of demand shock is smoothed by which smoothing channels?

4.2.2 Smoothing Criterion and detecting approaches

In order to test whether firms in the periphery sector are more likely to engage in artificial smoothing than companies in the core sector, I first selected a classification criterion. Because artificial smoothing behavior is the variable of interest, income variability may be compared to sales variability to control for the effects of real smoothing and naturally smooth income streams.

According to Copeland (1968), profit smoothing could be discovered through three ways. First, get ascertain from management by interview or questionnaire. Second, contact other parties, such as auditors. Third, examine the financial statements. But the first two methods are difficult to depend on because management and auditors maybe unwilling to cooperate. In this regard Bao and Bao (2004) argued that profit smoothing behavior couldn't be observed directly. This means that the available way to detect profit smoothing is through examining the financial statements.

Among other approaches for detecting profit smoothing through examining the financial statements is Eckel's (1981) approach (income variability approach), which has been the most popular and most used one.[332] To build his model, Eckel (1981) stated the premises that: income is a linear function of sales and is equal to sales minus variable cost and fixed cost; the variable costs as percentage of sales remains constant over time; fixed costs may remain constant or increase from period to period, but may not be reduced; and the gross sales can only be intentionally smoothed by real smoothing but cannot be artificially smoothed. Accordingly, the following conclusions were stated:

if $I = S-(VC\% * S)- FC$

and $FC>0$

[332] See for example: Albrecht and Richardson 1990, Ashari et al. 1994, Kousenidis et al. 2003, Iñiguez and Poveda 2004, Bao and Bao 2004, Prencipe et al. 2011, Kangarlouei et al. 2012, Hamad and Abu- Nassar 2013, Alexandri and Anjani 2014, Aljuaidi and Aldaoor 2014, Harnovinsah and Indriani 2015, Bora and Saha 2016.

and $FC_{t+1} \geq FC_t$

and $0 < VC\% < 1$

and $VC\%_{t+1} = VC\%_t = VC\%$

then $CV_{\Delta S} \leq CV_{\Delta I}$

In the current study, I applied Eckel's (1981) method, in which the coefficient of variation is used to measure income and sales variability.[333] Under this approach, a firm is not classified as an income smoother if

$$Smoothing\ Index = \frac{CV_{\Delta I}}{CV_{\Delta s}} \geq 1$$

Where ΔI= one period change in income,

ΔS = one period change in sales,

CV = coefficient of variation.

$$= \frac{\sqrt{Variance}}{Expected\ Value}$$

So, when the variability of income is lower than the variability of sales, the firm is classified as a "smoother": $|CV\ \Delta I \div CV\ \Delta S| \leq 1$.

If the ratio of the coefficients of variation is less than 1, some measure of income is being smoothed. Note that even if the ratio is not less than 1 for a particular firm, the firm may still be engaging in artificial smoothing behavior.

Four measures of income that are possible objects of smoothing attempts are:

(1) Operating income (OI), defined as sales less cost of goods sold and less operating costs other than depreciation and amortization,

(2) Income from operations (IO), defined as OI less depreciation and amortization,

(3) Income before extraordinary items (IE),

(4) Net income (NI).

[333] The coefficient of variation is a dimensionless measure of the variation of a group, and allows for a comparison of variances between groups according to the *SAS Users Guide: Basics* (1985).

4.3 Methodology of research

I now analyze in detail the methodology and model prepared to study the phenomenon of inter-temporal profit smoothing.

4.3.1 Dataset and Data Collection

This dataset was made using the financial statement information of n° 3304 companies listed in Shanghai Stock Exchange (SSE: total analyzed companies 1315) and Shenzhen Stock Exchange (SZSE: total companies analyzed: 1989) from 2003 to 2016 via CSMAR database for Chinese companies. Domestic-only share (A-share) is listed in either Shenzhen or Shanghai; foreign-only share are listed in Shanghai or Shenzhen (B-share) or Hong Kong (H share). In order to maintain a homogeneous database and consistent for the analysis, it was cleaned from the B share type (listed in $) and only A-share were kept (listed in Yuan-RMB).

A study that focuses on a single country needs to be carefully designed so as to avoid biased results, as pointed out by Ruland, Shon, and Zhou (2007). The adopted model and sample selection in our study avoid such implications as they take into consideration potential biases and control for associated effects[334] as discussed below.

The Shanghai Stock Exchange (SSE) was founded on November 26th 1990, and commenced operation on December 19th of the same year. The China Securities Regulatory Commission (CSRC) directly governs it. SSE bases its development on the principles of rule of law, regulation, self-discipline, and compliance in order to create a transparent, open, secure and efficient marketplace. SSE endeavors to perform a variety of functions such as providing marketplace and facilities for the securities trading, formulating business rules, accepting and arranging listings, organizing and monitoring securities trading, regulating members and listed companies, and managing and publicizing market information. After 27 years of development, SSE has evolved into an exchange with a sound market structure and four major securities categories: equities, bonds, funds and derivatives. It has put into operation the world's leading exchange system and infrastructure communication facilities that can contribute to the efficient running of the

[334] Ruland et al. (2007) suggest that a properly designed test for within country experiments needs to control for firm specific attributes (e.g., size and profitability), industry effects, and self- selection bias. My tests do control for all these factors.

Shanghai securities market. Besides, a self-regulatory framework has been put into place regulating listed companies, SSE members and the securities market. By the end of 2016, SSE altogether had 1182 listed companies with the total market capitalization hitting 28.5 trillion RMB. Its total annual turnover in 2016 stands at 50.2 trillion RMB and the average daily turnover reached 205.6 billion RMB. The total capital raised in the equities market in 2016 was 805.6 billion RMB. The bond market consists of 8077 listed bonds with the outstanding value totaling 6.2 trillion RMB, the annual turnover standing at 224.7 trillion RMB. There are 137 funds with the annual turnover hitting 8.9 trillion RMB. The total value of premium of the derivatives market was 43.19 billion RMB in 2016. The number of registered accounts of investors has reached 224.85 million by the end of 2016.

Shenzhen Stock Exchange (SZSE), established on 1st December 1990, is a self-regulated legal entity under the supervision of China Securities Regulatory Commission (CSRC). It also organizes, supervises securities trading and performs duties prescribed by laws, regulations, rules and policies. Its main functions include providing the venue and facilities for securities trading, formulating operational rules, receiving listing applications and arranging securities listing, organizing and supervising securities trading, supervising members; regulating listed companies, managing and disseminating market information and other functions as approved by the CSRC.

SZSE is committed to developing China's multi-tiered capital market system, serving national economic development and transformation and supporting the national strategy of independent innovation. The SME Board was launched in May 2004. The ChiNext market was inaugurated in October 2009. Thus SZSE has basically put in place a framework of multi-tiered capital market comprising the Main Board, SME Board, and the ChiNext market. SZSE's products cover equities, mutual funds and bonds. The product lines include A-shares, B-shares, indices, mutual funds (including ETFs and LOFs), fixed income products (including SME collective bonds and asset-backed securities), and diversified derivative financial products (including warrants and repurchases). SZSE plays an increasingly important role in supporting the real economy and transforming the nation's economic growth model.

Since 2000, SZSE has signed MOUs with 30 major stock exchanges and financial institutions in the world and enhanced cross-border cooperation and communications. It has also taken an active part in international securities organizations. SZSE is a member of both the World Federation of Exchanges (WFE) and the Asian and Oceania Stock Exchanges Federation (AOSEF). It is also an affiliate member of the International

Organization of Securities Commissions (IOSCO).

4.3.2 Variables

Based on review of the literature, the model already tested and very useful for me to understand the variables to be used in my model, is of the following general form:

Smoothing index = f(accounting risk, market risk, agency costs, political costs, ownership structure, industry).

Accounting and market risk: drawing on the same literature reviewed in Moses (1987), they hypothesize a positive association between the smoothing of accounting earnings numbers and risk (both market and accounting). To the extent that smoothing can provide signals which enhance the accuracy of earnings forecasts, and given that unexpected earnings are positively associated with levels of systematic risk (Givoly and Lakonishok, 1983, quoted in Moses), it is argued that wealth-maximizing managers would be anxious to smooth accounting earnings in order to maximize firm value. Similarly, Beidleman's (1973) argument that smoothing tends to reduce a firm's beta, suggests that managers of firms with high levels of market risk would have more incentive to smooth. Accounting risk has been included in the model in addition to market risk for two reasons. First, Moses (1987), in the only prior smoothing study, which adopts a positive accounting theory perspective, found this to be a significant explanatory variable. Second, in addition to the effect of systematic risk on the appropriate discount rate, total risk can have a negative effect on the firm's expected cash flows because the expected costs of financial distress are related to total risk (Shapiro and Titman, 1985).

Agency costs: three variables are used to proxy agency costs: dividend cover, gearing and managerial holdings of share options. I hypothesize a negative association between smoothing and dividend cover. Three arguments can be put forward to support such an association. First, by generating a more stable earnings stream, smoothing behavior is deemed to support a higher level of dividends and hence a higher share price (Gordon, 1964). Second, smoothing reduces the probability of management having to cut dividends, an action usually associated with bad news and a negative share price response. Third, given the observed stability in dividend payout, smoothing reduces the expected transactions costs associated with the funding of an uncovered dividend (Rozeff, 1982). I hypothesize a positive relationship between smoothing behavior and gearing. Given that gearing proxies' closeness to financial ratio covenants in debt agreements, it follows that

smoothing reduces the probability of breaching these covenants and hence reduces the expected costs of default and/or renegotiation. I therefore expect managers in more highly geared firms to undertake a greater degree of smoothing. I also hypothesize a positive relationship between smoothing and the level of managerial holdings of share options. This variable is a measure of the direct impact of any increases in share values (achieved by smoothing) on managers' wealth, and represents an important accounting choice variable, which has been omitted in many previous studies (Watts and Zimmerman, 1990, p. 145).

Political costs: the firm's level of sales is used to proxy for the potential political costs, borne by the firm, arising from the impact of external groups on the firm's activities. Such costs can arise in a number of ways: the impact of a regulatory directive, the impact of the firm having to pursue non-profit maximizing behavior and the cost of lobbying. This external intervention might be motivated by the firm's supply of politically sensitive goods and services (Sutton, 1988) or the potential exercise of monopoly power (Watts and Zimmerman, 1986). Given that large unexpected earnings fluctuations can attract the attention of government regulators and/or the public, I hypothesize a positive association between political visibility and smoothing behavior, motivated by management's wish to minimize the expected costs of potential external intervention.

Ownership structure: I hypothesize that smoothing is negatively associated with the degree of outside ownership concentration. This tests the early smoothing studies' argument that the incentive to smooth is largely confined to firms with diffuse share ownership, i.e. manager-controlled firms. It has become clear, however, that a single variable may not capture the full effects of ownership structure, especially the impact of significant managerial ownership (Hunt, 1986). To overcome this possible limitation, we therefore also include a managerial ownership variable, which captures two offsetting effects. First, as managerial ownership increases, the incentives of managers and outside shareholders become more closely aligned (Niehaus, 1989), and there is less incentive for wealth transferring activities. This suggests a negative association between smoothing and the level of managerial ownership. Second, however, as managerial ownership increases, the managerial labor market and the market for corporate control become less effective means by which managers are forced towards value-maximizing decisions. This is because a manager who owns a significant proportion of the firm's equity often has sufficient voting power to guarantee future employment (Morck et al., 1988, p. 294). In the face of managerial incentives to smooth, an increase in managerial discretion can be expected to result in greater smoothing. The direct wealth effects of any increases in share values

(achieved by smoothing) are also suggestive of a positive association. *A* pion', it is not clear which effect will dominate.

Industry: industry sector dummies are included to control for any differential industry effects on smoothing incentives (Watts and Zimmerman, 1990, p. 145).

Starting from this assumption, the variables calculated for each year (2003-2016) highlighted in my work are:

Value Added (VA) is defining as (Sales-Cost of Materials);

Gross Operating Margin (GOM) is equal to (VA-Wages);

Net Operating Margin (NOM) is equal to (GOM-Depreciation);

Operating Income (OI) is equal to (NOM-General and Administrative Expenses);

After Interests Profits (AIP) is equal to (OI-Interests);

After Tax Profits (ATP) is equal to (AIP-Taxes);

Net Profit (NP) is equal to (ATP-Extraordinary Items).

4.3.3 Model

Following Asdrubali, Sørensen, and Yosha (1996) and Asdrubali and Kim (2004), who identify different levels or channels of smoothing to decompose the cross-sectional variance in gross-state product, I propose a framework to quantify the contribution of each smoothing channels at the firm level. I build on the variance-decomposition method delevoloped by Asdrubali, Sørensen, and Yosha, who have used a panel SUL (Nota: Seemingly Related Regression) to regress successively smoother idiosyncratic income measures on idiosyncratic GDP (in growth rates) and I develop a methodology that leads to a relationship such as the following:

$$1= \beta_K+\beta_F + \beta_C + \beta_D + \beta_E + \beta_G + \beta_H + \beta_U$$

Where $\beta_K+\beta_F + \beta_C + \beta_D + \beta_E + \beta_G + \beta_H + \beta_U$ are the fractions of sales shock smoothed respectively via Materials (β_K), Wages (β_F), Depreciation (β_C), General and

Administrative Expenses (G&A Expenses, β_D), Interests (β_E), Taxes (β_G), Extraordinary Items (β_H) and β_U is the fraction unsmoothed.

In order to obtain a measure of smoothing from the identity in 1= β_K+$\beta_F + \beta_C + \beta_D + \beta_E + \beta_G + \beta_H + \beta_U$, I estimate the following model which takes the first differences of all variables:

$$\Delta Sales_t^i - \Delta VA_t^i = v_{K,t} + \beta_K \Delta Sales_t^i + u_{K,t}^i$$

$$\Delta VA_t^i - \Delta GOM_t^i = v_{F,t} + \beta_F \Delta Sales_t^i + u_{F,t}^i$$

$$\Delta GOM_t^i - \Delta NOM_t^i = v_{C,t} + \beta_C \Delta Sales_t^i + u_{C,t}^i$$

$$\Delta NOM_t^i - \Delta OI_t^i = v_{D,t} + \beta_D \Delta Sales_t^i + u_{D,t}^i$$

$$\Delta OI_t^i - \Delta AIP_t^i = v_{E,t} + \beta_E \Delta Sales_t^i + u_{E,t}^i$$

$$\Delta AIP_t^i - \Delta ATP_t^i = v_{G,t} + \beta_G \Delta Sales_t^i + u_{G,t}^i$$

$$\Delta ATP_t^i - \Delta NP_t^i = v_{H,t} + \beta_H \Delta Sales_t^i + u_{H,t}^i$$

$$\Delta NP_t^i = v_{U,t} + \beta_U \Delta Sales_t^i + u_{U,t}^i$$

Using the above system of equations, I measure the extent to which changes in sales affect, e.g., value added and operating income.

4.4 Results

As already defined, profit smoothing is the phenomenon that, through empirical study and analysis, can interpret the correlation between an income shock[335] with respect to business variables. This allows us to understand how much of that shock is absorbed by one or the other specific channels within a reclassified scalar economic account.

From this definition new visions are opened with respect to a profit interpretation: it can no longer be defined as a residual variable, as it has already been said, on the contrary it must be defined rather as a managerial objective.[336]

To begin the empirical study, it is necessary to make a descriptive statistic analysis of the variables mentioned in the previous paragraph.[337]

4.4.1 Descriptive analysis

The tables below show the descriptive analyzes of the variables examined year by year (2003-2016) in order to have a clearer context of the database being examined.

2003			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	1378	4.38e+08	2.76e+09
GOM	1378	1.39e+08	1.20e+09
NOM	1378	1.35e+08	1.19e+09
OI	1378	1.58e+08	1.23e+09
AIP	1378	1.51e+08	1.08e+09
ATP	1378	1.12e+08	8.09+08
NP	1378	1.09e+08	6.71e+08

Figure 3: Profit Statement variables 2003.

2004			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	1466	5.33e+08	3.68e+09
GOM	1466	1.85e+08	1.73e+09
NOM	1466	1.78e+08	1.72e+09
OI	1466	1.99e+08	1.78e+09
AIP	1466	1.91e+08	1.53e+09

335 Positive or negative.

336 Indeed, those who behave according to this canon have greater survival opportunities (shareholders are more willing to invest, banks consider them more trustworthy and have more resources from self-financing) - an evolutionist approach.

337 See §4.3.2.

ATP	1466	1.39e+08	1.09e+09
NP	1466	1.41e+08	1.10e+09

Figure 4: Profit Statement variables 2004.

2005			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	1461	5.58e+08	3.73e+09
GOM	1461	1.66e+08	1.63e+09
NOM	1461	1.60e+08	1.62e+09
OI	1461	1.83e+08	1.68e+09
AIP	1461	1.85e+08	1.77e+09
ATP	1461	1.27e+08	1.24e+09
NP	1461	1.29e+08	1.25e+09

Figure 5: Profit Statement variables 2005.

2006			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	1544	1.05e+09	8.74e+09
GOM	1544	4.92e+08	5.87e+09
NOM	1544	4.54e+08	5.44e+09
OI	1544	4.76e+08	4.95e+09
AIP	1544	4.80e+08	4.99e+09
ATP	1544	3.81e+08	4.42e+09
NP	1544	3.86e+08	4.41e+09

Figure 6: Profit Statement variables 2006.

2007			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	1658	1.83e+09	1.50e+10
GOM	1658	9.72e+08	9.07e+09
NOM	1658	8.83e+08	8.33e+09
OI	1658	1.05e+09	9.85e+09
AIP	1658	1.08e+09	9.88e+09
ATP	1658	8.62e+08	8.50e+09
NP	1658	8.60e+08	8.51e+09

Figure 7: Profit Statement variables 2007.

2008			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	1712	2.00e+09	1.70e+10
GOM	1712	9.96e+08	1.08e+10
NOM	1712	7.60e+08	8.87e+09
OI	1712	8.28e+08	9.75e+09

AIP	1712	8.93e+09	9.87e+09
ATP	1712	5.59e+08	9.02e+09
NP	1712	7.75e+08	9.05e+09

Figure 8: Profit Statement variables 2008.

2009			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	1860	2.05e+09	1.73e+10
GOM	1860	9.52e+08	9.71e+09
NOM	1860	8.67e+08	9.04e+09
OI	1860	9.90e+08	1.02e+10
AIP	1860	1.01e+09	1.02e+10
ATP	1860	8.43e+08	8.96e+09
NP	1860	8.45e+08	8.99e+09

Figure 9: Profit Statement variables 2009.

2010			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	2215	2.45e+09	2.07e+10
GOM	2215	1.21e+09	1.17e+10
NOM	2215	1.10e+09	1.07e+10
OI	2215	1.22e+09	1.18e+10
AIP	2215	1.26e+09	1.18e+10
ATP	2215	1.04e+09	1.03e+10
NP	2215	1.05e+09	1.04e+10

Figure 10: Profit Statement variables 2010.

2011			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	2449	2.73e+09	2.34e+10
GOM	2449	1.32e+09	1.30e+10
NOM	2449	1.19e+09	1.16e+10
OI	2449	1.31e+09	1.26e+10
AIP	2449	1.36e+09	1.26e+10
ATP	2449	1.11e+09	1.09e+10
NP	2249	1.12e+09	1.10e+10

Figure 11: Profit Statement variables 20011.

2012			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	2577	2.83e+09	2.46e+10
GOM	2577	1.32e+09	1.39e+10

NOM	2577	1.16e+09	1.24e+10
OI	2577	1.28e+09	1.33e+10
AIP	2577	1.34e+09	1.33e+10
ATP	2577	1.09e+09	1.14e+10
NP	2577	1.07e+09	1.17e+10

Figure 12: Profit Statement variables 2012.

2013			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	2621	3.10e+09	2.62e+10
GOM	2621	1.46e+09	1.52e+10
NOM	2621	1.30e+09	1.37e+10
OI	2621	1.45e+09	1.48e+10
AIP	2621	1.51e+09	1.48e+10
ATP	2621	1.24e+09	1.28e+10
NP	2621	1.25e+09	1.29e+10

Figure 13: Profit Statement variables 2013.

2014			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	2736	3.26e+09	2.77e+10
GOM	2736	1.54e+09	1.66e+10
NOM	2736	1.30e+09	1.44e+10
OI	2736	1.49e+09	1.56e+10
AIP	2736	1.55e+09	1.57e+10
ATP	2736	1.27e+09	1.34e+10
NP	2736	1.28e+09	1.35e+10

Figure 14: Profit Statement variables 2014.

2015			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	2924	3.32e+09	2.79e+10
GOM	2924	1.53e+09	1.73e+10
NOM	2924	1.20e+09	1.42e+10
OI	2924	1.47e+09	1.62e+10
AIP	2924	1.54e+09	1.63e+10
ATP	2924	1.26e+09	1.42e+10
NP	2924	1.27e+09	1.43e+10

Figure 15: Profit Statement variables 2015.

2016			
Variable	**N° of obs.**	**Mean**	**Stand. Dev.**
VA	3217	3.29e+09	2.70e+10
GOM	3217	1.60e+09	1.78e+10
NOM	3217	1.26e+09	1.46e+10
OI	3217	1.48e+09	1.62e+10
AIP	3217	1.54e+09	1.62e+10
ATP	3217	1.29e+09	1.45e+10
NP	3217	1.30e+09	1.46e+10

Figure 16: Profit Statement variables 2016.

The predominant role of a first phase of analysis, the descriptive one, has already been clarified. Descriptive statistics are a set of techniques used to describe the basic characteristics of data collected in an experiment/study. They provide a simple synthesis of the sample and the measurements collected. Along with simple graphic analysis, they are the initial starting point for any quantitative data analysis. While with descriptive statistics it is simply describing what we observe or what the data points in their essential traits, with inferential statistics, then we will try to reach conclusions that extend beyond the data collected in their immediate and which can be valid and relevant to a wider context than that of the single experiment/study data. To describe and summarize the sample information of a numeric interest phenomenon, the descriptive statistic focuses on three main aspects:

1. Description and form of the distribution;
2. Central position or tendency;
3. Variability or dispersion.

The tools provided by the descriptive statistics can be both graphical and numeric. In the last case, these are appropriate synthesis indexes, which in a single value express a specific characteristic of the data distribution: the central tendency, variability, and the form of the distribution. Summary indices are divided into middle or middle trend indices a) average, median, and mode; b) indices of variability or dispersion variance, standard deviation, range, and quantile range; asymmetry index. In this case, a descriptive study of the main variables on which the profit smoothing phenomenon is being studied has been made. Note how the individual variables are rather constant from one year to another indicating that there were no obvious economic shocks that influenced the analysis. The analysis was carried out through the indexes of position, highlighting the mean values and the standard deviation.

4.4.2 ANOVA test: general effects

The table below (table number) shows the results for the percentage of shock (variation) of sales that is absorbed, for each smoothing level. Statistical inference is a process of generalization of the results obtained through partial sampling, limited to the consideration of some units or individual cases of the phenomenon of study, to the totality of the units or cases of the phenomenon, on the basis of plausible hypotheses.

Taking into account the data highlighted in paragraph above,[338] profit-smoothing phenomenon is described in a variance fragmentation model and the results are apparent in the following tables:

Percentage of shock to sales absorbed at each level of smoothing

Variable (2003-2016)	**Coef.**	**Robust Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**		**Wald χ^2 (13)**
Materials (β_K)	.87930	.0656	13.57	0.000	.7617	1.0189	3034.01
Wages (β_F)	.06518	.0310	2.13	0.033	.0052	.1269	224.46
Depreciation (β_C)	.00819	.0053	1.56	0.119	-.0021	.0188	118.25
G&A Expenses[339] (β_D)	.00335	.0021	1.58	0.114	-.0008	.0076	57.41
Interests (β_E)	-.00800	.0014	-5.77	0.000	-.0109	-.0053	433.79
Taxes (β_G)	.00977	.0042	2.31	0.021	.0014	.0183	141.26
Extraordinary Items (β_H)	-.00059	.0004	-1.62	0.105	-.0015	.0001	54.93
Unsmoothed (β_U)	.04276	.0246	1.76	0.078	-.0049	.0915	135.21

Figure 17: ANOVA, table for regression model to understand the channel of smoothing.

Percentage of shock to sales absorbed at each level of smoothing. In this panes equation, the β coefficient s a weighted average of the year-by-year cross-sectional regression. That is, I interpret β_K, β_F, β_C, β_D, β_E, β_G, β_H as the GLS estimate of the risk sharing equation regression, i.e. the incremental amount of smoothing achieved at each level, β_U is the amount not smoothed.

Table 17 shows my empirical results for the percentage of shock to sales absorbed at each level of smoothing. Consider the decomposition of smoothing into its various channels. One can easily notice that "Materials" (87.93%) plays the biggest part in absorbing shock sales. Such results imply that material costs –external costs- tend to provide insurance almost in order to 88.00% reduction in the standard deviation of sales. In addition, my breakdown shows that the amount of smoothing accomplished by "Wages" and "Depreciation" are respectively 6.51% and 0.81%, and are both significant as the previous

[338] See § 4.3.

[339] General and Administrative Expenses.

components. Such findings are consistent with most existing literature (e.g. Barefield and Comiskey, 1971; Michaely and Roberts, 2012), and at the same time they somewhat confute the latter, at least for what concerns the impact of firm depreciation policy on sales volatility. Indeed, based on the premise that "effective smoothing device should not establishing a precedent to which the principles of consistency may apply"[340] does not acknowledge the use of depreciation to produce a smoother income stream. Although the smoothing effect of depreciation being small, my evidence instead implies that depreciation is mot irrelevant for income smoothing. In addition it signals that a lower amount of smoothing is accomplished through "G&A Expenses" (0.33%), and "Taxes" (0.09%) considerations. Contrary to claims found elsewhere in the literature (Beattie et al., 1994; Craig and Walsh, 1989), "Interest" and "Extraordinary Items" have a dis-smoothing effect.

Finally, the amount of smoothing at the last level, i.e. the unsmoothed fraction, equals to 4.42%, and suggests that the residual share of income, i.e. what is commonly conceived as owners' profit, is less likely to be used as a major time-varying risk-sharing device. All in all, the evidence from Table 17 suggests that most of my findings be not explained solely by firm material costs considerations.

4.4.3 Profit Smoothing and sign of demand shock

To gain further insight and ensure the robustness of my inferences, I analyze the differential response of sales to negative and positive demand shocks. The results are presented in Table 18 and 19. Interestingly, given a similar smoothing impact of "Materials", my evidence here emphasizes that a different smoothing mechanism tends to be used in the two cases. In case of a negative demand shock, a considerable part of such shock is absorbed by "Taxes" (2.05%), also we can see a dis-smoothing effect by "Depreciation" (-2.09%). Conversely, in case of a positive demand shock, the major part of income smoothing (11.41%) is achieved by maneuvering "Wages" versus -0.93% for a negative shock for the same variable. There is thus an asymmetry in shock absorption.

[340] Copeland, 1968 (p.102).

Percentage of negative shock to sales absorbed at each level of smoothing: sign of shock to sales

Variable (2003-2016)	**Coef.**	**Robust Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**		**Wald χ^2 (13)**
Materials (β_K)	.95462	.0027	347.5	0.000	.9395	.9502	121107.5
Wages (β_F)	-.00939	.0013	-7.09	0.000	-.0119	-.0067	95.10
Depreciation (β_C)	-.02091	.0008	-23.46	0.000	-.0224	-.0190	610.10
G&A Expenses (β_D)	.00889	.0008	10.72	0.000	.0071	.0104	137.51
Interests (β_E)	-.00424	.0006	-6.52	0.000	-.0055	-.0029	59.84
Taxes (β_G)	.02020	.0004	46.21	0.000	.0192	.0209	2176.56
Extraordinary Items (β_H)	.00001	.0000	0.50	0.618	.0000	.0000	105.85
Unsmoothed (β_U)	.05081	.0013	37.68	0.000	.0477	.0529	1460.85

Figure 18: Test for Negative Shock.

Percentage of positive shock to sales absorbed at each level of smoothing: sign of shock to sales

Variable (2003-2016)	**Coef.**	**Robust Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**		**Wald χ^2 (13)**
Materials (β_K)	.82239	.0018	446.5	0.000	.8123	.8195	200801.3
Wages (β_F)	.11410	.0007	162.4	0.000	.1118	.1146	26589.25
Depreciation (β_C)	.01733	.0006	27.94	0.000	.0160	.0184	888.56
G&A Expenses (β_D)	-.00181	.0008	-2.18	0.029	-.0035	-.0001	42.03
Interests (β_E)	-.01007	.0003	-32.95	0.000	-.0106	-.0094	1097.45
Taxes (β_G)	.00796	.0003	23.86	0.000	.0073	.0086	723.29
Extraordinary Items (β_H)	-.00100	.0001	-5.35	0.000	-.0014	-0.006	47.03
Unsmoothed (β_U)	.05110	.0014	34.06	0.000	.0478	.0537	1246.58

Figure 19: Test for Positive Shock.

4.4.4 Firms' Size and Profit Smoothing

Continuing the analysis more profoundly of the profit smoothing phenomenon, I was thinking of widening the study also through a business-size classification. The size of the enterprise was assessed by the number of employees involved in a firm (2003-2016). I wanted to point out the size analysis, as business choices can be very dissimilar between big corporations and small firms. Since there are no specific regulations classifying for Chinese companies according to the classic (small-medium-big) dimensions, I've

considered updated directives and EC parameters (European Community, 2016) as the source of reference.

The EC provides the following dimensional classifications of enterprises considering the variable of employees:

A. Small businesses: 0-49 employees;
B. Medium businesses: 50-249 employees;
C. Large businesses: >250 employees.

Dimensional classification of firms (variable: employees)

Dimensions	**Number of firms**
Small (0-49)	58
Medium (50-249)	185
Big (>250)	3061
TOTAL	**3304**

Figure 20: Sample dimension.

Percentage of shock to sales absorbed to each level of smoothing: small dimension

Variable (2003-2016)	**Coef.**	**Robust Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**		**Wald χ^2 (13)**
Materials (β_K)	.80688	.0078	102.9	0.000	.7903	.8210	10946.24
Wages (β_F)	.08995	.0037	24.22	0.000	.0825	.0971	622.84
Depreciation (β_C)	-.00035	.0040	-0.09	0.929	-.0082	.0075	21.69
G&A Expenses (β_D)	-.00528	.0022	-2.30	0.021	-.0097	-.0007	20.13
Interests (β_E)	-.00223	.0024	-0.93	0.353	-.0069	.0024	11.49
Taxes (β_G)	.01926	.0014	13.46	0.000	.0164	.0220	211.34
Extraordinary Items (β_H)	-.00005	.0005	-0.10	0.918	-.0011	.0010	13.97
Unsmoothed (β_U)	.09180	.0071	12.74	0.000	.0776	.1058	176.64

Figure 21: Small dimension.

Percentage of shock to sales absorbed to each level of smoothing: medium dimension

Variable (2003-2016)	**Coef.**	**Robust Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**		**Wald χ^2 (13)**
Materials (β_K)	.82468	.0064	126.8	0.000	.8115	.8370	16692.75
Wages (β_F)	.07654	.0037	20.62	0.000	.0692	.0692	472.03
Depreciation (β_C)	.00124	.0021	0.57	0.568	-.0030	.0055	26.73
G&A Expenses (β_D)	.00469	.0031	1.49	0.137	-.0014	.0108	22.74

Interests (β_E)	.00187	.0034	0.54	0.591	-.0049	.0087	22.24
Taxes (β_G)	.02563	.0012	19.99	0.000	.0231	.0281	416.44
Extraordinary Items (β_H)	.000099	.0003	0.27	0.791	-.0006	.0008	11.88
Unsmoothed (β_U)	.065616	.0063	10.39	0.000	.0532	.0779	136.17

Figure 22: Medium dimension.

Percentage of shock to sales absorbed to each level of smoothing: big dimension

Variable (2003-2016)	**Coef.**	**Robust Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**		**Wald χ^2 (13)**
Materials (β_K)	.87940	.0015	587.0	0.000	.8873	.8932	345677.3
Wages (β_F)	.06512	.0007	92.77	0.000	.0646	.0674	8690.58
Depreciation (β_C)	.00817	.0005	16.04	0.000	.0073	.0094	387.40
G&A Expenses (β_D)	.00334	.0006	5.16	0.000	.0021	.0047	73.64
Interests (β_E)	-.00805	.0003	-27.03	0.000	-.0087	-.0075	751.59
Taxes (β_G)	.00968	.0002	38.35	0.000	.0093	.0103	1598.95
Extraordinary Items (β_H)	-.00059	.0001	-4.97	0.000	-.0009	-.0004	41.24
Unsmoothed (β_U)	.04266	.0009	47.12	0.000	.0414	.0450	2310.13

Figure 23: Big dimension.

4.4.5 Profit smoothing: sectorial breakdown

An interesting question is whether smoothing channels vary according to the industry in which organizations operate. The following Tables show evidence concerning the sectorial breakdown of my results. Although it is confirmed that "Wages" absorb the largest percentage of shock in all sector (without considering "Materials"), some interesting differences emerge among primary, manufacturing and service sectors.

Given the Chinese database, before starting the sector analysis, I have highlighted the areas of reference. In particular, I have highlighted six sectors:

1. Financial;
2. Utilities;
3. Real Estate;
4. Integrate (Mining & Transportation);
5. Manufacturing;
6. Service, Retail & Wholesale.

Compare Shanghai Stock Exchange to Shenzhen Stock Exchange by Sector (2016)

Sector	Shanghai Stock Exchange	Shenzhen Stock Exchange
Financial	32%	7.2%
Utilities	14.5%	Less than 3%
Real Estate	Less than 3%	14.9%
Integrate	4.5%	3.6%
Manufacturing	43%	60%
Service, Retail & Wholesales	Less than 3%	11.3%

Figure 24: Shanghai and Shenzhen Stock Exchange by Sector.

To understand my analysis is necessary specify even the number of the firms in the Chinese Database:

Sectorial breakdown

Sector	Numbers of firms
Financial	332
Utilities	378
Real Estate	158
Integrate	123
Manufacturing	2202
Service, Retail & Wholesales	111
TOTAL	**3304**

Figure 25: Dimension of Sectorial Breakdown.

Percentage of shocks to sales absorbed at each level of smoothing. Sectorial composition: Financial

Variable (2003-2016)	Coef.	Robust Std. Err.	z	P>|z|	[95% Conf. Interval]		Wald χ^2 (13)
Materials (β_K)	.05182	.0042	10.77	0.000	.0370	.0535	138.69
Wages (β_F)	.29031	.0034	72.58	0.000	24.63	.2600	5447.62
Depreciation (β_C)	.16457	.0059	24.19	0.000	.1319	.1552	674.19
G&A Expenses (β_D)	.03255	.0091	3.10	0.002	.0104	.0464	39.65
Interests (β_E)	-.00149	.0004	-3.06	0.002	-.0022	-.0005	28.61
Taxes (β_G)	.00150	.0004	3.06	0.002	.0005	.0022	28.61
Extraordinary Items (β_H)	-.08118	.0023	-30.24	0.000	-.0754	-.0662	1014.58
Unsmoothed (β_U)	.54199	.0091	51.81	0.000	.4549	.4906	2729.79

Figure 26: Financial.

Percentage of shocks to sales absorbed at each level of smoothing. Sectorial composition: Utilities

Variable (2003-2016)	**Coef.**	**Robust Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**		**Wald χ^2 (13)**
Materials (β_K)	.84338	.0042	191.2	0.000	.7952	.8117	37214.04
Wages (β_F)	.10599	.0017	58.40	0.000	.0975	.1043	3517.90
Depreciation (β_C)	.00539	.0009	50.19	0.000	.0031	.0070	62.85
G&A Expenses (β_D)	-.00395	.0018	-1.99	0.047	-.0074	.0000	25.07
Interests (β_E)	-.00190	.0008	-2.21	0.027	-.0035	-.0002	25.38
Taxes (β_G)	.00199	.0008	2.21	0.027	.0002	.0035	25.38
Extraordinary Items (β_H)	-.02574	.0010	-23.75	0.000	-.0265	-.0224	625.84
Unsmoothed (β_U)	.07493	.0033	21.37	0.000	.0648	.0779	541.23

Figure 27: Utilities.

Percentage of shocks to sales absorbed at each level of smoothing. Sectorial composition: Real Estate

Variable (2003-2016)	**Coef.**	**Robust Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**		**Wald χ^2 (13)**
Materials (β_K)	.82397	.0054	146.3	0.000	.7835	.8048	21707.74
Wages (β_F)	.13436	.0021	60.94	0.000	.1252	.1336	3844.01
Depreciation (β_C)	.02608	.0034	7.34	0.000	.0183	.0317	79.92
G&A Expenses (β_D)	-.03218	.0020	-15.46	0.000	-.0349	-.0270	286.08
Interests (β_E)	-.00068	.0007	-0.74	0.460	-.0021	.0009	11.39
Taxes (β_G)	.00058	.0007	0.74	0.460	-.0009	.0021	11.39
Extraordinary Items (β_H)	-.02842	.0011	-23.90	0.000	-.0296	-.0251	617.87
Unsmoothed (β_U)	.07620	.0035	20.46	0.000	.0664	.0805	439.59

Figure 28: Real Estate.

Percentage of shocks to sales absorbed at each level of smoothing. Sectorial composition: Integrate

Variable (2003-2016)	**Coef.**	**Robust Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**		**Wald χ^2 (13)**
Materials (β_K)	.47892	.0170	27.70	0.000	.4392	.5061	800.93
Wages (β_F)	.06925	.0034	20.11	0.000	.0616	.0750	435.83
Depreciation (β_C)	.03355	.0051	6.43	0.000	.0230	.0432	43.81
G&A Expenses (β_D)	.01279	.0051	2.45	0.014	.0025	.0226	14.65

Interests (β_E)	.00553	.0065	0.84	0.399	-.0073	.0183	16.30
Taxes (β_G)	-.00563	.0065	-0.84	0.399	-.0183	.0073	16.30
Extraordinary Items (β_H)	-.00792	.0019	-4.05	0.000	-.0116	-.0040	21.85
Unsmoothed (β_U)	.41339	.0173	23.56	0.000	.3740	.4419	614.77

Figure 29: Integrate.

Percentage of shocks to sales absorbed at each level of smoothing. Sectorial composition: Manufacturing

Variable (2003-2016)	**Coef.**	**Robust Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**		**Wald χ^2 (13)**
Materials (β_K)	.91864	.0012	715.9	0.000	.9134	.9184	514751.7
Wages (β_F)	.05509	.0007	72.97	0.000	.0534	.0563	5366.30
Depreciation (β_C)	.00063	.0002	2.23	0.026	.0000	.0011	83.25
G&A Expenses (β_D)	.00314	.0002	12.36	0.000	.0026	.0036	185.74
Interests (β_E)	-.00880	.0003	-23.57	0.000	-.0095	-.0080	573.52
Taxes (β_G)	.00801	.0003	23.57	0.000	.0080	.0095	573.52
Extraordinary Items (β_H)	-.00624	.0002	-29.01	0.000	-.0066	-.0058	923.69
Unsmoothed (β_U)	.02879	.0006	43.10	0.000	.0273	.0299	1982.15

Figure 30: Manufacturing.

Percentage of shocks to sales absorbed at each level of smoothing. Sectorial composition: Service, Retail & Wholesales

Variable (2003-2016)	**Coef.**	**Robust Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**		**Wald χ^2 (13)**
Materials (β_K)	.95581	.0019	493.0	0.000	.9455	.9530	246663.7
Wages (β_F)	.03565	.0017	20.71	0.000	.0320	.0388	476.74
Depreciation (β_C)	.00241	.0003	6.87	0.000	.0017	.0031	58.80
G&A Expenses (β_D)	-.00596	.0007	-7.76	0.000	-.0073	-.0043	90.54
Interests (β_E)	-.00099	.0003	-2.56	0.002	-.0015	-.0002	19.39
Taxes (β_G)	.00109	.0003	2.56	0.002	.0002	.0015	19.39
Extraordinary Items (β_H)	-.00395	.0002	-18.00	0.000	-.0043	-.0035	381.70
Unsmoothed (β_U)	.01587	.0008	18.23	0.000	.0140	.0174	394.88

Figure 31: Service, Retail & Wholesales.

First, my finding demonstrates that the fraction of smoothing occurring through wages tends to be higher (25.32%) in the "Financial" sector rather in the remainders.

Second, a di-smoothing effect of "Extraordinary Items" is registered in all sectors. Furthermore, a di-smoothing effect of "General & Administrative Expenses" is registering in "Utilities" (-0.37%), "Real Estate" (-3.09%), and "Service, Retail & Wholesales" sectors (-0.58%) as compared to the "Financial", "Integrate", and "Manufacturing" sectors. Conversely, "General & Administrative Expensive" in such sectors might be said to absorb a rather small but positive amount of demand shocks to sales (2.84%; 1.25%; and 0.31%). Third, "Depreciation" sector seems to play a bigger part in determining depreciation smoothing in all sector, especially in the "Financial", "Real Estate", and "Integrate" sector (14.35%; 2.50%; and 3.31%). I interpret these results as a consequence of the fact that depreciation burden passed between sectors varies from one sector to the others, and accordingly the role of net profits as a smoothing channels changes.

Fourth, my results clearly indicate an increasing importance (47.27%; 7.14%; 7.35%; and 40.79%) of smoothing occurring through profits (i.e. the unsmoothing percentage) in the "Financial", "Utilities", "Real Estate", and "Integrate" sectors, rather than in the "Manufacturing" and "Service, Retail & Wholesales" sectors.

Finally, another important factor to note is that sectors that have a third party as counterparts into the company can absorb (and thus smooth) a shock in sales to external costs (Materials). Instead, if the sectors that fail to blur outside ("Financial" and "Integrate" sector) must somehow find the internal channel to smooth the shock of sales. As we can see, especially in "Financial" Sector, Material can absorbed just 5.18% of shock because this channel means that those who support this shock are just those who deposit money into financial companies and therefore customers. Much higher is the level of non-smooth (Unsmoothed), that is, the level of profit that cannot be blunted. In this case, as we can see, there are not many channels to go to touch to absorb a shock; all the shock is poured into profit (54.19% for "Financial" Sector and 41.33% for "Integrate" Sector versus 7.4% in "Utilities", 7.6% in "Real Estate", 2.8% in "Manufacturing" and 1.5% in "Service, Retail and Wholesales".

CHAPTER 5.
MANAGEMENT BEHAVIOR AND PROFIT SMOOTHING. IMPLICATIONS OF THE STUDY

5.1 Country breakdown analysis

In order to further understand the role of each smoothing channels, I now turn to the analysis of risk sharing by country. Compared to the general case, some relevant differences are detected at the country level. In particular, the insurance function provided by G&A Expenses is confirmed in most countries, the only exception being Belgium and Estonia. However, inter-country differences emerge in term of risk sharing via other channels. Consider, in particular, Extraordinary Items. Whereas Extraordinary Items register a dis-smoothing effect in the general case, one can note how such effect turns to positive and significant in such countries as Austria, Spain, Norway, Romania, Sweden, Slovenia, and Portugal especially (18.14%). The result obtained for Portugal is particularly and further assesse what has been already demonstrate in previous studies on the implications of tax policy (Marques, Rodrigues, and Craig, 2011) and accruals be regarded as one country in which firms mostly tend to smooth income via extraordinary items and taxes due to tax savings incentives and higher accounting discretion.

Finally, it should be noted that a sort of substitution pattern for income smoothing occurs between wages and profit within specific countries. In particular, I register lower percentage of wages smoothing whereas higher profit smoothing in Estonia, Italy, Poland, Sweden, Slovenia, Slovakia, and Ukraine. Conversely, the case if Germany is somewhat singular in that wages smoothing is considerably high (17.03%) whereas profits have a dis-smoothing effect. I interpret such findings in light of the differences in terms of labor protection and trade unions role between the considered countries. For instance, if one loos at the OECD data on trade union density and labor protection for the period 2003-2013 (OECD, 2014) one might easily notice that the above mentioned countries are featured by considerably high levels of protection of workers against individual and collective dismissals, as signaled by average values of the OECD indicator of labor protection for the period 2003-2013, which assume values grater than 2. Thus, the average indicator for Portugal (4.19) confirms my previous intuition that income smoothing tends to occur through channels other than wages. The same holds if one looks at trade union density. According to OECD estimate, Estonia, Italy, Poland, Sweden, Slovenia, Slovakia, and Ukraine have the highest trade union density (i.e. the percentage of employees who are members of a trade-union), which makes it difficult to maneuver wages in such countries. Again one exception is Germany where wages smoothing is considerable in split of comparably high levels of workers unionization and protection.

Under a different viewpoint, country variations in smoothing channels might also be related to institutional ownership of publicity-listed companies. Thus, particularly high levels of profits smoothing in such countries as Sweden might be explained by similarly high percentages of GDP in term of assets under management by institutional investors, which usually push firm managers to focus on long-term profitability rather than be pre-occupied with smoothing income on a year-by-year basis. Indeed, there are studies showing that, when institutional investors collectively own a large percentage of outstanding shares, managers are deterred from fully pursuing opportunistic earnings management through discretionary accrual choices (Chung, Firth and Kim, 2002). Thus, a lower percentage of smoothing via profits relative to wager might be seen as a consequence of the corporate governance function of large institutional investors. Such observation helps further explain the unexpected results obtained for Portugal, where profits appear to have a strong dis-smoothing impact (-13.64%). Indeed, OECD average 2003-2013 percentage of asset owned by institutional investors on GDP for Portugal is one of the highest (60.7%) in the sample of OECD countries.

Risk sharing country breakdown (percent) 1/2

	AT	**BE**	**BG**	**CZ**	**DE**	**EE**	**ES**	**FR**	**IT**
Materials (β_K)	81.9	92.0	64.7	80.4	62.6	94.05	71.53	79.1	76,2
Wages (β_F)	4.45	1.42	0.64	2.90	17.0	1.03	4.46	5.03	1.80
Depreciation (β_C)	1.13	0.90	1.22	2.30	3.98	0.25	2.75	1.26	6.13
G&A Expenses (β_D)	11.5	3.55	30.1	7.73	18.5	2.35	14.6	12.4	9.36
Interests (β_E)	-1.19	1.63	1.78	1.47	0.94	-0.77	1.47	0.24	2.93
Taxes (β_G)	0.57	0.28	0.31	1.11	-0.45	0.04	1.55	0.37	3.09
Extraordinary Items (β_H)	0.09	-2.2	-0.02	-0.12	-0.47	0.00	0.45	-0.4	-2.5
Unsmoothed (β_U)	**1.46**	**2.36**	**1.20**	**1.20**	**-2.16**	**3.06**	**3.17**	**2.84**	**2.94**

Figure 32: Sample of OECD countries 1/2.

Risk sharing country breakdown (percent) 2/2

	NO	PL	PT	RO	RS	SE	SI	SK	UA
Materials (β_K)	62.6	33.7	44.5	58.1	68.9	53.0	85.6	89.1	16.4
Wages (β_F)	6.06	1.67	3.09	1.43	6.33	6.37	2.64	1.04	1.30
Depreciation (β_C)	10.6	0.68	4.10	1.34	2.75	-1.59	0.86	0.23	0.35
G&A Expenses (β_D)	8.55	55.2	41.4	31.4	15.0	30.0	8.21	8.35	77.8
Interests (β_E)	4.08	-0.3	1.99	0.24	-3.2	1.18	-0.9	-0.1	0.54
Taxes (β_G)	8.22	0.90	0.31	0.72	0.96	2.19	0.38	0.26	1.24
Extraordinary Items (β_H)	1.94	-0.06	18.1	0.01	-0.4	0.51	0.24	-0.04	-1.62
Unsmoothed (β_U)	**-2.14**	**3.80**	**-13.6**	**6.68**	**9.64**	**7.94**	**3.02**	**1.10**	**3.87**

Figure 33: Sample of OECD counties 2/2. Source: Asdrubali, Vagnani, Ventura (2014).
Note: Austria (AT), Belgium (BE), Bulgaria (BG), Czech Republic (CZ), Germany (GE), Estonia (EE), Spain (ES), France (FR), Italy (IT), Norway (NO), Poland (PL), Portugal (PT), Romania (RO), Serbia (RS), Sweden (SE), Slovenia (SI), Slovakia (SK), Ukraine (UA).

My framework considers the full range of firm constituents, rather than a single smoothing variable or technique, thus providing insight on which channels firm tend to use mostly as a "shock absorbed" in order to provide insurance to specific constituents. Each firm constituent, upon joining the firm, seems to agree accepting a more or less large fraction of its income in the form of a share of the residual, depending for instance on the degree of mobility (and relatedly on the extend of transaction costs incurred in changing employment) and information that each factor can leverage (Schumpeter, 1934). Firms might thus been said ho have the two-faced nature of both work-sharing and risk-sharing entities (Eisenhardt, 1985). However, most of previous studies on risk have contemplated only the perspectives of shareholders or managers and often considered dividends as a natural shock absorbed. This study instead shifts attention to the overall firms' costs structures. More generally, I analyze the properties of different smoothing device in order to uncover as whether and to what extend they abide by Copeland's (1968) original definition of a "perfect smoothing device".

Going on, I extend extant empirical works on income smoothing by analyzing the decomposition of income variance in a wider inter-temporal and spatial perspective. Concerning the spatial dimension, in particular, I show the extent to which results on income smoothing at the firm level can be generalized across different sample size and EU

counties.[341]

Furthermore, I shed some light on the relationship between firm size and income smoothing behavior, and relatedly on how risk sharing tends to occur at the "Small" and "Medium-Sized" Enterprise (SMEs) level. Under this perspective, my findings might contribute to understand the magnitude of insurance provide for specific SMEs' constituents, such as e.g. financial intermediaries, through which most resources are channeled to SMEs.

Finally and more generally, this work allows gaining insight on firm income smoothing behavior by employing a more robust and accurate methodology than those traditionally based on the use of the coefficient of variation to measure income and sales variability.

[341] Magni D., *Profit Smoothing. Verso una implicazione strategica del ruolo del profitto,* 2014. EAI, Edizioni Accademiche Italiane.

5.2 Summary of findings and future research directions

The economic and financial press regularly comments on the accounting manipulations of managers to modify their firms' published results. In this respect, income smoothing has attracted substantial attention in the literature. We saw that there are many studies in the international literature that indicate that firms engage in practices to reduce the variance of earnings. This work adds to this evidence, showing empirically that Chinese companies listed in Shanghai and Shenzhen Stock Exchange engage in smoothing, i.e., they take advantage of the inherent leeway in accounting rules to artificially smooth out their earnings.

Based on the analysis of a sample of firms over the period from 2003 to 2016, this work presents empirical evidence that Chinese companies that engage in smoothing on average stand apart from those that do not with respect to risk, return, size and industrial sector.

The results can be summarized by the hypotheses investigated, as follows in Table 34, 35 :

Summary of Findings: general effect

Channels	**2003-2016**
Materials	87.93%
Wages	6.51%
Depreciation	0.84%
General and Administrative Expenses	0.33%
Interests	-0.80%
Taxes	0.97%
Extraordinary Items	-0.05%
Unsmoothed	**4.27%**

Figure 34: General effect.

Summary of Findings: Negative and Positive shock

2003-2016		
Channels	**Negative shock**	**Positive shock**
Materials	95.46%	82.23%
Wages	-0.93%	11.41%
Depreciation	-2.09%	1.73%
General and Administrative Expenses	0.88%	-0.18%
Interests	-0.42%	-1.00%
Taxes	2.02%	0.79%
Extraordinary Items	0.001%	-0.11%
Unsmoothed	**5.08%**	**5.11%**

Figure 35: Negative and Positive shock.

Summary of Findings: Size

2003-2016	Size		
Channels	**Small**	**Medium**	**Big**
Materials	80.68%	82.46%	87.94%
Wages	9.00%	7.65%	6.51%
Depreciation	-0.03%	0.12%	0.81%
Gen.& Adm. Expenses	-0.52%	0.46%	0.33%
Interests	-0.22%	0.18%	-0.80%
Taxes	1.92%	2.56%	0.96%
Extraordinary Items	0.00%	0,00%	-0.05%
Unsmoothed	**9.18%**	**6.56%**	**4.26%**

Figure 36: Size

Summary of Findings: Industry

2003-2016						
	Industry					
Channels	**Financial**	**Utilities**	**Real Estate**	**Integrate**	**Industry**	**Business**
Materials	5.18%	84.33%	82.39%	47.89%	91.86%	95.58%
Wages	29.03%	10.59%	13.43%	6.92%	5.50%	3.56%
Depreciation	16.45%	0.53%	2.60%	3.35%	0.06%	0.24%
Gen.& Adm. Expenses	3.25%	-0.39%	-3.21%	1.27%	0.31%	-0.59%
Interests	-0.14%	-0.19%	-0.06%	0.55%	-0.88%	-0.09%
Taxes	0.15%	0.20%	0.05%	-0.56%	0.89%	0.10%
Extraordinary Items	-8.11%	-2.57%	-2.84%	-0.79%	-0.62%	-0.39%
Unsmoothed	**54.19%**	**7.49%**	**7.62%**	**41.33%**	**2.87%**	**1.58%**

Figure 37: Industry.

The results of this study are particularly important for risk-averse investors who wish to obtain higher returns by structuring their portfolios. The results indicate that strategies can be formulated from classifying firms as smoothers and non-smoothers because the sample portfolios formed of companies showing smoothing behavior in all cases obtained better returns than those formed of non-smoothing firms. I detected a progressive decline in the adjusted returns for each risk level, from positive sale's shock to negative one. In all the returns calculated with the corresponding risk adjustment, as well as alternative adjustments, as in the case of the market portfolio, in all cases there was sufficient evidence to consider the results significant and robust in light of the multiple refinements proposed in the comparison of abnormal returns.

With respect to the systematic risk of the stocks, both on an individual basis, I detected that the risk declines with the degree of smoothing by firms, with the riskiest ones being those that did not show any evidence of smoothing behavior and the risk significantly lower in

firms engaging in smoothing.

However, my results should be interpreted with care, leading to suggestions for more comprehensive and complex future studies on the theme. A possible extension would be to include firms from several different countries. Besides allowing for more robust statistical tests, this would permit extending the time frame and making broader comparative analyses of income smoothing (determining whether this practice exists in the same intensity and for the same reasons in different countries). The questions addressed here can also be developed further in various ways. Among the points for future research are: How does the practice of income smoothing dynamically affect firm value? How can the difference in abnormal returns between smoothers and non-smoothers be explained? A critical point of any study is the definition of alternative metrics for classifying companies. Another interesting extension would be to examine the relationship between smoothing and the cost of equity capital.

Among the main implications of this study, perhaps the main one is that financial managers can find scientific evidence here justifying earnings management with positive effects (beneficial smoothing). From this perspective, the practice of managing earnings to reduce variability could be beneficial by reducing possible distortions in stock prices. Smoothing signals value to the market to the extent it reduces systematic risk and constitutes an unquestionable guide to value. Since the objective function of management is to increase the firm's value, and since managers have a certain degree of discretion to manage accounting numbers, smoothing out earnings can generate value for shareholders.

However, a caveat is in order here. Since less variability in the series of reported earnings can boost the value of the firm, this can lead to abusive smoothing, where in a market with asymmetric information, the pooling equilibrium in signaling, in the context of game theory, prompts managers to engage in pernicious smoothing to mimic firms with genuinely smooth earnings series. In such a context, it is important to have regulatory instruments to discourage the abusive manipulation of the risk perception of investors.

5.3 Conclusive remarks on the profit smoothing phenomenon

There is inherently a part of profit that is not smooth, that is, is not literally "blanched" or "unsmoothed" by the initial shock of the proceeds. The higher this part no smooth, the more variance[342] will insist on other business items, especially on labor costs.

We cannot comment, at an absolute level, on whether this mechanism is good or bad for the company. It can be noted, however, that if management decides to increase the smooth profit side, it is implementing a policy of profit implication as a true strategic variable,[343] which depends on the figure itself and the stability of the social structure firm and therefore management.

As previously analyzed, a very important variable associated with operating profit is the dividend. From the empirical analysis of the dividend policy adopted by a large sample of US companies some empirical evidence can be observed:[344]

- Dividends tend to partially follow the trend of profit: increases in profits generally result in dividend increases; but if earnings decrease, dividends tend to be "rigid downwards";
- Dividend policy tends to be stable: managers are often reluctant to make changes in distribution policy;
- From the first two points it follows that dividends tend to have, for this reason, a more regular trend of profits;
- There are obvious differences in dividend policies adopted at different times of the firm's life cycle; these differences reflect changes in growth rates and cash flows, in addition to the availability of sound investment opportunities.

Based on the empirical observations described above, John Lintner elaborated, in the 1950s, a business decision-making model, which could be synthesized in four points, on the distribution of dividends:

1. Companies have long-term goals about the payout ratio;
2. Managers focus their attention on dividend variations rather than absolute levels;
3. Dividend variations follow changes in long-term profits;
4. Managers avoid in all ways raising the dividends to avoid risk to have to return to lower levels.

Therefore, the model in question, theorized, that the distributed dividend partly depends on

342 Sales Shock.
343 See §1.
344 See Damodaran, 2006.

the period's profits, partly from the dividend distributed in the previous periods.[345] Subsequently, additions to the original Lintner study substantially confirmed these findings, but added a further variable decision-making: the firm's growth prospects. The touch point of the various studies is that an increase in dividends signals manager optimism about the future prospects of the company. An increase in dividends, therefore, is perceived by the market as "good news", thus raising stock prices and confirming, implicitly, again the management structure.

The dissertation attempted to integrate literature into the notion of profit study, within the dynamics of evaluation and statistics between the profit itself and other business variables. From this attempt came the proposal of a conceptual model that, leading to a re-reading of the traditional process of evaluating and designing correlation between business variables, appears to be loaded with multiple and significant implications for both business theory and managerial practices.

Well-behaved, the advanced model also establishes a new, plausible relationship between business competitiveness and negotiating power of certain stakeholder and shareholder categories, capable of combining the development of new organizational skills, such as before a high competitiveness, with the presence of asymmetries of knowledge, which typically accompanies this development.

From the point of view of managerial practice, the implications of the advanced conceptual proposal are developed on a double front. The first concerns the need for future research on issues related to smooth and no smooth profit. In particular, the need for a more in-depth exploration of the relationship between actions taken by specific stakeholder groups in order to influence the amount of the rent (*ex-ante*) and the total profit left to the vital needs of the enterprise. On the other hand, a second reflection point emerges in relation to the fact that a very important no smooth part in the profit variable may favor the configuration of the organizational structures of the firm to increase strongly the negotiating power of the top management within the enterprise, even though inadequate in the light of contextual conditions.

Finally, it should be emphasized that, in the light of the contribution made to theory and practice, the proposed model does not appear to be free of any limitations and appropriate analysis integrations. In particular, the hypothesis that organizational planning is limited to the assessment of the variance of business variables introduces sufficient motivations, but

[345] It also depends on the operating profit of the previous period.

no further and necessary integrations and research studies, in order to explain the programming choices related to the distribution of dividends.

In any case, it is believed that the questions raised must lead to the overcoming of the proposed model's limits by preparing a fertile soil on which future theoretical and empirical research may take place.

By revisiting and re-evaluating the concept of profit, this model ends up showing again, the intrinsic multi-disciplinarily and inter-disciplinarily, to be understood as the concomitant presence and interrelation between distant disciplinary approaches but applied to the study of the same phenomenon. Inter-disciplinarily means in fact the ability to go beyond the variety of definitions, logic and metrics that arise from the mere overflow of many and different approaches to the concept of profit. To see, the model proposed in this thesis tends to face the challenge of inter-disciplinarily.

In other words, the model depicts a unitary vision of the enterprise, interpreting the dynamics that characterize it through the peculiar lens of processes that preclude the generation and approximation of profit from key interest bearers. Finally, the study of the phenomenon of profit smoothing emerges as a fundamental concept associated with business variables.

The aim pursued by the work of analysis and comparison between the different theories and the model presented in the thesis is an attempt to stimulate debate and orientate research on the complex phenomenon of profit smoothing. Lastly, it is believed that the search for meaning linked to the need to clarify the link between profit and enterprise dynamics can find a significant engagement in propositions based on the developed model as well as in the trend lines emerging from the vast corpus of analyzed and systematized theories.

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