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Research Article

The Manipulation Of Financial Statements: A Theoretical Explanation

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ABSTRACT

Objective: This paper delves into the realm of agency theory to elucidate the dynamics between company owners and managers, exploring how managers, as rational agents, may exploit their positions to prioritize personal gains over the company's interests. It aims to examine the role of accounting as a primary conduit for conveying information, misrepresenting facts, or engaging in deceptive practices, particularly focusing on financial statement manipulation.
Methods: Drawing upon insights from the financial literature, this study offers a theoretical exploration of financial statement manipulation practices. It synthesizes key theories relevant to accounting fraud, shedding light on the underlying mechanisms and motivations driving such behaviors.
Results: The analysis reveals that agency theory provides a framework for understanding the principal-agent relationship within organizations, highlighting the potential conflicts of interest between owners and managers. Furthermore, it underscores the pivotal role of accounting in facilitating or thwarting deceptive practices, emphasizing the significance of transparency and accountability in financial reporting.
Conclusion: By leveraging insights from agency theory and the broader financial literature, this paper offers a theoretical foundation for comprehending financial statement manipulation. It underscores the need for robust governance mechanisms and ethical standards to mitigate the risks associated with accounting fraud, ultimately safeguarding the interests of company stakeholders

Keywords: Accounting; Manipulation; Financial Statements; Theory

INTRODUCTION.

In classical models, information was considered to be perfect. Since then, there has been no incentive for researchers to study the behaviour of economic agents, since they were assumed to be rational (Beidleman (1973).
The separation between ownership and decision-making in the firm has marked the content of the theory of property rights and that of transaction costs. This implies an imperfect flow of information between agents. This asymmetry can be profitable for anyone who masters it. Consequently, agency theory's recognition of the existence of asymmetric information has revealed the existence of conflicts of interest.
The first section defines the opportunism of managers with regard to accounting information. This cannot be explained solely by agency theory. In fact, entrenchment theory, regulatory theory, signal theory and, more

particularly, political-contractual theory provide a better explanation of the actions of actors in the inappropriate use of their discretionary latitude (Jensen & Meckling (1976); Ross (1977); Watts & Zimmerman (1978); Fama & Jensen (1983a); Noe & Rebello (1996); Libby & Kinney Jr (2000); Hossain et al. (2011).
All of these theories explain managerial opportunism in accounting by identifying several motivations. These will be the subject of the second section which, according to Breton & Schatt (2003), pursue three different groups of objectives:
- Modifying executive remuneration ;
- Minimizing financing costs
- Controlling political costs

From Marx's doctrine to social theories, opportunism has fuelled a number of writings and left its mark on the field of several scientific domains. As a result, several theories intersect in explaining this notion. In management science, the identification of opportunism was initially approached by the theory of information asymmetry. Subsequently, several other theories have placed this notion at the heart of their thinking. The combination of regulatory theory, agency theory, positive accounting theory and signal theory makes it possible to explain opportunism in accounting information.

Conflict of interest: the role of asymmetric information theory

The purpose of this section is not to give a detailed account of the theories used in this part, but to show that the opportunism of the manager (1.1) is the result of a situation of asymmetric information (1.2).

1.1 Highlighting the divergence of interests

During the 1970s, significant progress was made in the theory of the firm by bringing together economists, managers and lawyers. This rapprochement focused on the organisation of the firm and on the set of relationships it constituted, giving rise to what was later called "agency theory". In fact, this progress was partly due to the seminal work of Berle & Means (1932). The separation between the functions of ownership and management was highlighted (Demsetz (1967). This separation of responsibilities can create conflicts and generate costs (Jensen (1986).
Indeed, Jensen & Meckling (1976) highlighted the problematic relationship between conflicts of interest between owner and manager and company performance. This idea has its origins in the work of Adam Smith, who stated as early as 1776 that "we can hardly expect the stewards of other people's money to exercise that exact and solicitous vigilance which the partners in a partnership often exercise in the handling of their funds".
Agency theory states that the performance of firms is the result of their organisational choices. The firm is represented by a network of contracts in which managers and shareholders are the main players (Jensen & Meckling (1976). The articulation of these contracts and the management of conflicts between the various stakeholders determine the efficiency of the firm and its ability to produce value (Agrawal & Knoeber (1996).
It is for this reason that Jensen & Meckling (1994) believe that an understanding of human nature is important if we are to understand how companies operate, and to put in place a system of governance. These authors advocate the introduction of a REMM model, according to which individuals are insatiable, maximise their own utility function and are also endowed with a capacity for adaptation and creativity. Jensen & Meckling (1994) state that this conception is the fruit of more than two centuries of research and debate in economics, the social sciences and philosophy.
Friedberg & Crozier (1977) explain that individuals adopt strategies from two perspectives. On the offensive, they seize opportunities to improve their situation. They also maintain or widen their margin of freedom, and therefore their capacity to act, in an offensive mode. For example, an employee seeking to improve his pay-effort ratio is encouraged to demand an increase in pay. Similarly, the outcome of these demands depends on the balance of power and the assessments of the players involved. To sum up, the firm is now understood as a set of contractual relationships between the different agents that make it up. These relationships are cooperative, since all the participants have a common interest in the smooth running of the business.
On the other hand, the relationships are also conflictual, since the objectives of the different agents are distinct, and incomplete or asymmetric information allows opportunistic behaviour. In general, the work of Caby and Hirigoyen clearly shows that the theories of agency and transaction costs contain the seeds of a shift towards an active manager, i.e. one who uses his discretionary latitude to act in his own interests (Caby & Hirigoyen (2005).

Opportunism as a result of asymmetric information

The recognition of asymmetric information between actors in the theories of the firm has opened up new perspectives in the analysis of the behaviour of actors.
As early as Coase's pioneering work (1937) on the nature of the firm, uncertainty and problems of access to information were highlighted about contractual relations between agents. These elements were at the origin of what would later be called transaction costs, a concept taken up and developed by Williamson (1985).
Starting from the managerial theory defined in the work of Berle & Means (1932), and on the opposition between the market and Coase's hierarchy (1937), the first part of Williamson's work attempted to conceive a theory of the firm without taking advantage of intermediate forms, then in the remainder of his research the imprint of the vision of the firm as a "contract node" marked the rest of his work (Coriat & Weinstein (1995).

By incorporating into his analysis the limits of individuals' cognitive capacity and their preference for maximising their own utility, Williamson distinguishes two characteristics:

- **The incompleteness of contracts:**
  Williamson's analysis of the incompleteness of contracts is the result of the bounded rationality defined by Simon (1955). In fact, agents enter into relationships in which they cannot foresee in advance all the contingencies that will affect the outcome of their transactions. The inability of contracts to set all the conditions for the different partners is thus apparent.
- **Opportunism:**
  Opportunism is defined by Willamson as the result of "adverse selection" and "moral hazard".
  moral hazard".

- **Adverse selection :**
  Adverse selection arises, when in a transaction, one of the parties has private information about elements likely to affect the net benefits that the other party may derive from the contract. Adverse selection refers to cases where the principal is unaware of a characteristic of the agent that has an impact on the outcome of the agreement between him and the agent. Adverse selection is the impossibility of obtaining full information on the characteristics of goods that are visibly identical. It is a problem of pre-contractual opportunism. For Akerlof (1970), this phenomenon results from the fact that individuals hold private information that is not accessible to the other party.
- **Moral hazard:**
  Moral hazard is the possibility for an individual to strategically, voluntarily exploit a situation not foreseen by the designers of a system. Entering into a contract with an agent runs the risk of provoking negative behaviour on his part (low "moral") likely to worsen a posteriori the conditions of the principal party who entered into the contract. Moral hazard is defined as post-contractual opportunism that occurs when the actions of co-contractors cannot be identified. In this case, the economic agents who adopt it pursue their own interests at the expense of other economic actors.

In his book, Gomez (1996) stresses the importance of information as a disciplinary means of resolving conflicts in the relationship between the manager and those around him. For the author, the manager's ability to manipulate data represents a risk for the partners' decision-making, and the free transfer of information is therefore necessary. Asymmetry in the distribution of information combined with a divergence of interests gives rise to agency problems (Jensen (1986). In fact, informational asymmetry, by minimising the impact of the divergence of interests, does not pose any organisational problems.
In this case, the agent will make decisions in accordance with the principal's interests (Fama & Jensen (1983a). Similarly, conflicts of interest do not pose organisational problems in the absence of asymmetric information. According to Armstrong et al (2010), in this case the principal will easily discover any opportunistic behaviour on the part of the agent.
However, the agency relationship only exists because the principal believes that the agent is in a better position to manage his asset. He recognises the agent's know-how and distinctive abilities. For these reasons, asymmetric information is considered to be at the origin of the contractual relationship (Bushman et al. (2004).

2- The leader's roots

This concept, which has been around for several centuries, illustrates the main ways in which politicians can maintain and increase their power. The principle of entrenchment applied to leaders can be summed up by their opportunistic behaviour. In business, managers have to persuade shareholders of their skills, because they are perfectly replaceable by someone else, since there is a large supply of managers on the market. However, managers have various ways of making themselves "irreplaceable". These are known as "entrenchment strategies", and are used to ensure job security.
The work of Shleifer & Vishny (1989) and Morck et al (1990) shows that managers develop assets specific to their know-how in order to raise their replacement costs and increase their value in the eyes of owners. This makes it possible to increase salaries and freedom of action to the detriment of shareholders' interests. Company managers therefore have the ability to generate additional profits and eliminate competing managers. This attitude is only conceivable thanks to the asymmetry of information and the implicit contracts linking the various partners to the managers.
According to agency theory, the divergence of interest between managers and shareholders can be limited by increasing the share held by managers, and this behaviour is not necessarily harmful to shareholder wealth (Ang et al. (2000). According to the entrenchment theory, owner-managers are more sensitive than other shareholders to variations in the firm's performance. It is therefore in their interest to minimise the risks of their investment and to protect and retain their power (Alexandre & Paquerot (2000).
This view is not shared by some authors, since Charreaux (1997), in his theory of managerial entrenchment, assumes that managers who own a very large proportion of the firm's capital can use their voting rights to

entrench themselves. What is more, this entrenchment may encourage managers to invest in the company over the long term and to develop the human capital that is essential for managing the firm's specific assets.
In this sense, we must accept that the interests of shareholders and managers will never be perfectly aligned. Indeed, Jensen & Meckling (1976) argue that this is only conceivable in the event that the managers manage to acquire all of the firm's capital.
In the same context, Alexandre & Paquerot (2000) explain that the entrenchment strategies developed by managers aim to increase their discretionary space. By using the means at their disposal, such as human capital and the firm's assets, managers can neutralise the control systems and increase the attachment of the firm's stakeholders to the resources they control (specific human capital, information asymmetry, etc.).
The manager's position at the centre of the contract node gives him easier access to information than all the company's stakeholders. His strategic position in the company allows him to control information by limiting access by other agents. These actions allow him to take root and increase his discretionary space, while aggravating the informational asymmetry towards the agents responsible for his control.
According to Charreaux (1997), entrenchment strategies lead managers who hold significant shares of the capital to increase their power over the owners and to manage the company in a way that is unfavourable to value maximisation. As for the impact of management entrenchment on the quality of financial information, the work of Gul & Wah (2002) corroborates Charreaux's point of view.
Charreaux's point of view and points to a deterioration in the quality of information when there is an increase in the number of shares held by managers. In fact, Gul & Wah (2002) explain that an increase in managerial shareholding amplifies the probability of recourse to accounting manipulation.

3. Regulatory theory

From the point of view of the economic theory of regulation, the company is considered as an entity in relation to society as a whole (Posner (1974); Peltzman (1976); Watts (1977); Libby & Kinney (2000); Ibrahim (2009). The protection of the public interest is at the heart of this theory, as it enables a measured allocation of resources between the various stakeholders (Posner (1974). As a result, several interest groups emerge, prompting the company to arbitrate between costs and benefits in order to lobby for regulation (Libby & Kinney (2000).
According to Peltzman (1976), the interests within each group are homogeneous. Consequently, it is difficult to assume this homogeneity from one group to another. In the political process, the concept of the interest group is important insofar as grouping allows economies of scale to be achieved. The costs of information seem to outweigh the benefits derived from the use of this information by a single individual.
In this same perspective, Watts & Zimmerman (1986) indicate that politicians apply this arbitration rule when they decide to regulate. It is essential to compare the costs associated with
regulation with the benefits derived from it. In this respect, all laws and regulations are the result of a balance between two antagonistic forces: the group benefiting from the profits and the group producing them. Similarly, Watts & Zimmerman (1986) argue that large companies are targeted by politicians as sources of state funding. In short, the contribution of regulatory theory to accounting is reflected in its importance in explaining the actions of accounting standard-setters. However, managers may manage profits downwards to counter political pressure. These actions bear the seeds of the need to manipulate financial statements (Ball et al. (2000).

Positive accounting theory

Alongside agency theory, ownership theory and signal theory, which explain the motives for managerial opportunism, a number of accounting studies have identified certain motives and practices in the modification of financial information. Watts & Zimmerman (1978) in their famous article "Towards a positive theory of the determination of accounting standards" identified several motivations justifying the practices of managers. These are the results of the transformation of published information thanks to the elasticity of the principles of consistency of methods, prudence and faithfulness.
The positive theory of accounting has generated numerous hypotheses. The most confirmed hypotheses are those relating to debt, remuneration and size. The work of Watts & Zimmerman (1986) explains these hypotheses in the following points:

- Managers who transfer profits from future years to the current year are probably those who manage companies with a high debt-to-equity ratio.
- Management remuneration, in the form of profit-sharing contracts, encourages the deferral of profits from future financial years to the current financial year.
- The size of the company encourages managers to manage profits, and encourages managers in large companies to defer profits to future years.

According to Jeanjean (1999), the assumptions relating to debt, remuneration and size are based on the following reasoning: The firm is a knot of contracts between stakeholders (creditors, shareholders, managers,

employees, suppliers, etc.) who have divergent interests. In order to resolve organisational problems, agents draw up contracts to limit the transfer of wealth, using accounting standards implicitly or explicitly.
From this perspective, agents seek to maximise their utility, and their opportunistic behaviour allows them to use cunning, lies and manipulation. In terms of financial reporting, managers have discretionary latitude in their choice of accounting options. They are favoured by asymmetric information, which makes it difficult to control the manager's activity.

Signals theory

Signal theory was first applied in finance by Ross and Myers. It is based on the fact that information is unequally shared by economic players (Charreaux (1993). In this case, the emission of a signal is interpreted as additional information provided to the financial market with the aim of influencing investors and provoking a reaction in share prices (Noe & Rebello (1996).
For these reasons, managers of financially strong firms have an interest in providing information to investors in order to distinguish themselves from financially weak firms. However, the managers of the companies may in turn wish to make the information public in order to give the impression that their companies are in good health (Rappaport (1987). The work initiated by Ross (1977) has stimulated a number of studies of the various signalling variables: capital structure, indebtedness and dividend distribution policy.

5.1. Signalling through the company's capital structure

A company's capital structure comprises all the cash flows it receives from investors. The structure includes ordinary shares, preference shares, bonds and other items. Investors only receive the company's financial statements once they have been published, whereas the company's managers are aware of the company's financial position at all times.
In addition, the shareholder-manager has privileged information on the company's investment projects. If these have good prospects, it will be in their interest to allocate a significant proportion of their savings to these projects. By benefiting from this advantage, the shareholder-manager will forgo the diversification of his portfolio, the objective of which is to minimise financial risks (Rappaport (1987).
As a result, the executive shareholder sends a signal to the financial market through the shares he buys in his company. In effect, the savings invested by the manager are greater than if the market were perfect, with information available to all. This type of practice is considered by Leland & Pyle (1977) to be a signalling cost borne by the manager.

Signalling through debt levels

The financial literature has explored ways of limiting situations of asymmetric information. Some studies have shown the benefits of a signalling strategy aimed at financial backers (Baglioni (1995). In the presence of asymmetric information, signalling the level of debt on the market can influence investors in relation to the company's anticipated cash flows (Ross (1977).
On the one hand, it is assumed that a company takes on debt in order to limit management's recourse to false signalling. This policy is justified if the company plans to generate cash inflows or to set up a profit-sharing contract for managers. Directors' remuneration is therefore a signalling cost (Blazenko (1987). On the other hand, debt reduces the risk of undervaluation by signalling the fair value of the company to its shareholders. its stakeholders. It thus limits the risk of a sub-optimal investment strategy engendered by the opening up of the firm's capital (Blazenko (1987). In conclusion, the work of Ross (1977) argues that the value of the firm increases as the leverage ratio increases. He assumes that a high debt ratio favours the use of this means of financing and explains the over-indebtedness of certain firms.

Signalling through dividend policy

In general, researchers argue that companies pay out more dividends when their earnings outlook is favourable. This signal is an effective lever on the market insofar as a poor quality company can hardly afford to pay high dividends, given its mediocre results. So if dividends do indeed convey this type of information, we can expect the market to react upwards when dividends rise and downwards when they fall.
This body of work proposes equilibrium models to explain the different financial strategies of the companies in question. They generally focus on the combination of capital structure, debt policy and dividend distribution. However, many of these studies have omitted certain variables such as the company's reputation. This type of variable seems to be neglected by the signalling models, even though it could significantly affect the equilibria obtained.

What's more, shareholders could sell their shares if the signalling costs are incurred in the future. Thus, the emission of a false signal may not give rise to costs or financial consequences. In this situation, shareholders will have an incentive to issue false signals. Given these limitations, it seems worthwhile to assess the contribution of signal theory to the study of earnings management. Signal theory adds explanatory power to researchers. On the one hand, it forms the basis of the hypotheses of the positive theory of accounting.

Secondly, it helps to explain the pressures exerted by financial analysts and the financial market on earnings management practices.

5.4. Signal theory and the manipulation of financial statements

The accounting literature suggests several reasons for manipulating financial statements, some of which are related to the positive theory of accounting (Watts & Zimmerman (1986). Earnings are one of the main components of financial information. Consequently, earnings management can be used by managers to send signals by modifying the information content of accounting figures (Schipper (1989).

Company managers can freely mislead their partners by managing accounting figures to their advantage. The aim behind these accounting actions, based on the theory of signals, is to avoid violating restrictive clauses in debt contracts that would be onerous for the company (DeFond & Jiambalvo (1994); Sweeney (1994); Beatty & Weber (2003); Saleh & Ahmed (2005), to benefit from a reduction in the cost of financing that additional debt could cause (Iatridis & Kadorinis (2009) and to reduce the premonition of the risk of bankruptcy feared by investors (Djama (2003). To achieve their objectives, company managers can, on the one hand, choose the usual procedures and rules for determining what information will be disclosed (Cormier et al. (1998), and on the other hand, managers in possession of privileged information use earnings management to try to reveal information by sending signals to the markets, or on the contrary to try to deceive partners who do not have certain information by sending false signals (Daniel et al. (2008). In the second case, the choice of accounting methods can provide management with a means of signalling to the company's stakeholders.

This is how Raffournier (1990) argues that the choice of accounting methods can have a positive impact on the assessment of a company: "the choice of an accounting method can also constitute a signal. This is the case when there is a tax impact: the choice of a method that increases tax can be interpreted as a sign that the company has favourable information about its future". In effect, the accounting decisions intentionally taken by management provide information about the company's future cash flows. Thus, earnings management is a way for the company to provide certain information about its prospects (Healy & Palepu (1993).

However, based on the hypothesis of shareholder reaction to accounting decisions , several studies conclude that accounting changes, which increase earnings, may signal a poor outlook for the company (Hsu & Kross (2011). Cohen et al (2011) argue that these accounting decisions bear the seeds of managerial opportunism. They try to limit the decline in earnings, reach accounting thresholds and/or get closer to the forecasts of financial analysts. However, the usefulness of the signal theory increases for companies that want to hide a poor performance by sending out positive signals. In this case, managers issue false signals to mislead stakeholders.

In this context, Mosebach & Simko (2010) examine the accounting adjustments associated with profitability after a series of quarterly losses. The authors find that the behaviour of increasing discretionary accruals differs for companies that remain profitable compared with a sample of companies that were unprofitable at certain times. These results are consistent with the findings of Subramanyam (1996a).

The author explains that accounting adjustments have an additional explanatory contribution to that provided by non-discretionary income or cash flow. Their advantage is that they predict changes in dividends as well as future break-even points. The results found by these authors are consistent with the hypothesis of the use of discretionary accruals from a market signalling perspective.

Based on these findings, Kang et al (2010) find that, when testing the effect of total accruals on market returns, accruals are a key component in forecasting stock returns. Hirshleifer et al (2009), for their part, note that discretionary accruals dominate expectations of the trend in returns compared with normal accruals.

Similarly, Ahmed & Zhou (2000) found a positive association between discretionary accruals and stock market returns, confirming the impact of earnings management on the financial market. In short, the signalling mechanisms available to managers intervene in the presence of asymmetric information to enable investors to benefit from the same informational advantage as managers or to distract them from the company's true image (Subramanyam (1996a); Ahmed A & Zhou (2000); Xie (2001); Hirshleifer et al. (2009); Kang et al. (2010)

CONCLUSIONS:

The theories used demonstrate the fragility of the concept of the quality of financial statements due to the various techniques of accounting manipulation. The assessment of the quality of financial statements through the phenomenon of earnings management reflects the difficulty of the measurement task (McNichols (2002).

In conclusion, there are many reasons why managers manipulate financial statements. Many studies have attempted to validate the hypothesis that managers manipulate earnings in order to obtain higher rents or higher share prices (Hunt et al. (1997).

Others have shown that they engage in the same practices in order to reduce the cost of capital, taxes payable, etc. (DeAngelo (1988); McNichols & Wilson (1988); Perry & Williams (1994); Burgstahler & Dichev (1997); Wu (1997); Bushee (1998); Bartov et al. (2002).

All these practices have motivations and potential gains determined essentially by the "positive accounting theory", the "rooting" theory and the "signals theory". According to the political-contractual theory of Watts & Zimmerman (1978) and Watts & Zimmerman (1986), the accounting choices of a company's managers are the result of the agency costs and political costs it incurs. In fact, political-contractual theory is concerned with the accounting choices generated by the contracts that bind managers to the firm's partners. In this sense, the manager chooses from among a set of accounting rules taking into account, on the one hand, his contractual commitments and, on the other hand, the regulations in force.

However, accounting rules, as well as contracts and regulations, are constantly changing as a result of economic and governmental pressures. For these reasons, it is clear that there are interactions between P&L management, accounting rules and contractual relationships (Hossain et al. (2011). In this sense, P&L management can lead to changes in existing contracts and accounting rules.

In short, these considerations naturally lead us to question the role played by corporate governance mechanisms. These are supposed to control, on the one hand, the large number of incentives to manage earnings and, on the other hand, the discretionary space left by the accounting rules. The emergence of governance was therefore essential. This could limit the opportunistic behaviour of managers and, consequently, the manipulation of financial statements.

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