THE IMPACT OF SIGNALING THEORY AND AGENCY THEORY ON THE FINANCIAL REPORTING

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Abstract: *The current work tries to bring into front the incidence of financial theories in the process of financial reporting. Thus, there are theories like: signaling theory, which justifies the accounting information producers' predilection for the use of various alternative methods or agency theory, which places in the centre of attention the conflict between managers, stockholders and stakeholders, under the concept of informational asymmetry.*

Key words*: theory, signaling, agency, accounting information, asymmetry.*

INTRODUCTION

The signaling theory, although especially useful for investors and creditors, it has the purpose of informing all the capital market operators in an equivalent manner, relying on the emitting of signals meant to uncover inefficient entities that try to copy the model of efficient entities. Signals refer, for the most part, to the personal contribution of managers in the financing of new projects, the entity's debt policy, or the dividend distribution policy.

They agency theory says that "the firm represents a judicial fiction that serves as a focusing point for a complex process, in which the conflicts between individuals are resolved by putting into practice a contractual relationship." In other words, within the entity duties will be delegated in specific ways in order to increase efficiency , leaving from the premise that the agent will have an ethical behavior and last but not least, and that the delegation of duties will be made in accordance to his/her professional competence.

MATERIALS AND METHODS

In order to piece together this study, multiple methods have been used concurrently as follows: comparative analysis, in theory as well in practice, synthesis, induction and deduction.

RESEARCH RESULTS

Leland and Pyle (1977) consider that the manager's participation in forming an entity's social capital proves that the entity's activity is profitable, since the best informed decision makers within the entity are the first ones willing to invest in the profitable stocks of the entity they run.

In the same year, Ross proposes a signaling model by using the debt policy. Thus, he claims, only an indebted entity is able to put pressure on the managers, through the perspective of uncertainty regarding payment of accrued interest on contracted credits, in the future, as a consequence of bad management. Simultaneously, the manager's benefits will cease once this financial situation becomes reality. By looking at the dividend policy it is possible to achieve a signaling method which recognizes performing entities, due to the essential function of dividends which is to remunerate the stock-holders for their efficiently invested capital. The informational worth given by a steady dividend distribution policy cannot be copied by inefficient entity, because such financial pressure on its shoulders over the course of multiple financial years cannot be sustained for long.

There are numerous models that have been developed but each of them is being confronted by a series of limitations. For example, in the case of signaling through the dividend policy there is the risk that managers will rely on external financing in order to pay dividends. The signaling model that uses stock acquisition by managers from the entity they run cannot eliminate the situations where the managers are forced in one way or another to invest more than they should.

Under these circumstances, one way to reduce informational asymmetry and at the same time to create a clear differentiation between entities that are healthy from an economic and financial point of view from the ones that are characterized by a significant bankruptcy risk, is to redesign the financial statements packet by giving the external data users additional useful information and by modifying the data analysis method. One such example is the proposal regarding the necessity to compile a report concerning the entity’s value. There is a very well-drawn wish of stockholders that can be observed, which is to establish various methods of payment for managers based on the market value of one unit of stock, but the latter reject this solution through every mean possible.

Managers prefer to measure their own performance by calculation specific indicators which are concentrated primarily on financial-accounting data. The reason I simple, because the market has a self-sufficient mechanism, the entity’s market value is justified. Nonetheless the manager’s performance value indicators are strongly “embellished” by the use of diverse policies and strategies of “creative accounting” or financial tweaks that the law allows for. One such method is the forced dividend pay-out which relies on contracting loans (transferring wealth from creditors to stock holders and managers, when the latter are paid based on the distributed dividend’s value).

The capital market uses a large set of data; among the most important being the data offered by published summary financial statements. In order to send quality signals towards the financial-accounting data users, managers must also give proof of good faith when preparing summary statements. In addition, the costs incurred by them if the signaling is proven to be false must far outweigh the possible benefits.

Managers may opt for multiple signaling methods with the help of accounting information. The manager can chose the optimal accounting method which can ensure the painting of an accurate picture of the entity’s economic status, sector information, by which the manager influences expectations regarding the entity’s future profitability, supplying forecasted data in a timely fashion, etc.

The agency theory has been developed by Jensen and Meckling in the year 1976.

The delegation activities mentioned above are found, conceptually speaking, under the term agent relations, through which the delegator entrusts, completely or partially, a mandated trustee to watch over and administer their financial interests. These agency relations, in the context of unfair informing of all accounting data users, have been classified as follows:

- ✓ Classic agency relations, established between managers and stock holders, regardless of the residual interest of the latter;
- ✓ Informational asymmetry between partners relations, which is the case between diverse categories of an entity’s stockholders, or between the stockholders and other groups of accounting data users (employees, creditors, government, etc.);
- ✓ Bivalent informational asymmetry relations, existent between managers and stock holders, creditors, and the list can go on.

In the new vision set forth by the entity theory, which incorporates the recent financing theory (signaling theory, game theory, agency theory, etc.), the entity "is no longer seen as a collective player with a mutually utilitarian function (maximization of profit), but as an ensemble of groups of partners, each having its own utilitarian functions."

This is why, in order to obtain accurate information, the producers of the summary financial statements must truly be stimulated in the effort to reduce the phenomenon of informational asymmetry. This type of decisions have largely been studied throughout economical cybernetics works regarding governance decisions within entities, bringing into view the mathematical modeling of the stimulating contract which stimulates effort, a subject that has taken quite a long time before being discussed in Romanian specialty literature.

In her work, Liliana Malciu talks about three criteria that help define conflicting relations between the manager's interests and those of the stockholders, as Jensen and Smith proposed in their own studies:

- ✓ Establishing a policy that would stimulate managers for the extra effort by balancing the advantages obtained by the entity in proportion to the benefits gained by managers for their efforts;
- ✓ Managers are exposed to a higher risk than stockholders, as far as payment is concerned, because the managers' situation is influenced by the variations in company income, including the part of the variation which stockholders can eliminate by diversifying their portfolio;
- ✓ The view regarding economical calculations is quite different between the two types of players because managers are more open to multiannual strategic plans than stockholders.

Similarly, the agency relations between stockholders and creditors create serious difficulties when it comes to decision making. This time around, the conflict arises between two types of capital holders; therefore the influence between each combatant becomes balanced. Towards this purpose, Liliana Malciu, in her work, considers the specification of a few sources of conflict to be conclusive. Some of those sources are:

- ✓ The substitution of assets by means of the investing policy undertaken, due to the fact that indicators used by creditors when handing out loans have proven, many times, to be inefficient when it comes to assessing the positive and negative aspects of a specific investment;
- ✓ Underinvestment based on investment decisions which have as a validation algorithm the superiority of the updated net value of future liquidities afferent to the investment timeframe compared to the updated payment value that must be paid towards the creditors;
- ✓ Decreased liabilities;
- ✓ Dividend policy, etc.

CONCLUSIONS

The elimination of informational asymmetry represents a constant theme of interest for specialists lately. In addition to the methods proposed to perfect synthetic financial statements the issue regarding the cost of acquiring authentic information has also been taken into consideration.

Because of this, some of the accounting data users have no choice but to accept the data given by the entity's manager as a consequence of much too high cost incurred in order to get the "perfect data". Even in the case of users that have the possibility to obtain correct data, a cost-benefit analysis is absolutely necessary when making investment decisions.

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