

Agency theory is based on the relationship between two parties: the principal and the agent. This relationship is governed by a formal contract, wherein the principal delegates specific tasks to the agent and grants them authority to make decisions on their behalf. The theory is built upon several fundamental assumptions, the most significant of which are: Both the principal and the agent are rational and fully aware of their own interests. As a result, they act in ways that maximize their expected benefits, which in turn shape their decisions. Based on the above, the agent is primarily driven by the goal of maximizing their own benefits, even if it comes at the expense of the principal's interests. This inherent conflict of interest necessitates the inclusion of specific contractual conditions, as well as the establishment of an incentive system within the enterprise to minimize the potential for such conflicts. While the conflict of interest between the principal (shareholders) and the agent (company management) is acknowledged, this does not eliminate the presence of shared objectives between them. Their common interest lies in ensuring the company's long-term success and sustainability. Strengthening this shared goal can lead to a cooperative effort that enhances business performance and reduces risks, ultimately benefiting both parties. Although both the principal and the agent possess the ability to interpret financial and operational information, their levels of expertise are not necessarily equal. In most cases, the agent has a greater understanding of accounting information and company operations, creating an imbalance in knowledge. If a contract stipulates, for example, that a manager's salary or bonus is tied to net profit, shareholders should anticipate that the manager may take advantage of any possible methods to inflate reported earnings in order to maximize their compensation. This potential for earnings manipulation highlights the importance of strong governance and oversight mechanisms. To mitigate the risks associated with managerial discretion in earnings management, the owner must establish clear controls that restrict the manager's absolute freedom in this area. The key measures that the owner should ensure include: The manager must have a clear understanding of how net profit is calculated. The company's financial statements should be prepared and presented in accordance with generally accepted accounting principles and standards. Additionally, it is crucial to ensure that the auditor remains independent and impartial from the company's management and has performed their professional duties in accordance with auditing standards and ethical guidelines. The company must have an effective and efficient internal control system, along with a well-structured accounting system that ensures accuracy and reliability in financial reporting.