Positive Accounting Theory: Theoretical Perspectives on Accounting Policy Choice

Shabrina Tri Asti Nasution[1], Rizqy Fadhlina Putri[1], Iskandar Muda[2] and Syafruddin Ginting[2]
[1]*Student Postgraduate,Faculty of Economics and Business, Universitas Sumatera Utara, Medan –Indonesia*
[2]*Lecture Faculty of Economics and Business, Universitas Sumatera Utara, Medan -Indonesia*

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Abstract: This article reviews the positive accounting theory and its relation to accounting policy choice and identify its broad contribution to the accounting research. By using literature reviews, there are researches that discussing how management influenced by positive accounting theory before their decision of certain accounting policy. The view from positive accounting theory that it can predict management's choices regarding accounting policies to maximizes their own best interests. The choices that firm makes are related on what industry the firms are in, and the factors within that industry. Although three hypotheses from positive accounting theory such as the bonus plan, the debt covenant and the political cost, has been subjected to numerous criticism from different perspectives, positive accounting theory will continue to be part of empirical research nowaday and the basic questions that related to accounting positive theory are still relevant today.

1 INTRODUCTION

As a theory, a scientific accounting theory should be able to explain the actual choices of accounting standards. (Watts and Zimmerman, 1979) stated the beginning of a positive theory of accounting by exploring those factors influencing management's attitudes on accounting standards that are likely to affect a firm's cashflows and in turn are affected by accounting standards. These factors are taxes, regulation, management compensation plans, bookkeeping costs and political costs, and they are combined into a model that predicts that large firms that experience reduced earnings due to changed accounting standards favor the change. This theory become generally known as positive accounting theory (Watts and Zimmerman, 1986).

Positive accounting theory has been subject to heated debate. (Zimmerman, 2001) said that a unifying theory should emerge, but as a mater of course it should be based on economics. (Ittner and Larcker, 2002) address Zimmerman's criticisms that managerial accounting studies are purely descriptive, conducted without an underlying theory, and unguided by research hypotheses. They also discuss their views regarding the importance of practice-orientated research for understanding managerial accounting choices and for testing economic and non-economic theories. (Hopwood, 2002), responded by said, although having some sympathies with Zimmerman's critique of Ittner and Larcker's review of the empirical management accounting research literature, his analysis points out how Zimmerman has too easily allowed his own prejudices to influence both his assessment of the empirical management accounting literature and his recommendations for improvement. (Lukka and Mouritsen, 2002), viewing Zimmerman's accepting the rule of a monolithic economics-based paradigm would limit our abilities to develop a critical stance, and threatens the ability ofmanagement accounting research community for good scientific conversation and progress. Hence, in contrast to Zimmerman, they argue for remaining open for heterogeneity in management accounting research.

It can be seen that the birth of positive accounting theory has led to contradictions among experts. This article discusses, that based on literature studies, it is important to it is important to understand positive accounting theory as part of part

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of empirical research nowaday and its relation to accounting policy choice.

2 THEORICAL FRAMEWORK

Positive accounting theory in principle assumes that the purpose of accounting theory is to explain and predict accounting practices. Positive accounting theory seeks to explain a process, which uses the ability, understanding and knowledge of accounting and the use of accounting policies that are most suitable for dealing with certain conditions in the future.

The development of positive theory cannot be separated from dissatisfaction with normative theory (Watts and Zimmerman, 1986). Furthermore it was stated that the reason for analyzing accounting theory in a normative approach were too simple and did not provide a strong theoretical basis. \

There are three fundamental reasons for the shifting of the normative to positive approach, namely (Watts and Zimmerman, 1986) : The inability of the normative approach to test theory empirically, because it is based on premise or false assumptions so that the validity cannot be tested empirically. The normative approach focuses more on the prosperity of individual investors than the prosperity of the wider community. The normative approach does not encourage or allow the optimal allocation of economic resources in the capital market. It is given that in an economic system based on market mechanisms, accounting information can be a controlling tool for the community in allocating economic resources efficiently.

Furthermore, (Watts and Zimmerman, 1986)stated that the rationale for analyzing accounting theory in a normative approach was too simple and did not provide a strong theoretical basis. To reduce the gap in the normative approach, Watts and Zimmerman developed a positive approach that was more oriented towards empirical research and justified various accounting techniques or methods that are now used or looking for new models for the development of accounting theory in the future.

There are three hypotheses of Positive Accounting Theory. Predictions made by Positive Accounting Theory are widely organized on three hypotheses formulated by Watts and Zimmerman (Watts and Zimmerman, 1986). These three hypotheses are intheir opportunistic form, because according to Watts and Zimmerman (Watts and Zimmerman, 1990), this is the method most often used when they are interpreted:

Bonus Plan Hypothesis

In this hypothesis, all other things in a fixed state, company managers with bonus plans tend to choose accounting procedures with changes in reported earnings from the future period to the present period This hypothesis seems reasonable. Corporate managers, like others, want high returns. If their compensation depends, at least in part, on bonuses reported on net income, then it is likely that they can increase their bonus in that period by reporting as high net income as possible. One way to do this is to choose an accounting policy that increases reported profits during that period. Of course, according to the character of the accrual process, this will tend to cause a decrease in profits and bonuses reported in the future, with other factors remaining the same. However, the present value of the usefulness of the manager from the line of his future bonuses will increase by giving changes to the present.

Debt Contract Hypothesis

In this hypothesis, all other things are in a fixed state, the closer a company is to a violation of accounting based on a debt agreement, the tendency is the more likely the company manager chooses accounting procedures with changes in reported earnings from the future period to the present period. The reason is that the reported profits that are increasing will reduce technical negligence. Most of the debt agreements agree that the lender must meet during the agreement period. For example, a company that gets a loan may agree to maintain a certain level of debt to assets, interest reports, working capital, and assets of shareholders. If such an agreement is betrayed, the debt agreement can provide / issue a penalty, such as limiting dividends or additional loans. Clearly, the prospect of violating the agreement limits the company's activities in the operations of the company itself. To prevent, or at least delay, such violations, companies can choose certain accounting policies that can increase current profits. Based on the hypothesis the debt agreement, when the company approaches negligence, or is already in default / defective, is more likely to do this.

Political Cost Hypothesis

In this hypothesis all other things are in a fixed state, the greater the political costs that must be borne by the company, managers tend to prefer accounting procedures that give up on reported earnings from the present to the future. The political cost hypothesis introduces a political dimension to the selection of accounting policies. Companies of very large size may be subject to higher standards of performance, with respect for environmental responsibility, simply because they feel that they are big and powerful. If large companies also have the ability to gain high profits, then political costs can be increased. Companies may also face political costs at certain points of time. Foreign competition may lead to a decline in profitability unless the affected companies can influence the political process in order to protect imports as a whole. One way to do this is to adopt income-decreasing accounting policies (decreasing income) in order to convince the government that profits are falling.

The different approaches and the basis of accounting theory cause two accounting perspectives : positive accounting theory approaches produce perspectives of accounting as science. While the normative accounting theory approach produces perspective of accounting as an art. Which both are equally recognized as a means of accounting theory approach.

Normative Accounting Theory in the form of General Acceptable Accounting Practices is a theoretical reference in providing the best way to predict various accounting phenomena and illustrates how the interaction between accounting variables in the real world is a function of the Positive Accounting Theory approach. It does not rule out the possibility that facts in the real world (accounting practices) will influence Normative Accounting Theory.

After we understand positive accounting theory, the question arises, "what underlies many researchers criticize positive accounting theory?". This article tries to answer this question by using a comparison of reviews from previous literatures.

3 RESEARCH METHOD

This article uses literature reviews to identify gaps in the literatures about positive accounting theory and its relation to accounting policy choice and identify its broad contribution to the accounting research.

4 ANALYSIS AND RESULTS

At the beginning of its development, accounting theory produced a normative theory which was defined as a theory that requires and uses value policy that contains a minimum of a premise. Normative theory at first did not use a formal investigative approach, only in later developments began the use of a formal structured investigative approach, namely a deductive approach (starting from basic accounting propositions to rational accounting principles), as a basis for developing accounting techniques. In addition, accounting developments also leads to positive or descriptive accounting theory whose investigation is more structured using an inductive approach (based on conclusions that are generalized based on). Detailed observation and measurement results. Various positive or descriptive theories develop rapidly in accounting. Theoretical developments lead to positive theory (descriptive). This is accompanied by changes in the focus of accounting theory used by accounting institutions, for example FASB, which emphasizes usability in decision making and is no longer focused on postulate.

Accounting theory is sometimes confused with normative and positive terms. Watts and Zimmerman (Watts and Zimmerman, 1986) explain normative theory as follows: normative theory seeks to explain what information should be communicated to users of accounting information and how the accounting will be presented. So normative theory tries to explain what accountants should do in the process of presenting financial information to users rather than explaining what financial information is and why it occurs. Normative theory is often called a priori theory (from cause to effect and deductive). Normative theory is not generated from empirical research but is generated from semi research activities.

The development of positive accounting theory cannot be separated from dissatisfaction with normative theory (Watts and Zimmerman, 1986). Furthermore it was stated that the rationale for analyzing accounting theory in a normative approach was too simple and did not provide a strong theoretical basis. There are three fundamental reasons for the shifting of the normative to positive approach, namely: 1. The inability of the normative approach to test the theory empirically, because it is based on the premise or wrong assumption so that its validity cannot be tested empirically. 2. The normative approach focuses more on the prosperity of individual investors than the prosperity of the wider community. 3. The normative approach does not encourage or allow the optimal allocation of economic resources in the capital market. This is considering that in an economic system based on market mechanisms, accounting information can be a controlling tool for the community in efficiently allocating economic resources.

(BOLAND and GORDON, 1992) said that one theoretical approach emphasized in the accounting literature is positive accounting theory. Synonymous with this theoretical view are the 1978 and 1979 articles published by Ross Watts and Jerold Zimmerman. These two articles prompted criticism from three different perspectives. There are critiques that refer to technical research methods problems, critiques concerned with philosophy of science issues, and critiques centered on the limitations of economics-based accounting research. In their 1990 article, Watts and Zimmerman responded to most of the published critiques. They specifically claimed that methodological criticisms have failed to have any influence on accounting research. In theur article, Boland and Gordon provides a critical examination and assessment of these alleged failures by examining two types of critiques, economics-based critiques and those based on issues of the philosophy of science. The critiques discussed include those to which Watts and Zimmerman responded as well as several other critiques that either Watts and Zimmerman failed to discuss or that were not published until after their 1990 article appeared. Positive accounting theory is shown to be applied economic positivism. Tracing the historical background of positive accounting research through its economic roots shows that the "positive" aspect of the Watts and Zimmerman approach is more rhetoric than methodology.

Besides opinions from (Ittner and Larcker, 2002), (Hopwood, 2002) and (Lukka and Mouritsen, 2002), there are still other researchers who disagree with (Watts and Zimmerman, 1986). (Kabir, 2007) examines the development of positive accounting theory. He said that Positive Accounting Theory has been one of the most influential accounting research programs during the last four decades. One important reason which (Watts and Zimmerman, 1986) have used to popularize and legitimize their approach is that their view of accounting theory is the same as that used in science. Thus, it is important to examine how far accounting has been successful in imitating natural science and how the development of Positive Accounting Theory. The paper shows that accounting could not emulate the success of natural science. Further, the methodological positions of Positive Accounting Theory conform to none of the standard accounts of science. Rather, Positive Accounting Theory contains elements of all three. Finally, this paper identifies some methodological gaps in Positive Accounting Theory.

In other side, (Christie, 1990) noted that more powerful tests of a theory of choice of accounting methods and the effect of changes in these choices on equity values are provided. The power increase comes from efficiently aggregating results across studies. One conclusion is that at least six variables common to more than one study have explanatory power. These variables are managerial compensation, leverage, size, risk, and constraints on interest coverage and dividends. Another conclusion is that the posterior probability that the theory taken as a whole has explanatory power is close to one. This conclusion includes the effect of variables that only appear in one study. This clearly supports positive eccounting theory.

(Lev and Sunder, 1979) also support positive accounting theory. It appears that the extensive use of financial ratios by both practitioners and researchers is often motivated by tradition and convenience rather than resulting from theoretical considerations or from a careful statistical analysis. Basic questions, such as: Is the control for firm size, a major objective of the ratio form, called for by the theory examined; what is the structural relationship between the examined variables and size; and what is the optimal way to control for industry-wide factors, are rarely addressed by users of financial ratios. The major purpose of their research is to discuss the conditions under which conventional tools, such as financial ratios and measures of industry central tendency, achieve the intended objectives of analysis (e.g., size control).

(Healy, 1985) did a research examining managerial accounting decisions postulate that executives rewarded by earnings-based bonuses select accounting procedures that increase their compensation. His test results suggest that (1) accrual policies of managers are related to income-reporting incentives of their bonus contracts, and (2) changes in accounting procedures by managers are associated with adoption or modification of their bonus plan.

The main purpose of positive accounting theory as described earlier is being able to explain and predict accounting practices, associated with individual behavior in choosing accounting methods that can maximize their utility. To be able to understand the interests of management in financial reporting, it is necessary to appreciate the concept of economic consequences (Scoot, 2009). Positive accounting theory tries to understand and predict a company's accounting policy choices. In general, the assessment of accounting policies to be chosen is aimed at minimizing the cost of capital and other contract costs. Accounting policies are generally determined by the organizational structure of the company, which is influenced by the environment in which the company is located. Thus the choice of accounting method to be used is part of the entire process of corporate governance.

Positive accounting theory does not directly determine the choice of accounting policies that are appropriate for the company. In this case, the selection of accounting policies will be easier if viewed from the management side. Because management has the flexibility to choose accounting policies for its companies, this indicates flexibility also for management to respond to changes that occur in the corporate environment, such as the existence of new accounting standards. The financial accounting standards were originally made by the standard board in each country, as a result the accounting standards between one country and another country are very different. But with globalization and because of differences in the environment, legal, social, political, and economic conditions between countries, international accounting emerged, which tried to describe accounting theories and practices that apply internationally. This has caused some changes related to the accounting method that management can choose. As an illustration, International Accounting Standard Board (IASB) establishes fair value as a basis for measuring assets and liabilities. Fair value is the price that will be received in the sale of an asset or payment to transfer liabilities in a structured transaction between participants in the market and the date of measurement. There are 3 hierarchies in estimating fair value, that is by using market value, comparison with market prices of items that can be compared with items assessed, and using estimates. But the weakness of the fair value is not based on historical evidence, so that it raises subjective implications. The use of fair value on depreciated fixed assets can have no small economic consequences. This can occur when a fixed asset is revalued, which shows market value that is higher than its historical cost. As a result, the value of the company's assets increases and the meaning must be balanced with an increase in the debt side. Besides that, it also has an impact on the company's income statement, which later leads to taxes that must be paid by the company. The emergence of new accounting standards requires managers to be able to understand it well and be able to choose accounting methods that provide prosperity for shareholders.

5 CONCLUSIONS

The presence of positive accounting theory has contributed significantly development of accounting, which is to produce systematic patterns in accounting choices and provide a specific explanation for the pattern, providing a framework clear in understanding accounting, shows the main role of contracting cost in theory accounting, explains why accounting is used and provides an internal framework predict accounting choices, encourage relevant research where accounting emphasizes predictions and explanations for accounting phenomena.

Criticism of positive accounting theory is a discourse that actually can provide accounting scientific contributions. Criticism arises because of the frame of mind Watts and Zimmerman are more motivated by the existence of pragmatism utility of knowledge accounting research, where the size used is determined according to contribution the result, positive accounting theory can provide direct benefits in the form of the ability to explain and predict the associated accounting practices with individual behavior in maximizing its utility.

Positive accounting theory will always be a part of accounting researchs and one of a base of management's choices regarding accounting policies to maximizes their own best interests

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