

**How to Cite:**

Kejriwal, M. A. (2022). Positive accounting theory: A critical evaluation. *International Journal of Health Sciences*, 6(S3), 4500–4509. <https://doi.org/10.53730/ijhs.v6nS3.6886>

# Positive accounting theory: A critical evaluation

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**Abstract**---Accounting is broadly defined as a measurement and communication technique for providing relevant economic information to the users. The unprecedented development in quantitative methods, behavioral science, and an unbelievable spurt in information technology and intermediaries in the financial domain stimulates the researchers to apply quantitative models and empirical analysis to have an in-depth understanding of the accounting phenomenon and how the accounting information is provided to the users. These developments have played a key role in redefining the nature of accounting and expanding its scope. One most important conclusion of this research direction has been the explanatory model, i.e., the 'Positive Accounting Theory'. The positive research in accounting was predominant during the mid-1960s and contributed to a dramatic shift in financial accounting research. The positive accounting theory attempts to describe and better predict accounting practices. This theory is highly dependent on the task undertaken in economics, and it mainly borrows the principles from the efficient market hypothesis, capital assets pricing model, and agency theory. The paper tries to present an overview of the positive accounting theory and analyze the tested hypothesis. Moreover, it also attempts to make a critical evaluation of the significance of the positive accounting theory.

**Keywords**---accounting, positive accounting theory, critical evaluation.

**Introduction**

Accounting is broadly defined as a measurement and communication technique for providing relevant economic information to the users (AAA, 1966). Development in quantitative methods, behavioral sciences, and spurt in information technology and financial intermediaries motivates the researchers to apply quantitative models and empirical analysis to understand the accounting phenomenon and how the accounting information is provided to the users. These developments have been instrumental in redefining the nature of accounting and

expanding its scope. One most important conclusion of this research direction has been the explanatory model, i.e., the 'Positive Accounting Theory. The construct of this theory triggered a paradigm shift in accounting research dimension by modifying the nature of accounting from authoritative to extrapolative. This new concept was first pronounced by Ross Watts and Jerold Zimmerman through their most influential article "Towards a Positive Theory of the Determination of accounting Standards" in 1978 and "The demand for and supply of Accounting Theories: The Market Excuses" in 1979 in the Accounting Review. The main focus of this theory is to describe and forecast why the management and practitioner of a firm choose a particular accounting method over alternatives. They also argued that the firm's features, such as leverage and size, are the prognostic factors determining accounting methods. The philosophy of the underlying positive theory differs from descriptive theory because descriptive theory only focuses on describing the phenomenon.

On the other hand, normative or prescriptive theory prescribes what ought to happen. The positive theory endeavors to describe experiential accounting events by enquiring the reasons for that happenings. Further, it also predicts the unobserved phenomena. Friedman (1953) observed that "the primary goal of positive science is developing a 'theory or 'hypothesis' that generates valid and meaningful predictions about phenomena not yet observed." The positive research in accounting was predominant during the mid-1960s and contributed to a dramatic shift in financial accounting research. The positive accounting theory attempts to describe and better predict accounting practices. This theory is highly dependent on the task undertaken in economics, and it mainly borrowed the principles from the efficient market hypothesis, capital assets pricing model, and agency theory. The paper tries to present an overview of the positive accounting theory and analyze the tested hypothesis. Moreover, it also attempts to evaluate the positive accounting theory's relevance critically.

### **Philosophy of positive accounting theory**

The focus on developing a positive theory which began in 1968, tried to explain observed accounting phenomena by enquiring the reasons behind the occurrence of events. Ball and Brown (1968) introduced the concept of positive theory. In the 1970s, this concept gradually started receiving the attention of other researchers. The positive theory differs from normative and descriptive theory because one emphasizes 'what might occur' and the other seeks 'to describe events.' Milton Friedman stated that the main thrust of the positive approach is the development of a theory and assumption, the outcomes of which are in the form of logical, acceptable, and systematic predictions relating to unobserved events. Watts and Zimmerman viewed that positive accounting theory describes and forecasts accounting behavior. Watts and Zimmerman further explain that the term 'prediction in positive theory' specifies the forecast of accounting phenomena not yet observed. These unobserved phenomena do not expressly indicate the future event, but those events that already had taken place and systematic substantiation is still waiting. Positive accounting theory tries to collect experimental proof about the characteristics of business entities that simultaneously use the same accounting practices year after year and the characteristics of business entities that keep on changing their accounting

practices over time. Jensen (1976) criticized the normative accounting approach because it had devoted entirely to examining the questions of 'what ought to be done.' He viewed positive accounting theory, which will improve the usefulness of accounting research provided the approach will describe the present status of accounting in terms of 'what' and 'why'. Further, it also explains 'why' and 'what' the accountant performs and the consequent effect of these phenomena on the utilization of resources and people. Accepting these views of Jensen, Watts and Zimmerman, viewed positive accounting theory for determination of accounting standards is necessary for deciding what prescriptions from normative theories are feasible (Watts and Zimmerman 1978). The Positive Accounting approach involves certain economic aspects and certain critical questions which need to be answered:

- The costs and associated benefits of alternative accounting techniques.
- The concerning expenses and utilities of accounting regulation and accounting standards.
- The impact of the financial information in a financial statement on corporate share prices.
- In order to respond to the above queries, the positive accounting approach has some expressed hypotheses in regards to the action of an individual, which are enlisted hereafter:
- Management, providers of funds, creditors, and other people are nationals who judge the affairs of the entity intending to enhance the value of their respective interests.
- Management has the discretion to select accounting practices and techniques or alter capital structure decisions and manufacturing techniques in order to make their utility to the highest level.
- Usually, management initiates required actions to maximize the worth of the corporate entity.
- Positive accounting theory appears to be more systematic, logical in its approach, and explicitly or implicitly, it emphasizes empirical studies.

### **Nature and role of positive accounting theory**

The first paper on positive accounting theory was published in 1978 by Watts and Zimmerman, which examined the Accounting Standards setting process. Subsequently, in 1979, they had published another paper on Demand and Supply of Accounting theories. Again in 1986, they published a book on Positive Accounting Theory. Basically, these publications appeared to be the background and detailed description of the Positive Accounting approach. The nature of Positive Accounting Theory has clearly differentiated itself from prescriptive and normative approaches. Watts and Zimmerman viewed that positive propositions relate to how the world works. For example, the price of the stock will rise if an entity changes its inventory valuation method from FIFO to LIFO, and the stock market has not expected the changes (Watts and Zimmerman 1986 P.8). The positive accounting theory is expected to play a significant role in providing information to the users for framing decisions regarding accounting policies. The importance is especially felt when predictions are developed and decisions are made, particularly when consequences are anticipated. As such, the positive

accounting theory has two perspectives, firstly it states how the world works, and secondly, it can be used to measure the consequences of prediction for the welfare of the users. Watts and Zimmerman are of the view that the theory has the potential to eliminate confusion, and its application will make the selection of accounting policies more understandable when the objective of such selection is apparent.

### **Methodology of positive accounting theory**

The positive accounting theory involves two processes:

- The contracting process, and
- The political process
- This process explains how accounting functions.

### **The Contracting process**

The contracting process assumes that the firm has a contract sequence between self-centered personnel. Each personnel identifies that the welfare of themselves depends on the survival of the entity but at the same time has incentives to take actions that reduce the firm's value and the chance of survival (Watts and Zimmerman, 1986, P. 198). Again, the contracting process may be of a formal and informal nature. There may be a formal contract between the firm's manager and debt holder. There may be an informal contract in the form of working arrangements as per organizational charts and compensation schemes for different levels of managers and employees as per organizational policies and regulations between managers and employees. One of the important assumptions of the contracting process is that there are non-zero contracting and information costs. As such, for any analysis, the firm's contracting cost is equally vital for its survival and profitability, and it should be considered along with the production cost. The effects of contracting and information cost become important for explaining the variations in the accounting policies of the firm. Considering the importance of relevant costs, the manager would choose the accounting policies that would be more appropriate to achieve the desired income. As a result of choosing the accounting method, the firm's cash flow is affected.

In 1976, Jensen and Meckling developed a new model: agency relationship. The model explains the contracting between shareholders and managers of a firm. The model described "a contract under which one or more (principals) engage another person (the agent) to perform some services on their behalf, which on the other hand, involves delegation of decision making authority to the agent" (Jensen and Meckling, 1976, P. 308). According to the agency theory, all the investment decision by the owner-manager is based on market value. All the investment proposals with positive net present value are accepted because they enhance the owner-manager wealth. Further, financial decisions are also guided by the agency relationship. In order to maximize the owner-manager wealth, the manager has to consider the wealth transfer techniques. The wealth transfer techniques can be achieved through (a) dividend (b) re-ordering the debt claims. Under certain circumstances, the owner-managers will have incentives to let go of the projects

that generate positive net present value to make the payment of dividends to themselves to meet the existing debt claim.

These agency models for professional managers and outside capital suppliers will need clauses that decrease the manager's incentive to take the firm value - reducing actions that include restrictions on their financing, dividend, etc. In both the types of contract, that is, management compensation agreement and lending or debt agreement, the role of accounting is crucial contract terms on the one hand and in monitoring terms on the other hand. Accounting information is extensively used in both contracts.

### **Accounting procedure and management compensation plans**

Management Compensation Plans may be connected with either firm's market value or accounting earnings. There is three supported rationale behind earning-based compensation plans. Firstly, non-availability of firm's market value; secondly, disaggregation of performance; and thirdly, tax elements (Watts and Zimmerman, 1986). Non availability of a firm's market value arises because most corporate debt is not traded. As such, the total firm's value, including that of debt, cannot be determined. In such cases, a firm's earning could be used as a substitute for the firm's value because a close association is recognized between a firm's market value and the firm's earning. Again, if the total firm's value becomes available, it would again be difficult to identify the firm's market value of sub-parts or sub-units to identify the responsibility of the individual managers (Disaggregation Problem of Performance). Healey (1985) found that one-third of the bonus plans investigated by him added interest back to earnings in this bonus formula. As far as taxes are concerned, both corporate and individual tax rates (managers' tax rates) have been instrumental in determining the accounting numbers on which compensation is based. Selection of accounting method based on which results in lowering of taxes. As such, earning-based compensation plans would incentivize managers to choose those accounting policies that would increase current earnings.

### **Accounting procedure and Debt control**

The agreement that uses accounting numbers in debt contracts is usually formulated to restrict the managers from engaging in investment and financing decisions, which reduces the firm's value. Dividend and share purchase restrictions are the typical restrictions adopted in debt contracts. These restrictions serve the purpose of preventing the managers from paying cash dividends. Some contracts require the firm to maintain working capital above a certain level, which prevents the payment of liquidity dividends. This agreement also serves as a dividend and minimum investment constraints. This constraint also acts as the anti-merger firm approach. Further, it also compels the firm's manager to maintain a particular interest coverage ratio.

Accounting-based debt contracts are effective only if restrictions are placed on managers' ability to control numbers' calculations. If accounting policies used for calculating numbers are not regulated, a set of accounting procedures restricting the manager's choice are developed, which should be acceptable to parties involved. Sometimes these procedures are standard practices, but sometimes debt

-contracts need to be explicit regarding those procedures. GAAP allows managers considerable discretion in selecting accounting policies. It is because that non-compliance with a debt contract is more expensive. A manager is permitted with an incentive to select accounting policies in case a contract defines a violation in terms of the accounting numbers. The managers, in this case, would prefer accounting policies that increase assets, decrease liabilities, increase income, and decrease expenses. However, if a breach is likely to occur under a specific accounting policy, it would be expected that the managers change the accounting policy in order to avoid a breach. The important testable hypotheses under this process are that the firm with a higher debt-equity ratio will choose the accounting policy to increase the income for the current period.

### **Political process in positive accounting theory**

Positive accounting theory as a political process stands on the assumption that there was contracting and data collection cost. This theory also assumes that there is non-zero information, lobbying coalition costs. As opposed to the view that the purpose of the political process is to remedy perceived market failures, such as insufficient or inadequate corporate disclosures, the alternative view is that the individuals under this process, like individuals in the market, operate to maximize their utilities (Olson, 1971, Stigler, 1971, Peltzman, 1976). The rules and regulations are developed in order to achieve equilibrium between those who receive benefits and those who provide benefits. The equilibrium is achieved when the receiver's costs and benefits are equal at the margin. The marginal costs of those providing wealth equal the expected marginal reduction in their wealth transfers.

The elements which influence the equilibrium process include information cost, heterogeneity of interests, and organizational costs. The information costs are the cost that relates to being informed and that determine the effect of different legislations on one's welfare or benefit. Large groups generally have a more significant influence on the political process. Organizational Cost may also limit the size of the groups in addition to variances in interest. As such, these limit the influence of the group on the political process. Politicians and bureaucrats form an essential group in this process, and their incentive is to achieve wealth transfer through the political process. When the cost of information is high, they will get a special opportunity to develop laws and regulations to curb the crisis. As the politicians and regulators use the reported profits as an ideal for developing regulations, corporate managers are expected to select accounting techniques that will show lower profits for their firms to decrease the apprehensions of adverse action from politicians and regulators. The government's power to formulate rates and prescribe regulations provides an incentive to management to choose an accounting policy that lowers reported profits. From the above discussion, it is suggested that bigger entities are usually more responsive than comparatively smaller entities because their reported profits are higher than the smaller ones. It is expected to draw higher consideration of the bureaucrats and regulators (Alchain and Kessal, 1962, P. 162). As such, managers get extinguished rewards in selecting accounting policies (Walter and Zimmerman, 1978).

### **Empirical test on positive accounting theory**

Numerous empirical studies have been piloted to test the validity of the positive accounting theory hypothesis. These tests focused either on stock price movements or choice of accounting method. The stock price test examined whether there was any response to price due to obligatory changes in accounting. On the other hand, accounting method choice examined whether the management motivation in choosing a particular accounting method was critical. According to Watts and Zimmerman, the stock price studies were relatively weak tests, and that the accounting choice studies would provide more meaningful information and results for the theory. The choice of selecting a single accounting method involves testing one of the following possible hypotheses:

- Compensation plan
- Debt/ equity
- Size

Significantly, this research emphasis has largely been conditioned by the availability of relevant data. The compensation plan and debt/equity hypothesis are based on the contracting process. On the other hand, the size hypothesis is based on a political process in which the firm's size is used as a surrogate for the political process. Bonus hypothesis examines whether the managers of firms with earning-based compensation plans are expected to choose techniques that enhance the current period's reported income. Hagerman and Zmijewski (1979) appear to be important in this context. The scholar investigated this hypothesis in relation to stock, tax on investment, amortization, and depreciation of post- usage cost variable. The findings were consistent with the bonus hypothesis for all variables except inventory or stock.

The debt/equity hypothesis holds that manager of a company are prone to choose accounting method which enhances the current period earnings provided that the debt/equity ratio is high. The findings of empirical studies have rejected the null hypothesis that there is no correlation between leverage and choice of accounting technique (Bowen, Noreen and Lacey 1981, Lilien and Pastena 1982, Dhaliwal Salamon and Smith, 1982, Daley and Vigiland, 1983). The findings of these empirical studies support the assumption that if the entity has a higher debt/equity ratio, the greater is the likelihood for the firm to choose the accounting method which enhances the earnings of the current period. Moreover, several studies were conducted to test the size hypothesis, which reveals that the bigger the firm is, the managers are more likely to choose an accounting method that decreases the firm's current profit. (Hagerman and Zmijewski, 1979, Deakin, 1979, Dhaliwal , Salamon and Smith 1982). The outcomes of these studies cleared the hypothesis that the choice of accounting method is based not on the positive correlation between the size of the entity and current period income.

In addition to the tests of accounting method choice, certain empirical tests have been conducted to determine the stock prices effects of accounting choices. (Foster, 1980, Rickes, 1982, Lev and Olson, 1982, Holthausen and Leftwich,1983). Those, however, that focused on debt/ equity hypothesis through the testing of a variety of variables have yielded less clear statistical inferences. It

is possible that the variations could be due to collinearity and econometric problems. The studies on voluntary adaptation of accounting changes have found no stock price effect.

### **Critical evaluation of positive accounting theory**

Positive accounting theory witnessed criticism on philosophical grounds subsequent to its emanation as an alternative paradigm contrary to normative theory. Jinker, Merino, and Neimark proposed that the positive accounting approach inflicts a value judgment about what is worthy of being surveyed in all kinds of research. Since the investigator selects the subject matter to be surveyed and decides methodology and hypothesis to be formulated, it is value-based contrary to its claims. However, Watts and Zimmerman (1986) argued that though positive accounting theory imposes a value judgment on what is to be investigated, there will be numerable constraints faced by the investigator at the time of exercising the same. This is so because users rely on positive accounting theory for information, and the users will use the available accounting theories when they are in need. Subsequently, they will face constraints due to the existing competition among theories. Christenson (1983) opined that positive accounting theory is a branch of sociology of accounting and not as accounting theory because it focuses on social actions and deeds as opposed to the measurement of the behaviour of corporate accounting entities. Acknowledging the same, Watts and Zimmerman (1986) stated that accounting entities could be perceived in the light of the behaviour of the people involved in managing the operations of the entity, such as managers, shareholders, auditors, and accountants. As such, it follows from apprehending firms as a sequence of contracts in the form of social, political, and economic products. Numerous authors opined that the applicability of positive accounting theory is incongruous for the objectives it seeks to achieve. Christenson (1983) observed that positive accounting theory concerns itself with detailing, explaining, and forecasting the behaviour and actions of the individuals involved in the firm rather than predicting the behaviour of accounting entities.

Watts and Zimmerman nullify the above criticism as being misunderstood. The approaches of positive accounting theory derive the principles from positive economics and the financial domain, and accordingly, it provides useful descriptions and forecasts about how people operate and behave. They also viewed that the word 'positive' has been used to distinguish between experimental propositions and the propositions as used in the normative approach. Further, the problem arose concerning the specification of cross-sectional models and the interpretation of variables in the financial statement appearing on both sides (Mckee et al. 1984).

### **Conclusion**

The principles of positive accounting theory have been regarded as a strong theoretical background in accounting research for the last twenty years. Despite methodological problems, it has been the focus of several accounting studies. These have attempted to explain the nature of the accounting phenomenon and seek answers to why particular accounting methods are selected over others. As



such, the theory has a tremendous contribution towards the formulation of accounting policies and practices.

The framework of positive accounting theory opens a broad scope for research. This theory continues to develop through several imperatives, including the development of hypothetical connections between observed experimental relationships among descriptive attributes and accounting policy decisions. The underlying agency model also needs development, and the validities of proxies must be ascertained. While the principles of positive accounting theory have been criticized by scholars in various ways, its merit as a descriptive theory is imperative and obvious. To date, no other theory has emerged with greater strength to describe the underlying experimental propositions and regulations that positive accounting theory has explained.

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