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# A GLIMPSE OF POSITIVE ACCOUNTING THEORY (PAT)

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***Abstract***

*Positive accounting theory (PAT) has been more developed than normative accounting theory in this era. The development of PAT research has discussed about what factors influenced management to report earnings. By using literature reviews, there are many researches in discussing the external factors to influence management to report earnings, such as bonuses, the debt equity ratio, political costs, and good governance. The other researches have discussed the association between earnings and stock prices. There are still few discussions about the self-motivation of the directors or managers why choose a certain accounting method. The difference of environment, types of industry, and timing of financial statement reporting can be a further research. By using theories introduced by Popper, Kuhn, and Lakatos, PAT has elements in these three theories; however, PAT has not been categorized as science.*

***Keywords****: earning, normative, bonus, management.*
***JEL: M410***

## Introduction

Before developing of Positive Accounting Theory (PAT), the research of normative in accounting (normative accounting research) has developed earlier. Normative accounting theory (NAT) is discussing how the financial statement should be reported. Researching in NAT is answering the question of 'should'. NAT has developed from semi-research activities, not from empirical studies.

For the four last decade, PAT has been growing rapidly and influencing the researching in accounting field. This is evidenced by the abundance of empirical study that making association among the number in financial statements, stock prices, return on investments, and management decision in choosing the accounting methods. This development can be proved by the existence of research PAT published in top journal, such as Journal of Accounting and Economics, Journal of Accounting Research, the Accounting Review, and Accounting, Organizations and Society.[1]

This article discusses briefly the development of PAT, the research in determining earning, and the question whether PAT as a science or not.

## Theoretical Review

Research in PAT has been started around 1960s. At the beginning, this research examined some of assumption in NAT. There are two main points in PAT research, namely:

1. Examination the association between the number in the financial statement and the stock prices;
2. Distinction between two hypothesis, no-effects hypothesis and mechanistic hypothesis.

The examination of the association between the number in financial reporting and the stock prices has been done by Ball & Brown, 1968; Beaver, 1968; Foster, 1977; Beaver, Clarke, & Wright, 1979; Beaver, Lambert, & Morse, 1980; Grant, 1980; McNichols & Manegold, 1983. The results of these researches indicate some associations, namely (1) the number of financial reports, earnings and stock prices, and (2) cash flow and risks. The literatures of NAT have different point of view. NAT explains that the numbers in earning reports do not have association to stock prices because the numbers have been valued in the diverse based of valuation (Kabir, 2011).

The examination of the difference of two hypotheses (no-effect and mechanistic hypothesis) has been done by, among others, Kaplan & Roll, 1972; Sunder, 1973, 1975; Ricks, 1982; Biddle & Lindahl, 1982. The results of these researches are varied and cannot be distinguished between the two hypotheses.

No-effects hypothesis explains that the change of stock prices cannot be explained by the change of accounting procedure deliberately except there is the change in cash flow. This hypothesis is based on Efficient Market Hypothesis (EMH), Capital Asset Pricing Model (CAPM), and zero contracting cost. Contracting cost is defined as a mix of transaction cost, agency cost, renegotiation cost, and bankrupt cost (Watts & Zimmermen, Positive accounting theory: A ten year perpective, 1990). This hypothesis explains that market can estimate stock prices through earning reported. On other hand, mechanistic hypothesis is based on mechanic relations between accounting method changing and stock prices changing. This hypothesis gives an argument that managers systematically mislead capital market by manipulating earning in accounting method changing.

[1] Brinn, Jones, and Pendlebury (1996) has surveyed to UK academia about journal perception.

EMH explains that there is a competition in delivering information. Information is not only from financial statement, but it is also from management press release, interviewing the company's staffs or employees, and analysts. The relation between unexpected earning and abnormal earning, indicated in stock prices, is influenced by many factors.

Generally, in the beginning empirical studies in accounting examined what variables influenced the accounting choosing. The variables influenced earning and investigated are (Watts & Zimmermen, Positive accounting theory, 1986):

1. hypotheses in giving bonus;
2. hypotheses in debt to equity ratio;
3. hypotheses in political cost.

Bonus plan hypotheses explain that a company with planning to give bonus will choose accounting methods increasing earning in the current period. Debt-equity hypotheses state that a company with high debt-equity ratio will choose accounting method shifting earning from future to current year. Political cost hypotheses explain that a big company will choose accounting method shifting earning from current to future year.

In its development, earning management study has extended to many situations. Some conducted in the variables influenced earning management, namely (Kabir, 2011):

1. management buyout (DeAngelo, 1986). This research explains there are no indication managers systematically reporting earning lower in the period before buyout than after that of. The buyout action is the managers buy stocks from public shareholders.
2. labor negotiation (Liberty & Zimmermen, 1986). This research states that there are little incentives for reducing earning as long as a contract with labor union.
3. non-routine executive changing (Pourciau, 2005). This research explains that the new manager will postpone earning in the period the changing of the managers. The earning will be increased in the next year.
4. Initial Public Offering or IPO (Teoh, Wong, & Rao, 1998). This research finds that in the year of IPO, the return on sales of the company is relatively higher and significant than that of years before. This ratio is higher too than that of other a kind of company without IPO.

The further development is the study about the relation between good governance and earning management. Some researches in this study are (Kabir, 2011):

1. association between institutions ownership and behavior in research and development (R&D) (Bushee, 1998). This research explains that manager tends to reduce R&D expenses to anticipate reducing in earning when the ownership of shareholders by a big institution.
2. The influence of independent director and the ownership shares by CEO (Reitenga & Tearney, 2003). This research proves that there is earning management in a

company when CEO leaves the company. The earning management has happened in one and two last year of the CEO leaving. The independent CEO and director ownership in shares can reduce earning management. The institutional ownership can worsen earning management in the last year before the CEO leaving the company.

3. The influence of Big 6 auditor in accrual accounting (Becker, Defond, Jiambalvo, & Subramanyam, 1998) (Francis, Maydew, & Sparks, 1999). Becker et al states that companies not audited by Big 6 auditors make accrual discretion in financial statement more than that of companies audited by Big 6 auditors. It is an indication that the lower of audit quality as an evidence the flexibility in choosing accounting methods. In other hand, Francis et al finds that the using of Big 6 auditors increases for the companies using accrual accounting methods.
4. The influence of Big 6 auditors' skill in earning management (Krishnan, 2003). This research finds that specialist auditors can reduce earning management based on accrual accounting. The influence from non-specialist auditors to reduce earning management is lower than that of specialist auditor. For this reason, specialist auditor can influence earning quality.
5. The relationship between fees for audit and fees for non-audit services to earning management (Frankel, Johnson, & Nelson, 2002). This research finds that non-audit fees have positive association with the little change on earning and the big change on accrual discretions. Audit fees have negative relations to earning management.
6. The influence of outside directors and audit committee to abnormal accrual (Peasnell, Pope, & Young, 2005). This research finds that managers increase abnormal earning in accrual methods. The purpose of managers is to avoid losses in the financial statement. The composition of outside directors has negative association to decrease earning. There is no evidence that audit committee has direct influence in increasing earning manipulation in certain level, abnormal accrual.

The next study that has developed rapidly is *capital market based accounting research*. This research has growth in examining the relation between stock prices and numbers in accounting reports. Some researches in this area namely (Kabir, 2011):

1. to examine whether fair values are a relevant value in different situations. Some researches have done by, namely:
    a. American Accounting Association Financial Accounting Standards Committee, 2005
    b. Barth, Beaver, and Landsman, 1996, 2001
    c. Barth and Clinch, 1998
    d. Eccher, Ramesh, and Thiagarajan, 1996

2. to examine whether fair values are relevant to numbers in financial statement reports using different accounting principles. Some researches have done by, namely:
    a. German GAAP;
    b. International Financial Reporting Standard;
    c. US GAAP;
    d. Claskson et al, 2009;
    e. Hung and Subramanyam, 2007;
    f. Morais and Curto, 2009;

The other research is to explore whether accounting researches as a science or not. The experts say that accounting is as a social science, as explained by Lowe and Tinker, 1989; Hopwood, 1989; and Mauttz, 1963. On the other hand, accounting is not wholly as a social science if the research criteria are using naïve assumption and natural science approaching (Gaffikin, 2006).

**Results and discussions**

In accounting, there are two theories, namely Normative Theory and Positive Theory. Normative theory explains what should be done. The assumption is to obtain certain outcomes what should be done to support the goals. For example, a company will generate the best performance if the company cares for all stakeholders, not only for the shareholders. This normative theory focuses to prescribe behavior, not to describe behavior. This theory will be oriented to the future (Gaffikin, 2006).

Positive theory explains or predicts the facts and does not use assumptions such as outcomes as the goals. For example, a company is shifting its future earning to current year because of bonus plan as an incentive to directors. The research in this theory explains that one factor of earning management is bonus plan. Positive theory describes and predicts human behavior, not to prescribe behavior. Positive theory sees the facts to predict what will happen in the future (Gaffikin, 2006). Because the future is uncertain, the facts are needed to predict the future. There is one reason why positive accounting theory is developing rapidly in this day.

Accounting relates to records and reports the financial transactions. In recording, there are some methods that can be chosen. For a certain transaction can be recorded in the different methods, consequently the reporting can be different, such as variance in earning reports. From this fact, accounting research will examine what factors influenced the decision makers in choosing the accounting methods.

In one financial statement report, there are many accounting methods applied and chosen. For example, there are some choices in recording inventory and depreciation that can influence earning. This earning, finally, will influence the company value that can be estimated from stock prices in capital market. Besides the value, earning report will decide how much dividend receiving by shareholders. For this reason, the decision factors to choose a certain accounting method in a company are a critical point of view. From the previous researches, the researchers have explored factors influenced managers in reporting earning. Most of the factors are from the outside of directors or managers as an individual. There are few researches that explore what directors or managers inside factors to report earning, such as motivation.

A human behavior is influenced by many factors, such as environment and time. When reporting earning, industry environment and timing will influence the management behavior. The different industry will use different accounting methods. For example, in determining or calculating sales can be different between a contracting company and a retailing company. If there is a special moment or condition, it can influence the choice of accounting methods. For example, the recording in palm plantation companies for fertilizer the trees. When the trees still in plant timing, the recording of fertilizer expenditure will be different when the trees are generating fruit palm.

There is still debatable whether accounting research as a science or not. Accounting is a part of knowledge about human life aspects. Accounting is systematics thinking created by human to help the others to make decision and influence human behavior. For this reason, a new question has arisen: ia accounting theory a concept or a science. According to Karl Popper (1902-1994), the development of science firstly is organized by building hypotheses. The next step is making observation and interpretation to examine the hypotheses and theory. This procedure is called hypothetic-deductive. The extraordinary or abnormal moment can be rejected by the theory. Some scholars criticize Popper's point of view. One of them is Thomas Kuhn (1922-1998) who states that theory should be created from collecting data. One kind of knowledge can be stated as science if it has paradigm acknowledge by society. Every paradigm has anomaly and consequently paradigm can be changed. Imre Lakatos (1922-1974) tried to bridge Pepper's opinion and Kuhn's opinion. Lakatos differentiate falsification in science, namely dogmatic, naive, and sophisticated.

Dogmatic falsification states that all the theories are guess. If the science cannot prove a theory, the theory is denied and finally rejected. Naive falsification states that the rejected of the theory cannot be too fast. The rejected should be used decision making method. Both dogmatic and naive falsifications in denying the theory, they should use a test and compare the theory and the experiment to prove or to reject the theory. Only satisfied results of the experiments that can support the theory. Sophisticated falsification states that a theory cannot be rejected before a new better theory arises.

According to Kabir (2011), Positive Accounting Theory (PAT) methods are not fully suitable to the three theories that discussed by Popper, Kuhn, and Lakatos. However, PAT has elements in these theories.

## Conclusions

After the development of PAT, accounting researches have growth rapidly. These researches explain the association between the facts and predictions in the future. Other topics in PAT researches examine about choosing accounting methods and accounting procedures in reporting earning. Management has discretions in reporting earning, such as using accrual accounting methods. Management should have reasons why chooses a certain accounting methods and an accounting procedure. These factors that influenced securities prices are the main point in PAT researches. Other side, PAT also examines the association between earning and stock prices.

Management behavior that rises from deep inside of the individual needs to explore can be a crucial factor in influencing decision-making. The differences of industry types and timing can be other factors in choosing accounting methods. Accounting includes as social science but according to Pooper, Kuhn, and Lakatos, accounting theory is not suitable as science. However, accounting theory elements has been in science criteria.

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