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TABLE OF CONTENTS

1. Learning Outcomes

After studying this module, you shall be able to

- Know the origins of Positive Accounting theory
- Learn how a positive theory differs from a normative theory
- Know the perceived role of accounting in minimising the transaction costs of an organisation
- Understand how accounting can be used to reduce the costs associated with various political processes
- Understand how particular accounting-based agreements with parties such as debt holders and managers can provide incentives for managers to manipulate accounting numbers

2. Accounting Theory

Theory is defined as “a set of interrelated concepts, definitions and propositions that present a systematic view of phenomena by specifying relations among variables with the purpose of explaining and predicting the phenomena.”

Simply stated, a theory is “a systematic statement of the rules or principles which underlie or govern a set of phenomena”.

The importance of theory to the development of any organized body of knowledge cannot be overemphasized. Essentially, theories are generalizations which serve to organize otherwise meaningless masses of data and which thereby establish significant relationship in respect of such information.

According to Hendriksen:

Accounting theory may be defined as logical reasoning in the form of a set of broad principles that (1) provide a general frame of reference by which accounting practice can be evaluated, and (2) guide the development of new practices and procedures. Accounting theory can also be used to describe present practices to acquire a better understanding of them. But the most important objective of accounting theory should be to provide a systematic set of logical principles that form the general frame of reference for the evaluation and development of sound practices od accounting.

3. METHODOLOGY IN ACCOUNTING THEORY

Methodology is the systematic, theoretical analysis of the methods applied to a field of study. It encompasses the theoretical study of the body of principles and methods associated with a branch of knowledge.

A methodology offers the theoretical underpinning for understanding which method, set of methods, or so-called “best practices” can be applied to specific case, for example, to calculating a particular result.

Like in other disciplines, a methodology is required for the formulation of an accounting theory. Different perspectives are given by different researchers on the importance of accounting theory.

a. Some researchers are of the view that the principal function of accounting theory should be to "**explain and predict**" particular accounting-related phenomena.

b. Other researchers are of the view that the task of accounting theory is to **"prescribe"** based on a perspective of the role of accounting, particular approaches to accounting. E.g. a theory prescribing that the assets should be valued not on the historical costs but on the basis of market values.

"The divergences of opinions, approaches, and values between accounting research and accounting practice have led to the use of two methodologies, one descriptive or positive and other normative":

1. Positive methodology
2. Normative methodology

3.1 Positive Methodology

Positive methodology, often known as Descriptive methodology, Positive Accounting Theory, tries to lay down and explain what and how financial information is presented and communicated to users of accounting data. Positive theory yields no prescriptions and norms for accounting practices. It is concerned with explaining accounting practice.

Positive accounting came into view with factual and real studies that grew rapidly in accounting in the late 1960s. It was organized as an academic school of thought of discipline by the work of Ross Watts and Jerold Zimmerman (in 1978 and 1986) through their various writings. Watts and Zimmerman found that prescriptions and proposed accounting methodologies and objectives in the form of 'should be' could not satisfy all and were not accepted generally by all standard setting bodies. Positive Accounting Theory seeks to predict and describe why managers elect to adopt particular accounting methods in preference to others. The theory relied in great part of work undertaken in the fields of economics, and central to the development of Positive Accounting Theory was the acceptance of economics based 'rational economic person assumption".

There is an assumption that an accountant is motivated primarily by self-interest, and that depending on the certain conditions the particular accounting method would be chosen. Under positive accounting theory (PAT), firms seek to maximize their likelihood for survival, so they conduct themselves efficiently. Actual organization is dependent on factors particular to a firm, which help to determine of their prospects. Examples include legal and institutional environment, technology, and competition. Firms are viewed as the accumulation of the contracts they have entered into.

In relation to PAT, as there is a requirement to be efficient, the firm will seek to minimize costs related with contracts. Examples of costs of contract include negotiation, renegotiation, and monitoring costs. Costs of contract involve variables of accounting as contracts can be specified in terms of accounting information such as net income and financial ratios. The firm will opt for the policies of accounting that best recognize the need for minimization of costs of contract. PAT acknowledges that changing situations need managers to have flexibility in selecting accounting policies. This brings to notice the problem of "opportunistic behaviour". This occurs when the management acts in its own personal interests. Keeping this in mind, the most favourable set of policies of accounting are explained as best trade-off between selecting accounting policies to minimize costs of contract and providing flexibility in times of changing situations (taking tinto account the impact of opportunistic behaviour).

3.2 Normative Methodology

Normative methodology**,** commonly known as normative theory also, attempts to prescribe what data ought to be communicated, and how they ought to be presented; that is, they attempt to describe 'what should be' rather than 'what is'.

Accounting researcher became more concerned with: Policy recommendations & what should / ought to be done, rather than analyzing and explaining the currently accepted practice. Normative accounting is a type of value judgement that can suggest subjective morality into accounting. For example, if a company which has increased payment of dividend could use some of those funds to improve corporate sustainability measures, a normative accounting statement would show how much money should be invested in those measures to maintain corporate growth. Rather than past data normative accounting deals with future events, which is the field of positive accounting practices. This is a theory that is not based on observation, but on how an accounting process should be done. This method uses a formula to figure out income based on value, not cost. It has been found that government regulations relating to accounting and reporting has acted as a major influence in establishing a demand for normative accounting theories which employ arguments in public interest, that is, for theories purporting to show that certain accounting procedures should be used, because they lead to better decisions by investors, more efficient capital market, etc.

4. Positive Accounting Theory: three hypotheses

The positive Accounting Theory comprises of three hypotheses: the debt / equity hypothesis the bonus plan hypothesis and the political cost hypothesis. To explain and foresee whether an organization would support or disapprove a particular method pf accounting, these three key hypotheses in the Positive Accounting Theory literature have been used frequently. By using a different possibility, the three hypotheses try to explain the utilisation of earnings management. As a result, all the three hypotheses have the incentives or possibility of the use of earnings management.

4.1 Bonus plan hypothesis

"The bonus plan hypothesis states that managers of firms with bonus plans are more likely to use accounting methods that increase or maximizes current period reported income. Such selection is assumed to increase the present value of bonuses if the compensation committee of the board of directors does not adjust for the chosen method" (Watts and Zimmerman).

As they choose the methods of accounting, from which they get the maximum profit, based on this definition the assumption show that managers are opportunistic. The positive accounting theory assert that all actions are based on self-interest. Managers will select an action that will meet their own interests and desires the best.

4.2 Debt/equity hypothesis

"The debt/equity hypothesis predicts the higher the debt/equity ratio of a firm, the more likely it is that managers' use methods of accounting that increase the income. The more the debt/equity ratio, the closer tighter the firm is to the constraints in the debt covenants. The tighter the covenant constraint, the higher the probability of a covenant violation and of incurring costs from technical default. Managers exercise discretion by choosing income increasing accounting methods, relax debt constraints and reduce the costs of technical default" (Watts and Zimmerman).

The debt / equity hypothesis states that when the debt / equity ratio increases, that management will select the method of accounting that increase reported profit. The higher the debt / equity ratio, the closer (i.e. 'tighter') the firm will be to the constraints in the debt covenants. Management's motivation to adopt particular accounting method to relax debt constraints and decrease technical default costs can be categorized as earnings management.

4.3 Political cost hypothesis

If managers consider that they are under a deal of political scrutiny, this could motivate them to adopt accounting methods that reduce reported income, and thereby reduce the possibility that people will argue that the organization is exploiting other parties.

This hypothesis has based on the assumption that larger companies will receive more political attention than smaller companies. This could motivate management to adopt certain accounting method, use earnings management that reduces the reported profit. Increased political attention may result in new laws and regulation with a negative impact on the company's performance. Political attention may result in governmental interference. By changing the accounting method, and by lowering the reported profit, the risk of facing governmental interference can be reduced.

The Positive Accounting Theory describes the existence of incentives and the opportunity for the management to use earnings management. Hence, earnings management can be used to improve management's own situation.

5. COMPARISON BETWEEN POSITIVE THEORY AND NORMATIVE THEORY

Positive theories are concerned with how world works. For example, the following is a proposition made in positive accounting: “if a business enterprise changes from FIFO to LIFO and the share market has not anticipated the change, the share price will rise.” This statement is a prediction that can be refuted by evidence. The positive theory is a predictive model. Normative theories are concerned with prescriptions, goal setting. For example, “given the set of conditions A, alternative E should be selected,” is a normative proposition. “Since prices are rising, LIFO should be adopted”, is another normative proposition. These normative propositions are not refutable. Positive accounting practices are best used to explain past financial events, as well as the causes of a business’s current financial standing. Determining why a company is operating at a net loss requires the positive accounting practices of comparing actual revenue to actual expenses over an accounting period. Normative accounting practices are best used when trying to set future economic policy based on theory. A company’s mission statement or the market strategies included in business plans can be viewed as normative statements- they reflect the business ideals that a company wants to accomplish.

The positive Accounting Theory focuses on the choices of accounting methods and the implications of these choices.

It is difficult to say which methodology-positive or normative-should be used in the formulation and construction of accounting theory. Both methodologies may be needed for the formulation of an accounting theory, given the complex nature of accounting, accounting environment.

Scott suggests:

“...it is sufficient to recognise that both normative and positive approaches to theory development and testing are valuable. To the extent that decision makers proceed normatively, both positive and normative theories will make similar predictions. By insisting on empirical testing of these predictions, positive theory helps to keep the normative predictions on track. In effect, the two approaches complement each other.”

6. EXAMPLES OF “NORMATIVE” AND “POSITIVE” QUESTIONS

"Normative" Questions

1) How should leases be treated on the balance sheet? 2) Should replacement (or liquidation) values be used in the balance sheet and income statements? 3) How should changing price levels be accounted for? 4) How should changes in foreign exchange rates be accounted for by firms with foreign interests? 5) How should inventories be valued? 6) What should be reported in annual financial statements? 7) Should interim financial statements be audited? 8) How should minority interests in subsidiaries be treated in consolidated statements?

"Positive" Questions

1) Why do most firms continue to allocate overhead charges to performance centers? 2) Why do firms change accounting techniques? 3) Why do firms change auditors? 4) How have court regulation and rulings influenced accounting practice? 5) Why do firms continue to use historical cost depreciation for other than tax purposes? 6) Why are public accounting firms organized as partnerships?

7. Summary

Normative theories attempt to tell what “people or constituencies should do”. A normative theory is not evaluated solely by predictive value, but is also assessed by its rational consistency of how practical individuals should behave. Positive theories “attempt to make good predictions of real world events.”

Positive Accounting Theory (PAT) is a positive theory whose objective is to predict activities such as what policies of accounting firms will select and how newly selected standards of accounting will make firms to react. Its whole purpose is to understand and foresee the choice of accounting policies

Positive Accounting Theory has three hypotheses around which its predictions are organized.

The bonus plan hypothesis mentions that with all other things remaining equal, firm’s managers with bonus plans more likely select procedures of accounting that shift reported earnings from future time periods to the current time period. By this, they can increase bonuses for the current year.

The debt covenant hypothesis states that all other things being equal, the closer a firm is to violating accounting-based debt covenants, the more likely the firm manager is to select accounting procedures that shift reported earnings from future periods to the current period. By increasing current earnings, the company is less likely to violate debt covenants, and management has minimized its constraints in running the company.

The political cost hypothesis states that all other things remaining equal, more the political costs the firm faces, the manager is more likely to choose procedures of accounting that defer reported earnings from present to future time periods. This is because high profitability can lead to increased political “heat”, and can lead to new taxes or regulations.

Pragmatic testing of positive theory supplements normative theory by holding its predictions in the correct direction.