Nat and pat

Finance

Normative and Positive Accounting Theories Normative and Positive Accounting Theories Introduction Accounting theoriesare those methodologies, assumptions as well as frameworks that are applied when studying the application of financial principles. To study accounting theories, there is requirement to review both historical foundations and of accounting practices and the verification of accounting practices. In this essay, the aim will be to discuss the differences between normative and positive accounting theories. The essay will, then go on and critically discuss the role and application of the theories in improving accounting practice.

Differences between Positive and Normative Accounting Theories

Positive Accounting Theory (PAT) is an objective theory aiming at predicting accounting practices and policies that are chosen applied by firms as well as the effects of such, on the firms after the implementation. Under this theory, available data and statistics in the firm are analyzed to enable the firm to derive applicable conclusions based on the results. The main purpose of the results of the analysis is to create an understanding when predicting accounting policies across differing firms. On the other hand, Normative Accounting Theory (NAT) is a subjective kind of theory with an aim to describe the economic future of a given firm or investor. This is the theory that usually attempts to tell economists what they should do. This theory does not solely use predictive values to make evaluations, but it also considers the logical consistency of the rationality of individuals. Therefore, as positive accounting theories tend to make predictions of the events of the real world, normative accounting theories tend to inform people about what they should do (Coetsee, 2010).

Main Elements of PAT

PAT has two different perspectives that include the efficiency perspective and the opportunistic perspective. Under the opportunistic perspective of PAT, there are three elements including the bonus plan hypothesis, debt covenant hypothesis as well as the political cost hypothesis. The bonus plan hypothesis of PAT has the assumption that the manager with the bonus plan has a high likelihood of using accounting methods intended to increase the current period reported income. As such, this makes a prediction that a manager will be rewarded on the basis of their performance. Debt covenant hypothesis, on the other hand, tries to put a limit on the managers ability to transfer assets to new creditors, themselves or new shareholders. Political cost hypothesis, on the other hand, refers to how a firm would react to the possibility of regulation of other regulators as well as other interest groups and how these might affect the wealth of the firm.

Elements of NAT

Some of the elements of NAT include the current cost accounting (CCA), historical cost accounting in times of rising prices, exit-price accounting, and the current purchasing power accounting. Under the latter, the theory focuses on the purchasing power and capital maintenance and performing current purchase power adjustments.

Strengths of NAT and PAT

To begin with, positive accounting theory practices can best be applied in explaining past financial events. They also help in offering an explanation about the current financial standings of either a business or an individual. For a company to determine the reason it is operating at a net loss, the positive accounting theory practices help to compare its actual revenue to the actual expenses over the course a year. The accounting practices used under PAT enable the construction of financial documents like cash flow statements and balance sheets.

On the other hand, NAT practices become very useful in trying to set future policies of economics which are theory based. Normative statements can be viewed in the form of the mission statement of a company or the market strategies that are included in the companys business plan. Such statements are a reflection of the business ideals to be accomplished by a company.

Limitations of PAT

One limitation of PAT is that it fails to provide accountants with a prescription of how to account, which is a critical issue for practicing accountants. The theory is also very slow and limited for development. It is flawed scientifically with hypotheses that are frequently not supported. The theory is also not as value free as it asserts.

Limitations of NAT

NAT, through the exit price theory, does not consider the assets value in use. It supposes that the value in use of an asset that is retained rather than sold is greater than its current exit price. During asset valuation at their perceived sales value, it usually implies that the firm has an intention of liquidating its assets. Another limitation through its historical cost accounting theory is that there is a justification for the historical cost utilization through the going concern assumption. It becomes difficult to build an evidential case for a continuity projection. There is no business capable of continuing indefinitely. Therefore, assuming continuity is rather less reasonable than cessation.

Application ad use of PAT and NAT and their Role in Improving Accounting Practice

PAT is usually applied by these managers for the benefits of the company. Given the fact that PAT theories promote the fact that a manager is compensated depending on the performance, the theory makes managers work harder as they want more compensation. This has an influence in improving accounting practice as it enhances the relationship between the agents and the shareholders as in the agency theory. On the other hand, NAT theories affect accounting practice in such a way that, their influence has some effects in the historical costs that may change the values in the financial statement, with time. The application of different accounting policies by firms due to the normative evaluations make it possible for the firms to change their accounting practice due to the subjective influences.

Conclusion

Positive and normative accounting theories are theories that either guide people or firms on the accounting policies to apply, or predicting the policies and practices that are applied by various forms. In as much as various firms apply both the PAT and NAT, the two has their limitations. At the same time, these theories have the potential to change accounting practice as they predict and provide an application of the best or most appropriate policies and accounting practices by firms.

Bibliography

Coetsee, D., 2010. The role of accounting theory in the development of accounting principles. Meditari Accountancy Research, 18(1), pp. 1-16.