These valuation methods are concerned with the measurement of economic phenomena. They are discussed in more depth in Chapter 14, but they are also referred to in the intervening chapters on accounting theory.

**Accounting Theory and Policy Making**

The relationship between accounting theory and the standard-setting process must be understood within its wider context, as shown in Exhibit 1.1. We caution that Exhibit 1.1 is extremely simplistic. Economic conditions have an impact on both political factors and accounting theory. Political factors, in turn, also have an effect on accounting theory. For example, after Statement of Financial Accounting Standards (SFAS) No. 96 on income tax allocation appeared in 1987, several journal articles as well as corporate preparers of financial statements severely criticized it. Eventually, political factors (see the following discussion) such as the costliness and difficulty of implementing SFAS No. 96 led to its replacement by SFAS No. 109. Despite its simplicity, Exhibit 1.1 is a good starting point for bringing out how ideas and conditions eventually coalesce into policy-making decisions that shape financial reporting.

Bodies such as the FASB and the SEC, which have been charged with making financial accounting rules, perform a policy function. This policy function is also called *standard setting* or *rule making* and specifically refers to the process of arriving at the pronouncements issued by the FASB or SEC. The inputs to the policy-making function come from three main (although not necessarily equal) sources: Economic factors, political factors, and accounting theory.

**Exhibit 1.1** The Financial Accounting Environment
The best example of an economic factor would be the steep inflation of the 1970s, which was undoubtedly the catalyst that led the FASB to force the disclosure of information concerning price changes, is a classic example of an economic condition that impinged on policy making. Another example of an economic factor would be the acceleration of mergers and acquisitions.

The term political factors refers to the effect on policy making of those who would be subject to the resulting rules or regulations. Included in this category would be auditors, who are responsible for assessing whether the rules have been followed; preparers of financial statements, represented by organizations such as Financial Executives International (FEI); and investors, represented by organizations such as the CFA Institute and the public itself, who might be represented by governmental groups such as Congress or by departments or agencies of the executive branch of government, such as the Securities and Exchange Commission (SEC).

In addition, the management of major firms and industry trade associations are important political components of the policy-making process. Although it has been important to give voice to those who are affected by accounting rule making, it should be remembered that political factors may subvert the standard-setting process. One example of this has been the special purpose entity (SPE). SPEs, as the name implies, are arrangements whereby the firm and an outside equity investor jointly own an entity that may largely be a shell enterprise. SPEs allow firms to “park” liabilities on the SPE’s balance sheet if the outside equity investor owns as little as 3% of the SPE. Leaving the liability off its own balance sheet improves the firm’s debt–equity ratio and, in general, gives the firm’s balance sheet what we might call a facelift. The FASB’s initial attempt to solve the SPE problem failed because of political interference by the then Big Five public accounting firms. However, owing to public pressure resulting from the Enron debacle, the FASB has begun again to address this problem (see Chapter 18).

Accounting theory is developed and refined by the process of accounting research. Accounting professors mainly carry out research, but many individuals from policy-making organizations, public accounting firms, and private industry also play an important role in the research process.

Standards and other pronouncements of policy-making organizations are interpreted and put into practice at the organizational level. Hence, the output of the policy level is implemented at the accounting practice level. Of course we have now entered an era when failures of large publicly traded companies (e.g., Enron, WorldCom) are going to have a significant impact on financial accounting standards, auditing rules, and institutional structures of organizations such as the FASB and the SEC. Many of these issues will be discussed in Chapters 3, 12, and 17, among others.

Users consist of many groups and include actual and potential shareholders and creditors as well as the public at large. It is important to remember that users not only employ financial statements and reporting in making decisions, but they are also affected by the policy-making function and its implementation at the accounting practice level.

All facets of the accounting theory and policy environment are important and are considered in this book. Our principal focus is on that part of the track running between accounting theory and the accounting policy function.