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NORMATIVE THEORIES OF ACCOUNTING: THE CASE OF ACCOUNTING FOR CHANGING PRICES

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ABSTRACT

This paper gives an overview of the limitation of historical cost accounting in its ability to cope with various issue associated with changing prices as well as market conditions. There are a number of alternative accounting methods which have been being developed to address problems associated with changing prices and market conditions in arriving at market values, including fair value accounting. Each of the alternative accounting methods has its own strength and weakness. The calculation of income under a particular method will depend on the perspective of capital maintenance which has been adopted.

Keywords: Limitation of Historical Cost Accounting, Changing Prices and Market Conditions, Fair Value Accounting.

INTRODUCTION

Despite the development by well-respected academics of numerous normative accounting theories, however these theories have typically failed to be embraced by the accounting profession, or to be mandated within financial accounting regulations. This journal specifically consider various prescriptive accounting normative theories that were formulated on the basis that historical cost accounting has too many shortcomings, in particular in times of rising prices (high inflation) and changing market conditions. Some of these shortcomings were summarized by the International Accounting Standards Committee (subsequently replaced by the International Accounting Standards Board) in IAS 29 'Financial Reporting in Hyperinflationary Economies', as follow: "In a hyperinflationary economy, reporting of operating results and financial position in the local currency without restatement is not useful. Money loses purchasing power at such a rate that comparison of amounts from transactions and other events that have occurred at different times, even within the same accounting period, is misleading."

LITERATURE REVIEW

Limitations of historical cost accounting in times of rising prices

Criticisms of historical cost accounting have been raised by a number of notable scholars, particularly in relation to its inability to provide useful information in times of rising prices and changing market conditions. Historical cost accounting (HCA) assumes that money holds a constant purchasing power. As Elliot (1986, p. 33) states:

> An implicit and troublesome assumption in the historical cost model is that the monetary unit is fixed and constant over time. However, there are three components of the modern economy that make this assumption less valid than it was at the time the model was developed. One component is specific price-level changes, occasioned by such things as technological advances and shifts in consumer preferences; the second component is general price-level changes (inflation); and the third component is the fluctuation in exchange rates for currencies. Thus, the book value of a company, as reported in its financial statements, only coincidentally reflects the current value of assets.

There has been increasing concern to the adequacy of the Historical Cost Accounting (HCA) system in the current business environment. The Australian Accounting research Foundation (AARF) has released the Monograph 10, they claim that HCA failed to provide objective information and proposes alternatives that consider the changing value of assets and liabilities. Historical cost is insufficient for the evaluation of business decisions. Edwards and Bell argued that managements need HCA information in order to evaluate their past performance; so they can make a right decision for their future. Similarly with those findings Edward and Bell argued that HCA has insufficient for the evaluation of business decisions; they claim that a proper evaluation of past decision must entail a division of total profit in given period while the price of asset and liabilities are changed. Chambers (1966), argued that historical cost accounting information suffers from problems of irrelevance in times of rising prices. That is, it is questioned whether it is useful to be informed that something cost a particular amount many years ago when its current value (as perhaps reflected by its replacement cost, or current market value) might be considerably different. It has also been argued that there is a real problem of additivity. At issue is whether it is really logical to add together assets acquired in different periods when those assets were acquired with euros of different purchasing power. Sterling (1967), he argued that conservatism was the fundamental principle of valuation but due to arguments that for the historical cost realization convention are manifestly specious when removed from the context of conservatism, they come up with second hypothesis that the cost rule is, in fact, nothing more than manifestation of conservatism. Sterling concluded that conservatism yields are not just giving zero information but also giving misinformation. Hence they claim that historical cost yield misinformation. They agree that the present value were more realistic and more likely what people mean by wealth. Such criticisms continued through to the early 1980s, but declined thereafter as levels of inflation began to drop throughout the world. Subsequently the debate focus changed to the use of current market values (fair values) – (supposedly reflecting current market conditions at the accounting date) for valuing assets, rather than amending historic costs simply to take account of inflation. Across time, these criticisms appear to have been accepted by accounting regulators – at least on a piecemeal basis. In recent years, various accounting

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standards have been released that require or permit the application of fair values when measuring assets, e.g.: IAS 39: financial instruments, adoption of fair value model as one of the options in IAS 16: property, plant and equipment, IAS 38: intangible assets, IAS 14: investment properties, and IAS 41: biological assets.

Current purchasing power (CPP) accounting

Current purchasing power (CPP)accounting was developed on the basis of a view that, in times of rising prices, if an entity were to distribute unadjusted profits based on historical costs the result could be a reduction in the real value of an entity (the entity could risk distributing part of its capital). CPP accounting can be traced to the early works of such authors as Sweeney (1964, but originally published in 1936) and has since been favoured by a number of other researchers. CPP is also called as: general purchasing power accounting, general price level accounting, or constant dollar/euro accounting. CPP accounting has also, at various times, been supported by professional accounting bodies throughout the world, but more in the form of supplementary disclosures to accompany financial statements prepared under historical cost accounting principles.

Current cost accounting (CCA)

Edwards and Bell (1961), adopted a physical capital maintenance approach to income recognition. In this approach, which determines valuations on the basis of replacement costs, operating income represents realized revenues, less the replacement cost of the assets in question. It is considered that this generates a measure of income which represents the maximum amount that can be distributed, while maintaining operating capacity intact. Duncan and Moores (1998) examine the usefulness of CCA information for investor decision making. With the New Zealand Society of Accountants CCA-1 Standard (Information Reflecting the Effects of Changing Prices) became a mandatory reporting requirement as from April 1982, majority of listed companies were not complying with its requirements. The reason given by the company directors for non-compliance, a significant proportion were categorized implying either the non-relevance or the subjectivity and complexity of such CCA information. These negative statements by company directors about the relevance and reliability of CCA information imply that such information is not useful to investors. In contrast to the directors comments, the objective of the CCA-1 Standard states that it is intended to provide more useful information. CCA accounts are expected to better facilitate an assessment of the financial viability of the business' and return on investment by managers, shareholders, investors, and others in their decision making than historical cost. Duncan and Moores (1998) study results show that CCA are more useful for investor decision making because they are both more relevant and perceived to be more reliable than conventional historical cost accounts. With the limitations from this study, the experiment CCA information was found to provide more relevant information. This is because the treatment groups receiving such information made different and better decisions than those receiving HCA information. Furthermore, current cost accounts were found to result in different and better favorability rankings and slightly more accurate rate of return predictions. Complementing these findings, the CCA financial statements were perceived to be just as, and possibly more, reliable than the HCA statements. Finally reliability was shown to be positively associated with relevance.

Exit price accounting

Exit price accounting is a form of current cost accounting that is based on valuing assets at their net selling prices (exit prices) at the accounting date and on the basis of orderly sales. Chambers (1966): Accounting, Evaluation and Economic Behavior, argued that the key information for economic decision-making relates to capacity to adapt – which was argued to be a function of current cash equivalents. 'Current cash equivalent' refers to the cash that an entity would expect to receive through the orderly sale of an asset. Chambers labeled his method of accounting as 'continuously contemporary accounting' (CoCoA). Balance sheet is considered to be the prime financial statement under CoCoA, and should show the net selling prices of the entity's assets. Profit would directly relate to changes in adaptive capital, with adaptive capital reflected by the total exit values of the entity's assets. So, profit is directly tied to the movement of current net selling prices of the entity's assets. There is no distinction drawn between realized and unrealized gains.

Fair value accounting

Fair value is an asset (and liability) measurement concept that has been used in an increasing number of accounting standards in recent years. IASB's accounting standard, fair value is defined as:

> the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (IASB, 2010, p. 5, paragraph 1, emphasis in original)

Mark to market is the technique of identifying a fair value should there is an active and liquid market in which assets are traded that are identical to the asset to be valued, then the fair value will be equivalent to the asset's market value. Mark to model is the technique of identifying a fair value when a directly comparable market value is not available, as there is no market where identical assets are actively traded. In these circumstances the market price of a very similar asset or liability can be used or, where there is not an active market for the form of asset that is to be fair valued (so market values for an identical or similar asset cannot be observed), an alternative is to use an accepted valuation model to infer the fair value. The IASB and FASB's accounting standards on fair value measurement establish a fair value hierarchy in which the highest attainable level of inputs must be used to establish the fair value of an asset or liability. Levels 1 and 2 in the hierarchy are mark to market situations, with the highest level, level 1, being 'quoted prices (unadjusted) in active markets for identical assets or liabilities'. While level 2 are directly observable inputs other than level 1 market prices (level 2 inputs could include market prices for similar assets or liabilities, or market prices for identical assets but that are observed in less active markets). Level 3 inputs are mark to model situations where observable inputs are not available and risk-adjusted valuation models need to be used instead.

Demand for price-adjusted and value-adjusted accounting information

Watts and Zimmerman (1978), investigated the lobbying positions taken by corporate managers with respect to the FASB's 1974 Discussion Memorandum on general price level accounting (current purchasing power accounting). If general price level accounting were introduced, then in times of rising prices, reported profits would be reduced relative to profits reported under historical cost conventions. The reduction in profits would be due to such effects as higher depreciation and purchasing power losses due to holding net monetary assets. Watts and Zimmerman proposed that the political process was a major factor in explaining which corporate managers were more likely to favour or oppose the introduction of general price level accounting. The political process itself is seen as a competition

for wealth transfers. For example, some groups may lobby government to transfer wealth away from particular companies or industries (for example, through increased taxes, decreased tariff support, decreased subsidies, increases in wages awarded, more stringent licensing arrangements) and towards other organizations or groups otherwise considered to be poorly treated. Apart from government, groups such as consumer groups (perhaps through product boycotts), employee groups (through wage demands or strikes) and community interest groups (through impeding operations or lobbying government) can act to transfer wealth away from organizations through political processes. The perspective of Watts and Zimmerman was that entities deemed to be politically visible are more likely to favour methods of accounting that allow them to reduce their reported profits. High profitability itself was considered to be one attribute that could lead to the unwanted (and perhaps costly) attention and scrutiny of particular corporations.

Professional support for various approaches to accounting for changing prices and assets values

Throughout the 1970s and 1980s, many organizations opposed the introduction of alternative methods of accounting (alternative to historical cost). Corporate opposition to various alternative methods of accounting could also be explained by the notion of self-interest as embraced within the economic interest theory of regulation. Under historical cost accounting, management has a mechanism available to manage its reported profitability. Holding gains might not be recognized for income purposes until such time as the assets are sold. For example, an organization might have acquired shares in another organization some years earlier. In periods in which reported profits are expected to be lower than management wants, management could elect to sell some of the shares to offset other losses. If alternative methods of accounting were introduced, this ability to manipulate reported results could be lost. Hence such corporations might have lobbied government, the basis of the submissions being rooted in self-interest. Because there are typically corporate or business representatives on most standard-setting bodies, there is also the possibility that corporations/business interests were able to capture effectively the standard-setting process (Walker, 1987). Accounting Research Division of AICPA commissioned studies by Moonitz (1961), and by Sprouse and Moonitz (1962) respectively, proposed that accounting measurement systems be changed from historical cost to a system based on current values. However, prior to the release of the Sprouse and Moonitz study the Accounting Principles Board of AICPA stated in relation to the Moonitz and the Sprouse and Moonitz studies that 'while these studies are a valuable contribution to accounting principles, they are tooradically different from generally accepted principles for acceptance at this time' (Statement by the Accounting Principles Board, AICPA, April 1962).

ANALYSIS AND DISCUSSION

Historical Cost Accounting versus Current Cost Accounting in Changing Price

Historical cost accounting has some defects in relation with the movements of price. Elliott and Elliott (2002) argue that there are some problems arise when the movement of changing price becomes the issue. These problems are there are Significant information concerning equity progress and wealth is not reported. Comparability of business entities becomes distorted, the decision making process become intrinsically flawed, financial reports become misleading because the financial data evolve and unrealized profits arise. However, current cost accounting model measures income with adopting the price index system. Movements in price levels are estimate at the retail price index; price changes in a group of goods and services in general (Elliott and Elliott, 2002). Based on the support and criticism from the research literature above, it is that there are several issue related with historical cost accounting model. First issues are the timeliness of the historical cost model, which is whether historical more relevant to decision makers than objectivity or verifiability. Secondly, based on the market change, historical cost records may change with the passage of and subsequent events. Furthermore, there is also argument on the accounting whether to use cost or value? There's also some questions arises whether cost is a consistent measurement system for calculating income. Finally, we the issues whether historical cost accounting needs supplementary data additional disclosure to make financial report more relevant to decision making.

Required and permitted uses of fair values

Under current IASB rules, within a range of International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs), many assets are required to be included in the statement of financial position at historical cost (less amortization or impairment where appropriate), some are required to be included at fair value, and there are some types of assets where organizations have the option of including the asset either at historical cost or fair value (Nobes and Parker, 2010, p. 204). Where an organization chooses to use fair value for a type of asset in this final category, it must then use fair values for all of the assets it has of the same type and cannot usually change back to using historical costs for this type of asset in the future. FASB accounting rules in the United States have in the past been much more restrictive in the use of fair values than the IASB rules (Zeff, 2007), although there are moves towards much greater use of fair values.

Fair value and the decision usefulness versus stewardship role of financial accounting

Whittington (2008) distinguished between what he refers to as two competing 'world views' underlying present-day normative positions on financial accounting: the Fair Value View and the Alternative View. Under the Fair Value View, the sole purpose of financial accounting is seen as being to provide information useful for a range of financial stakeholders making economic decisions based on future cash flows. In contrast, proponents of the Alternative View believe that 'stewardship, defined as accountability to present shareholders is a distinct objective, ranking equally with decision usefulness'. Market prices should give an informed, non-entity specific estimate of cash flow potential, and markets are generally sufficiently complete and efficient to provide evidence for representation ally faithful measurement on this basis. (Whittington, 2008, p. 158, emphasis in original).As market values are considered to provide the most relevant decision-useful information, fair values in the statement of financial position are considered to be more important than information in the income statement. The former thus becomes the primary financial statement while income statements just record the difference in net asset (fair) value from one year to the next (Ronen, 2008).In contrast, for a primarily stewardship role the reporting of the impact of transactions entered into by the firm is considered to be of key importance. This information is captured primarily in the income statement, with the statement of financial position recording the residual amounts of cash flows that have not yet been 'used up' (or have been used but not yet received or paid) in accordance with the realization and matching principles of accrual accounting (such as inventory purchased but not yet sold, the useful lives of tangible non-current assets that have not yet been used and can help generate

income in future periods, and so on) (Ronen, 2008). For these purposes, reliability of measurement is important, and the application of prudence is regarded as important in enhancing the reliability of information (Whittington, 2008).In considering issues of relevance versus reliability in fair value accounting, Ronen (2008, p. 186) argues that fair values do not measure the value of assets in their use to the specific firm. Therefore, despite the rationale of fair values being that they provide relevant decision-useful information, Ronen claims that fair values do not always provide the most relevant measures:

> Since the fair value measurements …are based on exit values, they do not reflect the value of the assets' employment within the specific operations of the firm. In other words, they do not reflect the use value of the asset, so they do not inform investors about the future cash flows to be generated by these assets within the firm, the present value of which is the fair value to share holders. Thus, these exit values fall short of meeting the in formativeness objective of financial statements. In a similar vein, they do not do well in serving the stewardship function, as they do not properly measure the managers' ability to create value for shareholders.
>
> Nonetheless, exit value measures have partial relevance. Specifically, they quantify the opportunity cost to the firm of continuing as a going concern, engaging in the specific operations of its business plan; the exit values reflect the benefits foregone by not selling the assets.

In assessing the reliability of fair value information, Ronen (2008, p. 186) explains that under fair value accounting, level 1 measurements can generally be considered reliable, but for level 2 and 3 measurements:

> Level 2 involves estimations of fair value based on predictable relationships among the observed input prices and the value of the asset or liability being measured. The degree of reliability one can attach to these derived measures would depend on the goodness of the fit between the observed input prices and the estimated value. Measurement errors and miss-specified models may compromise the precision of the derived estimates. Nonetheless, Level 2 is not as hazardous as Level 3. In the latter, unobservable inputs, subjectively deter- mined by the firm's management, and subject to random errors and moral hazard, may cause significant distortions both in the balance sheet and in the income statement. Moreover, discounting cash flows to derive a fair value invites deception.

Looking at considerations of reliability in more depth, Power (2010) argues that reliability is understood differently by different people and is, in effect, socially constructed. He partially explains the rise of fair value accounting in terms of a specific perception of reliability grounded in the developing discipline of financial economics, which has been increasingly drawn upon by accounting regulators to give authority (from outside the discipline of accounting) to their pronouncements. He explains (p. 202) that despite the many unrealistic assumptions underlying financial economics, with these being widely articulated in the wake of the sub-prime banking crisis, financial economics has provided an attractive body of knowledge for accounting standard setters:

> Whitley (1986) suggests that the close links [of finance theory] with practice had more to do with financial economics as a reputational system and less to do with the direct applicability of its analytical core. This is consistent with Hopwood's (2009: 549) critique of the 'growing distance of the academic finance knowledge base from the complexities of practice and practical institutions.' Yet, as Abbott (1988) has argued, purely 'academic' knowledge has always played a significant role for professions, providing the rational theorisations needed by practice. Financial economics is almost the perfect example of this. (Power, 2010, p. 202)
>
> … proponents of fair values in accounting argue for their greater relevance to users of financial information, but the deeper point is that they also redefine the reliability of fair values supported by financial economics, both in terms of specific assumptions and in terms of its general cultural authority. Against skeptics, key accounting policy makers were able to acquire confidence in a knowledge base for accounting estimates rooted in a legitimized discipline. (Power, 2010, p. 205)

Power (2010, p. 201) argues that in this context, fair value – as a measurement basis grounded in financial economics' conceptions of the role of accounting as being to provide decision-useful information to a range of financial stakeholders – becomes the 'acceptable' measurement basis:

> once it is admitted that market prices may not reveal fundamental value, due to liquidity issues or other reasons, then it can be argued that the real foundation of fair value lies in economic valuation methodologies; level 3 methods are in fact the engine of markets themselves, capable of 'discovering' values for accounting objects which can only be sold in 'imaginary markets'. It follows that the [fair value] hierarchy is more of a liquidity hierarchy than one of method, but overall it expresses the imperative of market alignment which informs fair value enthusiasts.
>
> The sociology of reliability to emerge from these arguments suggests that subjectivity and uncertainty can be transformed into acceptable fact via strategies which appeal to broader values in the institutional environment which even opponents must accept. Accounting 'estimates' can acquire authority when they come to be embedded in taken-for granted routines. (Power, 2010, p. 201, emphasis in original)

As fair value accounting looks likely to grow in importance and influence, as an increasing number of accounting standards require its use, debates over issues such as the impact of fair values and normative questions about the desirability of different aspects of fair values are also likely to gain even greater prominence. Academic studies examining the reactions of users to fair value accounting disclosures should provide important evidence to inform this debate. Many such studies have in the past examined reactions to the earlier attempts at reflecting current values in financial statements, such as current cost and CPP accounting.

Pricing of Level 3 Assets and Market Implications

Chang Joon Song, Wayne B. Thomas, and Han Yi pioneered research on the three-level hierarchy after the adoption of SFAS 157 ("Value Relevance of FAS 157 Fair Value Hierarchy Information and the Impact of Corporate Governance Mechanisms," Accounting Review, vol. 85, no. 4, pp. 1375–1410, 2010). Using the financial statements of 431 banks from 2008, they examined how stock market participants priced level 1, 2, and 3 assets. Their analysis presents evidence that the stock market values each dollar of level 1, 2, and 3 assets at $0.98, $0.97, and $0.68, respectively. The drop in valuation of level 3 assets indicates that investors are concerned about the reliability of management's estimates of their fair values. This concern must be justified, given the well-known cases of fraudulent earnings

management (e.g., Enron or WorldCom). Businesses could easily overstate their level 3 assets and recognize the gains from fair value changes in those assets whenever necessary to paint up decent earnings numbers. Using financial data from 467 financial institutions, Edward J. Riedl and George Serafeim examined the effect of level 3 assets on a company's cost of equity capital ("Information Risk and Fair Values: An Examination of Equity Betas," Journal of Accounting Research, vol. 49, no. 4, pp. 1083–1122, 2011). They hypothesized that, given management's discretion to estimate the value of level 3 assets and the incentives to overstate earnings, market participants might suspect management of overestimating future cash flows to value those assets. Thus, market participants might be likely to discount such valuation, which is ultimately reflected in stock prices. Riedl and Serafeim found evidence supporting this notion; specifically, that companies with higher exposure to level 3 assets have a higher cost of equity capital. Michael Magnan, Andrea Menini, and Antonio Parbonetti examined the association between the amount of a company's fair-valued assets and the properties of earnings forecasts made by financial analysts working at brokerage houses ("Fair Value Accounting: Information or Confusion for Financial Markets?" Review of Accounting Studies, vol. 20, no. 1, pp. 559–591, 2015). Specifically, they investigated analysts' earnings forecast errors and dispersions for companies with a large proportion of fair-valued assets to total assets and found that both the errors and dispersions were higher for those firms. In short, a high proportion of fair-valued assets in a financial statement creates an "information bottleneck" that prevents analysts from obtaining the information they need to make reliable earnings forecasts. Therefore, fair value accounting does not necessarily lead to a better information environment. In a related study using financial data from 120 European banks, Emanuel Bagna, Giuseppe Di Martino, and Davide Rossi investigated the stock market discount related to holding level 3 assets in the European markets ("An Anatomy of the Level 3 Fair Value Hierarchy Discount," working paper, 2014, https://ideas.repec.org/p/pav/demw-pp/demwp0065.html). They suggested three reasons for such a discount: 1) the lack of disclosure, specifically regarding how management makes level 3 fair value estimates; 2) the possible use of level 3 valuations for "earnings management," as suggested by Song, Thomas, and Yi above; and 3) the lack of liquidity. This liquidity concern relates to the absence of an active market for level 3 assets; as a result, those assets remain illiquid and cannot be readily converted into cash. Therefore, companies with a large amount of level 3 assets are riskier than others, resulting in a higher price discount in the stock market.

CONCLUSION

The support and criticism against HCA financial statements and the incremental information of current cost disclosure is debatable. Research on the incremental information of SFAS 33 find that there is no additional explanatory power of supplementary data that requires by the statements when historical cost based earnings are already known. However, even after any one of the supplementary data variables is known, knowledge of historical cost accounting based earnings still provides additional explanatory power. Under SFAS 107, Barth et al (1996) finds that fair value disclosure provide significant explanatory power for bank share prices beyond that provided by book values for three of the five major asset and liability categories disclosed. They consistently find incremental explanatory power for loans fair values. This indicates that fair value disclosure of certain asset requires by SFAS 107 has value relevance. Many capital research have examined the advantages and disadvantages of historical cost accounting and the value relevance of its financial statements. Collins et al. (1997) argue that, based on their empirical evidence, the claims that the conventional historical cost accounting model has lost its value relevance are premature.

The major advantages of fair value accounting are:

- Reflects current condition, in contrast to the (can be) outdated historical cost information, fair value accounting reflects current information regarding the value of assets and liabilities on the balance sheet.
- Consistent measurement criteria, fair value accounting provides the only conceptually consistent measurement criteria for assets and liabilities.
- Comparability, fair value accounting will improve comparability, that is, the ability to compare financial statements of different firms.
- No conservative bias, eliminating conservatism is expected to improve reliability because of neutrality, that is, reporting information without any bias.
- More useful for equity analysis, one complaint of traditional accounting is that it is largely oriented to provide information useful for credit analysis. For example, the use of conservative historical costs is more designed to provide an estimate of a business's downside risk than evaluate its upside potential.

While the major disadvantages of fair value accounting are:

- Lower objectivity, fair value accounting is less reliable because it often lacks objectivity. This issue is crucially linked to the type of inputs that are used. While nobody can question the objectivity of Level 1 inputs, the same cannot be said about Level 3 inputs. Because Level 3 inputs are unobservable and based on assumptions made by managers, many fear that the extensive use of Level 3 inputs especially for operating assets and liabilities—will lower the reliability of financial statement information.
- Susceptibility to manipulation, fair value accounting would considerably increase the ability of managers to manipulate financial statements. Again, this issue is closely linked to the use of Level 3 inputs—it is more difficult to manipulate fair values when Level 1 or Level 2 inputs are used.
- Use of Level 3 inputs, which are less objective.
- Lack of conservatism, supporters of conservative accounting are alarmed that adopting the fair value model which purports to be unbiased will cause financial statements to be prepared aggressively, therefore reducing its usefulness to creditors, who are one of the most important set of users of financial information.
- Excessive income volatility, under the fair value accounting model income is simply the net change in value of assets and liabilities. Because assets (or liabilities) are typically large in relation to income and because fair values can change significantly across time, changes in fair values of assets can cause reported income to become excessively volatile. Much of this volatility is attributable to swings in the fair value of assets and liabilities rather than changes in the underlying profitability of the business's operations.

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