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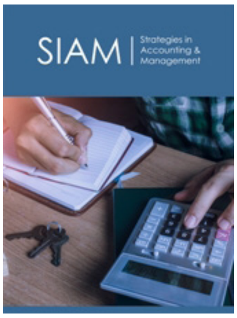
The Revaluation Decision for Fixed Assets After the Covid-19 Crisis: The Italian Case

Alberto Marchesi*

School of Banking, Finance and Insurance, Catholic University of Milan, Italy



***Corresponding author:** Alberto Marchesi, School of Banking, Finance and Insurance, Catholic University of Milan, Italy

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Abstract

This paper aims at discussing the major implications in the case of the recent special law which allows to Italian GAAPs compliant companies the possibility to revalue non-current assets in their 2020 financial statements, one of the various government interventions to face the economic crisis generated by the Covid- 19 pandemic. It appears to be an interesting opportunity for Italian SMEs, which could benefit both from an important increase in equity, with consequent reduction of their leverage ratios, and from relevant tax savings, stemming from tax-deductible higher depreciation against the payment of a moderate substitutive tax. Still, the operation has to be carefully analyzed by companies in its complexity, in order to take an optimal decision on a rational basis, considering the need of full compliance with accounting procedures and requirements, of balancing effects on financial ratios and on risks of future impairment, as well as of compatibility with the company's overall financial strategy and with signaling effects to the financial market. Financial statements after revaluation will also have to be thoroughly studied by banks and other financial analysts, in order to rate correctly the company and to apply adequate loan covenants.

Introduction

The current economic and social context is characterized by a dramatic crisis that spread all over the world because of the pandemic. The problems deriving from the Covid-19 virus do not deal only with the health status of the population, but also with the economic crisis that affected most of the industries. In every country the governments adopted a variety of measures to sustain firms and families. This paper would like to illustrate a special decision adopted by the Italian government, because it can represent a useful example also for other countries strongly hit by the consequences of the pandemic. Italy, in fact, was strongly impacted by the Covid-19 pandemic, with long periods of lockdown or partial restrictions to business activities and social life. In order to face the economic turmoil and downturn generated by the pandemic crisis, the government adopted a number of extraordinary measures for year 2020 and first half of 2021, among which several ones are quite relevant for the accounting and the financial management of companies, such as, for instance: the possibility to postpone loans repayments and leases instalments, the access to additional bank loans with guarantee from State agencies, the softening of the requirements for the going concern assessment in financial statements, the possibility to reduce or suspend the depreciation and amortization of fixed assets[1], etc. One of these measures is the possibility for corporations[2] adopting Italian GAAPs to revalue non-current assets in their end-of-the-year 2020 financial statements[3]: assets interested by this possible revaluation are tangible and identifiable intangible fixed assets, as well as shareholdings in subsidiaries. Focusing on tangible and intangible fixed assets, corporations are allowed to choose the single assets they intend to revaluate, and consequently to apply to these assets a revaluation model; in short, the non-current asset can

[1]In this paper depreciation will be used in its broad sense, including also amortization of intangibles.

[2]The special revaluation law can be accessed also by other firms, which are not the focus of this paper.

[3]Art. 110, titled "General revaluation of firms' assets and shareholdings 2020", of law-decree nr. 104 dated 14th August 2020, titled "Urgent measures for support and recovery of the economy" and named for short "August decree", in its final text as approved by conversion law nr. 126 dated 13th October 2020 [1].

be written at a higher (revalued) net value (i.e., carrying amount), with a corresponding revaluation reserve to be written into equity[4]. The revaluation can be valid: either for accounting purposes only, that is, for the preparing of the financial statement, without any tax relevance; or with both accounting purposes and tax relevance, that is with the additional possibility to obtain corporate tax benefits paying one-off substitutive taxes.

This is not the first time-window in which firms have been allowed, with special laws, to revaluate non-current assets in Italy[5], due to the fact that the Italian GAAPs valuation method for these assets is based on cost of purchase or production at inception, and on subsequent depreciation. The present extraordinary revaluation regulation appears to have strategic relevance, due to the following major facts. (i) SMEs still represent a particularly important part of the Italian economy, even after the negative effects of the long economic crisis which followed the 2008 world financial crisis[6]. (ii) A big number of Italian SMEs, run in form of corporation or small corporation, prepare their financial statements according to Italian GAAPs, with general principles and rules set by a specific financial statements section of the Italian civil code[7] and with important indications given by OIC[8] , the Italian GAAPs standards setter[9]. (iii) Many Italian SMEs are, typically, characterized by quite high financial leverages, with high level of bank and lease financing. (iv) Depreciation is frequently calculated on a straight-line basis, according to maximum yearly rates admitted by tax law, differentiated depending on the industry in which the company operates and considering an average obsolescence of the specific assets class in that industry. This can produce, for profitable firms applying the maximum tax-admitted depreciation rate and with assets subject to lower obsolescence and sound maintenance, underestimated values of net fixed assets and, consequently, of equity, namely of retained earnings. (v) A similar effect holds for fixed assets purchased at the end of lease contracts. In fact, applying Italian GAAPs, in the lessee statement of financial position, outstanding lease contracts are treated not according to their financial substance, but according to their legal form; that is, they are not recognized in fixed assets with corresponding financial liabilities, but are considered as "pure rented" goods (owned by a third party, the lessor) and therefore are excluded from the lessees' statement of financial position[10]. Furthermore, the minimum lease period admitted by tax law amounts to half of the full tax-admitted depreciation period of a similar purchased asset: this means that the end-of-the-lease purchase price of the fixed asset tends to be quite low, but the formerly leased asset, which quite often is purchased by the former lessee at the end of the contract, frequently has still a significant useful life and therefore might still have a higher current value. (vi) Tax benefits are material: by paying a 3% one-off substitutive tax on the revaluation value[11], in subsequent years additional depreciation will be tax-deductible from corporate tax, with current average corporate tax rate around 27.9%[12]. This is a strong incentive to revaluation, makes the exertion of the tax-relevance option quite likely for profitable corporations, but some of them might as well feel entitled to adopt aggressive revaluation policies.

In short, this 2020 revaluation law appears to open for Italian SMEs interesting opportunities. But, at the same time, it gives rise to several issues to be carefully considered, both for a rational, accounting principles compliant, value-creating revaluation decision, and for an effective financial analysis of companies: issues range from the above tax benefits, to the need of assessing past and prospective profitability, to the effects on financial ratios, on comparability, on signalling, etc[13].

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[4]According to Italian GAAPs, no other comprehensive income section of the financial statement is allowed, and the revaluation reserve is written directly into equity. The impact of revaluation and write-offs on equity is deeply described in previous research, such as Lin and Peasnell [2].

[5]For instance, in 1975 and in 1983 two important special revaluation laws (named Visentini one and two, after the Minister of economics who proposed them) were introduced, in order to allow firms to express at more updated values their assets, after the strong inflation of the preceding years. Some other special laws with similar effects were introduced in the following decades.

[6]Manera C, Śmigelska G [3].

[7]Articles from 2423 to 2435-ter of the Italian civil code (titled "On financial statement"), and, in particular, article 2426 concerning valuation methods.

[8]OIC - Organismo Italiano di Contabilità (Italian Accounting Standards Board), issuing national accounting standards (named "OIC") and interpretation documents (named "Documenti interpretativi").

[9]Listed companies, banks, other financial entities, and insurance companies are required to apply IFRSs; other companies, not required to apply IFRSs, can adopt them on a voluntary basis.

[10]Specific financial information on leases is required in the notes to the financial statement of the lessee.

[11]The revaluation rules allow also the possibility, with the payment of a second and additional substitutive tax, of assuring tax recognition to the revaluation reserve, but this further aspect is not within the aim of this paper.

[12]Although the fact that Italian tax rules are more articulated than that, and the obvious need for the single company to consider its own specific tax profile, the 27.9% rate can be roughly estimated as the sum of a national corporate tax rate of 24% and of a regional one of 3.9%.

[13]For a dissertation about motivation and choice of the items to revalue see Choi [4] and Missonier-Piera [5]. Na Ra [6], considering Korean companies, discuss about the balance between out-of-the-pocket costs (namely for incurring in appraisal fees) and the benefits from related higher revaluation value. They analyze the 2008 case, when the Korean Accounting Standards Board granted the asset revaluation, in order to smooth out the effects from mandatory K-IFRS adoption scheduled to 2011: since the authors focus on land revaluation only, their study considers a case not affecting both reported profits and taxes.

The revaluation value problem

Deciding the value of the revaluation, if any, is of primary importance from the financial information point of view, that is for the financial statement of companies. In fact, the revaluation rules set by the law and by OIC indicate as maximum values for the fixed assets after the revaluation "values effectively attributable to assets considering their substance", based on either value in use ("production capacity and effective possibility of economic use in the firm") or market value ("current values")[14]. A correct process for the revaluation decision should be articulated as follows: (1) preliminary analyses by the company; (2) appraisal by an independent expert[15]; (3) revaluation decision by the board of directors, to be included in the year 2020 financial statement proposed to shareholders, duly explained and motivated by directors in the notes to the financial statement and by statutory auditors in their report[16]; (4) approval of the financial statement by the shareholders' meeting.

These activities shall be particularly accurate and comprehensive, since fixed assets values and their obsolescence pose complex, and differentiated, problems. Major areas to be considered can be summarized as follows. (i) For tangible fixed assets, technical issues concerning production capacity, productivity, useful life, foreseeable major maintenance expenses, and compliance from the labour-safety, product-safety and environmental points of view, etc. (ii) For identifiable intangible fixed assets - like patents, trademarks, or similar - the legal protection profiles, considering the countries in which they are registered, expiry dates, possibility of renewal, etc. (iii) For all fixed assets, their contribution to future gross profit margins and cash flows from operations, to be studied in appropriate financial plans. (iv) For all fixed assets: their updated depreciation schedule after the revaluation; a mid-term general budget of the firm, covering at least three years, in order to appreciate the reasonably foreseeable capacity of the state of income of the whole company to carry higher depreciation in the future.

In addition, and related to the former accounting-focused areas, further managerial issues shall be considered in the analysis. (v) Reflections on the increase in the risk of incurring in future impairments, since Italian GAAPs require an impairment procedure, based[17]: either on measurement of the fair value less cost of disposal and of the value in use of CGUs, substantially in line with IFRSs; or, for SMEs under specific dimension limits, on an optional simplified procedure, named depreciation capacity test, considering a mid-term income budget of the entire company or, if possible and relevant, of its major businesses. In any case, the higher the revaluation value, the residual useful life and the business risk, the higher the risk of incurring in future impairments. (vi) Compatibility with the overall financial strategy of the company. It's a vast area, which could pose different problems, depending on the features of the financial policy of the single company. For instance, relevant issues could stem from the reduction of EBIT, produced by the increase in depreciation: the reduction in EBIT could limit the future capital expenditure programs, due to lower remaining depreciation capacity for the new investments; the reduction in net profit, produced by the reduction in EBIT higher than the tax savings, could lead to restrictions in dividend policy for some years[18]; etc.

The effects on financial ratios, and the comparability and signalling issues

The revaluation operation and its dimension have also to be considered for their effects on financial analysis. Financial analysts shall weigh all the above discussed issues in order to appraise the grounds of the operation and its accounting, managerial and tax facets; furthermore, both managers of the company and financial analysts shall examine a wide set of implications concerning key financial ratios, interpretations to be given to revaluation reserve, comparability issues, and signalling effects[19]. As for key financial ratios, first of all and of course, financial structure positive effects, in terms of reduction of total leverage and of financial leverage (including widely used ratios, like Net financial position/Equity), are expected. Secondly, in the case of tax-relevant revaluation, the reduction in tax cash outflows over the period of the higher depreciation will - all other conditions being equal - produce increases in future cash flow from operations, exerting a positive effect both on cash flow related ratios (Cash flow/Net financial position, Cash flow/Sales, etc.) and, ultimately, on the company value measured in terms of present value of its future free cash flows.

[14] Art. 110, of law-decree nr. 104 and OIC - Interpretation document 7 [7].

[15] The appraisal is not required by law, but it is considered particularly appropriate and advisable by best practice, in order to provide a documented basis to the decision and to limit potential future legal responsibilities for directors and statutory auditors, who are required to certify that the revaluation doesn't exceed the maximum attributable value, and for accounting auditors, who audit the financial statement.

[16] For a complete discussion of the benefits of revaluation for shareholders, see Bae [8].

[17] Even if the Italian fixed assets accounting system is cost-oriented and not fair value-oriented, specific requirements are set for "permanent losses in value", which make recoverable value of a fixed asset lower than its carrying amount, in a long-term perspective. See Art. 2426, nr. 3, Italian civil code, OIC 16 - Tangible fixed assets, OIC 24 - Intangible fixed assets, and OIC 9 - Impairment of tangible and intangible fixed assets for permanent losses in value [9-11].

[18] This reduction in dividends could, for instance, generate problems in a small group, with the holding in need of cashing dividends in order to repay loans or to finance other investment plans, or in cases in which a fairly stable payment of dividends to shareholders is requested (family owners, merchant banks, etc.).

[19] Gaeremynck, Veugelers [12].

These are evident benefits from the operation, but not all that glitters is gold.

A number of other effects on key financial ratios shall be considered, among which: the fact that reductions in the various leverage ratios will be different for each company, depending on industry, specific business features, intensity of fixed capital and of working capital from operations, life cycle of existing fixed assets, previous leverage level, etc.; EBITDA will not be influenced, and, with it, some widely used EBITDA related measures will remain unchanged (EBITDA/Sales, Net financial position/EBITDA, EBITDA/Interest expense, etc.); the increases in fixed assets, depreciation and equity will negatively influence profitability ratios, like ROI and ROE, as well as capital efficiency ratios, like Sales/Total assets, Sales/Total fixed assets.

Furthermore, the analyst's opinion on the revaluation will condition the interpretation given to after-revaluation values in financial statements and ratios: the analyst might consider the after-revaluation values either as better representing the financial structure of the company, or, on the contrary, as partly or totally unjustified, and, on these different bases, formulate quite different assessments[20]. This issue becomes even more important in the case of intangibles, since not a few analysts and internal rating systems tend to adopt a prudent approach not only to goodwill (topic not discussed in this paper) but also to identifiable intangible values recognized in assets, considering the latter - no matter if right or wrong - as the measure of particularly risky expectations to favourably exploit these specific conditions in future and not as value-creating strategic drivers: some analysts and internal rating systems, in the set of financial ratios used, include tangible net worth[21] and consequent tangible financial structure ratios, in addition to standard equity and leverage measures.

Therefore, a comprehensive analysis of the effects of the revaluation on key financial ratios of the company appears to be advisable. Not to be forgotten the comparability issues, arising from the fact that revaluation is one of the major cases of inconsistency of financial data and ratios. Using the specific information on revaluation which is required in the notes to the financial statement[22] and other information from the company, analysts shall consider the need for adjustments, in order to compare correctly both the dynamics of the company in time and its position versus competitors or industry average data. In particular, starting from these general issues, analysts of banks and of other financial institutions shall also consider: the effects of revalued data and adjustments in the internal rating assignment process; the need to correctly tune financial covenants on existing and future loans. Last, but not least, the problem of the signalling content and of its effects. In general terms, not necessarily limited to Italy nor to the special law discussed in this paper, the revaluation operation is a relevant signal to the financial market, and, as such, its possible interpretations shall be carefully weighed. It's a delicate matter, with no straightforward answer, since interpretation might differ, even strongly, depending on differences in countries, historical periods, position of the analyst, approach adopted by the entity analyzing the company, situation of the company, etc. Considering the revaluation regulated by law-decree nr. 104/2020 discussed in this paper, some more specific reflections arise on the signalling issue, not necessarily complete. Since this special law was introduced to incentivize corporations to recognize their higher values in assets and equity, face the economic downturn due to the pandemic: for companies not particularly hit by the crisis and showing in 2020 either good profitability or not particularly heavy reductions in profits, revaluation could be seen as a signal of strength, highlighting financial structure soundness and future profitability, associated to benefits from prospective tax savings; in companies more hardly hit by the crisis and accounting in 2020 for heavier reductions in profits or for losses, it could be read in a similar, of course less strong and more uncertain, perspective, but it could also be read as an attempt to postpone the full emersion of the disruptive effects of the crisis on profitability and equity[23]; for companies recognizing particularly relevant revaluation values, it could be viewed as a signal of particular strength, or of an excessively aggressive use of the operation; for companies not opting for revaluation, it could be seen as a signal of prudence, or of obsolescence of the production structure, or of a financial policy oriented towards new investments in advanced-technology and more efficient assets[24]; for companies revaluing patents or trademarks, as a signal of the importance of the intangible asset within their overall strategy. Of course, the relative size of the revaluation should also be considered: the revaluation

[20]Paik [13].

[21]Named also tangible equity, calculated as the difference between total equity and intangible assets.

[22]Major disclosure requirements can be summarized as follows: art. 2423-bis of Italian civil code (Principles of financial statements) requires that, when a valuation method is changed from the former financial year, the notes to the financial statement shall explain the grounds of the change and disclose its effects on the financial statement; art. 2427 of Italian civil code (Content of the notes to the financial statement) requires to disclose, for fixed assets, the revaluations operated during the fiscal year and the total value of revaluations at the end of the year; OIC - Interpretation document 7 requires to disclose in the notes to the financial statement the reference to the special law of revaluation, the revaluation model chosen, and all other information requested on revaluation by OIC accounting standards.

[23]Although it should be considered that, at the light of the discussion conducted in this paper, particularly fragile and hardly-hit by the crisis companies don't seem to be in the condition to access correctly to relevant revaluations. Furthermore, as anticipated in the Introduction, for companies in difficult situations, other extraordinary measures have been introduced by the government.

[24]For which particular tax incentives are available.

[25]The value in use or market value from the appraisal is the maximum limit of possible revaluation. Of course, the board of directors can decide, for several reasons among which prudence and overall compatibility, to recognize a lower revaluation value.

operated should be compared to the maximum limit of a reasonable market value or value in use which could have been recognized for the asset[25], but also compared to the size of the company. All this highlights the need for a sound analysis and interpretation of the financial and business situation and perspectives of the company which operated the revaluation, in order to appreciate correctly the signal; as well as of monitoring the company in subsequent years.

Conclusion

The Italian special revaluation law discussed in this paper, introduced as one of the extraordinary measures for helping SMEs to tackle the economic crisis produced by the Covid-19 pandemic, seems an interesting and complex case. Even if not based on empirical analysis, some major indications emerge from the above discussion. For profitable or fairly profitable companies, the operation appears interesting, for the chance to express their assets and equity at current values, accompanied by the tax savings allowed; an excessively aggressive revaluation is not advisable. For weaker companies, it still appears possible, but with increased need of attention to all its implications. For strongly distressed companies, it doesn't seem appropriate, and other policies should be considered. Companies not accessing to revaluation should be studied in their reasons for that. Revaluation of identifiable intangible assets should be approached with a particular attention to the contribution of the asset to the company's strategy.

In any case, the revaluation operation should be performed and analyzed looking carefully at the trade-off between expected benefits and complexities, disadvantages and potential risks, including signalling effects to the financial market, not straightforward in their outcomes. Analysts of banks and other financial institutions are requested a particular attention, in order to understand the grounds and quality of the operation, as well as to consider revalued data in an appropriate and consistent way and manage correctly loan covenants. Of course, no empirical research on the topic was possible at the moment of writing this paper. Further research could examine: in a short term perspective, the financial statements for year 2020, in order to study the profiles of companies which have revalued their assets compared to the ones which haven't, the size of the revaluation, its impact and its foreseeable effects; in a mid-term perspective, the financial statements for subsequent years, in order to study the impact and effectiveness of the revaluation law, in terms of overall resilience of Italian SMEs having accessed the revaluation, for what concerns economic performance, financial structure, cost of debt and lease financing, real benefits from the tax incentive. These analyses should also consider the possible bias of the other extraordinary measures adopted by Italian government to face this unexpected and complex economic crisis.

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