

# FROM ACCOUNTING REGULATIONS TO VALUATION PRACTICE - THE APPRAISER'S ROLE IN TANGIBLE ASSETS' REVALUATION

**Crişan Sorana Adina**

***Babeş-Bolyai University, Faculty of Economics and Business Administration***

*Tangible assets revaluation has an impact over equity, profit and the financial indicators of the company, several being relevant for the decision making process of investor's and company management. The revaluation process is usually done by valuation experts who have to start their mission departing from the accounting information regarding the revalued assets. A sound understanding of accounting rules and of the necessities of the revaluation process is essential for a reliable revaluation. Lack of specific accounting knowledge on the valuer's side can lead to distorted representations of the valued assets which will affect faithful representation, have accounting and fiscal impacts and can also raise problems when auditing the company. The quality and valuation expertise of the called-in appraiser are also relevant for the outcome of the revaluation process, especially if market values evidence is scarce or the revaluated assets are highly specialised. We present the actions that the valuer and the entity have to pursue in order to ensure a reliable revaluation process, contributing thus to a better understanding of the practical approach to assets revaluation and its specific requirements.*

*Keywords: tangible assets, revaluation, appraisal, fair value*

*JEL Classification: M49*

## **1. Introduction**

The tangible assets can be revalued periodically as IAS 16 provisions respectively OMFP 3055/2009 allow an alternative treatment: maintenance at cost or revaluation at fair value. In Romania, due to Fiscal Code stipulations, companies often revalue fixed assets, especially buildings, every three years. The results of these revaluations have an impact over the financial statements of the revaluing companies which can be split into accounting impact and fiscal impact. These results are opposed to the management of the company, auditors and fiscal bodies of control, the public. The revaluation itself is made, as stipulated in both IAS 16 and OMFP, by valuation professionals. The company can choose to have it done by the management and in this case the reliability of the management's own assessment of values can be an issue. In either case, it is important that the results of the revaluation are accepted by all involved parties and that the financial situations resulted will reflect a faithful representation.

We aim to offer a relevant picture of all elements involved in the revaluation process: decision drivers and management incentives, legal stipulation, international financial reporting standards, international valuation standards, valuation practice and its practical requirements and limitations, mirroring their actions and interactions. The goal is to highlight the importance of the approach of the revaluation process in itself and to put an emphasis on the role of the independent expert – the appraiser – whose expertise and knowledge of the particularities of this kind of valuation mission are essential for the outcome of the revaluation process. The key to reliable revaluation of fixed assets is based as much on the company's policies and support offered to the appraiser as on the appraiser's own quality, experience and knowledge of the needed approach. Our analysis will show that without specific accounting related knowledge, the appraiser will have difficulties in providing a reliable result of his mission. This way, we contribute to a better understanding of this process, of the importance of the interaction between the appraiser and the entity and of the importance of employing a valuer with sound valuation expertise but also accounting knowledge related to this process.

The article unfolds as follows: first, we present the research methodology used. Second, we make a literature review, aiming to offer reflections of the literature's general position relative to fair value and the fair value concept and, in particular, to the existing conclusions with regard to

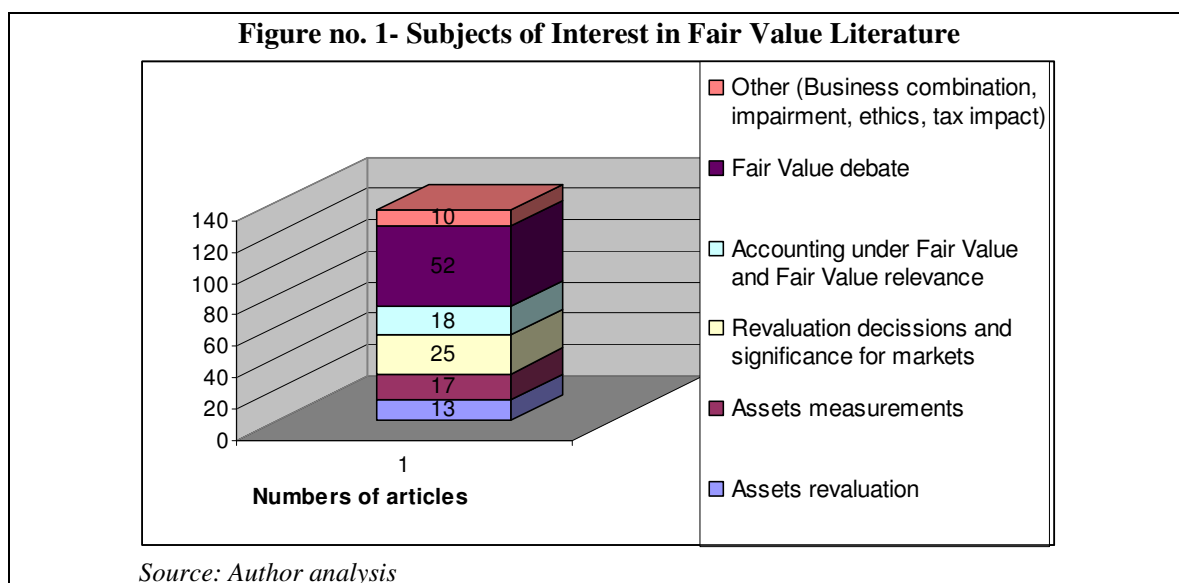
incentives behind assets revaluations. Our literature review will also show how often the revaluation of tangible assets and valuation practical problems are issues that were researched. Then, our findings are presented in mirroring tables forms in order to enhance the interactions between domains. We then draw conclusions and point to further research possibilities.

## 2. Research Methodology

Our research is situated at the frontier between accounting and valuation. Literature review has involved both a qualitative and quantitative analysis, allowing us to draw conclusions with regard to the frequency of the themes of interest pursued and their content. We have relied during our research process on content analysis, comparative analysis and critical analysis. Our content analysis is orientated to the meaning of the studied documents. Regulations and standards were studied using description and explanations techniques. Comparative analysis was used in order to emphasis resemblances and differences between standards. In the end, critique analysis is used to highlight difficulties when comparing regulations with practical possibilities in valuation.

## 3. Literature Review

Discussions over fair value are numerous and embrace many of the domains where fair value has an impact: relevance of fair value for financial reporting, fair value versus cost, the role of fair value during the financial crisis, investors' perceptions with regard to fair value, reliability of fair value etc. As our research is focused on revaluation of tangible assets, we have proceeded first to position this subject in the larger context of the debate regarding the quality, importance and relevance of financial reporting under fair value. We have reviewed first articles published in established academic accounting publications but also several articles written by practitioners and opinion leaders from relevant fields, including speeches gave by financial world personalities. Our review has settled for 135 articles. We have then divided the subjects of interest in several categories obtaining the following spread:



Most of the debate is concentrated on the fair values pros and cons and its role in the financial crisis. Another important topic is related to the decision of revaluation and the reactions of markets and investors to revaluation of assets. Asset measurement, as a separate topic, represents about 13% of the reviewed articles, allowing us to believe that the subject is less under focus due to involvement of another profession – valuers.

Incentives behind the revaluation of assets are researched in the literature with the use of empirical research mostly. The prevailing motives scrutinised are: influence over leverage indicators of the companies (Cotter and Zimmer 1995: 150, Gaeremynck and Veugelers, 1999: 135, Missonier Pierra, 2007: 23) and earnings management (Bartow 1993: 854, Black, Sellers and Manly, 1998: 1314-1316). Other incentives as information asymmetry reduction, company size, assets nature are also analysed. Quagli and Avalone (2010: 461-493) in an empirical study over real estate companies in Europe which are first time adopters of IFRS demonstrate that the decision to choose the fair value model is motivated by information asymmetry, contractual efficiency and management opportunism.

Nevertheless, attention to the necessity of employing specialised experts is drawn by Mary Barth (IFRS standard setter), showing that “*accountants must become more comfortable with valuation theories, techniques, and practicalities*” (Barth, M., 2007:14). Cotter and Richardson, in an empirical study made on 225 firm-assets-class in Australia (1981 to 1999) find that independent revaluations of plant and equipment are more reliable than revaluations made by company management (Cotter and Richardson, 2002: 438).

#### **4. Research Results**

Regarding the revaluation of tangible assets, the regulations to be abided are those stipulated by OMFP 3055/2009 and the provisions of the applicable financial reporting standards (IAS 16, IAS 17, IAS 40, IAS 36) applicable. Starting with January 2013, a new standard will be in force: IFRS 13 – Fair Value Measurement which brings higher convergence with US GAAP stipulations regarding fair value and also orientates the fair value definition towards an exit value. The stipulations of today's in force regulations are outlined below. These specific requirements have an impact over the valuation approaches when the company decides to revalue the assets at fair value due to the interaction between accounting and valuation practice.

*IFRS and OMFP stipulation regarding tangible assets treatment:*

- an item of property plant and equipment is recognized as an asset only if it is probable to bring future benefits to the company and its cost can be measured reliably;
- assets are initially measured at cost or at fair value. OMFP makes no distinction between assets held for sale or as investments while IFRS stipulates different measures for these categories;
- land is not depreciated;
- several initial expenses can be capitalised in the assets value (e.g. dismantling and removal costs, financing expenses, operational losses of the first period) but these provisions are not entirely consistent between the two mentioned reference systems (e.g. OMFP does not mention first period's operational losses as eligible for capitalisation);
- several subsequent expenses can be capitalised in the asset's value (modernisations, if meeting the capitalisation requirements, new spare parts of significant value, major overhauls and periodical inspections);
- IFRSs state that the depreciable amount of an asset is determined after deducting its residual value;
- after recognition, the entity can choose the cost model or the revaluation model. If choosing the revaluation model, the revaluation shall have to be applied to the entire class of assets. Revaluations shall be made with sufficient regularity.
- fair value is usually determined on market-based evidence through appraisals made by qualified valuers. Assets can also be evaluated using the cost approach when no active markets can be identified or using an income approach for those assets which are usually sold as part of an on-going business;
- when applying the revaluation model, the entity will re-calculate the book values and depreciation of the revalued assets. There are two models for depreciation re-calculation: (1)

proportionally with the change within the asset value, the revalued value being the new net book value and (2) by eliminating the depreciation from the gross book value of the asset and restating the net book value at the revalued value of the asset;

- fixed assets have to be tested for impairment especially when there is an indication that it might be the case. The relevant standard is IAS 36 – Impairment of Assets;
- revaluation differences are impacting the company's equity and depending upon their bearing and the existence of previous reserves from revaluation they can lead to a reserves' increase or an expense.

*Fiscal stipulations regarding revaluation of assets:*

In our country there are also fiscal regulations to be taken into account, as in Romania taxation of buildings property of companies is made in direct connection to book values. Land is not taxed in connection with book values. Relevant provisions are:

- taxation is calculated in relation with gross book value of buildings;
- taxation quota is different depending upon the duration since the last revaluation date (higher as the last revaluation is older);
- for entirely depreciated buildings the taxable value is reduced with 15%;
- in case of a decrease following the revaluation of fixed assets (below cost), the difference in depreciation is not a deductible expense.

The direct connection between buildings taxation and registered book values makes Romanian companies to revalue their tangible assets registered in the first accounting group regularly. It is expected that the recent increase of this taxation quota and the inclusion of the second interval (buildings not revaluated for more than five years) at an even higher tax percent will result in an expansion of the mass of buildings being revaluated rhythmically.

*Revaluation impact:*

Considering both accounting and fiscal stipulations it is to be noted that the level at which tangible assets are being revaluated has more than one effect. This effect is different from accounting to fiscality and depends upon the differences from revaluation. Revaluation of assets impacts the company's financial position and can subsequently influence its financial performance. An upward revaluation will lead to an increase in assets and equity and modify relevant financial ratios, thus influencing the decisions taken by the users of financial reports. Accounting profit will be diminished. Local tax will increase while profit tax will not be affected (or will decrease due to a higher local tax expense).

In the opposite case, when revaluation results in a decrease of value, the impact is correlated with the existence of previous re-valuation reserves. If values do not decrease under cost, accounting impact will be a decrease in assets and equity and a raise in accounting profit. Fiscal impact will be a decrease of local tax and profit tax will not be affected (or will increase due to a lower local tax expense). If values decrease under cost the accounting profit will also be affected due to an increase of expenses.

*The valuation approach:*

Most often companies revert to valuation professionals in order to perform the required valuations. Valuers in Romania are members of the professional body known under the name of ANEVAR (National Association of Romanian Valuers) and the profession was recently regulated by the Government under a new professional body named Uniunea Nationala a Evaluatorilor Autorizati din Romania. In practice, Romanian valuers (or appraisers) abide by the provisions of the International Valuation Standards (IVS), the standards applicable starting with January 2012 being the 2011 edition. For valuation for financial reporting the relevant standards applied are IVS 300 – Valuation for Financial Reporting and all other standards with

incidence in valuation of assets. IVS 300 mentions that IFRS's definition of fair value is consistent with IVS's definition of market value.

Considering all requirements made by IFRSs, Romanian accounting regulations and fiscal code (reviewed above) and practical approaches and possibilities of the appraisers, we present below the action-reaction table [Table 1] between accounting and fiscal requirements and the appraiser's approach necessary in order to make the revaluation process reliable, recognised and approved by the auditor and with consideration to the accounting and fiscal impact.

**Table 1 – The connection between accounting and fiscal demands and valuation process**

<b>IFRSs and OMFP 3055 provisions</b>	<b>Valuation process</b>
Conditions to be recognised as an asset	<ul style="list-style-type: none"> <li>- the appraiser requests the fixed asset register (FAR) from the company;</li> <li>- identification and description of the valued assets;</li> <li>- assessment of the possibility of obtaining a "reliable" valuation given the assets to be evaluated and market information available.</li> </ul>
Revaluation of the entire class	- the appraiser should check the reconciliation between the FAR and trial balance. If this information is not provided to the valuer, appropriate disclaimers have to be included in the valuation report.
Capitalisation of initial expenses	- this can raise valuation issues as initial expenses might not be recognised when marking to market;
Subsequent expenses capitalisation	<ul style="list-style-type: none"> <li>-the appraiser has to ask and the entity provide all correspondence cases between a principal asset and the items of modernisation or other subsequent expenditure capitalised for the respective asset;</li> <li>- the appraiser has to ask and the entity to provide the list of on-going investments (fixed assets in progress) in order not to double their value by including the investment into the valuation of the subject asset;</li> <li>- the asset is valued „as it is" and subsequently the value can be allocated (unless the entity decides to unify all FAR positions).</li> </ul>
Different approaches depending upon asset type and market information available	- the appraiser, based on entity information, has to classify the assets subject to revaluation into sub-categories (used in operation, non-core assets, held as investment etc.) before deciding on valuation approach.
Alternative treatments in re-computation of book values and depreciation	- the outcome of the valuation process is a value that corresponds to the net book value. Appraisers should not give another indication and the approach in re-computation of gross book value and depreciation is the entity's decision.
Impairment	- when revaluation of fixed assets is based on the cost approach the appraiser has to advise about the necessity of applying an impairment test or can perform if it was foreseen in the services contract
Totally depreciated assets	- these have to be revalued if they are still operated by the entity and bringing benefices to the entity. If agreed with the company, the valuator can make estimates of the future life duration of these assets for the purpose of depreciation computation.

Land is not depreciated. Property tax is calculated at gross book value for buildings but has no correlation with the registered value for land.	- allocation of value between land and buildings for real estate type properties (where the valuation approach is either income approach or market approach for the property treated as a whole – land + building). - buildings' gross book value recalculation treatment is the entity option.
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*Source: Author analysis*

Besides the above noted, the appraiser has to abide by all valuation and valuation reporting requirements included in the International Valuation Standards. Before starting the valuation process it is important that the appraiser establishes the conditions within which the appraisal is being made, respectively the company is an on-going concern or is being liquidated.

## 5. Conclusions

Depending upon the direction of the revaluation results of tangible assets (upwards or downwards) revaluation may have an impact over the financial indicators of the company and influence decision makers which use the financial statements. Various requirements and possible accounting treatment regarding tangible assets recognition, initial and subsequent measurement, depreciation policy and impairment are reflected in the registered value levels and completeness of the fixed assets register which is, for the appraiser, the basis from which revaluation process begins. Understanding of accounting rules and of the necessities of the revaluation process is essential for a reliable revaluation. The appraiser has to be familiar with specific requisites while the entity has to provide the valuer with all relevant information plus access to the appraised assets. Lack of specific accounting knowledge on the valuer's side can lead to distorted representations of the valued assets (e.g. not considering assets' classification in establishing the valuation approaches, not allocating separate values for land and building, doubling the effect of on-going investments etc.) which will affect faithful representation, have accounting and fiscal impacts and can also raise problems when auditing the company. In the meantime, the quality and valuation expertise of the called-in appraiser are also relevant for the outcome of the revaluation process, especially if market values evidence is scarce or for revaluation of specialised assets. Impairment analysis is another important aspect, when the appraiser is required to perform it.

The valuation issues to which we have pointed in this article can lead to further research. Many of these are related to the financial reporting standards requirement of measurement and subsequent expense capitalisation versus practical possibilities of the valuation process. The new fair value definition included in IFRS 13 also opens the road to analysis of the exit value versus market value, which should also be placed in the context of this standards' relevance for the Romanian market. Also, further research might involve a study in order to establish if for Romanian companies buildings taxation (as stipulated by the fiscal code) is the main driver of revaluation and not the requirements of faithful representation or other managerial incentives.

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