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Fixed Asset Revaluation Motivations
Les Motivations De Revaluation Des Immobilisation

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Abstract:
The purpose of our research is to highlight, by means of case study, potential motivations that can be behind asset revaluation. The results from this study indicate that the motivation that can be behind the revaluation decision is to convey a faithful image of the company situation to different stakeholder. Improving borrowing capacity, management opportunism and political costs are not fond to influence the revaluation decision of this company.

Keywords: Asset revaluation motivations; Fair value, financial statements.

(JEL) Classification: M41.

Résumé:

L'objectif de notre recherche est de mettre en évidence, au moyen d'études de cas, les motivations potentielles pouvant être à l'origine de la réévaluation des actifs. Les résultats de cette étude indiquent que la motivation qui peut inciter la décision de réévaluation c'est de donner une image fidèle de la situation de l'entreprise aux différentes parties prenantes. L'amélioration de la capacité d'emprunt, l'opportunisme des gestionnaires et les coûts politiques n'ont aucune influence sur la décision de réévaluation de cette société.

Mots-clés: Motivations de réévaluation des actifs; Juste valeur, états financiers.

(JEL) Classification : M41

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1. INTRODUCTION:

In countries without a developed stock market, financial statement is the major accounting information source to investors, banks and debt holders. Hence, financial statements should be relevant and faithfully represented for making better resource allocation decisions. For preparing a useful financial statement to users companies are allowed to revalue their assets at fair value.

While the aim to present useful financial information is a legitimate goal, managers use discretion in revaluation for other purposes more or less legitimate. Besides presenting a faithful image, studies have shown a numerous motivations to asset revaluation, fall in one of these categories: improving borrowing capacity, the intensity of assets, management opportunism and political costs.

In Algeria, firms can choose whether or not to report a revaluation in the financial statements (***FAS, 2008***). However, motivations in this context are not yet studied, maybe because of the newness of Algerian accounting and financial environment of the concept of fair value in general.

The purpose of our research is to highlight, by means of case study, potential motivations that can be behind asset revaluation. A revaluation of fixed assets may be required to accurately present the true value of the capital goods a company owns. And the main objective of financial reporting is to provide useful financial information to users in making decisions about providing resources to the entity (IASB 2010). Thereby, we suppose that the primary motivation of asset revaluation is to show the fair value of the firm properties.

The rest of the paper is organized as follows: first, we present a literature review on findings regarding motivations behind revaluation decision. Second, we show the impact of asset revaluation over the company's financial statements and highlighting the possible motivations behind revaluation decision. Third, conclusions and further research possibilities are made.

2. Literature Review:

The main purpose of asset revaluation is to present a fair value of company properties to users in order to make better resource allocation decision. But managers' motives behind revaluation decision are diverse (***Adina, 2013***). The extant studies consider that the main motivations are: (A) improving borrowing capacity, (B) faithful representation of the firm image, (C) the intensity of assets, (D) management opportunism and (E) political costs (for large companies).

A. Improving borrowing capacity:

Improving financial image was one of the most studied motivations. Many studies consider that risk of violating financial covenants; cash flow difficulties and better access to financing are serious incentives behind asset revaluation decision.

Cash flow difficulties motivate managers to revalue their assets to give lenders the perception that the firm is in well financial health. (***Cotter and Zimmer, 1995***) argue that the economic benefits associated with an asset revaluation are greatest for firms when they are experiencing times of declining cash flows from operations. That is, the revaluation enables firms to access additional borrowing capacity in times where cash flows from operations are declining, indicating to lenders that the firm may have a problem servicing further debt. From the opposite side, firms that have undertaken an asset revaluation are more likely to be experiencing declining cash flows from operations than firms that have not revalued.

Violating financial covenants incite firms to revalue assets in order to avoid litigations with creditors. (***Brown et. al, 1992***) find that firms that revalue their assets were more highly levered, closer to violating their debt covenant constraints. Moreover, (***Gaeremynck and Veugelers, 1999***) find that, when their net worth is lower, firms which are close to covenant violation are more likely to revalue their assets.

Better access to financing also drive managers to revalue fixed tangible assets in hope to enhance borrowing capacity of their firms. Firms incorporating explicit borrowing limitations and aiming to improve their borrowing capacity are more likely to revalue, particularly if they are also highly levered (***Whittered and Chan, 1992, Jaggi and Tsui, 2001***). In addition, (***Easton et. al 1993***) consider that the level of revaluation reserves has a significant explanatory power for the stock price of companies with important debts and high changes in debt-to-equity ratio. Results in (Pierra, 2007) show a positive association between revaluation and leverage, suggesting that revaluation is used as a device to improve creditors' perceptions of the firm financial health, and thereby improve the firm's borrowing capacity.

B. Faithful representation of the firm image:

Conveying true and fair image of the company is one of the motivations behind revaluation, especially when companies have favorable opportunities for growth. (***Whittered and Chan, 1992***) note that firms undertaken revaluation appear to have more growth opportunities than non-revaluers. And evidence provides that revaluations are motivated by conveying the fair value of fixed assets to financial statements users (***Jaggi***

and Tsui, 2001). Moreover, (***Easton et al. 1993***) conclude that book values including asset revaluation reserves are more aligned with the market value of the firm than book values excluding asset revaluations. That is, asset revaluation reserves help to provide a better summary of the current state of the firm. (***Quagli and Avallone, 2010***) also identified that, the need to reduce information asymmetry between management and stakeholders is also a motivation of revaluation.

C. Assets intensity:

Studies also find that revaluations of fixed tangible assets are motivated by the intensity and complexity of these assets. (***Brown et. al, 1992***) find that revaluers were larger and had relatively higher property holdings. Additional results in (***Diantimala et. al, 2019***) show that, from the firm size perspective, bigger firms are more likely to choose asset revaluation.

D. Management opportunism:

The opportunistic behavior of managers can push them to use discretion on their favor when revaluing assets. The findings in (***Hu et. al, 2015***) indicate that asset revaluations are positively associated with earnings management. Furthermore, companies that used revaluations undertaken by directors have higher discretionary accruals than those that employed external valuers. Nevertheless, (***Black et. al, 1998***) provide evidence that firms which revalue assets in the UK and New Zealand do not appear to engage in income smoothing behavior.

E. Political costs:

Afraid of additional costs, which they can be charged to large or successful firms, managers may resort to revaluation to mitigate that risk. (***Brown et. al, 1992***) indicate that firms which declared bonus issues were more likely to revalue, as were those facing a takeover, presumably to frustrate the bidder. The results in (***Brown et. al, 1992***) are consistent with the proposition that an asset revaluation lowers the probability of a wealth transfer arising from contracting and political costs. (***Seng and Su, 2009***) add that revaluations are used by large firms to reduce political costs. However, (***Quagli and Avallone, 2010***) find that political costs reduces the likelihood of using fair value (revaluation).

3. Case study:

We have used a case study to illustrate the possible impact of revaluation decision over financial statements. The case study is made over the financial statements of Saidal Company, the leader in medicines production in Algeria, and the data was picked from its web site (***saidalgroup.dz***).

Our goal is to compare how the decision of revaluing or not revaluing fixed tangible assets can impact the financial statements and financial ratios, thus influencing financial statement users' decisions. The case study will allow us a quantitative assessment of this impact, even if limited to the actual situation of the subject. Our analysis is limited to fixed assets revaluation, as these are the ones most revaluated by Algerian companies.

We can conclude from company financial statements that, revaluations are made every year, and this will allow us to make a comparison over the period of 2014 to 2016. This case study analyses the impact of the revaluation decision over:

a) Debt to equity ratio as a proxy of borrowing capacity;
b) Return on assets ratio as a proxy of management opportunism;
c) Tax pressure ratio as a proxy of political cost.

For asset intensity we need more than one company to assess whether the revolution was motivated by this factor or not. Nevertheless, this company is one of the complex firms in Algeria in terms of asset.

If we cannot find any of the previous three factors as a motivation for revaluation decision, we can infer that the motivation behind the revaluation decision is to convey a faithful image to users of company financial statement.

A. Improving borrowing capacity:

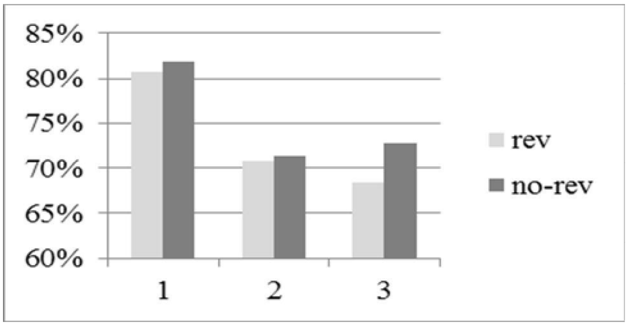
To appreciate improving borrowing capacity motivation, we calculate the debt to equity ratio, with and without revaluation.

Table 1: Comparative debt/equity ratio.

	2014	2015	2016
rev	80,74%	70,85%	68,41%
no-rev	81,82%	71,37%	72,81%

Source: The Authors

Figure 1: Comparative debt/equity ratio.



Source: The Authors

Comparing debt to equity ratios between the two alternatives (in table 1 and figure 1); shows that the revaluation has not improved of the borrowing capacity of the company in a significant manner except in the year of 2016. Thus we can conclude that the borrowing capacity was not an important motivation when company decides to revalue its fixed assets.

B. Management opportunism:

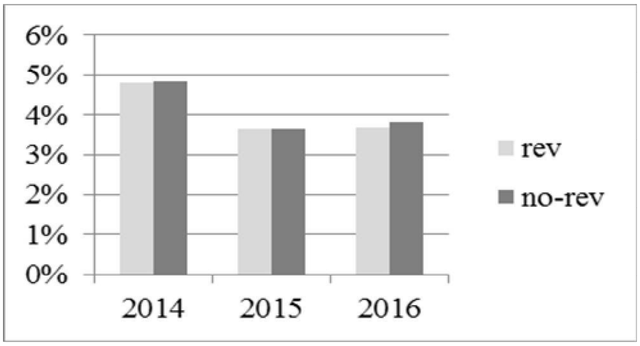
Because we have no information about the manager's contracts and compensation, we consider management opportunism as the desire of managers to convey a good image of the company to owners by mean of revaluation discretion; therefore we calculate and compare the return on assets ratio ROA for the two alternatives.

Table 2: Comparative return on assets.

	2014	2015	2016
rev	4,80%	3,63%	3,67%
no-rev	4,84%	3,65%	3,81%

Source: The Authors

Figure 2: Comparative return on assets.



Source: The Authors

The table 2 and figure 2 indicate no significant change in the return on assets ratio for both alternatives (even a regression of the ratio after the revaluation decision), so we can infer that management opportunism was not a motivation for the revaluation decision.

C. <u>Fiscal impact:</u>

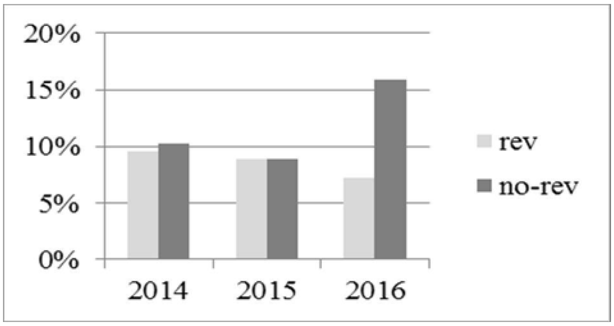
For assessing fiscal impact, and thereby considering the political cost motivation for revaluation, we have recalculated the tax pressure (∑ taxes / add value) after removing the revaluation impact from the result and taxes. By comparing the tax pressure with revaluation and without it, we can judge wither the revaluation was in benefit of the company or not.

Table 3: Comparative tax pressure

	2014	2015	2016
rev	9,62%	8,97%	7,26%
no-rev	10,33%	8,97%	15,91%

Source: The Authors

Figure 3: Comparative tax pressure



Source: The Authors

We can deduce from table 3 and figure 3 that the revaluation decision is not on the benefit of the company. Thus, we can conclude that political cost was not a motivation for revaluation decision.

4. CONCLUSION:

Motivations behind revaluation decisions are diverse. The extant studies consider that the main motivations are: improving borrowing capacity, faithful representation of the firm image, the intensity of assets, management opportunism and political costs. In Algeria, firms can choose whether or not to report the revaluation in the financial statements. Motivations of fixed asset revaluation are not yet studied, and this is probably, because of the newness of revaluation practices, and fair value concepts in general, in Algerian accounting and financial environment.

The purpose of this research is to highlight, by means of case study, potential incentives that can motivate asset revaluation. After examining the various possible motivations for revaluation decision, we find that, improving borrowing capacity, management opportunism and political costs are not incentives to this company to revalue its assets.

The remainder motivation that can be behind the revaluation decision is to convey a faithful image of the company situation to the different stakeholder.

The study has some limitations. The focus was on one case and limited periods. Thereby, results may not be generalizable to other settings. Further research can exploit the accumulation of revaluation practices and use more extended samples.

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