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Financial Statement Valuations in the Italian Civil Code: Is Fair Value Really So Extraneous to the Historical Cost Tradition?

Annalisa Baldissera¹ 

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Abstract: *The adequacy of the fair value concerning the historical cost is particularly debated in the literature. This study aims to analyze the Italian legislation on financial statements to verify whether the historical cost is so far from current values. The method applied by this study is based on the historical analysis, from 1942 to today, of the provisions of the Italian civil code on financial statements. The study found that, although the historical cost criterion has always been and still is fundamental, the application of fair value is by no means extraneous to Italian accounting tradition.*

1. INTRODUCTION

The debate on the contrast between historical cost and fair value represents a relevant theme in the literature (Jajjairam, 2013; Laux & Leuz, 2009) due to the different effects that each of the two evaluation criteria causes on the representativeness of the financial statements values (Magan & Parbonetti, 2018). This study aims to analyze the Italian legislation on financial statements to verify whether the historical cost is so far from current values, or, on the contrary, the cases in which it can or must be waived are far from marginal. In general terms, the historical cost criterion in financial reporting is based on the application of past values, originating from transactions that have already taken place. Conversely, fair value accounting refers to the current values and the values that could be formed in transactions yet to be implemented.

The application of fair value has significant implications for the drafters of the financial statements as it requires them to project management into the future and to forecast possible market trends. In the Italian accounting tradition, and more widely in that of the countries of continental Europe, the historical cost is generally considered a primary principle, on which the entire construction of the financial statements and most of the estimating processes are based. In Italy, the centrality of the historical cost dates back at least to the first formulation of the civil code of 1942 and was confirmed in subsequent reforms, up to the first radical one implemented with Legislative Decree No. 127 of 1991. The changes to the financial statements regulation that took place in the following years – first of all, the reform introduced with Legislative Decree No. 6/2003 – only slightly affected the historical cost principle, which continued to be fundamental for over a decade. In the current legal framework, in force since 2016 and resulting from the transposition of Directive 2013/34/EU, the historical cost, while remaining central, has been accompanied by the introduction, for the first time in Italy, of the fair value for the valuation of derivative financial instruments. However, in addition to this regulatory provision, there are many other cases where historical cost is not applicable and this study aims to intercept them.

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The study highlighted how the historical cost continues today to represent a central principle for the preparation of financial statements. However, this does not mean that Italian legislation excludes valuations at current values. On the contrary, such assessments are common but rather different from the Anglo-Saxon fair value in one fundamental aspect: historical values only deviate downwards, i.e. only where the presumed realizable values are lower than the costs incurred. It follows that, in all cases in which the values expressed by the market are lower than those recorded in the financial statements, the historical cost criterion and the fair value should lead, if correctly applied, to the same results.

Alongside the contribution to the theory of financial statements valuations, the study also has practical implications as it highlights the cases in which management must make a forecasting effort to reliably estimate future market values (Bandyopadhyay et al., 2017; Bratten et al., 2012; Liang & Riedl, 2014). The research differs from the traditional literature in demonstrating, unlike the prevailing studies (Demaria & Dufour, 2007; Herrmann et al., 2006), that the historical cost of continental accounting must be understood as a criterion compatible (Strouhal, 2009) and coexisting with fair value, albeit with the specificities highlighted above.

2. LITERATURE REVIEW

The existing literature highlights numerous divergences between historical cost and fair value, attributing them to a markedly different valuation approach. In this regard, Jajairam (2013) underlines that while the historical cost evaluates the assets and liabilities of the balance sheet at the price incurred when they were purchased or assumed, the fair value expresses the market price at the reference date of the financial statements. It follows that the fair value is often considered a better criterion than the historical cost since, unlike the latter, which refers to past events, it can reflect the current market situation in the financial statements. However, according to Palea (2014), empirical research has brought to light some doubts regarding the effective reliability of fair value, to which must also be added the insufficiency of this criterion concerning stewardship. A dual reporting system, which uses both criteria, would therefore be preferable and more functional to the needs of users.

Khurana and Kim (2003) also make a comparison between fair value and historical cost, in particular referring to bank holding companies, to appreciate whether the former is more informative than the latter in explaining equity values. Their investigation reveals that there are no appreciable differences, while for loans and deposits of small bank holding companies, the historical cost seems to be more informative. On the contrary, Barlev and Haddad (2007) underline the merits of fair value by highlighting how it is more suitable, compared to the historical cost, for achieving international accounting harmonization and thus for obtaining better comparability of company financial statements. This peculiarity is also recognized by Georgiou and Jack (2011), who favor fair value as a criterion that regulates the harmonization of corporate financial statements and favors efficient management. Differently, Krumwiede (2008) observes that, although supporters of fair value consider it capable of producing more timely and relevant information, in many cases only historical cost provides reliable and verifiable information. Kaya (2013) also points out that the transition from historical cost to fair value has introduced greater subjectivity in accounting and believes that the Enron case is an example of how the use of fair value can cause fraud. In this sense, given the ambiguity that characterizes fair value, the historical cost could be useful in preventing potential future crises.

A further profile implied by the two criteria concerns the object of the valuation given that, as observed by Christensen and Nikolaev (2013), the application of fair value is useful when it can be estimated at a reasonable cost and provides significant information for management. Conversely, for illiquid non-financial assets, the historical cost may be the more appropriate criterion. With regard instead to securities, Carroll et al. (2003) take note of the difficulties associated with the determination of reliable fair values and at the same time underline the signaling value of this criterion and its ability to influence the stock price. In addition to assets, the differences between the two criteria also concern the measurement of income on which, in turn, dividend distributions depend. This profile is highlighted by Bessong and Charles (2012), who, precisely because of the double income-capital effect exercised by the evaluations of the financial statements, recommend that companies draw up their reports taking into account both the historical cost and the fair value.

As can be deduced from the discussion summarized above, the differences between historical cost and fair value are multiple and complex. However, while the literature has extensively analyzed the incompatibility profiles of the two criteria, few scholars have investigated the circumstances in which fair value and historical cost can lead to similar results. In light of the gap found, this study investigated the aforementioned circumstances regarding the Italian context, based on the observation that the application of the historical cost criterion implies not only references to past values but also connections to current market values.

3. FAIR VALUE HISTORY AND APPLICATIONS IN ITALY

The evolution of the rules on financial statements allows us to understand the development of fair value in Italy. In particular, the first codification of an autonomous regulation on financial statements is represented by the civil code of 1942, considering that the preceding regulation, and specifically the commercial code of 1882, contained a very limited number of provisions on annual reports. For this reason, the study takes into consideration the evolution of fair value in the context of the main reforms that took place in the eighty years 1942-2022.

The first reform to be mentioned for its disruptive impact on financial reports was introduced with Legislative Decree 127/1991, in the transposition of the fourth and seventh EEC Directives. This reform defined, for the first time in Italy, an organic regulation of the financial statements, with which the structures of the balance sheet and income statement – previously in free form – assumed mandatory content. At the same time, the rules for entering the values in the new schemes of financial statements and the evaluation criteria were dictated. The legislative framework outlined by Legislative Decree 127/1991 remained practically unchanged until the reform of company law, which, with Legislative Decree n. 6/2003, introduced a particular provision for the valuation of items in foreign currency, to be converted at the year-end exchange rate. In 2015, a further – and to date last – reform followed the transposition of EU directive 34/2013. In terms of financial statements, the reform introduced numerous innovations, concerning both the historical cost and the fair value. For the first time in Italy, fair value has become part of the evaluation criteria, in particular, to be applied to derivative financial instruments.

The study starts from the assumption, generally accepted in the literature, that the historical cost represents a criterion oriented towards the past and is, as such, unable to express the effective value of the company. In this regard, however, two fundamental factors must be considered:

- a) any evaluation criterion – whether historical cost or fair value – must be adequate for the purpose assigned to the financial statements;

- b) historical cost – as adopted in continental Europe, and more specifically in Italy – does not exclude fair value, but rather implies a particular application of it, functional to the above purpose.

These two factors are extremely relevant since, first of all, the appropriateness of the historical cost cannot be defined in the abstract, but must be judged concerning what the financial statements are supposed to represent. Secondly, since the historical cost is not incompatible with fair value, its application has significant management implications, requiring that past values are adjusted according to future forecasts.

Concerning factor a), in Italy, the main purpose of the financial statements is not to represent the current value of the company, but to show a conservative and rather underestimated value. This purpose can be explained by considering that the entire regulatory framework of the financial statements, outlined by the civil code, is built based on the protection of the company's creditors. This protection is achieved, above all, through the protection of the share capital which, in turn, requires moderate valuations that do not overvalue the company. For the reasons described, the company financial statements drawn up according to the provisions of the civil code are defined as “creditors oriented”. On the contrary, in Anglo-Saxon countries, where fair value is mainly applied, the primary function that the financial statements must fulfill is to facilitate investors' decisions. It follows that, for this function, the fair value makes it possible to represent the current value of the company, also taking into account its prospective evolution. In this case, the financial statements are defined as “investor oriented”. With respect to factor b), the analysis of the Italian civil code highlights how, in reality, the historical cost is accompanied, in a significant number of cases, by the application of the fair value, which, under certain conditions, must prevail over the historical cost. Therefore, it is not possible to conclude that the historical cost means neglecting the present.

4. METHODOLOGY

Since the study concerns a legal-related field, the method used was based on law analysis, understood in a general sense, as a tool for retracing the provisions of the Italian regulatory framework for the preparation of financial statements, with particular regard to the rules governing the evaluation criteria. This analysis was applied from a historical perspective and reconstructed the evolution of the rules starting from the first enactment of the civil code in 1942.

Considering that the objective of the research is verifying whether the historical cost criterion belonging to the Italian accounting tradition is so extraneous to fair value, the study started from the notion of fair value contained in the IFRS 13 standard, which defines it 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”. In some cases, the market price of the asset or liability to be valued is available, while in others it must be estimated. In this second case, the valuation requires maximizing the observable input values and minimizing the unobservable inputs.

However, as established by IFRS 13 “the objective of a fair value measurement in both cases is the same — to estimate the price at which an *orderly transaction* to sell the asset or to transfer the liability would take place between *market participants* at the measurement date under current market conditions (i.e. an *exit price* at the measurement date from the perspective of a

market participant that holds the asset or owes the liability)”. It follows that, in any case, fair value is a market-based measurement, and the valuation must be made following an exchange perspective aimed at determining a price. Based on this premise, the study formulated the following research question:

RQ1 What are marked-oriented evaluation criteria in the Italian Civil Code?

To answer the research question and identify the market-oriented evaluation criteria, this study considered not only those – actually only one – that the civil code designates as such, but all the situations in which the current value must be applied instead of the historical cost. To this end, the research was conducted assuming that using the fair value does not mean applying higher values than the historical cost, but rather applying the values that can be inferred from the market at the reporting date; and these values could also be lower than the historical cost: it depends on the market.

5. FINDINGS

As the main result, the research has brought to light that concerning the Italian rules for preparing financial statements, the concept of fair value is very similar to the cases in which the civil code, while using different terms, refers to values that cannot be traced back to historical cost. In particular, within the Italian legislation and the national accounting standards (OIC), at least 5 categories of current values can be identified. As summarized in Table 1, one category corresponds verbatim (in the civil code) to fair value and the other 4 are similar to it.

Table 1. Fair and similar values in the Italian context

Types of evaluation criteria	Current value categories
Specific criterion	Fair value
Similar criterion	Realization value inferable from market trends
Similar criterion	Presumed realizable value
Similar criterion	Current values at the end of the financial year
Similar criterion	Recoverable value

Source: Own elaboration

On closer inspection, the 4 categories similar to fair value, albeit defined with different terms, imply that the valuation takes the market into account and that the values thus determined are not extraneous to, but if anything very close to, fair value.

Based on these considerations, the study has identified the most relevant cases of application of market-oriented evaluation criteria by recognizing them in the situations in which the civil code establishes that historical values cannot be used, but values belonging to the classes identified above must be used.

The identification of the primary evaluation principles and their exceptions made it possible to outline a summary scheme that highlights the cases of non-application of the historical cost in favor of current values. The main market-oriented evaluation criteria found through the analysis of the legal framework (civil code) and technical framework (OIC accounting standards) are summarized in Table 2.

Table 2. Main marked-oriented evaluation criteria in the Italian civil code

Item	Evaluation criterion	Conditions for application
Intangible assets	Recoverable value	If durably less than cost
Tangible assets	Recoverable value	If durably less than cost
Financial fixed assets	Realization value inferable from market trends	If durably less than cost
Monetary assets in foreign currency	Current values (exchange rate) at the end of the financial year	In any case
Monetary liabilities in foreign currency	Current values (exchange rate) at the end of the financial year	In any case
Inventories	Realization value inferable from market trends	If less than cost
Receivables	Presumed realizable value	In any case
Current securities	Realization value inferable from market trends	If less than cost
Current financial assets	Realization value inferable from market trends	If less than cost
Derivative financial instruments	Fair value	Only if reliably determinable

Source: Own elaboration

6. DISCUSSION AND CONCLUSION

Two fundamental elements emerge from Table 2:

- a) the cases of application of market-oriented evaluation criteria are far from marginal;
- b) the adoption of market-oriented valuation criteria is subject to the circumstance that the value resulting from their application is lower than the historical cost.

First of all, Table 2 shows that the market-oriented valuation applies to all the main items of the balance sheet assets, thus testifying that this valuation can be as frequent as the historical cost. Secondly, the market-oriented criteria are not applicable at the choice of the drafter of the financial statements but must be adopted only in cases where the historical cost implies an overvaluation compared to current values at the end of the financial year. It follows that, in all cases in which the values determined using market-oriented criteria are higher than the historical cost, these criteria cannot be applied and the historical cost must prevail.

It can therefore be concluded that fair value is by no means extraneous to the Italian accounting tradition but its application is rigorously limited by the principle of prudence dictated to protect corporate creditors. This observation makes it possible to affirm that the Italian financial statements are not oriented only to the past but also take into due consideration the current values at the reporting date. Understood in this sense, the orientation of the financial statements in the past or the present depends, ultimately, on the trend in market values which, where decreasing for the most varied reasons, will determine a prevalence of current values over historical ones.

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