Explain what you understand by the term ‘substance over form’. Is it appropriate that this concept should be used as a guide in setting accounting standards?

Introduction

The overriding requirement of a company’s financial statements is that they should present a true and fair view, and represent faithfully the underlying transactions and other events that have occurred. To achieve this, transactions are required to be accounted for in terms of their ‘substance’ or commercial reality rather than their legal form. This principle is introduced in the Accounting Standard Board ‘Statement of Principle for Financial Reporting’, and also in many standards, in particular Financial Reporting Standard No. 5 (FRS 5), "Reporting the Substance of Transactions" and SSAP 21 ‘Accounting for Leases and Hire Purchase Contracts’.

To understand the term ‘substance over form’ (henceforth SOF) properly, this essay firstly describes briefly what is mean by the ‘substance’ of a transaction and how to determine ‘substance’. It secondly explains the importance of SOF. This point is illustrated by analysing an example of the treatment of ‘consignment stock’ and MicroStrategy case. Thirdly, it discusses some debates over the ‘SOF’ methodology, and argues it would not be enforced as a standard but used to develop individual and specific standards to deal with particular areas. Finally, it concludes this essay.

Part 1 The Substance of the Transaction

‘Substance’ can be viewed as the ‘reality’ or commercial substance of a transaction or an event, whereas ‘Form’ can be viewed as the strict ‘legal’ interpretation of a transaction of event.[1] Hence, SOF essentially means that it is more important to report in financial statements the economic substance or reality, rather than the legal form.[2]

---

[1] R E Jupe, S Manson, B A Rutherford, and R T Wearing (1995), Cases in Company Financial Reporting Cases in Company Financial Reporting, p123.
[2] Wearing, B. AC 301 Company Financial Statements , the notes of Lecture 7,

i.e. if there is conflict between the substance of a transaction and the legal form of a transaction, the economic substance should take precedence over legal form.[3]

The substance of transactions should be recorded in financial statements.[4] According to the references of FRS 5, a key factor in determining the substance of a transaction is to identify whether it changes the existing assets and liabilities of the company either by creating new ones or altering the existing ones.[5] This process requires the consideration of both the legal form and the economic substance of the transaction. The approach to determining the most appropriate treatment is to answer some questions such as, what is the detail of the transaction in the question? What is the legal position? What accounting treatment follows the legal position?

Part 2 The Importance of SOF

Most transactions of most companies are simple and straightforward. They can be assessed easily by the accounting standards, because they naturally coincide with the legal form of the transactions. For example, if an item of stock is sold for cash or on debit the impact on the company's assets and liabilities can easily be assessed.

However, occasionally a company may have a more complex transaction whose substance may not be apparent. The legal form may not appropriately represent the true economic effects of such a transaction. Under this circumstance, the exterior form might reflect high sales, strong profits, good returns and prudent asset management, while the substance reveals insignificant returns or losses, and fraudulent misrepresentation. The two diverge and the choice of how to present the transactions can give very different results. Obviously, to achieve the accountability and transparency in accounting, the principle of SOF is essential.

[3] R. Lewis and D Pendrill(2000) Advanced Financial Accounting, p205.
[4] R. Lewis and D Pendrill(2000) Advanced Financial Accounting, p206.
[5] FRS 5: Reporting the Substance of Transactions,(1994a), reproduced in Accountancy, Para 16.

2.1 The Application: An Example of 'Consignment Stock'

Consignment stock is often found in the motor industry, whereby the stock is held by a dealer but legally owned by a manufacturer. The dealer has the stock on premises, and has the right to sell the stock. However, title to the stock does not pass to the dealer at the time when the stock was delivered. It means that the dealership in fact has not yet bought the stock and so should not yet include the stock, or any liability to pay for it, in its financial statement.

So what treatment should be used for the dealer? Determining if the stock should be classified as an asset of the dealer, involves assessing what the commercial substance of the transaction is. If only the legal form of the transaction was assessed, it might appear that the stock is an asset of the manufacturer.

However, according to FRS 5, the substance of the transaction is determined by assessing where the greatest benefit and risk lies.[6] If the manufacturer cannot require the dealer to return the stock, the dealer has no right to return the stock. Consequently, the dealer bears the obsolescence risk and slow movement risk. This indicates that the stock is in substance an asset of the dealer. On the other side of the argument, if the dealer has the legal right to return the unsold stock without incurring an obsolescence risk and a slow movement risk, then the dealer does not have an asset.

Therefore, the substance of transaction should be reflected faithfully in its financial statements not merely the legal form of the transaction, particularly if the legal form of the transaction would present a misleading view of the financial position or results of operations of an entity.[7]

2.2 What would happen if we instead took 'Form over Substance'?

In fact, fraudulent financial reporting usually involves the presentation of form over substance. A March 1999 report sponsored by the National Commission on

[6] D Alexander and A. Brition, (2001), Financial Reporting, p324
[7] FRS 5: Reporting the Substance of Transactions,(1994a), reproduced in Accountancy, Para 14.

Fraudulent Financial Reporting found that more than half of all financial reporting frauds involved overstating revenue. For example, In March 2000, MicroStrategy (MSTR), a worldwide software company, announced that it was revising its financial results. Revenue would be lowered by roughly 25 percent, from $205 million to about $150 million; the problem was caused by recognition of revenue that did not exist. The key question in revenue recognition is this – when is a sale a sale, and when do companies get to recognize the revenues? The answer varies depending on the industry and nature of the revenues. So, it is important that substance (nature) rather than legal form is used to account for a transaction. By recording the substance of transactions, we might reduce the ways in which some companies stretch generally accepted accounting principles to inflate their value.

Part 3 The Debates of the SOF

The evidence presented in the discussion above suggests that the proper reflection of substance over form is essential in order to achieve accountability and transparency in accounting. However there is still much controversy over this issue. Some have discussed that SOF should be used as a guide in setting accounting standards. While others argued 'substance' does not necessarily override 'form', the importance of 'substance' was overrated. This attitude is not supported heavily in the legal profession.[8] In the Department of Trade and Industry's statement on the Argyll Foods case, it argued that:

> *It is axiomatic that any emphasis on substance over form must not be at the expense of compliance with the law.*[9]

So how should we best treat the SOF principle? The accounting bodies in the UK have adopted the view that the important element in any transaction or situation is the commercial substance and not the legal form.[10] The documents emerging from ED 42 to FRS 5 in the last few years develop a framework of relevant principles. For

---

[8] D Alexander and A. Brition(2001), Financial Reporting, p330.
[9] Department of Trade and Industry(1982)Statement on the Argyll Foods Case, Accountancy, February.
[10] D Alexander and A. Brition(2001), Financial Reporting, p330.

example, a set of definitions of the elements of financial statements. These would enable the substance of transactions and other evens to be identified directly. It is likely to be able to successfully deal with new challenges facing financial accounts, including the emergency of new financial instruments and grey leasing. It seems that the principle of SOF has indicators set to be an accounting standard.

But, perhaps the biggest problem of SOF when coupled with the true and fair view, is that it then depends heavily on the accounting profession's ability to interpret sensibly commercial reality, in many different situations, while still following consistent conventions and tenets.

Therefore, the framework of the principle of SOF would not be enforced as a standard but used to develop individual and specific standards to deal with particular areas. [11] It would consume far more resources, but would produce treatments that were consistent and respond adequately to novel transaction and other event. Specific standards would also be easier to enforce than general guidance as to the identification of the substance of transaction and other events.[12]

Conclusion

In conclusion, We have provided the meaning of SOF, and examined the determinants of the substance of transactions. Then, we have explained why the SOF was so important in accounting through a discussion of the treatment of consignment stock. At the same time, we have illustrated how financial statements can be adversely affected if the company emphasises ‘Form’ of the transactions rather than ‘Substance’ of the transactions. We have also discussed the debates over SOF, and finally, we have argued how the principle of SOF would be used as a guide in setting accounting standards.

---

[11] Rutherford, B (1988), The Doctrine of Substance of Form, p39.
[12] Rutherford, B (1988), The Doctrine of Substance of Form, p39.

References:

Accounting Standards Board (ASB), (1994a), FRS 5: Reporting the Substance of Transactions April, reproduced in *Accountancy*, May 1994.

Alexander, D. and A. Brition, (2001), Financial Reporting, 6th edition, International Thomson Business Press.

Department of Trade and Industry (1982) *Statement on the Argyll Foods Case*, Accountancy, February.

Jupe, R.E., S. Manson, B.A. Rutherford and R.T. Wearing (1995), Cases in Company Financial Reporting Cases in Company Financial Reporting, 2nd edition, Paul Chapman Publishing.

Lewis, R. and D. Pendrill, (2000) Advanced Financial Accounting, 6th, edition, Pearson Education Limited.

Rutherford, B, (1988), The Doctrine of Substance of Form, Certified Accountants Publications, London.

Wearing, B. (2003), AC 301 Company Financial Statements, Lecture 7 notes.