

## Understanding 'Substance over form'



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We often hear of instances where the term 'Substance over form' is used especially in the accounting and auditing environment; and one has to wonder why this term is such a relevant term in ensuring the fair presentation of an entity's financial statements.

For financial statements to be fairly represented, they must be presented in a manner that best reflects the true essence of their underlying transactions, providing useful and relevant information to the user. The preparers of the financial statements can exercise judgement and use their discretion to ensure that these set of financial statements reflect the true nature and facts of the transactions captured.

However, there are some transactions that are complex in nature where the legal terms of the transactions that are outlined in their specific binding arrangements, be it legislation, contracts or otherwise do not necessarily represent the true economic substance of these transactions.

Substance over form is a term that was introduced to address the confusion caused by the differences between the economic substance vs the legal form of transactions.

### What is 'Substance over form'?

This concept refers to transactions recorded in financial statements that reflect their economic substance rather than merely their legal form. Simply put, this means that the financial statements should capture the true intent of the transaction rather than only following their strict legal form. Often, the economic substance and legal form are the same for a transaction, but when they reflect fundamental differences, recording them based on the legal form may not give a fair or accurate representation of the transaction.



**Economic substance** of a transaction refers to the overall economic reality of that transaction.



**Legal form** refers to the legal reality of a transaction according to law.

The concept of substance over form becomes a cause for concern when transactions are extremely complex. When a party or individual intentionally hides the true extent and nature of the transaction, this makes it difficult to identify the substance of the transaction. Therefore, the substance of all transactions represented in financial statements should be considered thoroughly in respect of their contractual terms and obligations to ensure that all items presented fairly and there is no intent to mislead or intentionally hide the true extent of these transactions.

## The importance of the contractual rights and obligations

When two or more parties or persons enter into a contract, the terms of that contract creates rights and obligations for all parties or persons involved. To represent those rights and obligations accurately, it is advised practice to report the transactions that arise from these contracts based on their substance in the financial statements.

All terms in a contract (explicit or implicit) should be considered unless they have no substance. Terms that have no substance are disregarded, such as:

- terms that bind neither party;
- rights, including options, that the holder will not have the practical ability to exercise in any circumstances.

Although capturing items in their legal or true form is important, it does not always translate to accurate capturing of the true extent of a particular line item. Let's unpack this further.

Let's use the example of purchasing a new car from a dealership using vehicle finance to further illustrate the above concepts.

When doing so, you enter into a binding contract with your financial institution or bank, stating that you are liable to pay for the vehicle over a fixed term period of approximately five years, until its value is paid off. Despite you taking ownership of the vehicle after you've signed the contract, making you the vehicle owner from an economic substance point of view; you will only legally be recognised as the owner when your final installment has been paid.

And while your purchase is a sales agreement, it may very well be recorded as a finance lease agreement for accounting purposes until the final payment is made as a result of the economic substance of the transaction.

## So how will the economic substance and legal form differ?

*Economic substance* – refers to the overall economic reality of that transaction. In this case you are recognised as the vehicle owner from the date of purchase.

*Legal form* – refers to the reality of a transaction according to law. In this case, you are the lessee of the vehicle and will only legally own the vehicle once it has been paid for in full.

To create an accurate representation of items across the board, and ensure conformity, all transactions should first be analysed to determine if the substance of the transaction may be different from its legal form.

Here are further examples of transactions where the legal form maybe be different from the substance:

- Inventory swaps between entities
- Control relationships
- Principal-agent arrangements
- Classification of financial instruments between equity and financial liabilities
- Lease agreements
- Advances to other entities that are not repayable (depending on whether it is a loan or not)

Therefore when preparing financial statements, one should always remember the following when analysing transactions to ensure they are accounted for correctly:

- ✓ Be aware of substance over form and ensure that the economic substance of the transaction is reflected in how it is reported in the financial statements and not only based on consideration of the legal form alone.
- ✓ Review all the terms of the contract that have an economic effect to determine the economic substance of a particular transaction.

*Note: While some examples are given in this article to illustrate the consideration and application of the principles, each individual transaction should be considered based on its own merits and the specific terms and conditions that are applicable to it.*