

SUBSTANCE OVER FORM



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BACKGROUND:

The principle of substance over legal form is central to the faithful representation and reliability of information contained in the financial statements. The responsibility on the preparers of financial statements is to actively consider the economic reality of transactions and events to be reflected in the financial statements. And more importantly, account for them in a manner that does fairly reflect the substance of the transaction (and situation). This is because, preparers understand the commercial reality best and also the reason why the legal form was considered appropriate to a particular set of transactions.

In the same way, it is important for accountants and auditors whose responsibility it is to review financial statements that they obtain the commercial reality and substance of the transactions from the preparers to serve the overall objective of "faithful representation" which represents one of the two 'Fundamental Characteristics' and components of the Conceptual Framework for financial reporting.

What is critical to both the preparer and the reviewer is that 'substance over form' does not mean that we ignore 'Form' in that case, the entire edifice on which Ind AS 115 on Revenue Recognition where the contract with the customer is fundamental to revenue recognition, would collapse! What is meant is, we focus on the commercial substance and reality of the transaction(s) in its entirety.

Accordingly, this article does not seek to judge the legality of transactions from the narrow prism of a reviewer. Instead, it focuses on working together as preparers and reviewers to reflect the substance of transactions in the financial statements.

1. Introduction:

1.1 We are all aware that an entity's financial statements should report the substance of the transactions that it has entered into. Normally, transactions are such that

the substance and form do not differ and therefore, do not require any further inquiry. However, some of these would:

- a. The party that gains the principal benefits from the transaction is not the legal owner of the asset;
- b. There are a set of transactions that we know are all inter-linked in such manner that the commercial substance can be determined only by putting together all these transactions, treating them as "interlinked";
- c. An option is included on terms that make its exercise highly likely;

1.2 Let us now look at a couple of transactions:

- a. A finance company buys a huge item of plant & machinery that it will not use and plans to sell it to the previous owner? Is this a sale transaction or a financing arrangement is what we may need to establish.
- b. An auto manufacturing company appoints dealers through whom it sells cars on the condition that it will transfer the cars at a fixed price, will bear the cost of price fluctuations and the risk of obsolescence... in effect, the auto maker bears all the significant risks and this could be a significant indicator whether the company needs to derecognise the asset.

2. Substance of transactions and the standard setters...

2.1 There has been a fair amount of understanding and consensus among various authorities and accounting standard setters that except for certain circumstances and reasons, "substance should follow form", although, it is not necessary that transactions should not follow form.

2.2 Very recently, Tax Authorities introduced General

Anti Avoidance Regulations (GAAR) to deal with certain set of transactions entered into by entities, with the sole objective of reducing or shifting the tax base, etc to the detriment of the Exchequer. The net effect of the **GAAR** provisions (to put them simply) is **to disregard the legal form of these transactions** and look only at the substance, that is the “Commercial Reality” and tax the entity accordingly. Obviously, these relate to a specific set of transactions entered into with the only significant objective of reducing tax liability.

2.3 Financial markets have been developing products and solutions around financial reengineering, segregating risks between parties and selling these products. Lease financing, Securitisation, Derivative instruments, the creation of SPVs, are part of innovative products that were developed to help finance companies. Regulators and accounting bodies have been putting together their collective wisdom and market knowledge to address these complexities.

Sale and Lease back arrangements were an accepted tax planning device until GAAR came in and so were financial leases on the basis of which an entire industry came into being. Financial instruments became more complex with the issue of complex derivative products, securitisation etc. The introduction of convertible securities raised issues regarding the nature and classification of capital and debt.

3. The response of the IASB

There is no specific international financial standard that deals with the topic of substance over form. Unless specifically governed by specific standards, the terms of transactions will be scrutinised to determine how the transaction should be recorded.

It was only around 1985 that the Institute of England and Wales issued the first authoritative document on Off Balance Sheet Financing with a view to determining the accounting treatment of transactions and their economic substance rather than their mere legal form.

The IASB came up over a period of time with a fairly comprehensive Financial Reporting Framework that formed the basis and context for standard setters across the world. Notwithstanding that, substance over matter forms an all-pervading aspect of financial accounting; its reference was omitted from the Framework for the Preparation and Presentation of Financial Statements

because it was considered “redundant” to be presented as a separate component of “**Faithful Representation**”. Except for **FRS 5** which sets out the principles that will apply to all transactions where we need to inquire into the basic principles for identifying and **recognising the substance of transactions**, none of the accounting bodies devote a separate standard to deal with the complexities arising out of “substance over form”.

4. Let us look at some of the accounting standards that specifically address the issue of substance over form in greater detail:

a. **Ind AS 115** the new **Revenue Recognition Standard** that replaces Ind AS 11: Construction Contracts and Ind AS 18: Revenue specifically to deal with the complexities and changes that have been taking place in the structuring of business transactions of various types and in several sectors such as Information Technology, Infrastructure and Real Estate, etc. by focusing on Revenue Recognition from the customer’s point of view.

b. **Ind AS 17 Leases** where Operating Leases have also come within the ambit of the Standard.

c. **Ind AS 110** that deals with Consolidated and Separate Financial Statements. The standard deals with various scenario which emphasises on reflecting the substance in determination of control such as *de-facto* control, assessment of participating rights vs. protective rights, analysing the rights and obligation assumed by the shareholders irrespective of their legal shareholding in the entity.

d. **Ind AS 32 on Financial Instruments:** Presentation specifically deals with the classification of debt instruments into debt and equity in certain cases, like for example Convertible Debentures that are broken based on a fair valuation into equity and debt. This standard also covers a situation where in a financial instrument would classify as equity instruments but if the other members of the group assumed any obligation or provided any guarantee to the holder of the instrument, then such additional terms and conditions would need to be considered for the determination such instrument as equity or financial liability.

5. Illustrative “Principles” that could apply to most transactions:

i. **UK GAAP deals with the concept of “substance over form”** through FRS 5 that lays down the general principles

that could apply to transactions. **It adopts a strictly Balance Sheet strategy namely, settle the assets and liabilities and let the profit and loss entry emerge.** One simple governing principle is when determining the nature of transactions, one needs to decide whether, as a result of the transaction, the reporting entity has created new assets or liabilities or whether it has changed any of its assets and liabilities. The Standard emphasises the need to focus on the commercial logic of the (set of) transactions of the respective parties. And, if this does not make sense, probably, all aspects of the transaction or all parties to the transaction(s) have not been identified.

ii. Complex transactions have certain common features that we need to look out for, such as:

a. Where the legal title to an item is separated from the ability to enjoy the principle benefits and exposure to the principle risks associated with it; the main issue here is the identification of assets and liabilities and tests to ascertain whether the asset or liability should be recognised in the balance sheet

b. The tying up of all related transactions to make sense of the commercial reality or substance;

c. The inclusion in the transaction of option whose terms make it highly likely that the option will be exercised;

d. Situations where the relationship between the two entities is that of parent and subsidiary; the concept of 'control' becomes very critical here;

iii. The identification and recognition of the substance of transaction is to identify whether it has resulted in complete alienation of the asset or the liability or whether, it has given rise to new assets or liabilities for the entity or whether it has increased the existing assets or liabilities of the entity. The transaction may result in the entity losing control over the future economic benefits of the asset.

iv. Transactions may result in the creation of new obligations where the entity is unable to avoid the outflow of benefits. If that be so, the liability is recognised!

v. Complexities arise when there are subsequent transactions that result in affecting these rights or obligations. Where the transaction does not significantly alter the entity's rights to benefits or its exposure to risks, the entity should continue to maintain "status quo". When

significant variations occur, it may be necessary to vary the valuation of the asset or the liability. For example, through a series of transactions, an entity hands over the economic benefits from a financial asset in part (one specific revenue stream is parted with), there is no complete alienation, in which case, it may be necessary to recognise the variation in the books.

In this context, it may help revisit some of the key definitions to get to the substance of the transactions and these are: Assets, Liabilities, Common Control, Options, etc.

6. Looking at Illustrative Case Studies to demystify some of the complexity:

A small list of illustrations to better understand this principle....

A. Ind AS 115: Revenue Recognition

Consignment Sales:

This is a case of Principal vs Agent. In this case, the Consignor sends goods to the consignee to the specifications of the ultimate customer and is responsible for any deviations. The Consignee sells the stock in the normal course and returns the unsold goods to the Consignor.

Some of the key or significant risks for consideration that would determine whose asset or obligation it is would be:

... does the Principal take primary responsibility for fulfilling the terms of the contract on acceptability of the product and its specifications (that is, meeting with customer specifications)

... who bears the Inventory risk: this comprises of two components that is, whom bears the risk of slow moving inventory and second, the risk of inventory after it reaches the customer (that is, where the customer has the right of return)

... is the stock transferred at a price fixed by the entity.

Comments: The crucial tests are:

i. Consignment revenues are not recognised when the goods are delivered to the consignee because control is not transferred. Revenue is generally recognised on sale to the customer.

ii. Revenue recognition upon transfer of 'control' is different from the 'risk and rewards model' under Ind AS 18. Per Ind AS 115, 'control of an asset refers to the ability to direct the use of an obtaining substantially all of the remaining benefits from the asset.

Sale & Repurchase:

A is a Developer in the Real Estate business, he also possesses significant land banks. He enters into an agreement with ABC Bank to sell some of the land based on:

i) Sale price on date of sale will be decided by the seller who will appoint his own valuer;

ii) A gets the right to develop the land during any time commencing within the next three years during ABC's ownership. Given A's credentials in the sector, ABC will not unreasonably withhold any of the development plans. However, ABC will bear all the outgoings during this entire period including taxes etc. ABC will also charge an addition fee of 10% of costs incurred that will cover its administration costs;

iii) The bank will maintain a "Memorandum" account to which all costs incurred will be debited and should A reacquire the land, all these costs will be recovered including interest calculated at the average of the last three years;

iv. The Bank grants A an option to buy the land anytime within the next 5 years at the price that is determined on the date of the repurchase, except that the Bank will deduct all expenses it incurred during the period of its holding.

v. The Bank also has an option to sell the land at the same price as determined in the Memorandum to any third party, except that A will be given the first right of refusal. In the event of the land being sold to a third party, all proceeds net of incidental costs including brokerage etc. will be deducted by the bank and made good to A.

Comments: The substance of the transaction appears clearly as a secured loan because, A continues to control possession of the land, control's its development, bearing all costs and acknowledging all the obligations relating to ownership and use. The right to first refusal virtually ensures that the return of the asset is controlled fairly through the entire transaction.

Real Estate Transactions: Performance obligation relating to the provision of common amenities:

One area of significant judgment is with regard to performance obligations made by the builder. It is common, builders are able to sell individual apartments whereas common facilities forming part of the performance obligations, remain incomplete.

1. Hypothetically, a builder had launched a project of five buildings, out of which, he has completed three of them in full. Under RERA, all the five buildings were considered as one project. The builder has completed all necessary steps with regard to the individual apartments sold, viz:

- The builder has a present right for full payment from the respective owners

- Legal title has been transferred for each of the apartments

- Physical possession has been completed.

2. Significant risks and rewards of ownership have been transferred to the individual owners and

- The owner has accepted the apartment.

3. Common facilities such as sports complex and social function halls;

4. These were all part of the performance obligations of the builder.

The builder says that Occupancy Certificate is pending and therefore, the builder's contention is that they do not propose to recognise any revenue on the completed units. The alternate view is as under:

i. Revenue should be recognised on the units actually sold; the amenities represent implicit obligations because they are not 'distinct' from the project and real estate has been sold without completion of these facilities;

ii. The individual units are ready and the builder has actually been advised that they can apply for an OC for the completed part because it is completed in every which way, however, the builder has been postponing this process.

Comments: In the case above: This is an area of complexity and responses will differ upon circumstances of the case:

i. There is a valid contract (whose attributes meet with the conditions specified in Ind AS 115) that has been entered into with the owners;

ii. Individual performance level obligations have been met except that obligations that are implied such as sports complex and function halls are yet valid expectations and therefore, obligations that remain unfulfilled yet; however, the contract states that these areas are scheduled to be complete by the time the other two buildings are completed.

iii. Given the fact that the three residential buildings are complete in every which manner, the only question that remains unanswered is whether the builder is in a position to apply for the OC immediately; that would require him to confirm several matters including mainly, an affirmation that all aspects of the three buildings have been completed for survey by the Authorities. If the builder is in a position to do so, Revenue should be recognised in respect of every apartment sold, which meets the criteria set out in Ind AS 115 and para I above that is, there should be a valid contract, individual (apartment) performance level obligations have been met, legal title has been transferred for each of the apartments, physical possession has been completed, significant risks and rewards of ownership have been transferred to the individual owners and the owner has accepted the apartment.

B. Ind AS 109: Financial Instruments

Factoring of Debts:

Factoring is a common practice to raise money's especially in cases where a company wishes to remove the factored debts from the balance sheet and preferably, show no liability for payments made by the Factor.

Factoring: a Case Study:

A company with a poor history of collections approaches a "Factor" because a stage has arrived where the bankers have threatened not to increase working capital limits to the extent of overdue debts. The company holds a portfolio of Rs.300 million. It enters into a "factoring"

arrangement with a reputed factor with the following key conditions:

i. The company will transfer the portfolio through an assignment to the Factor for Rs. 275 million of cash. All debts have been subject to a credit appraisal by an independent agency to ensure that the portfolio transferred is, ab ignition, not a "troubled" debt. The Factor will pay the cash of Rs. 275 million "upfront" to the company.

ii. The company will open a separately nominated account into which it shall deposit all the collections it makes from its debtors. The Factor will charge a collection fee and this will be added up to the amounts collected by the company upon settlement and end of agreement;

iii. Any collections falling short of Rs.275 million will be to the company's account and so will any collections in excess of Rs.275 million: the company takes the upside too;

iv. Upon termination of the agreement, all outstanding are agreed upon and settled in cash.

The substance of the transaction is as under:

i. Under the agreement, the maximum exposure that the company has is to the extent of Rs.275 million that it has received from the Factor, upfront;

ii. It means, the company has given a guarantee to the Factor to the extent of the entire Rs.275 million, that is, for all credit losses;

iii. In addition, the company is entitled to the upside too;

Comments:

i. This means, the company has retained both the credit and late payment risks associated with the portfolio; therefore, the entity has retained substantially all the risks and rewards of ownership of the receivables and continues to recognise the receivables.

ii. Such type of transactions can be a very useful way of raising cash quickly and can be tricky from accounting perspective. It involves analysing terms of arrangement to establish the substance of the transaction. **Key**

point here is, understanding the “ownership” of the receivable in establishing the commercial substance of the transaction.

iii The company will therefore need to recognise the consideration received from the broker as a secured borrowing.

C. Ind AS 110: Consolidation

Case Study: Control

The assessment whether an investor has control over an investee depends whether the entity has all the three elements of control over the investee, viz; power over the investee, exposure, or rights to variable returns and the ability to use its power to influence the investor’s returns.

It is a simple situation where control of an investee is held through voting rights; however, it is not clear whether control of the investee is through voting rights, a critical step in assessing control is identifying the relevant activities of the investee, and the way decisions about such activities are made. Relevant activities are activities that significantly impact the investee’s returns. Power over an investee is fairly established when an investor who does not have majority voting rights has power to influence decision making with regard to the relevant activities that significantly affect the investee’s returns.

Generally, decision making is controlled by majority voting rights that also give rise to variable returns. But in certain cases, the investor may be holding less than majority of the voting rights, in which case, it may not be as straight forward. This is particularly so in the case of a structured entity (SPV) that is used to control an investee company and the investor does not have any dominant holding in the structured entity and voting rights are not the dominant factor in deciding who controls that structured entity. This is where all factors listed above (power, exposure to variable returns and ability to use power over investee) may all be need to be taken into consideration

to determine the real substance behind the structuring.

In cases cited above (that is, where voting rights are not the dominant factor in deciding control over the investee), an understanding of the purpose and design of the investee would help to understand the reasons why the investor is involved with the investee, what risks was the investee designed to be exposed and which are the key parties exposed to those risks and variable returns. Such mapping of power with the ability to use that power to influence the variable returns will be helpful in determining who has the control.

In certain complex situations where two or more investors control several relevant activities of the investee, it is important to ascertain which investor controls the activities with the most significant returns.

One may conclude that the substance of the control can be determined by examining where the decision-making powers resides i.e. seat of power. To establish the decision making with complex legal structure, it is necessary to look into framework for assessment of control i.e. i) Assessment of purpose and design of the investee, ii) Its relevant activities, iii) and how decision about these relevant activities are made. **This involves complete understanding of the lucidity behind the structure and role of each party.**

7. Conclusion:

Given the complexities that the financial markets are made of and also given the financial structuring options that businesses have, it is necessary that the Financial Accounting and Reporting Framework specifically may necessitate separate guidance that deals with 'Substance over Form'. While the specific standards such as Leasing, Revenue Recognition and Consolidation have dealt with several of the complexities, the need for an independent standard that builds the logic for accountants and auditors to apply cannot be overemphasised. ■

Learning is not virtue but the means to bring us an acquaintance with it. Integrity without knowledge is weak and useless, and knowledge without integrity is dangerous and dreadful. Let these be your motives to action throughout life: the relief of the distressed, the detection of frauds, the defeat of oppression, and diffusion of happiness. — Nathanael Greene