



Policy Paper Substance over form

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EXECUTIVE SUMMARY

1. The Substance over Form Principle and the Conceptual Framework

The Substance over Form Principle is reaffirmed in the various conceptual frameworks of the IASC/IASB. It is reincorporated in the draft Conceptual Framework (ES/2015/3), in §2.14 under these terms:

“(…) A faithful representation provides information about the substance of an economic phenomenon instead of merely providing information about its legal form. Providing information only about a legal form that differs from the economic substance of the underlying economic phenomenon would not result in a faithful representation”. The principle is further detailed in §4.53 to 4.56 related to the Communication of the substance of the contractual rights and obligations.

2. The Substance over Form Principle and the faithful representation Principle

The Substance over Form principle is presented, in the various conceptual frameworks of IAS/IASB as **the necessary way to provide for a faithful representation of transactions and phenomenon to be recognised.**

The faithful representation is a translation of the anglo-saxon term *“true and fair view”* and expresses a standard, that is to say a behavior to be followed by users to reach the objective assigned to financial information. In the draft Conceptual Framework, financial information must be faithful to the financial situation of the entity. **Therefore, the Substance over Form Principle is the way to ensure that financial information faithfully represents the financial reality of the entity.**

3. The meaning of the Substance over Form Principle

The Principle of *“prééminence du fond sur la forme”* is the translation of the *“Substance over Form Principle”*, coming from the anglo-saxon professional accounting practice of the 19th Century. Sometime also called *“principe de substance”*, the Substance over Form Principle does not express an opposition between the economic substance on one side, and the legal form on the other side, in favor of the first, but it **reflects the primacy of the economic and legal substance of transactions and phenomenon to be recognised according to their sole legal form**, that is to say according to the national legal categories in which these transactions and phenomenon are classified.

4. The Substance over Form Principle and the Law

Because the Substance over Form Principle is akin to a classification process, it invites the accountant to take into account the reality – economic and legal – of transactions and phenomenon, and if needed, going beyond the sole retained legal categories. Precisely, it **refers to transactions and phenomenon classification process to be recognised according to**

accounting categories defined in the Conceptual Framework and standing out, where necessary, national legal categories.

Because it designates a standalone classification process, based on accounting categories turned away from national legal categories, the Substance over Form Principle marks a disconnection with legal and patrimonial based accounting system, and more globally, a disconnection with law. Thus, the “accounting property” or “economic property” is distinguished from legal property. This achieves (or aims to achieve) an international accounting language.

5. The Substance over Form Principle and the autonomy of the international accounting system

Because there is a way to ensure faithful financial information to the real financial situation of the entity, **the Substance over Form Principle irrigates the whole international accounting standards-setting**, which stands out, where necessary, from national legal notions and categories.

Thus for consolidated accounts, the accounting scope is distinct from the legal scope. For legal categories, such as contracts, they may sometimes be fragmented in several rights and obligations (what are the rights and obligations of a sale with a buyback clause?), sometimes aggregated to show, in case of several contracts, the reality of the economic and financial arrangement (e.g: leasing contracts).

6. The Substance over Form Principle and the accounting judgement

Because the Substance over Form Principle is a classification process, it implies a real **judgement** of the accountant, who proceeds to a reclassification according to accounting categories of transactions and phenomenon classified in legal categories. This raises the question of the **control of the classification and of the sanction of the financial information** deemed inaccurate by the competent national authority.

7. Proposals

The Substance over Form Principle...

- Shall be **explicitly** addressed in the Conceptual Framework
- Shall be better **articulated** with the Faithful Representation Principle (the faithful representation of a legal and patrimonial accounting system is not based on the Substance over Form Principle),
- Shall be better **defined** as giving the primacy to the economic and legal substance over legal form (and not as the opposition between economic and legal aspects),
- Shall be based on clear definitions of the used accounting notions (faithful representation, resources, economic phenomenon etc), taking into account the different languages and legal existing cultures between countries which implement the IFRS.

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I THE ACCOUNTING CONCEPT OF SUBSTANCE OVER FORM

The substance over form principle originates from 19th century Anglo-American accounting theory derived from professional practice. Based on the official texts, doctrine and case law setting forth this principle, the substance over form principle is commonly interpreted as the pre-eminence of economic substance over legal form.

The purpose of this paper is to clarify the substance over form principle and define the issues it raises.

1.1 The substance over form principle and the faithful representation principle

The Draft Conceptual Framework (ED/2015/3) reaffirms the substance over form principle and, apart from a few presentation differences, is consistent with the two previous versions of the Conceptual Framework (1989 et 2010). Indeed, although there have been changes in the way the principle is presented in the different Conceptual Frameworks proposed by the IASB/IASB (explicit reference in paragraph 35 of the 1989 version of the Conceptual Framework, implicit reference in the faithful representation principle of the 2010 version of the Conceptual Framework, in the definition of the faithful representation principle in the Draft Conceptual Framework for 2015, (paragraph 2.14), it is always presented as **a prerequisite for achieving a faithful representation of accounting transactions and events**; its purpose of achieving faithful representation makes it one of the qualitative characteristics that financial information must possess to be useful to users.

Even though the paragraph on faithful representation had already been revised in 2010, the IASB proposes further revision and clarification in the 2015 draft in response to comments received. The new paragraph 2.14 (Chapter 2 on the Qualitative Characteristics of Useful Financial Information) states explicitly that faithful representation provides information on the substance of an economic phenomenon instead of merely on its legal form: ***“A faithful representation provides information about the substance of an economic phenomenon instead of merely providing information about its legal form. Providing information only about a legal form that differs from the economic substance of the underlying economic phenomenon would not result in a faithful representation”***. The principle is repeated and explained in the components of the financial statements with respect to *Reporting the substance of contractual rights and contractual obligations* (Chapter 4, Paragraphs 4.53 to 4.56 of the Conceptual Framework).

The link established by the IASB between faithful representation and the substance over form principle is necessary because this link is not systematic, depending on the accounting framework concerned. Faithful representation is a subjective notion which does not require the systematic application of substance over form, and may be achieved by pursuing other objectives. Indeed, the true and fair view concept, developed in the 19th century by English accounting practice, and now known as the faithful representation (F. Pasqualini, thesis), is not so much an objectively definable principle (there is no definition) as a standard of behaviour (F. Pasqualini, 2015); it determines the judgment, the attitude of the accountant in complying with the dominant accounting principles when preparing the financial statements. It represents the obligation to depict the reality of an entity's position faithfully (F. Pasqualini, thesis) or to provide a true and honest portrayal (B. Colasse, 2007). But a faithful representation of reality is a subjective judgment based on an accounting environment with its generally accepted accounting principles. There are therefore several faithful representation (L. Klee, encyclopaedia), or several subjective faithful representations (J. Richard and Ch. Collette, work, 2008), which reflect the diversity of national accounting conventions. In other words, **the**

faithfulness of financial information can only be assessed by reference to the objectives assigned to it. Information is not intrinsically faithful but is faithful to something; according to international accounting standards the financial statements give a faithful representation of the entity's economic and financial reality.

A recent decision of the European Court of Justice (ECJ) may illustrate the possible distinction between a true and fair view and the substance over form principle. Indeed, in the European Accounting Directive 2013/34/EU of 26 June 2013 on annual financial statements and consolidated financial statements (following the accounting directives of 1978 and 1983) the European legislator reaffirms a true and fair view (Article 4, paragraph 3) and substance over form as general reporting principles (Art. 6, para.1 (h)) (see paragraph 1.2 hereafter about this interpretation). However, Member States are authorized (Art. 6, para.3) to exempt entities from the substance over form requirement, therefore implying that a true and fair view may be achieved without applying the substance over form requirement. The ECJ has confirmed the dissociation of a true and fair view and substance over form. The Court had to rule on the appeal filed by Estonia in respect of the 2013 Accounting Directive, on the grounds that Member States' option to exempt entities from the substance over form requirement was not compliant with the true and fair view principle (set out in Article 4 para. 3 of the Directive) and would be contrary to the objective of improving the comparability and clarity of entities' financial statements. The ECJ ruled that, on the contrary, this exemption enables one of the Directive's objectives to be achieved, which is to reduce the administrative burden of small entities which may *"(...) merely set out the legal form of a transaction rather than its commercial substance"* (translated by the ANC). In other words the requirement that *"The financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss"* (translated by the ANC) may be interpreted in a restricted manner. The true and fair view may be just a true and fair view of legally defined assets and liabilities.

1.2 The substance over form principle and the "substance principle"

The European Accounting Directive 2013/34 establishes "substance" as one of the general financial reporting principles (see Chapter 2, Article 6 paragraph 1(h)). This principle requires items in the profit or loss account and the balance sheet to be accounted for and presented **having regard to the substance of the transaction or arrangement concerned** or more precisely, as stated in Recital 16 of the Directive, with "regard to the economic reality or commercial substance of the underlying transaction or arrangement". The "substance principle" refers solely to the substance of the transaction or arrangement without opposing substance and form as in the substance over form principle. Consequently, it was inferred that the substance principle "should not be confused with the substance over form principle, because it does not oppose substance and form" (translated by the ANC) as the substance principle should be interpreted as the obligation to take account of the economic reality or commercial substance of the underlying transaction or arrangement (Focus IFRS, quarterly newsletter, n° 30, September 2013; G. Gélard, 2013).

This interpretation is however in contradiction with a recent judgment of the ECJ of 18 June 2015 (C-508/13, Estonia v Parliament and Council) relating to an action for partial annulment of the Directive brought by the Republic of Estonia. When called upon to judge whether it is possible for Member States to exempt entities from the application of the substance principle set out in Article 6 paragraph 1 (h), the ECJ refers specifically "to observing the accounting principle of substance over form" (translated by the ANC). The assimilation of the substance principle to substance over form is significant in that it implies that the latter principle is more

the expression of a combination of the substance and the form of an accounting transaction rather than of a trade-off or the hierarchy of the two terms. (M. Teller, 2015).

On the basis of the first paragraph, we may conclude that:

- 1) the substance over form principle is essential in achieving faithful representation of transactions and events in accordance with the objectives assigned to international financial reporting standards by the conceptual framework;
- 2) the substance over form principle and the substance principle are equivalent terms.

II THE MEANING OF THE SUBSTANCE OVER FORM PRINCIPLE: A CLASSIFICATION PROCESS – The combination of substance and form in the classification process

2.1. Combining substance and form in the classification process

The substance over form principle is an approach to accounting for transactions and events that is independent of national legal classification because it requires information to be reported *“about the substance of an economic phenomenon rather instead of ...about its legal form”*. Some authors have concluded that there is an opposition between economic and legal that works in favour of the former. This would appear to be corroborated by all the translations that use expressions denoting a hierarchical relationship such as *“predominance, pre-eminence or primacy”* (*“primacy of economic substance over legal form”*, M. Teller, BJB, 2007, translated by the ANC ; *“pre-eminence of (economic) substance over (legal) form”* J. Saghroun and Cl. Simon, CCC, 1999, translated by the ANC ; *“pre-eminence of financial reality over legal appearance”*, *“predominance of substance over appearance”*, *“pre-eminence of reality over appearance”* (F. Pasqualini, thesis ; Regulation 99-02 of 29 April 1999 relating to the consolidated accounts of commercial companies and government business enterprises, paragraph 300 ; AMF decision of 8 December 2005, translated by the ANC). Substance over form is supposed to be the principle underlying the idea *that “legal form must be replaced by economic substance”* (M. Teller, 2015, translated by the ANC); the idea is not so much to *“restore legal reality”* as to *“provide a certain view of economic reality in order to satisfy investors’ needs”* (M. Teller, 2007, translated by the ANC).

This interpretation of the principle as the expression of the supremacy of economic reality over legal appearance was however criticised at a very early stage by several authors (F. Pasqualini, thesis; J-L. Medus, 1993) and is considered to be the result of an incorrect translation of the English expression substance over form (F. Pasqualini, thesis); there would appear to be a difference between the French translation and the original wording of the *substance over form* principle (B. Raybaud-Turillo, thesis).

In fact, the principle which refers to the relationship between substance and form is an expression of a well-known legal issue: the relationship between law and fact which is addressed by the process of legal classification. The classification of facts is the identification of the legal regime to which they belong. Similarly, the substance over form principle which aims at restoring the economic substance of transactions whatever their legal form, is not the expression of a choice between economic and legal but a **process for classifying transactions and events in pure accounting categories**.

This process consists of analysing both the legal (rights and obligations) and economic substance of transactions and events and thereby ignoring, where necessary, their legal classification. This is behind the idea, which certain legal specialists supported at an early stage, that the substance over form principle supposes a *“legal substance analysis”* (B.

Raybaud-Turillo and R. Teller, 2009, translated by the ANC) which is different to a formal analysis, in that it implies “a legal reclassification of transactions when their legal presentation does not reflect their legal and economic substance” (B. Raybaud-Turillo and R. Teller, 2009, translated by the ANC).

It is important to note that the legal system is not purely formal and allows existing legal classifications to be discarded where necessary (A. Bénabent, 2007). There are many legal instruments and principles that act as an *adjusting mechanism* to deal with the contradictions between appearance and reality with a view to restoring the latter. We may mention fraud (*fraus omnia corrumpit*), abuse of rights, simulation, interpretation of a contract according to the common intention of the parties instead of the literal sense of the language used (art. 1156 code civil) which may lead to a legal reclassification of the contract.

In other words, the substance over form principle enables the accounting classification of transactions and events to be determined by comparing their economic and legal substance to the formal pre-defined legal categories, as a result of which the latter may be validated, invalidated or complemented (J-L. Médus, 1996): substantive reality prevails over legal form (formal reality) when the latter does not reflect economic reality. The basis for this approach is to be found in and may be clarified by the existence of an independent accounting classification.

2.2. Taking into consideration the legal and economic substance

Relying on the definition granted by the French Dictionary Larousse, substance is what constitutes something, it is matter and content. It is what exists by itself. Hence, substance, as a fundamental element, is what does not change. It can take different appearances and different forms. Identifying the transactions' and events' substance, consist in searching for its different properties, according to the economic effects and the different rights and obligations it content, beyond the form (legal form) the transactions or events can carry with them or are granted with. Form is somehow an attribute that does not overlay the intrinsic characteristics of the transactions or events and provides their appearance.

The predominance of substance over form specifically aims at finding, beyond the form and, beyond appearances, those intrinsic characteristics that help recognizing the true representation of a transaction taking into account the economic and legal aspects, and not only its formal appearance.

Hence a legal substance, considered to represent the main characteristics parties have in mind when realizing a transaction, thus exists for all elements; in the same way there is an economic substance that can be defined as the economic effects (value, wealth...) generated by a transaction or an event. More concisely, the economic substance refers to the economic and financial impacts produced by the operations and events accounted for, whereas the legal substance refers to rights and obligations contained in those transactions or events. The legal substance is then crucial as the nature of the control exercised differs depending on the rights and obligations the transaction or event carries with it ; in the same way the economic substance, meaning the purpose of the transaction, can modify the legal customary concepts. Hence, when a property is used as a guarantee (v. infra § 4.2.2), its classification may need to be adapted to the purpose it carries, it will then be referred to the economic property (advantage granted by the asset) in regards to the legal property (property title), the concept of economic property, in the accounting language, will require the owner to recognize an asset in the balance sheet without having the legal property. If the concept of economic property

questions the usual concept of legal property, absolute and near-sacred right, it has nonetheless be scrutinized in a way that led to the issuance of studies of interest (C. Mouly, 1984, G. Blanluet, 1999) that revealed, if this were necessary, that accounting principles, notably the predominance of substance over form, are not far away from the legal theories and principles. Hence, as a lawyer has been writing on lease “acknowledging that the lease has the economic function of a guarantee should lead to acknowledge it also has its legal nature (...) the legal characteristics of the lease does not prohibit this classification and its economic characteristics justify this position” (C. Mouly, 1984, translated by the ANC).

The conclusions of the second paragraph are:

- 1) The substance over form principle involves a classification process for transactions and events, which must be accounted for solely on the basis of the classification in the conceptual framework which may, where applicable, be different to that of the national legal framework;
- 2) The substance over form principle therefore implies a reclassification of accounting transactions and events where their legal form does not reflect their economic and legal substance;
- 3) The substance over form principle does not oppose economic substance and legal form but legal and economic substance to legal classification (form).

III THE CONSEQUENCES OF THE SUBSTANCE OVER FORM PRINCIPLE AND THE DEVELOPMENT OF AN INDEPENDENT ACCOUNTING CLASSIFICATION

3.1 The contribution of the substance over form principle to the harmonisation of the international accounting system

Accounting classification by reference to the substance over form principle, independent of national legal classification, forms the basis for a common international accounting language. The substance over form principle therefore contributes to the harmonisation of international accounting standards in an environment of legal diversity. Indeed, it transcends divergent national legal frameworks in order to reclassify transactions and events according to common accounting categories. The substance over form principle is therefore essential in adapting “standards to the international environment by transcending the specific characteristics of national legal frameworks” (Danjou, 2013, translated by the ANC).

The harmonising effect of transcending national legal classification (form) is specifically referred to by the CJEC (latterly the CJEU) ruling of 8 February 1990 (n° 320/88) on the definition of the supply of goods under Article 5 of the Sixth Directive (77/388/EEC) of 17 May 1977 on the harmonisation of the laws relating to turnover taxes. In its judgment, the Court ruled that *“the supply of goods does not refer to the transfer of ownership in accordance with the procedures prescribed by the applicable national law but covers any transfer of tangible property by one party which empowers the other party actually to dispose of it as if he were the owner of the property”*, adding that this view is in accordance with the harmonization objective of the directive which might be *“jeopardized if the preconditions for a supply of goods varied from one Member State to another ...”*(translated by the ANC).

3.2. The contribution of the substance over form principle to the objectives of international financial reporting standards

International financial reporting standards include an accounting classification developed, without political or state supervision, by a private international body (IASB then IASB) according to the objectives fixed in its Conceptual Framework. Financial analysis sets out to measure the profitability and solvency of an entity over several years (F. Romon, 2014); Or, to put it more precisely, the objective of financial statements, as defined in international reporting standards, is not to provide information about the ownership of assets, i.e. about the assets the entity owns, but to portray the financial effect of transactions and other events by grouping them into broad classes according to their economic characteristics.

The Conceptual Framework further stipulates that the financial statements *“provide information about the financial position of a reporting entity, which is information about the entity’s economic resources and the claims against the reporting entity”* (Paragraph 1.12). Such financial information *“can help users to assess the entity’s financial strengths and weaknesses”* (Paragraph 1.13), it is also *“useful in assessing the entity’s past and future ability to generate net cash inflows”* (Paragraph 1.18). Such financial information is useful for investors, lenders and other creditors in making decisions about providing resources to an entity (Paragraph 1.2).

Therefore, to meet the definition of an asset, a liability or equity (Paragraph 4.5 Conceptual Framework: *“an asset is a present economic resource controlled by the entity as a result of past events”*, see also Paragraph 4.24 for a liability, Paragraph 4.43 for equity), attention must be paid to the underlying substance and economic reality and not just to legal form (F. Romon, 2014). The legal criterion of ownership is no longer essential in the definition of an asset. Property which an entity controls, without owning it, is an entity’s asset (J. Paillusseau, 2014).

The substance over form principle is necessary here to achieve the objectives of financial reporting and to provide information in the financial statements about economic resources controlled by the entity and to help users to predict the entity’s future cash flow generating ability (P. Pintaux, 2005); indeed the principle requires the accounting treatment of transactions to look beyond their legal form (classification), in order to focus on whether the entity exercises control over the item to be recognized, and on its ability to generate future economic benefits (asset), or on the obligation to transfer a resource (liability).

The substance over form principle enables the preparation of financial statements which are based on the economic and accounting notions of control, performance and profitability rather than on the legal notions associated with asset ownership (notions not considered in the accounting classification). This is what differentiates it from a legalistic accounting system.

3.3. The substance over form principle as a split from a legalistic accounting approach

The objective of financial reporting directed towards *assisting investors, lenders and other creditors in making decisions about providing resources to the entity* (Paragraph 1.2 Conceptual Framework) is seen as the recognition of the role of the Anglo-American accounting system in responding to the needs of capital markets and consequently in breaking away from the legalistic system of accounting for rights and obligations associated with Romano-Germanic law. Authors speak about a *“legal split”* (M. Teller, 2007) caused mainly by the introduction of the substance over form principle (M. Teller, 2007) and as a result of which international accounting standards serve financial capitalism (M. Capron (s/dir.) 2005).

The legalistic system of accounting for rights and obligations is historically a model based on ownership rights and the protection of creditors and credit. Under this system, accounting information is provided from the perspective of creditors who are potentially entitled to a

share of the entity's assets on winding up and for whom the entity's assets therefore represent security. Therefore, in order to give information to creditors about their security and provide them with credit protection, the balance sheet presents the amount of the debtor's (legal entity's) net assets by quantifying its legal rights and obligations. In this sense, the accounts are a form of "legal algebra". (D. Ledouble, 2005, F. Pasqualini and D. Burbi, 2013, M. Teller, 2007). In this case, the balance sheet is a static representation of the entity's legally defined net assets. This accounting system directed toward protecting lenders is based on prudence and does not provide the latter with information on the entity's performance but on whether, if the worst comes to the worst, they will actually be paid. (E. Chiapello, 2005, J. Saghroun et C. Simon, 1999).

In the legalistic system of accounting, accounting classification directly reflects legal classification: the reporting entity is the legal entity, the accounts provide a view of its legally defined net assets and assets are the property of which the entity is the legal owner. The accounts are clearly based on property law, security law, contract law, company law (M-A. Frison-Roche, 2011, F. Pasqualini and D. Burbi, 2013); The legal foundation of the accounts makes them a robust measurement tool for liabilities and receivables, a reliable source of evidence (for commercial transactions) and a reliable monitoring instrument. Because the accounts are based on legal sources there is no need for a conceptual framework to define its general principles as these are derived from civil and commercial legislation (J. Haas, D. Nechelis, 2013).

And, from this point of view, the introduction of the substance over form principle represents a clear dissociation of accounting from law and affirms independent accounting classification as the basis for the international accounting system. Whereas in the legalistic system, accounting rules are based on and derive legitimacy from the legal framework, in financial reporting accounting rules are based on a set of independent standards in search of legitimacy.

3.4. The substance over form principle in support of an independent accounting system

3.4.1 The substance over form principle as a basis for a change of accounting model

As the substance over form principle is the basis for defining a faithful representation, **it is a pervasive concept in international accounting standards directed towards the reporting of the entity's risks and performance and no longer just a view of its net assets.**

Thus the definition of the reporting entity may be dissociated from that of the legal entity (Paragraph 3.12 of the Conceptual Framework) and in this case, its boundaries are determined in order to "faithfully represent the economic activities of the entity" (Paragraph 3.18 (b) ; The definition of assets and liabilities, as stated above (see Paragraph 3.2) is related to the notion of economic resource defined as a right that has the potential to produce economic benefits (Paragraphs 4.5, and 4.24), equity is defined as the residual interest in the assets of the entity after deducting all its liabilities (Paragraph 4.43) which may therefore vary over the life of the entity in contrast to the legal concept of capital maintenance as a guarantee for creditors (D. Ledouble, 2005). In the same way, the financial statements are prepared on a going concern basis, meaning on the assumption the reporting entity is a going concern and will continue in operation for the foreseeable future (Paragraph 3.10 of the Conceptual Framework); the assets are not measured at liquidation value (see discussion on fair value) and do not therefore provide creditors with information useful in assessing whether they would recover their debt under the assumption of a winding up. Moreover, the Conceptual Framework states clearly that, in this case, the financial statements have to be prepared "on a different basis" (Paragraph 3.10 of the Conceptual Framework). Lastly the substance over form principle leads to a

definition of prudence associated with the obligation of neutrality (not to overstate assets or income, not to understate liabilities and expenses, Paragraph 2.18) distinct from the definition used by the legalistic system of accounting. According to the latter, the prudence principle includes the subjective requirement to ignore unrealised gains whilst recognising unrealised losses (J. Richard and Ch. Collette, 2008).

3.4.2 The close relationship of the substance over form principle with common law

If legal and accounting research associates the substance over form principle with the economic approach of Anglo-American accounting as opposed to the legal approach of accounting in continental Europe (Y. Ding, H. Stolowy and M. Tenenhaus 2001, P. Walton, 2009), it tends to explain the domination of Anglo-American accounting by the dominance of the Anglo-American legal system. Anglo-American accounting is indeed derived from common law, customary law that gives prominence to professional practice in developing accounting rules; the *true and fair view* and *substance over form* principles originate from English 19th Century accounting practice; whereas continental accounting law is based on Romano-Germanic law which is written law regulated by the State and influenced by Tax Law. Now, this difference in legal culture is considered to play an essential role in economic development, as the common law system is more favourable to economic and financial development when it is case law (developed bottom up) which respects and defends private enterprise whereas the Romano-Germanic model gives too much prominence to the State and the defence of public interest with a tendency to stifle private initiative. An example of this difference is to be found in the difficulty encountered by Romano-Germanic Law in recognising the notion of trust as defined by common law although the latter plays an important part in securitisation.

The *Legal origins* theory sets out to demonstrate that common law countries enjoy higher economic growth than those of Romano-Germanic Law (A. Gambaro, R. Sacco and L. Vogel, 2011). This would explain the birth of international accounting standards in the 20th century, based on Anglo-American accounting practice, on the back of the development of a global financial economy and the introduction at the end of the 20th century of a separate Conceptual Framework to ensure the consistency of the standards. But, international accounting standard-setting goes further than a simple opposition between common law and the Romano-Germanic legal system which, moreover, developments in the two legal systems tend to attenuate: in fact, it reflects via the substance over form principle an approach under which law is a simple tool used as an input to an independent accounting framework; less emphasis is put on the sum of legal rights and obligations, ownership and contracts as defined by national legislation and more emphasis is given to the economic effects of rights and obligations. Legal concepts (classifications) are dissected (an entity's assets may reflect legal rights or be allocated, ownership may be of a legal or economic nature, contracts may be broken down into components or grouped together, see below). The substance over form principle does not mean that there is a divorce between economy and law that works in favour of the former (see above Paragraph II) but that priority is given to economic as opposed to legal reasoning, in that legal rules are considered from an accounting and financial viewpoint. Accounting standards based on the substance over form principle portray facts according to their own rules which may be different to those applicable under national legislation (B. Raybaud-Turillo, 1997, F. Windsor and D. Ledouble, 1977, B. Bachy and M. Simon, 2009).

The substance over form principle is similar or equivalent to the specific analytical approach developed by economic law: substantive analysis (B. Raybaud-Turillo, thesis, 1997) consists of "*identifying the substance of a social relationship in order to classify it in the appropriate legal category*" (L. Boy, 2002, translated by the ANC). This consists of "(...) analysing, classifying, or

criticising (...) legal concepts or facts using legal assumptions, derived from a critical analysis of the legal system". This critical analysis leads us to define what we call: substantive or "material" law (G. Farjat, 2010, translated by the ANC). This approach contrasts with a purely formal analysis or classification" (J-B. Racine, F. Siirainen 2007). The principal legal concepts such as property and contracts are therefore subjected to a critical examination and reviewed as necessary. Substantive analysis *"takes into account the complexity of reality and therefore avoids the over-simplification of formal analysis which may provide a distorted image of reality"* (J-B. Racine, F. Siirainen, 2007, translated by the ANC). In the process, by questioning the main formal categories in law, it brings law up to date with social and economic change.

Thus substantive analysis identifies control as a component of legal ownership that reflects a situation of economic domination with certain legal consequences; this comes down to making a distinction between legal and economic ownership with legal consequences, not recognised by Romano-Germanic Law under which ownership in is an absolute and indissociable right exercised by the legal owner of the property.

The conclusion to be drawn from the third paragraph is that the substance over form principle is necessary to produce financial statements that provide a true and fair view of the entity's financial position which is distinct from national legal classifications and is therefore an expression of a common international accounting language.

IV – ILLUSTRATION OF THE APPLICATION OF THE SUBSTANCE OVER FORM PRINCIPLE: DIFFERENCES IN BOUNDARY BETWEEN THE REPORTING ENTITY AND THE LEGAL ENTITY

The substance over form principle is consistent with the objective of an international reporting system to provide economic and financial information that transcends national legal differences. Because the choice of the sources and the cost of funding are closely related to the level of risk incurred, it is useful to provide investors, lenders and other creditors with economic and financial information that measures risk and performance. What are the risks? Who bears them? What return in exchange for the risk? Thus Paragraph 1.3 of the Conceptual Framework states that *"investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty (the prospects for) of future net cash inflows to the entity (...)"*.

The substance over form principle, in setting out to satisfy users' economic and financial information needs, refers to a coherent set of accounting classifications and concepts with boundaries distinct from those of pure legal form. As such, it disrupts certain national legal classifications such as those pertaining to the definition of an entity's net assets, ownership and contracts.

4.1 Substance over form and consolidation scope

International financial reporting relates to the consolidated financial statements of listed groups, meaning the financial statements of a group of entities presented as those of a single economic entity; the reporting entity is therefore defined by reference to the consolidation boundary based on control exercised by one entity over the others and the relevance of the information for users irrespective of the legal form of the entity (see Paragraph 3.12 Conceptual Framework). Consolidation is a technique that uses the concept of control in order to provide a true representation of the economic entity (J. Montier, 2009) that transcends the boundaries established by the legal form of the entities.

Consolidation scope includes special purpose vehicles (SPV) i.e. separate legal entities set up by the entity to manage certain transactions (such as debt defeasance) even though the entity controls the SPV or bears the risks of the transaction. Legal techniques (based on a separate legal entity) might misrepresent the true financial and economic situation of the parent and it is therefore necessary to include the SPV in the scope of consolidation (P.Vernimmen, P. Quiry, Y. Le Fur, 2016)

Consolidation is considered by some authors (J. Gasbaoui, 2013) as one of the very first expressions of the substance over form principle because it gives priority to the reality of economic relationships over legal form (J. Gasbaoui, 2013). Above all, it reflects the pervasive nature of the substance over form principle in international reporting standards.

4.2 Substance over form and the scope of accounting transactions

The substance over form principle is directly related to the objectives of financial statements, namely to provide financial information as opposed to information based on legal ownership. The objective is no longer to provide information on the entity's solvency based on legal ownership, but to measure risk and performance based on future economic benefits (resources). This explains why the accounting classification of rights, obligations and arrangements is independent of the legal classification (form) for these transactions. In theory, as one author (J.Gasbaoui, 2013) points out, all contracts must be considered innominate.

From this point of view, for the purposes of accounting classification, the definition of an asset in the Conceptual Framework (Paragraph 4.5) as an economic resource (a right that has the potential to produce economic benefits) controlled by the entity as a result of past events as well as that of a liability, defined as the present obligation of the entity to transfer an economic resource as a result of past events (Paragraph 4.24) are consistent with the substance over form principle. Thus, accounting classification sets out to identify the elements contributing to the performance of an entity even when the latter has no legal ownership right (J. Gasbaoui, 2013) or to define equity as a residual interest in the assets of the entity after deducting all its liabilities rather than basing it on a legal definition of the entity's net assets (D. Ledouble, 2005 ; F. Pasqualini and D. Burbi, 2013).

In the same way, accounting classification requires legal transactions to be broken down into components or aggregated whenever necessary to portray the true nature of rights and obligations and the economic effects of the accounting transaction.

4.2.1 Substance over form and the classification of the terms of the transaction

The accounting classification of a contract requires an analysis of the substance of contractual rights and obligations, rather than of its legal regime, in order to determine for that particular type of contract which risks and rewards have actually been transferred. All the terms of the contract have to be considered unless they have no commercial substance. Thus a sales contract which includes a repurchase clause will not be classified in the same way as a straightforward sale. This is why the Conceptual Framework (Paragraph 4.54) requires all the terms of the contract to be considered unless they have no commercial substance, meaning no economic effects.

4.2.2 Substance over form and the treatment of a group of separate legal transactions as one

In the area of economic and financial law, industrial and financial engineering have given rise to increasingly complex contractual packages, the legal form of which does not provide an overall view of the economic and financial transaction which they embody. These legal packages may include a combination of contracts or layers of transactions that conceal funding mechanisms, credit management or a building project which would not be revealed by a straightforward legal analysis. These complex legal packages use contractual and asset engineering techniques specific to each legal system; in order to implement these packages in countries applying Romano-Germanic Law, it is often necessary to abandon traditional legal notions and adopt Anglo-Saxon legal concepts such as economic property, asset allocation or trusts.

When an economic and financial transaction is made up of a series of individual contracts classified according to the relevant national legal system, the application of the substance over form principle will restore the unity of the transaction for accounting purposes and make it intelligible at international level (see Paragraph 4.53 of the Conceptual Framework, *“the terms of the contract, or a group or series of contracts, require detailed analysis to identify the substance of the rights and obligations”*).

Thus, a rental transaction may conceal a **finance lease**, a technique imported from the United States which is a rental agreement for property, a business or shares including a purchase option in favour of the lessee. Legally speaking, a finance lease is a mixture of several contracts: a sale (supplier-lessor), a lease (to the lessee), a unilateral option agreement by which the seller promises to sell if the lessee exercises its purchase option, and sometimes an agency agreement (under which the bank grants the user the right to choose and take delivery of the leased property). Economically, this package masks a loan by the lessor to the lessee guaranteed by the lessor's ownership rights. Although it is a nominate contract, legal specialists agree that it is a complex transaction of which the precise legal nature is uncertain, given that there is *“a complete and utter distortion between the economic substance of the transaction and its legal form, which is an absolute fiction”* (A. Bénabent, 2007, translated by the ANC). In spite of its legal form, a finance lease is *“a technique for funding an investment”* and the lessee is *“more of a borrower than a renter”*. Similarly *“the lessor is first and foremost a lender”* (M. Bourassi, V. Brémond, M-N. Jobard-Bachelier, 2014, translated by the ANC). Even if the lessor is the legal owner of the leased property, the lessee exercises control and derives the benefits of ownership from it. For this reason, the lessee is considered to be the economic owner.

In these circumstances, as a legal analysis of the transfer of ownership does not portray the economic substance of the transaction, the application of the substance over form principle works in favour of economic ownership as opposed to legal ownership. Consequently, the leased property will be treated as an asset of the lessee in the consolidated accounts (but not in the statutory accounts) as the latter is the only one able to derive benefits from its use (F. Missonnier-Piera, Dick, 2006). There is therefore an adjustment outside the entity's statutory accounts to reflect the assumption that the latter has borrowed the amount necessary to acquire the assets held under a finance lease (P. Vernimmen, P. Quiry, Y. Le Fur, 2016). Recognition in the accounts is no longer the result of a transfer of legal ownership but of control (J. Haas and D. Nechelis, 2013), known as economic ownership which consists of an exclusive right to use the assets and access the economic benefits associated with ownership.

The same reasoning may be applied under different assumptions relating to the assignment of receivables which may take the form of factoring transactions (including those governed by the Dailly Law) or securitisation transactions. It also applies more generally to nominee agreements, research costs etc.

4.3. Substance over form and the timing of recognition of the transaction

The timing of the recognition of a transaction will depend on the date the transfer of risks and rewards is economically effective rather than on the legal terms of the transaction (contractual conditions, transfer of legal ownership, purchase commitment). In practical terms, a sale is recognised when the risks and rewards are transferred and not on the date legal ownership is transferred (which may be variable according to national legislation). A sale may be recognized and the seller's inventory reduced for goods which the latter still legally owns (W. Dick and F. Missonier-Piera 2006, M. Teller, 2013).

V - INTERPRETATION AND JUDGMENT

Judgment is required to classify transactions according to the substance over form principle. Indeed, an accountant when replacing legal by accounting classification is the "first judge" of what represents a faithful representation (J. Gasbaoui, 2013). In a system where accounting classification is based on and directly related to legal classification, the former is subject to judiciary supervision. However, where the accounting system possesses its own standards, classification and rules of interpretation separate from the legal classification, it raises the issue of the audit of accounting classification and the corresponding sanctions. Thus, in France the authorities that sanction the violation of international accounting standards are the securities commission (AMF), under a provision of its general regulations, and the criminal courts in the case of general or specific penal offences. Should we consider that these administrative and judiciary authorities are required to base their interpretations and sanctions on the Conceptual Framework? This raises several issues, of a technical (specialized knowledge required, clarity of the texts) as well as a philosophical and political nature. More specifically it raises the issue of the diversity and porous borders between standards.

VI – COMMENTS-PROPOSALS

As explained above, the substance over form principle relates to the classification of events and transactions according to independent accounting categories distinct from national legal classifications. This classification must provide **a faithful representation of the economic and financial reality of an entity so as to report useful financial information to its users.**

The substance over form principle has its place and meaning as part of a consistent set of general principles and accounting classes in the Conceptual Framework.

Substance over form therefore underlies all accounting principles (consolidation scope, definition of assets and liabilities, definition of equity etc.) and may be considered as a pervasive international accounting principle, in a similar way to general legal principles (D. Ledouble, Interview) underlining the independence of the accounting framework from States and their national law.

Therefore:

§1 – It is essential to **affirm the substance over form principle explicitly** in the Conceptual Framework.

§2 – In order to clarify the principle it might be helpful to link together the paragraphs in the Conceptual Framework in which it is mentioned (Paragraph 2.14 should refer to Paragraphs 4.53 to 4.56 but also (?) to 3.11 et seq. on the reporting entity or to Paragraphs 4.5 and 4.24 on the definition of assets and liabilities).

§3 – A clarification of the relationship between **the substance over form and faithful representation principles is required**. The faithful representation principle is a general concept the definition of which depends on the objectives of the accounting framework to which it relates. A faithful representation may be achieved, according to the 2013 Accounting Directive by providing a faithful representation of legal assets and liabilities. For international reporting purposes the faithful representation is the view that reflects the economic and financial substance of transactions and events irrespective of their national legal classification. To achieve a faithful representation, transactions and events must be classified in application of the substance over form principle.

§4 - A clarification of the relationship between the **substance over form and prudence principles is required**, as in certain jurisdictions there has been a perceived contradiction between the two principles.

§5 – A clarification of the substance over form principle is required dissociating it from a straightforward distinction between economic and legal. In our view, the substance over form principle is **indeed the pre-eminence of economic and legal substance over legal form**. It would avoid omitting the legal aspect of substance from the substance over form principle.

§6 - Lastly, **there is a general need for clarification which could be achieved by adding a paragraph to the Conceptual Framework defining the fundamental concepts**. This is necessary because the substance over form principle puts the onus for classification on the accountant who, in spite of the independent nature of the international accounting framework, is still subject to sanction through national legislation (in France the securities commission (AMF) and the criminal courts sanction the violation of international accounting standards). There is a real need for a multi-disciplinary project and a comparative-law study to clarify notions which combine financial, economic, management and legal concepts, the specific characteristics of different legal systems such as common law or Romano-Germanic Law and the uncertainties of translation (from English) (T. Bush, 2012 on the IASB's "inappropriate language"). The notions of *commercial substance, economic phenomenon, structure of the contract, economic aspect...* which are all used to explain the substance of contractual rights and obligations are not sufficiently clear to constitute a common international language.

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