10

Substance Over Form

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10

Learning Outcomes

- discuss the principle of substance over form applied to a range of transactions; including:
  - Sale and repurchase agreements;
  - Consignment stock;
  - Debt factoring;
  - Securitised assets and loan transfers;

10.1 Introduction

In this chapter we will consider the principles of reporting the substance of transactions and not their legal form. The terms of transactions will be scrutinised to determine how a transaction should be recorded and where appropriate the correcting entries that are required. Specific transactions will then be considered that commonly raise the issue of substance over form.

10.2 Principles of substance over form

There is no specific international financial reporting standard that deals with the topic of substance over form. The IASB *Framework* describes the principle: 'If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form'.

IAS 18 *Revenue* and IAS 39 *Financial Instruments: Recognition and Measurement* also contain some elements that are relevant to a consideration of substance over form. These will be considered later in the chapter.

10.2.1 Off-balance-sheet financing

Often the motivation behind transactions that require adjustment for substance over form is the avoidance of liabilities on the statement of financial position. Motivations for keeping financing off the statement of financial position include the following:

1. *Effect on the gearing (leverage) ratio.* If an entity is able to exclude liabilities from its statement of financial position it can manipulate the gearing ratio to the lowest possible level. High gearing levels tend to have adverse effects on share prices because the share is perceived by the market as riskier.
2. *Borrowing capacity.* The lower the level of liabilities recorded on the statement of financial position, the greater the capacity for further borrowings.
3. *Borrowing costs.* An entity with an already high level of borrowings will pay a risk premium for further borrowing in the form of a higher interest rate.
4. *Management incentives.* Bonuses and performance-related pay may be based upon reported earnings for a period. If an entity is able to benefit from off-balance-sheet financing arrangements, costs may be lower, thus improving earnings.

10.2.2 Applying substance over form

When assessing the validity of a transaction and its effects, it is important to consider the commercial sense of the transaction. Ask yourself:

- Does this make economic sense? – e.g. selling a property for less than market value.
- With what I know about business, does this make commercial sense? – e.g. why would a financial institution purchase a factory that it will not use and then plans to resell it to the previous owner.
- Which party holds the significant risks and rewards associated with the asset/liability? – has a party recorded a sale but will still be subject to the loss if the asset falls in value?

Often the legal aspects of the transaction are perfectly valid however to achieve a fair presentation of the financial statements we must adopt the principles of substance over form.

Identifying the significant risks and rewards associated with assets and liabilities is the key to establishing the appropriate treatment of transactions.

Consider the following example:

Example 10.A

A sells a machine to B for $20,000 and at the same time agrees to buy it back in 1 year's time for $21,800. The machine remains on A's premises and A continues to use and to insure the machine.

These related transactions are likely to arouse some suspicion. What is actually going on here?

In legal terms, following the first transaction, B is clearly the owner of the machine. However, the substance of the transaction is that A retains the risks and rewards of ownership, and effectively, has taken out a loan for a year at an interest rate of 9%.

Correcting accounting treatment

Applying the principle of substance over form, A should continue to carry the asset in its statement of financial position, with a corresponding liability to B. B would record the loan as a receivable in its own statement of financial position.

Why might this distinction between substance and form matter? What is the motivation for A to keep the loan off the statement of financial position?

Let us extend the example a little further. A is financed partly by long-term borrowing of $30,000. One of the conditions under which the loan was made (the 'covenant') was that A's total liabilities, both long- and short-term should not exceed $80,000. Extracts from two versions of A's statement of financial position, one drawn up to show substance over form and the other to show legal form after the transaction are as follows:

	Substance over form	*Legal form*
	$	$
Non-current assets	100,000	80,000
Current assets	85,000	85,000
	185,000	165,000
Capital and reserves	90,000	90,000
Long-term borrowing	30,000	30,000
Current liabilities	65,000	45,000
	185,000	165,000

The statement of financial position prepared adopting the principle of substance over form shown total liabilities of $30,000 +$65,000 = $95,000. This clearly breached the terms of the covenant. The statement of financial position prepared according to strict legal form, on the other hand, shown total liabilities of $30,000 + $45,000 = $75,000. The terms of the covenant, technically, have not been breached.

The key to applying the principle of substance over form is to fully appreciate the principles of:

- Revenue recognition; and
- Recognition and derecognition of assets and liabilities.

10.3 Recognition of Revenue

The detailed provisions of the IASB's framework and IAS 18 *Revenue* are not specifically tested in F2. The principles they contain, however are often essential benchmarks for deciding substance over form on sale versus financing transactions.

The IASB's *Framework for the Preparation and Presentation of Financial Statements* provides a definition of income, as follows:

> … income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent. Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity.

IAS 18 specifically concerns itself with revenue and expressly excludes gains from consideration. It encompasses revenue arising from three kinds of transactions and events:

1. the sale of goods;
2. the rendering of services;
3. the use by others of the assets of the entity, yielding interest, royalties and dividends.

10.3.1 Revenue recognition: sale of goods

Revenue is recognised from the sale of goods, provided that all of the conditions below have been satisfied:

- the significant risks and rewards of ownership have been transferred to the buyer;
- the entity retains no effective control over the goods sole, not does it retain any significant degree of the managerial involvement normally associated with ownership;
- revenue can be measured reliably;
- it is probable that the economic benefits associated with the transaction will flow to the entity;
- the costs associated with the transaction can be measured reliably.

The standard notes that, in most cases, the transfer of risks and rewards in the transaction takes place at the same time as the passing of possession to the buyer, or the transfer of legal title. Therefore, when goods are shipped, for example, the point of recognition would normally be the point at which the goods pass into the control of the purchaser. However, the point at which revenue can be recognised may, in some cases, be more difficult to establish. In complex cases it will be necessary to assess carefully where the risks and rewards of ownership reside.

In Example 10.A, there was an apparent sale of a machine, but it was noted that the seller, A, retained the risks and rewards of ownership.

10.3.2 Revenue recognition: sale of services

Revenue associated with transactions involving the rendering of services should be recognised by reference to the state of completion of the transaction at the year end date. Again, a consideration of the substance of the transaction should be undertaken.

A special problem in relation to revenue recognition arises where an agent acts as an intermediary on behalf of a principal, collecting a commission for arranging provision of goods or services.

Example 10.B

X is an advertising agency. It acts as intermediary in arranging magazine advertisements. A single page display in a nationally distributed women's magazine cost \$3,000. The magazine publisher invoices the agency \$3,000 less the agency's commission of 15%: the net amount of the invoice received by X is, therefore, \$2,550 (\$3,000 less commission of \$450).

X sends an invoice to the advertiser for the full cost of the magazine page, that is, \$3,000. There is a related cost of \$2,550 payable to the magazine publisher. How much revenue should be recognised by X? There are two possibilities depending upon whether or not X is classed as an agent:

1. Revenue of \$3,000 is recognised, together with related costs of \$2,550 (presentation of turnover as a principal).
2. Revenue of \$450 is recognised (presentation of turnover as an agent).

Clearly, there is quite a significant distinction between the two modes of presentation. In determining which mode is appropriate for X, we can examine the transaction from the risks and benefits perspective. A principal is exposed to all the risks and benefits associated with the selling price of goods and services. Where, by contrast, a seller acts as an agent, it would not normally be associated with the majority of the risks and benefits of the transaction.

In the example of X, the selling price of the services (the cost of a one page display advertisement) is determined by the magazine publisher, not by the advertising agency. The relationship of X to the publisher and to the advertiser appears to be one of agency, and the principles of substance over form would appear to require that X recognises only $450 of revenue in respect of this transaction.

10.4 Recognition and derecognition of assets and liabilities

In order to determine the substance of a transaction it is necessary to identify whether or not it has given rise to new assets or liabilities or has increased or decreased existing assets and liabilities. The existence of an asset may be indicated where an entity derives benefit and is exposed to the element of risk inherent in the benefit. The existence of a liability is indicated where an entity is unable to avoid, legally or commercially, an outflow of economic benefits.

10.4.1 Recognition of assets and liabilities

The recognition of assets and liabilities is covered in the *Framework for the Preparation and Presentation of Financial Statements.* Where a transaction has resulted in an item that meets the definition of an asset or liability, it should be recognised if:

- there is sufficient evidence of the existence of the item;
- the item can be measured at a monetary amount with sufficient reliability.

The *Framework for the Preparation and Presentation of Financial Statements* defines assets and liabilities as follows:

- *assets* are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events;
- *liabilities* are an entity's obligation to transfer economic benefits controlled by an entity as a result of past transactions or events.

10.4.2 Derecognition of assets and liabilities

Where an asset is sold in an outright sale, where all rights and rewards of ownership are transferred and no risks are retained, derecognition (i.e., removal of the asset from the statement of financial position of the transferor) is clearly appropriate. However, where conditions are attached to the transfer, the substance of the transaction must be examined carefully. It may be that each party has access to some of the benefits and subject to some of the risks. In this case it is important to assess which are the significant risks and rewards, e.g. in property the main rewards are the cash flows likely from its operation and the potential for increases in the value of the asset. The main risks are a fall in the value and obsolescence.

In Example 10.A we examined the case of a business (A) that sold a tangible non-current asset to another entity with a right of repurchase at a higher price in 1 year's time. We identified that the substance of this transaction was that of a lending arrangement, not a sale. In that case there was no derecognition of the asset, it should remain in A's financial statements.

Financial assets and liabilities

Derecognition of financial assets and liabilities is covered by IAS 39 *Financial Instruments: Recognition and Measurement.*

Derecognition may arise, under IAS 39, where a financial asset or financial liability is transferred. This will normally occur where the entity has transferred the contractual rights to the cash flows receivable. Financial liabilities should be derecognised only when the obligation which originated the liability is completely extinguished. (See Chapters 11 of this *Learning System* for more on accounting for financial instruments).

A transferred financial asset should not be derecognised where the transferor has a right to reacquire the transferred asset. Consider the details of the examples below:

Example 10.C

In its financial year ending 31 December 20X4, J enters into the following transactions in respect of its mortgage loans portfolio.

1. J transfers a set of mortgage loans to K, in exchange for $250,000. In 1 year's time J will be able to repurchase the loans from K for a fixed sum of $280,000.
2. J transfers a set of mortgage loans to L, in exchange for $250,000. If L decides subsequently to sell the portfolio of mortgage loans, an agreement between J and L stipulates that J has a right of first refusal to reacquire the portfolio and that the re-acquisition price would be the fair value at the time.

Should the mortgage loans be derecognised as financial assets?

In the first case, the answer is almost certainly that the assets should continue to be recognised in the books of J. This is a very similar situation to the one outlined in Example 10.A. In the second case, the financial assets would probably be derecognised. The reacquisition terms are vague and it is by no means certain that any reacquisition would ever take place. Also, the fact that there is no fixed price for a subsequent reacquisition is a influential factor in the decision.

10.5 Substance over form: cases

The following section provides illustrations of how substance over form is applied to specific transactions. The transactions covered are:

- Sale and repurchase agreements
- Consignment stock
- Factoring of receivables
- Securitised assets and loan transfers.

10.5.1 Sale and repurchase agreements

It is important to consider the terms of the arrangement and whether or not a sale has actually taken place. An assessment of the main risks and rewards will normally focus on the value and ultimate use of the asset being 'sold'. Consider the commercial sense of the transaction – would a financing company use the asset itself or is it just lending using the asset as security?

Example 10.D

On 1 February 20X4 BJ sold a freehold interest in land to a financing institution for $7.2 million. The contractual terms require that BJ will repurchase the freehold on 31 January 20X7 for $8.82 million. BJ has the option to repurchase on 31 January 20X5 for $7.7 million or on 31 January 20X6 for $8.24 million. Prior to the disposal the land was recorded at its carrying value of $6 million in BJ's accounting records. The receipt of $7.2 million has been recorded with a credit to suspense account. No other accounting entries have been made in respect of this transaction.

At 31 January 20X5, BJ's directors decide not to take up the option to repurchase.

Requirement

Briefly explain the substance of this transaction, and prepare journal entries to record it correctly in the accounting records of BJ for the year ended 31 January 20X5.

Solution

The substance of the transaction is that BJ has borrowed $7.2 million against the security of freehold land. The land will be repurchased by BJ and the price it will pay increases over time. In this case, the increase each year in the repayable amount reflects an interest charge. IAS 39 *Financial Instruments: Recognition and Measurement* requires initial recognition of the liability, and the related interest expense should be recognised over the relevant period. This is accounted for in the year ended 31 January 20X5 as follows:

	$'000	$'000
DR Suspense account	7,200	
CR Non-current liabilities		7,200
DR Interest expense for year ($7.7 2 7.2 m)	500	
CR Non-current liabilities		500

10.5.2 Consignment stock

Consignment stock is held by one party but owned by another. For example, motor dealers commonly hold inventory in the form of cars on their premises which will be either sold to customers or returned unsold to the manufacturer. There are benefits to both manufacturer and dealer in this type of arrangement. The dealer has access to a wider range of stock than would be possible if he or she were required to make a commitment to purchase, and the manufacturer avoids the costs of holding large quantities of inventory.

Which party, manufacturer or dealer, receives the benefits and is exposed to the risks associated with the inventory? The substance of the commercial arrangement must be examined carefully.

The table below shows the risks and benefits that may arise, depending upon the nature of the contractual arrangements, for the dealer:

Benefits	*Risks*
1. The cash flow arising from sales	1. The risk of having to retain obsolete inventory
2. The right to retain items of inventory to assist in making sales	2. The risk of slow movement of inventory, increasing finance costs and the risk of obsolescence
3. Insulation from price changes after the inventory has been consigned	
4. The right to use the inventory for demonstration purposes	

Based on this analysis of risks and benefits, the substance of the arrangement is identified:

1. Is the substance of the transaction that the inventory is an asset of the dealer?
   If this is the case, inventory is shown in the dealer's statement of financial postion and a corresponding liability to the manufacturer is recognised. The dealer in this case bears all the risks and obtains the rewards of ownership.
2. Is the substance of the transaction that the inventory is an asset of the manufacturer?
   In this case, the dealer will show neither the inventory nor the related liability in his or her statement of financial position.

Example 10.E

AB runs a car dealership. The terms of the agreement between AB and the car manufacturer are as follows:

- The price that AB pays for inventories is fixed at the date the cars arrive on the forecourt
- AB has no right to return the vehicles
- Legal title is not held by AB instead legal title passes when the cars are sold to a third party, or AB uses a car for demonstration purposes
- AB pays a finance charge to the manufacturer between the date of delivery and the date legal title passes or the date of return, whichever is earlier.

Solution

The inventories (cars) should be included in the assets of AB as it is subject to the major risks and rewards associated with the cars. The fact that AB pays the price ruling at the date the cars are delivered suggests that is the date of transfer. AB cannot return the cars and therefore retains the main risk of obsolesce and failure to sell. The finance charge that is payable to the manufacturer again points to AB having taking ownership of the cars but not yet having paid for them. In substance the inventories should be held on the books of AB and a corresponding liability should be shown for the financing element.

10.5.3 Factoring of receivables

Factoring of receivables can be a very useful way of raising cash quickly. However, where such transactions take place it is important to establish their substance. Factoring can be a financing transaction in substance, where cash is advanced against the security of receivables. Or, the transaction may be more in the nature of a working capital shift, where receivables are simply sold on in order to be able to receive cash more quickly.

Factors provide a range of services, and it can be difficult to establish the substance of the transaction. Essentially, the key to understanding lies in the ownership of the receivable. If the provider of the cash has any opportunity of recourse to the seller (i.e., being able to pass receivables back) the deal probably constitutes a financing arrangement.

Example 10.F

A decides to transfer responsibility for collection of its receivables to a factor, B. The arrangement is that B administers the sales ledger and handles all aspects of collection of the receivables in exchange for an administration fee of 1% of all receivables factored. A factoring account is opened, and A is able to draw in cash up to 75% of the receivables factored. The account is credited with cash received when the receivables are realised. It is debited with an interest charge of between 5% and 7.5% depending upon the speed of payment of the receivables. Any receivables not recovered after 90 days are resold to A and credited back to the factoring account.

Solution

In this example, A (the seller) bears the risk of slow payment, as reflected in the interest rate and the repurchase of slow debts. This type of arrangement is essentially a financing one, and should be reflected as a separate asset and liability in the statement of financial postion of A.

10.5.4 Securitised assets and loan transfers

These are similar in nature to factoring of receivables, where a loan asset is transferred to a third party as a way of securitising finance. The benefits associated with the asset are the future cash flows from the repayments and associated interest. The risks would include the risks of slow and non-payment or reduction in future cash flows as a result of early repayment.

10.6 Special purpose entities (SPEs)

The use of special purpose entities (SPEs) was an especially prominent feature of the Enron case in the USA. However, the potential of the SPE for accounting manipulation resulted in the IASC, the predecessor body to the IASB, issuing SIC-12 *Consolidation: special purpose entities* in 1998. The IASB intends to re-examine the problem in the future.

The SIC provides the following examples of an SPE's activities:

- The SPE is principally engaged in providing a source of long-term capital to an entity or funding to support an entity's ongoing major or central operations.
- The SPE provides a supply of goods or services that is consistent with an entity's ongoing major or central operations which, without the existence of the SPE, would have to be provided by the entity itself.

The purpose of SPEs is very often to remove part of a group's activities from the requirement to consolidate. They are often set up using complex legal structures. However, the SIC's guidance on this point is quite straightforward:

> An SPE should be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity (para 8).

The true substance of the relationship can be determined by examining where the decision-making powers lie, and which parties benefit from the rewards and bear the risks related to the SPE.

10.7 Summary

There is no separate international financial reporting standard that deals with substance over form. In this chapter we examined various sources of guidance on what is often a complex matter; these include IAS 18, IAS 39, SIC 12 and the *Framework for the Preparation and Presentation of Financial Statements.*

Revision Questions 10

Question 1

On 1 January 20X7, a 70% subsidiary of AB sold a leasehold interest in a property to a bank for $100 million. The property was carried in the financial statements at $80 million and the remaining term of the lease was 20 years from 1 January 20X7. The subsidiary has the option to repurchase the leasehold interest on 31 December 20X7 for $105 million or on 31 December 20X8 for $110 million.

The subsidiary is obliged to repurchase the interest on 31 December 20X9 for $117 million if not repurchased before. The early repurchase option was not exercised on 31 December 20X7.

Your assistant has credited the sales proceeds to a suspense account that is included in current liabilities. In previous years, the leasehold property has been amortised over the lease term with the amortisation expense included in cost of sales. However, no amortisation charge has been made for 20X7 on the grounds that the leasehold interest has been disposed of on the first day of the year.

Requirement

Explain the adjustments that would be required to correctly reflect this transaction in the consolidated financial statements of AB for the year ended 31 December 20X7. You should provide appropriate journal entries to support your adjustment. Refer to the provisions of international accounting standards where relevant. Where no accounting standard exists, you should refer to underlying accounting principles to support your argument.

(10 marks)

Question 2

Z trades in motor vehicles, which are supplied by their manufacturer, X. Trading between the two entities is subject to a contractual agreement, the principal terms of which are as follows:

- Z is entitled to hold on its premises at any one time up to 60 vehicles supplied by X.

X retains legal title to the vehicles until such time as they are sold to a third party by Z.

- Z is required to insure the vehicles on its property, against loss or damage.
- The price at which vehicles are supplied is determined at the time of delivery.

- When Z sells a vehicle to a third party, it is required to inform X within three working days. X submits an invoice to Z at the originally agreed price; the invoice is payable by Z within 30 days.
- Z has the right to return any vehicle to X at any time without incurring a penalty.
- Z is entitled to use any of the vehicles supplied to it for demonstration purposes and road testing. However, if more than a specified number of kilometres is driven in a vehicle, Z is required to pay X a rental charge.

Requirements

(a) Discuss the economic substance of the contractual arrangement between the two entities, in order to identify which entity should recognise the vehicles in inventory once they have been delivered to Z. **(7 marks)**

(b) Identify the point at which X should recognise the sale of its vehicles. **(3 marks)**

(10 marks)

Solutions to Revision Questions 10

Solution 1

This is a sale and repurchase which under the principles of IAS 18 could not be regarded as revenue. In order to identify the appropriate accounting treatment for the 'sales proceeds', it is necessary to apply the principles identified in the IASB *Framework for the Preparation and Presentation of Financial Statements*.

The IASB framework requires entities to account for the economic reality (or substance) of transactions in order to faithfully represent them. It appears that the substance of this transaction is that the entity has a financial liability that would be dealt with according to the requirements of IAS 39 *Financial Instruments: Recognition and Measurement*.

Furthermore, the instrument appears to be held to maturity financial liability which will be dealt with under the 'amortised cost' method. The relevant loan would be regarded as having a maturity date of 31 December 20X9 and therefore the loan would be a non-current liability. Interest charged at the effective interest rate would be included as an expense in the income statement.

Additionally, under the principles of IAS 16 *Property, Plant and Equipment*, the leasehold interest would need to be depreciated since the asset is retained and is consuming economic benefits. The charge to cost of sales would be \$4 million (\$80 m/20).

The overall impact of the adjustments is shown in the following journal entries:

	DR	*CR*
	\$'m	\$'m
Cost of sales	4	
Property		4
Being extra depreciation		
Current liabilities	100	
Finance cost	5	
Non-current liabilities		105
Being reallocation of loan and inclusion of finance cost		
Non-controlling interest (SOFP)	2.7	
Non-controlling interest (income statement)		2.7
Being allocation of minority element of adjustments [30% × (4 + 5)]		

Solution 2

(a) The economic substance of the arrangement between the two entities is determined by analysing the risks and benefits of the transaction. The entity that receives the benefits and bears the risks of ownership should recognise the vehicles as inventory. Z, the motor vehicle dealer, appears to derive the following benefits:

- It is free to determine the nature of the inventory it holds, in terms of ranges and models.
- It is protected against price increases between the date of delivery to it and the date of sale because the price is determined at the point of delivery.
- It has access to the inventory for demonstration purposes.

Z incurs the following costs and risks:

- X retains legal title to the goods, so in the case of dispute X would probably be entitled to recover its legal property.
- Z is required to bear the cost of insuring the vehicles against loss or damage.
- Although Z obtains the benefit of using vehicles for demonstration purposes a rental charge may become payable.
- If price reductions occur between the date of delivery and the date of sale, Z will lose out because it will be required to pay the higher price specified upon delivery.

The analysis of the risks and benefits of the transaction does not produce a clear decision as to the economic substance of the arrangement between the two parties. X bears the substantial risk of incurring costs related to slow-moving or obsolete vehicles because Z can return any vehicle to it, without incurring a penalty. This point alone is highly significant and may be sufficient to ensure that X, the manufacturer, should continue to recognise the vehicles in its own inventory. A further relevant point is that X is not paid until the point of sale to a third party, and thus it bears the significant financial risk involved in financing the entity.

(b) In respect of the sale of goods, IAS 18 *Revenue* requires that a sale should be recognised when the selling entity transfers to the buyer the significant risks and rewards of ownership of the goods. As noted above, significant risks and some of the rewards of ownership remain with the manufacturer, X, until such time as the goods are sold by the dealer to a third party. Therefore, revenue should be recognised by X only when a sale to a third party takes place.